

To: regfinance@ofgem.gov.uk

To whom it may concern,

ENA Response - Ofgem Ring Fence Review - Energy Networks Call for Input

Thank you for the opportunity to contribute to your Call For Input (CFI) on energy networks' ring fence arrangements. This response is submitted on behalf of our GB electricity Distribution Network Operator and Transmission Owner members.

Energy Networks ring fence CFI - Overview of our response

We agree with Ofgem that ensuring a financially resilient energy sector is in customers' interests. The financial resilience of networks cannot be considered in isolation to the wider benefits that networks provide to customers. The key benefits associated with safe and reliable networks, the facilitation of the transition to net zero and supporting wider economic growth (through the creation of jobs and provision of the infrastructure necessary to connect the homes, low carbon technologies and industries of the future) can only be achieved if networks are financially resilient and able to source sufficient investment.

Ofgem has frequently and robustly reviewed and updated the ring fence arrangements that apply to energy networks over the decades that they have been in place. Arrangements implemented by other regulators and for other sectors have not been as robust.

Ofgem already has a suite of robust arrangements in place. Companies take their obligations very seriously. Ofgem has recently reviewed those arrangements, amended reporting rules and proposes to introduce new, even more stringent arrangements for the next price control period.

There is no evidence to justify introducing any of Ofgem's suggested "higher intervention approaches". These would inappropriately increase regulatory burden, increase the cost of capital, negatively impact financeability or investability or, in some cases, might even precipitate financial distress. It would be counter to the principles of Better Regulation to implement such disproportionate or untargeted measures.

If Ofgem has concerns that were not addressed in its recent Sector Specific methodology Decision (SSMD), it should undertake a detailed review. This review should analyse the impact of available options in detail and, if demonstrated to be necessary, propose a proportionate and targeted approach to address any concerns identified. Ofgem should not enter such a review with a pre-conceived assumption that changes to requirements must result from such a review. Our members would be willing to support Ofgem to undertake such a review.

Financial resilience cannot be considered in isolation to financeability and investability. Current energy transformation activities mean that networks' need to attract sufficient finance is more important than ever. Any detailed review must take account of the interaction with the price control policies that the ring fence arrangements are designed to co-exist with. A number of Ofgem's proposed RIIO-3 policies are more likely to precipitate financial distress amongst energy networks than any perceived shortcoming in the ring fence arrangements.

We expand on these points below. Our members may provide further information in their own responses.

We look forward to discussing this further with you.

Yours faithfully,



Lawrence Slade

Chief Executive Officer

Energy Networks Association

Ofgem has frequently and robustly reviewed and updated the ring fence arrangements that apply to energy networks over the decades that they have been in place. Arrangements implemented by other regulators and for other sectors have not been as robust.

We agree with Ofgem that ensuring a financially resilient energy sector is in customers' interests. The financial resilience of networks cannot be considered in isolation to the wider benefits that networks provide to customers. The key benefits associated with safe and reliable networks, the facilitation of the transition to net zero and supporting wider economic growth (through the creation of jobs and provision of the infrastructure necessary to connect the homes, low carbon technologies and industries of the future) can only be achieved if networks are financially resilient and able to source sufficient investment.

Ofgem has frequently and robustly reviewed and updated the ring fence arrangements that apply to energy networks over the decades that they have been in place, including a significant review of arrangements in 2010.¹ No energy network failures have occurred, despite recent economic and energy market challenges. It therefore does not automatically follow that issues in other sectors necessitate changes for energy networks. Key is whether failures or issues arose due to shortcomings in other sector arrangements that might also exist in arrangements for energy networks. We do not believe that to be the case.

The ring fence arrangements implemented by Ofgem for energy networks have historically been more robust than those implemented by Ofwat for water. Ofwat has recently moved to introduce arrangements that are more in line with those that Ofgem has had in place historically for energy networks.² There is no evidence to suggest that the well-publicised financial difficulties of some companies in the water sector would have arisen had Ofwat always had Ofgem-style arrangements in place. In fact, the comparative evidence supports the opposite conclusion: that Ofgem's established arrangements have been successful in respect of energy networks, and have a demonstrated track record of robustness in the face of all the types of financial engineering that have been seen in other network sectors.

The ring fence arrangements implemented by Ofgem for energy networks are also necessarily different to those for energy supply licensees that do not have the large, regulated balance sheets (RAV) on which several elements of the network ring fence directly or indirectly depend. Unlike energy networks, suppliers are also exposed to the full uncertainties of the energy market.

Ofgem already has a suite of robust arrangements in place. Companies take their obligations very seriously. Ofgem has recently reviewed those arrangements, amended reporting rules and proposes to introduce new, even more stringent arrangements for the next price control period.

We continue to believe that Ofgem already has a comprehensive suite of obligations and mechanisms in place regarding financial resilience, dividends and their reporting. Companies take their obligations very seriously. Ofgem also has appropriate powers to intervene should it have evidence that intervention is required. We note that Ofgem has not shared with energy networks the evidence of potential customer harm that it says lead it to conclude that a "do nothing" approach would be inappropriate. We are surprised at Ofgem's conclusion and would welcome discussions to understand this further.

It is, of course, appropriate that Ofgem periodically reviews the ring fence arrangements in light of experience of their operation, market developments, and regulatory best practice. However, Ofgem has just done exactly that. Ofgem reviewed the effectiveness of its ring fence arrangements in its Sector Specific Methodology Consultation (SSMC) for RIIO-3³. This review was undertaken in light of the failures and issues that Ofgem refers to in this CFI and also considered the changes made by Ofwat. In that consultation, Ofgem said that:

¹ Ofgem, 3 March 2010, Review of the 'Ring Fence' Conditions in Network Operator Licences

² For example Ofwat, 9 July 2019, Conclusions on strengthening the regulatory ring-fencing framework and Ofwat, March 2023, Decision under sections 13 and 12A of the Water Industry Act 1991 to modify the ring-fencing licence conditions of the largest undertakers

³ Ofgem, 13 December 2023, RIIO-3 Sector Specific Methodology Consultation – Finance Annex, chapter 6

“we consider these financial resilience measures to have been broadly effective in helping to incentivise shareholders and management to maintain financial policies and outcomes that are consistent with a financially resilient sector.”⁴

Ofgem concluded on a number of changes that it will implement for RIIO-GD3 and RIIO-T3⁵ (and we assume will do similarly for RIIO-ED3 in its forthcoming consultations). We would be very happy to work with Ofgem on the implementation of those changes. Ofgem has already implemented a number of reporting changes for all sectors for RIIO-2⁶.

As Ofgem has only recently consulted on potential changes to ring fence arrangements in its SSMC and has yet to implement all of the changes resulting from that process, we are surprised to see this further consultation on potential changes to arrangements.

There is no evidence to justify introducing any of Ofgem’s suggested “higher intervention approaches”. These would inappropriately increase regulatory burden, increase the cost of capital, negatively impact financeability or investability or, in some cases, might even precipitate financial distress. It would be counter to the principles of Better Regulation to implement such disproportionate or untargeted measures.

Ofgem has not presented evidence to justify the need for any of the higher intervention changes that it considers could be introduced. These proposals could be highly damaging to customers and investors alike. They would increase the regulatory burden associated with investing in the regulated energy sector, with restrictions on financial arrangements outside the current ring fence and inappropriate intrusiveness into the wider financial arrangements of investors. Such changes would result in increased costs for customers: the costs associated with implementing the requirements, increased returns demanded by investors as certain ownership models are targeted and the costs associated with reduced investability of the sector at this crucial time. In some cases, Ofgem’s proposals might actually precipitate financial distress.

It would be counter to the principles of Better Regulation to implement such disproportionate or untargeted measures. Any changes should only be introduced on a proportionate and targeted basis when Ofgem has strong evidence of the need for a change and has undertaken an Impact Assessment that concludes that all the costs associated with introducing such a change would be more than offset by customer benefits. We do not anticipate that any of the proposed “higher intervention approaches” would meet the criteria to achieve a positive outcome in a balanced Impact Assessment. The evidential burden to justify any of the suggested “higher intervention approach” changes has not currently been met.

If Ofgem has concerns that were not addressed in its recent SSMD, it should undertake a detailed review. This review should analyse the impact of available options in detail and, if demonstrated to be necessary, propose a proportionate and targeted approach to address any concerns identified. Ofgem should not enter such a review with a pre-conceived assumption that changes to requirements must result from such a review. Our members would be willing to support Ofgem to undertake such a review.

If Ofgem has new evidence of financial resilience concerns that was not considered during its recent SSMD analysis, we agree that a detailed review and targeted approach to strengthening the ring fence would be appropriate. Any review needs to be undertaken in the broader context of financeability and investability, in the knowledge that Ofgem has only recently announced changes to arrangements and without any pre-conceived assumption that changes to requirements must result from such a review.

This review should comprise:

- Sharing with networks (confidentially if necessary) the evidence that Ofgem has that leads it to conclude that “do nothing” is inappropriate. This would enable networks to support Ofgem in considering whether

⁴ Ofgem, 13 December 2023, RIIO-3 Sector Specific Methodology Consultation – Finance Annex, paragraph 6.8

⁵ Ofgem, 13 December 2023, RIIO-3 Sector Specific Methodology Decision – Finance Annex, chapter 6

⁶ Ofgem, 28 June 2024, Direction to amend the Regulatory Instructions and Guidance (“RIGs”) for RIIO 2

they arise due to shortcomings in the current framework or other factors that should be addressed differently;

- Detailed consideration by Ofgem of the substantial information that networks already report to Ofgem regarding financial resilience and dividends, including Ofgem's own processes for routinely scrutinising such information;
- Providing feedback to all networks on any concerns that Ofgem might find regarding either the completeness or quality of the information reported to Ofgem or with the network's compliance with existing ring fence obligations or the resilience of the network's financial structure more generally;
- Engaging with investors to understand current financial structures and any concerns that investors would have if ring fence arrangements were to be further modified; and
- Based on the above, analysing findings to establish whether there is any evidence of shortcomings in the current arrangements. It will be important that the outcome of the review differentiates between any inadequacies in networks' compliance with or implementation of current obligations and any inadequacies in the requirements themselves.

Based on the evidence that is obtained from this review, Ofgem could:

- Conclude that no change to the current arrangements is required;
- Use its existing powers to intervene in a network's activities should it have evidence that intervention is required;
- Clarify the existing obligations, for example by issuing improved reporting guidance or amending the wording in the licence; or
- If evidence is found, consider targeted changes to the current ring fence arrangements.

If Ofgem's review concludes that changes to or clarification of the existing arrangements may be justified, we would be happy to work with Ofgem to explore possible options and to support Ofgem's work to understand the costs associated with any change and to undertake an Impact Assessment of the implications of introducing a targeted change. Ofgem must not progress with implementing further changes to its regulatory framework without robustly testing whether such changes are justified, assessing the associated costs and risks of the proposed changes and testing that there will be no unintended consequences.

In assessing the impact of any possible further measures, Ofgem must recognise that, unlike energy retail, networks have large, regulated balance sheets (the RAV) such that the costs of any special administration in the unlikely event of failure of an energy network should be covered by the equity value remaining in the RAV. Given lock up, etc will apply at or below 75% gearing there should be more than sufficient equity to fund any costs, meaning that customers would not have to pay more than they would if the network had not failed. In contrast, some of Ofgem's "higher intervention approaches" would involve high certainty of very real costs that would be borne by customers.

Based on the evidence currently available to us, we do not anticipate that the outcome of Ofgem's review would identify any required changes to current ring fence arrangements.

Financial resilience cannot be considered in isolation to financeability and investability. Current energy transformation activities mean that networks' need to attract sufficient finance is more important than ever. Any detailed review must take account of the interaction with the price control policies that the ring fence arrangements are designed to co-exist with. A number of Ofgem's proposed RII-3 policies are more likely to precipitate financial distress amongst energy networks than any perceived shortcoming in the ring fence arrangements.

The energy system is undergoing a period of significant transformation as it supports the changes needed to achieve net zero. The role of energy networks is more important than ever. The considerable levels of required future investment, and the need to attract the associated financing, means that the investability and financeability of energy networks must be at the front of Ofgem's mind. We welcome Ofgem's recognition that the investability of

the sector needs to be a key focus moving forwards. It is crucial that Ofgem's actions here are viewed by investors as being consistent with this.

Ofgem's CFI seems to imply that financial resilience can somehow be considered in isolation to financeability and investability. This is not the case. Financial resilience is a necessary prerequisite to financeable and investable networks. However, Ofgem needs to be very careful that any detailed ring fence review does not undermine the financeability or investability of energy networks by inappropriately focusing on introducing greater restrictions on network financing arrangements including dividend distributions or intervening in investor decision-making outside of the regulatory ring fence without considering the consequences of such approaches for financeability or investability. It is crucial that businesses can continue to invest when there is a need.

Ofgem needs to be careful that any changes made are clearly justifiable, that they do not introduce inappropriate regulatory burdens, undermine investor confidence or even precipitate financial distress. The fact that Ofgem is commencing a further review into ring fence arrangements so soon after its previous consultation, ahead of implementing many of the changes it decided as a result of that process, without any clear new evidence to justify a further review, and without considering the interaction with the price control policies that it needs to coexist with, risks undermining investor confidence in regulatory stability and predictability.

If Ofgem is concerned about the potential for networks to experience financial distress, it would be better placed to focus its efforts of ensuring that its financeability and investability policies for RIIIO-3 are fit to ensure that networks can secure the finance needed for the next decades at an efficient cost for customers. A number of Ofgem's proposed policies, such as its suggestion that it might target Baa2/BBB rating in its financeability assessment⁷ or that it might set the cost of equity significantly below prevailing market levels, are more likely to precipitate financial distress amongst energy networks than any perceived shortcoming in the ring fence arrangements.

⁷ Ofgem, 13 December 2023, RIIIO-3 Sector Specific Methodology Decision – Finance Annex, paragraph 5.33