

11 November 2024

Ofgem regulatory Finance Team

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Northern Gas Networks response to Ofgem Call for Input – Energy Networks Ring Fence Review

Thank you for the opportunity to respond to your call for input to the Energy Networks Ring Fence Review. Northern Gas Networks (NGN) notes that significant consideration must be given to any regulatory change to ensure it is transparent, proportionate and ensures that regulatory frameworks remain fit for purpose and are implemented in the best interests of current and future consumers, especially considering the challenges of net zero and the emergence of new financial and operational risks.

We consider that the measures currently in place within our RIIO-2 licence are adequate to provide Ofgem with oversight and assurance that regulated entities manage the risk of getting into financial distress and which protect the regulated asset base and therefore consumers. There is an extensive list of existing RIIO-2 Licence conditions and protections aimed at ensuring this which include:

- Standard Special Condition (SSC) A38: Credit Rating of the Licensee and Related Obligations;
- Standard Condition (StC) 45: Undertaking from Ultimate Controller;
- SSC A27: Disposal of Assets and Restrictions on Charges Over Receivables;
- SSC A35: Prohibition of Cross-Subsidies;
- SSC A36: Restriction on Activity and Financial Ring Fencing;
- SSC A37: Availability of Resources;
- SSC A39: Indebtedness;
- SSC A40: Regulatory Instructions and Guidance (RIGs).

We note that NGN has always acted responsibly and prudently in terms of the financial policies in general and dividend policies in particular, hence we consider Ofgem should be mindful of looking to introduce further regulatory burdens on a one size fits all basis, without a proper impact assessment of the impact of any proposals and new licence obligations.

This response sets out Northern Gas Networks' thoughts on Ofgem's Call for input.

1. Have we identified the issues and challenges network companies are facing accurately? (Yes/No)

No –We consider that additional ring fence conditions are unnecessary and unwarranted and any “*potential shortfalls*” with the current regime are overstated in the absence of any evidence that the sector is not financially resilient or that the current measures are not sufficient or effective.

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In particular, we consider that any perceived issues with the existing Licence conditions, should Ofgem be concerned about transparency and visibility of company-specific constraints, could be dealt with by providing further guidance or streamlining the existing processes.

2. Are there any other issues that may pose a threat to the regulatory ring fence that we should consider?

No

3. Are there any weaknesses within the current ring fence conditions that we should consider?

The new suggested requirement to give a minimum of 3 years of financial resource assurance could put additional costs on the consumer of having to refinance debt early to be able to satisfy this requirement.

For a Licensee to certify that it has sufficient financial resources to cover a period greater than twelve months (whether that be the entire price control period or a minimum of three years ahead) it would need to have fully committed funding in place to cover all expected obligations in that period, with headroom.

If the additional funding requirement were met through a larger bank facility, that would incur considerable additional costs by way of up-front fees and ongoing commitment fees. It is also unusual for the maturity of such credit facilities in the current environment to extend beyond three years, other than by way of extension options whose acceptance by lenders is not guaranteed, hence it is questionable whether such an arrangement would enable a Licensee's directors to give the necessary assurances.

Meeting the funding requirement with newly raised long-term debt would incur considerable carry costs, given that the funds would need to be in place up to five years before they are going to be utilised. Given that the Availability of Resources certification is given annually, this would be a rolling feature.

Fulfilling this proposed requirement is likely to be particularly challenging where there is a need to pre-finance across two price control periods. For example, it would be extremely difficult to forecast with any accuracy what level of financing would likely be required before the regulatory framework and its key parameters have been confirmed by Ofgem. Securing finance for a minimum of 3 years ahead of these circumstances where the upcoming regulatory framework is still under consideration results in Licensees being put into a situation where they are forecasting into periods of the unknown. This inherently results in forecasts being based on less certain estimates. Should it even be possible to achieve external audit sign off in this case, it raises a question of whether the outcome is achieving its intended policy objective. The uncertainty would very likely result in more costly financing given the risk involved and we do not see how this could be seen as being in the public interest.

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4. Which would be your preferred option of the three outlined and why?

We would prefer option 1, then option 3 and lastly option 2. We consider that the existing regime is effective, and no changes should be made.

5. What are your views on the three options outlined and the associated benefits and risks of each?

Option 1

We consider that Ofgem must evidence effectively any issues it has identified which lead to the belief that 'do nothing' is not appropriate? We consider that consumers get protection from the current measures including board approved certification of financial and operational resourcing and the credit rating requirements and the presence of at least two Independent Non-Executive Directors on the Board.

Option 3

A more targeted approach would lead to more understanding by the Regulator at a network level, compared to the broader approach suggested in option 2. We consider that any perceived issues with the existing Licence conditions, should Ofgem be concerned about transparency and visibility of company-specific constraints, could be dealt with by providing further guidance or streamlining the existing processes. We would suggest that licence conditions could then be amended for networks where there are concerns. This approach would reward transparency via reduced regulatory burden ensuring Ofgem targets measures where risk exist and needs to be managed.

Option 2:

Reserve requirements - Gas distribution networks are different business to retail or banking. We consider it would be unreasonable to ask customers to fund the debt required to maintain a cash reserve.

Dividend lock up – Proposal appears reasonable from NGN perspective but could have implications for different companies depending on financial structure.

Additional restriction of activity – we would need to see the detail on this, however, networks could request approval from Ofgem for any additional activities rather than introducing specific exclusions that may not capture everything.

Closer scrutiny of ownership structure – this appears to be in line with the current ultimate controller declaration.

6. Tell us if you have suggestions on how we can improve our proposed options.

See response to question 5 above

7. Tell us about any alternate options we should consider.

None

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Should you wish to discuss any aspect of our response to this consultation in more detail, please do not hesitate to contact me via email gdodd@northerngas.co.uk.

Kind Regards



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Northern Gas Networks

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