



## Response to Ofgem's ringfence review consultation

### KEY POINTS

- **Getting the ringfence right is important, not only due to recent events in the water sector but also due to the vital role of electricity network investment in facilitating the net-zero transition – but Ofgem must take a wider view of financial resilience and investability.**
- Energy networks are in an objectively much better financial position than water networks:
  - Ofgem established its financial resilience controls robustly from an earlier date than Ofwat.
  - Ofgem's recent consultations and changes have further improved transparency and provided iron-clad guarantees to customers; we think nothing more is needed.
- Electricity networks also present a substantial opportunity through increased investment: enabling decarbonisation and energy security; helping reduce bills for consumers in the longer term, especially when coupled with effective incentive regulation by Ofgem; and creating jobs through labour intensive investment that itself enables economic growth.
- Realising this opportunity relies on four separate pillars that make the proposition investable, enabling capital to flow into the sector at competitive rates and leading to well-balanced outcomes for customers, through a:
  - sensible return that is commensurate with the risks and can compete with other opportunities on a forward-looking basis to attract equity from the capital markets;
  - profile of cash-flows in terms of return of the capital over the life of the asset that is capable of sustaining dividends and an investment grade credit rating;
  - regime that ensures the financial resilience of the sector, in the eyes of all stakeholders;
  - fair balance in terms of how much each generation of customers pays.
- If any one of these pillars is impaired, the other three could not adequately compensate in anything but the short-term.
- On that basis, we can see why Ofgem would want to check it has everything it needs in place, including on the ringfence – but the context it has created is not good:
  - It has only just examined the ringfence and decided that it has what it needs. What are investors supposed to make of it having second thoughts?
  - Ofgem only recently confirmed it wouldn't break the inflation protection commitment in the established price controls (and still made large changes going forward).
  - It is yet to follow through on its 2015 commitment to review the options for solving the problems it identified in its own decision to lengthen regulatory depreciation, leaving the electricity distribution sector on a trajectory where the 2030s are unfinanceable, a concern especially given the slow-acting nature of the best measures to address this.
- If Ofgem considers it necessary to review the ringfence again, it should do so as part of a wider review of all four pillars – and signal the timing of this, the outcome Ofgem will seek to achieve in each one and the nature of the options Ofgem might consider as it explores the issue. Otherwise, the current consultation can only be seen – by a rational investor – as a(nother) knee-jerk move to try to limit the investor's ability to take a return.
- And in terms of the review of the ringfence pillar:
  - Ofgem should move to quickly rule out its option 2, of a materially higher intervention approach, which is compounding the already unhelpful set of signals to network investors.
  - Any review should settle the arrangements needed for at least the next decade.
  - We would expect Ofgem to find, once again, that the existing ringfence is effective.

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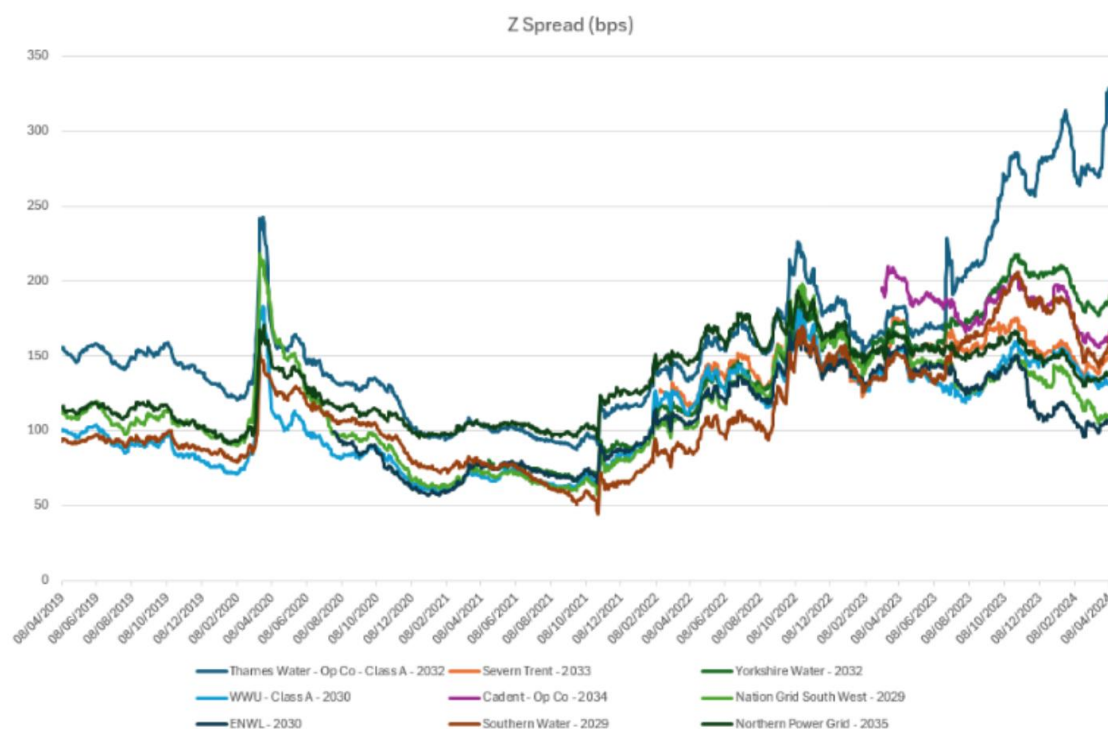
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## 1. Views on the critical issues raised by the consultation

1. In September 2024, Ofgem published a consultation on potential further changes to the regulatory ringfence (the Consultation). The Consultation presents options including (1) take no further action (2) implement higher intervention (3) review the ringfence in detail to develop targeted adjustments.
2. This response to the Consultation expands on four main themes:
  - a. Electricity networks are in an objectively much better financial position than water networks.
  - b. The changes Ofgem previously announced to the ringfence provide customers with further, cast iron, protections – we think nothing more is needed.
  - c. The opportunity presented by net-zero enabling investment makes it imperative for Ofgem to take a wider view, of the four pillars needed to support investability, to give investors confidence.
  - d. Ofgem should want to ensure everything needed to support investability is in place – but the context to the current consultation is not good and any review of the ringfence should form only one part of a wider review of all four investability pillars.
  - e. In terms of the ringfence itself, the Consultation option of an immediate and un-targeted higher intervention approach should be quickly ruled out to prevent further damage to investor confidence...
  - f. ... and any review should settle, once and for all, the targeted set of ringfence measures necessary for the next decade (at least) – although we expect no change is needed.
3. The sections below address each of these themes in turn.

### ***Electricity networks are in an objectively much better financial position than water networks***

4. Electricity networks have a much better financial backdrop than the water sector:
  - a. one of the main reasons is that Ofgem established its financial resilience measures more robustly, from an earlier date, than Ofwat.
  - b. Ofgem's recent consultations and changes have further improved transparency and provided iron-clad guarantees to customers; as we recently said we think nothing more is needed.
5. The fact electricity networks have a very substantially different financial profile to water networks is well illustrated by the evidence on financial resilience from bond spreads that Ofgem published as part of its T3 and GD3 methodology decision, which we reproduce below.



Source: Ofgem T3 and GD3 methodology decision, Finance annex, figure 12

6. The energy networks included in this sample all have bond spreads that are well below the two water networks that Ofgem included, while the electricity networks have bond spreads that are around 60-90 basis points below those seen for Southern Water, and 140-170 basis points below the Thames Water spread.
7. This is demonstrable, market based, evidence of the effectiveness of the financial resilience measures that Ofgem has had in place over the long term.
8. And Ofgem's T3 and GD3 methodology decision also provides evidence that Ofgem's approach had prevented the type of excessive financial leverage that characterised the water sector – since figures 14 and 13 show respectively that:
  - a. 80% plus financial gearing was commonplace in the water sector as recently as 3-4 years ago; and this has only been moderated in recent years as Ofwat has acted to bring its approach into closer alignment with Ofgem's.
  - b. Similar high leverage hadn't emerged in energy network licensees, thanks in whole or in part to Ofgem's approach to the ringfence and other financial issues in earlier price control periods.

***The changes Ofgem previously announced to the ringfence provide customers with further, cast iron, protections – we think nothing more is needed***

9. Following consultation in December 2023, and the accompanying decision in March 2024, Ofgem put in place the following additional measures, that it said were to address the evolving challenges facing energy networks.

- a. Amending the dividend block trigger so it is the earlier of reaching 75% net debt to RAV gearing, or the credit rating reaching BBB- with a negative outlook or watch.
  - b. Requiring energy networks to maintain more than one investment grade credit rating.
  - c. Increasing regulatory reporting of mid-co and hold-co financial structures.
  - d. Explicitly requiring stress testing as part of regulatory availability of resources evaluations.
  - e. Extending the time horizon for these availability of resources assessments, to the greater of 3 years or the entire price control period.
10. These have provided additional, iron-clad guarantees for energy consumers, as well as enhancing transparency and Ofgem's ability to monitor company finances; as we recently said (in our response to Ofgem's December 2023 consultation) we think nothing more is needed.
11. We note that the Consultation also mentions issues with financial resilience in the retail energy sector; here we simply note that the asset light nature of retail energy presents fundamentally different challenges for financial resilience, and that protections against these challenges are inherent in energy networks, where equity investors have to make very substantial upfront investments that are wholly at risk from financial mismanagement.

***The opportunity presented by net-zero enabling investment in electricity networks makes it imperative for Ofgem to take a wider view, of the four pillars needed to support investability, to give investors confidence***

12. As well as their positive backdrop, electricity networks have a different outlook to the water sector. While investment is required in the water sector, especially to enhance open water quality – which has fallen behind public expectations – this will have relatively limited implications for the wider economy, except in very specific sectors.
13. Electricity networks, on the other hand, present a substantial opportunity through increased investment:
- a. enabling decarbonisation and energy security;
  - b. helping reduce bills for consumers in the longer term, especially when coupled with effective incentive regulation by Ofgem; and
  - c. creating jobs through labour intensive investment that itself enables economic growth.
14. Realising this opportunity relies on four separate pillars that make the proposition investable, enabling capital to flow into the sector at competitive rates and leading to well-balanced outcomes for customers. These pillars are a:
- a. sensible return that is commensurate with the risks and can compete with other opportunities on a forward-looking basis to attract equity from the capital markets;
  - b. profile of cash-flows in terms of return of the capital over the life of the asset that is capable of sustaining dividends and an investment grade credit rating;
  - c. regime that ensures the financial resilience of the sector, in the eyes of all stakeholders; and

- d. fair balance in terms of how much each generation of customers pays.

15. If any one of these pillars is impaired, the other three could not adequately compensate in anything but the short-term.

***Ofgem should want to ensure everything needed to support investability is in place – but the context to the current consultation is not good and any review of the ringfence should form only one part of a wider review of all four investability pillars***

16. Given the critical nature of electricity network investment to achieving environmentally sustainable growth, we can see why Ofgem would want to check it has everything it needs in place, including on the ringfence.

17. However the context it has created is not good:

- a. It has only just examined the ringfence and decided that it has what it needs. What are investors supposed to make of it having second thoughts?
- b. Ofgem only recently confirmed it wouldn't break the inflation protection commitment in the established price controls (and still made large changes going forward).
- c. It is yet to follow through on its 2015 commitment to review the options for solving the problems it identified in its own decision to lengthen regulatory depreciation, leaving the electricity distribution sector on a trajectory where the 2030s are unfinanceable, a concern especially given the slow-acting nature of the best measures to address this.

18. Reputations are gained slowly and lost quickly – and Ofgem must now send a clear and sustained signal that the investment commitment remains intact, and any changes to price controls will be robustly tested and subject to open consultation. This current context undermines the fundamentals of Ofgem's own RIIO framework; it must regain its confidence in lighter-touch, incentive-based regulation built on upfront decisions.

19. If Ofgem considers it necessary to review the ringfence again, it should do so as part of a wider review of all four pillars – and signal:

- a. the timing of each of the constituent parts of the review;
- b. the outcome Ofgem will seek to achieve in each pillar; and
- c. the nature of the options Ofgem might consider as it explores the issues.

20. Otherwise, the current consultation can only be seen – by a rational investor – as a(nother) knee-jerk move to try to limit the investors ability to take a return.

***In terms of the ringfence itself, the consultation option of an immediate and un-targeted higher intervention approach should be quickly ruled out to prevent further damage to investor confidence...***

21. The option of un-targeted higher intervention is compounding an already unhelpful set of signals to investors in networks – at a time when they are still waiting to see Ofgem acknowledge that the framework needs to change for the 2030s so as to ensure companies can support their credit ratings and fund sensible dividends to equity.

22. Even absent the damaging signal to investors, this option can also be immediately ruled out on the basis that such changes would impose substantial additional costs on energy networks, that would then fall on energy consumers. These have not been considered properly or justified in the Consultation, and we do not believe that they could be justified. Our further views on each specific intervention are set out in the annex to this response.
23. Lastly, this option would also not meet the better regulation principles, that Ofgem must have regard to, that regulation be targeted and proportionate. The Consultation itself describes the detailed review option as being the “targeted approach” and involving “new requirements that are proportionate”. Given the implication that the immediate higher intervention option would be neither targeted nor proportionate, it can be immediately ruled out on this basis.

***... and any review should settle, once and for all, the targeted set of ringfence measures necessary for the next decade (at least) – although we expect no change is needed***

24. Ofgem has only just completed a review of the ring-fence, and stated in its December 2023 consultation that it has found its existing financial resilience measures to have been effective. In this consultation it stated that it has recognised the evolving challenges facing the sectors – and put in place measures specifically to address these. Moreover, this came relatively soon after the last review of the ringfence, which took place in 2018, and included commissioning a study from BDO to provide context on the ringfence, including the risks that particular activities or approaches might bring.
25. In light of the thoroughness and frequency with which Ofgem has reviewed and updated its financial resilience measures for energy networks, it is itself likely to be damaging to investor confidence when Ofgem consults soon afterwards, and this will remain the case going forwards.
26. So, if Ofgem does consider that a detailed review is needed, it is imperative that this should settle the arrangements needed for the next decade (at least), while still avoiding undue burden for energy companies and the associated costs for energy customers, to avoid the potential for further damage to investor confidence from the possibility (or expectation) of further similar reviews in the near term.
27. Given the thoroughness of the reviews already undertaken recently, we expect any review to find that no change is needed to the existing arrangements, beyond those already determined in the March 2024 decision.
28. Lastly, we note that the current outlook for gas networks is very different to electricity networks. Even if Ofgem considers measures are needed to address the issues of long-term RAV decline, potential decommissioning and network re-purposing in the gas sector, these measures should be targeted at the sector that requires them. They should not be applied in a blanket fashion to the electricity sector, where they would not be targeted (and where they would cause extra costs to energy consumers that are not justified).

## 2. Question responses

29. Our responses to the questions in the Consultation are set out below.

30. Our critical views, above, form part of our response so we have signposted the relevant paragraphs in our question responses (rather than reproducing the content, in order to minimise duplication).

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

31. No. The potential issues with financial resilience have not been clearly evidenced and appear to be exaggerated.

32. For example the Consultation mentions evidence from four issues that it does not fully adduce, including:

- a. Issues in the water sector (page 7), with no explanation of:
  - i) how Ofgem thinks the same scenario could arise for energy networks (in light of the ringfence provisions that are in place in the sector, and have effectively prevented the high licensee gearing issues that emerged historically in the water sector);
  - ii) what the consumer harm could be, given that shareholders bear the costs of any additional debt financing costs in the medium term under Ofgem's regulatory model (this being the one cost Ofgem has previously evidenced); or
  - iii) why there would be a sudden and new read across to electricity distribution, since the issues highlighted with Thames Water's financing are not new, evolved fairly gradually, and were known about when Ofgem undertook its last review of the ringfence in late 2023 to early 2024 – the latest developments only being an ongoing extension of a problem that was already clear.
- b. Events in the energy retail sector (pages 5 and 10), which are not relevant since:
  - i) the very different nature the capital structure of these businesses limits any read-across to energy network businesses;
  - ii) although Ofgem appears to state that they occurred in "seemingly well capitalised" businesses, their capital would amount to hundreds of millions or billions of pounds less than any individual RIIO network; therefore, in comparative terms, such retail businesses that experienced a crisis would in fact be extremely light on capital; and
  - iii) the issues we assume Ofgem is referring to are not new and were known about before the last review of the ringfence.
- c. Financial engineering (page 6) which, without knowing which specific changes Ofgem is referring, we believe must have happened prior to the 2023 consultation.



- d. Changes in corporate governance (page 6), where:
  - i) we are aware of no substantial recent changes in energy network corporate governance arrangements;
  - ii) Ofgem is incorrect to claim that the UK's corporate governance arrangements could lead to private equity investors or conglomerate owners exerting "undue influence from a smaller number of controlling parties over the vital infrastructure that the network companies operate, which may lead to suboptimal outcomes for the consumer." The UK's corporate governance structures have been tailored by the government to be appropriate for the types of ownership they apply to, and to rule out such suboptimal outcomes; and
  - iii) given the over-arching framework that the UK has in place, Ofgem should be neutral on the types of corporate ownership and financial structures that are in place.
- 33. Paragraphs 4 to 8 above provide further evidence on point a in this list, while paragraph 11 relates to point b. These paragraphs also form part of our response to this question.
- 34. Moreover, Ofgem states on page 6 of the Consultation that the risk areas it lists explain only "in part" why it considers it necessary to undertake yet another consultation on the issue. Ofgem should therefore set out details of the other factors that have entered into its reasoning.
- 35. The comparative evidence from other sectors in fact points to the effectiveness of the pre-existing arrangements the energy network sector – since it has remained resilient in face of the same set of financial market pressures over the last 20 years.
- 36. Lastly, the Consultation also lacks the clear link – from specific evidence to Ofgem's conclusion that there is evidence of potential customer harm in the energy network sectors, or a clear link to the proposed remedies. This would be necessary to allow well-informed consultation responses on the issues that Ofgem claims may justify intervention. This is a particular issue with option 2, which proposes an immediate move to a higher intervention approach (rather than a review that would entail further consultation on evidence).
- 37. To allow informed response, it is vital that Ofgem set out in detail the evidence and analysis that demonstrates potential consumer harm *in the electricity or gas network sector*, and how a remedy would address the specific issue.

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

- 38. Ofgem must take a wider view than just the regulatory ring fence or a narrow definition of financial resilience - it needs to consider investability of the sectors, especially in light of the opportunity that investment in electricity networks presents.
- 39. In the electricity network sector the issues of investability have not yet been adequately considered, in light of the:
  - a. scale of investment required in the sector;

- b. the long term investability problems set in motion through Ofgem's decision over ten years ago to move to 45 year straight line regulatory depreciation; and
- c. the long-term and slow-acting nature of one of the best levers that Ofgem has at its disposal, regulatory depreciation.

40. Therefore if a review is taken ahead it should have include in its scope all four pillars set out in paragraphs 12 to 20, above, which form part of our response to this question.

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

41. No, we consider that the ringfence was already strong prior to the changes Ofgem decided to implement following the December 2023 methodology consultation, and these additional changes have given energy consumers iron-clad guarantees. Indeed, Ofgem stated only a year ago, in its December 2023 consultation, that it had found the current arrangements to be effective.
42. However, the repeated review of the ringfence arrangements by Ofgem in a short space of time is itself a weakness, as it is likely to be damaging to investor confidence.
43. Therefore, if Ofgem does take ahead any further detailed review of the ringfence arrangements, the review should be explicitly intended to settle arrangements for the medium to long term, ideally more than the next decade.
44. Paragraphs 17-18 and 24-27, above, expand on these points and form part of our response to this question.

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

45. Our biggest priority is that Ofgem move quickly to rule-out option 2, the untargeted higher intervention approach. As long as Ofgem maintains this option it will continue to damage investor confidence.
46. Our preferred option is option 1. The ringfence has been consulted on very recently in the context of the ongoing RIIO-3 price controls, the measures put in place give cast-iron guarantees to customers (as expanded on in paragraphs 9 to 10 above, which form part of our response to this question), and a consultation is now underway on extending these measures to electricity distribution. Nothing more is needed.

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

47. In terms of option 2:
- a. This option carries significant additional costs – as explained in paragraphs 21 and 22 above, supplemented the annex (section 3) below.
  - b. It also does not meet the better regulation principles – as set out in paragraph 23 above.
48. These cross-referenced parts of this document form part of our response to this question.

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

49. Option 2 should be ruled out.
50. Option 3 (and 1, no change) would be improved by positioning the issue as part of a wider review of the pillars needed to support investability. Our response to question 2 above sets out why.
51. For all the options, a one size fits all approach is also not appropriate. The gas sector faces a very different outlook and set of challenges when compared to electricity, and to meet the better regulation principles all of Ofgem's options should be explicitly targeted based on the sectors they are being applied to. Paragraph 28, above, also relates to this issue and forms part of our response to this question.

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

52. As set out in response to question 2 above, if a detailed review of the ring-fence is taken ahead, it should be as part of the necessary wider review of investability that is needed for RIIO-3 and beyond.

### 3. Annex: costs of the higher intervention measures

53. This annex sets out our detailed views on each of the measures suggested by Ofgem as part of option 2, an immediate move to higher intervention.
54. **Specified reserve requirements:** there would be a direct cost to this policy, since the cost of raising reserves is higher than the interest rate that licensees could obtain on liquid and low risk assets in which reserves would need to be held; this additional carrying cost would need to be explicitly allowed for in the price control settlement, as would the cost of any reserves lost in the event of counterparty default, raising costs to energy consumers. The reserves would also provide no benefit to energy networks (and their customers) in the ordinary course of business since, by definition, they would need to continue holding them.
55. **Further tightening of the dividend lockup to include interest payments on loans from shareholders or related parties:** Ofgem has only recently consulted extensively on tightening the dividend lock up, and substantially enhanced it. Further tightening would not be justified and would strengthen emerging investor perceptions that Ofgem's approach to regulation exposes funds invested in UK energy networks to non-recoverability. This could trigger the opposite result to Ofgem's policy intent, precipitating capital exit (and leading to rationing of capital injections); at a minimum it would result in a higher cost of capital, which would again cost energy consumers more.
56. **Additional restrictions on financing activity, extending above the ring fence – potentially prohibiting whole business securitisation or the use of debt that is reliant on licensee dividends:** this could again limit the financing options available to investors in the sector in future, and hence to licensees, raising the overall cost of capital; and since the ringfence already restricts dividends (if relevant thresholds are breached) would result in no additional benefits.
57. **Potential additional transparency, including disclosure of all investors:** transparency should be a less detrimental and costly requirement – however:
- a) there are no obvious benefits to investor disclosure above and beyond the requirements already set out in UK company law;
  - b) it could reduce financing options available to licensees in certain very specific circumstances, if new investment was conditional on standard UK law levels of privacy (and hence have a marginal impact on the cost of capital); and
  - c) it could present privacy issues for individual minority investors.