

Date

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By Email:

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FAO: Mick Watson

**Call for Input on Energy Networks ring fence review**

Dear Mick,

I am writing to respond to Ofgem's Call for Input on Energy Networks ring fence review. Appended to this note I include our full response. To summarise our position on the key items:

- The fundamental driver of a resilient network is its operational performance and ability to deliver in line with the allowed returns envisioned by the regulatory framework. Ensuring sufficient allowances to invest efficiently for customers today and into the future is the backbone of a financeable and investable network that will support an equitable, safe and resilient transition to net zero.
- There may be some perceived weaknesses with the existing ring fence conditions, but we have not identified any material issue with them or evidence of consumer harm.
- As such, ruling out Option 1 "*Maintain the Existing Approach*" is not appropriate. We think this undersells the measures that have been put in place in the last 6 years and those planned to be put in place for RIIO-GD3 which all significantly enhance the ring fence and transparency over the financial positions of networks. This is not a "do nothing" option but demonstrates significant enhancements that are already in progress.
- We would like to see Ofgem give the new measures time, to properly evaluate them before considering alternatives.
- In general, we do not support Option 2 "*higher intervention approach to strengthening the ring fence*". We see the suggestion of prohibiting financing via a WBS structure as being very damaging to our investability, could increase costs to consumers and it is not proportionate to the risk identified. Although

increasing financial reserves could improve resilience, this would need to be funded and would come at a cost to consumers which may not be merited.

- We agree with Ofgem that the responsibility for financial resilience lies with management and shareholders; and that we must act responsibly in this regard with respect to our customers and wider stakeholders. In order to effectively comply with this duty, we must be permitted to arrange ourselves and our finances in a way that is economic and efficient and not excessively restricted because of a perceived risk that has not materialised despite the significant financial and industry challenges that there have been over recent years.
- We do not see strong evidence to support the requirement for Option 3 “*Detailed review and targeting approach to strengthening the ring fence*” to be initiated, but we could support this if completed in a targeted and proportionate manner. We would be happy to work with Ofgem as required to consider how this could be achieved.

We welcome further discussion on this topic and appreciate the importance of it.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Gary Baron', with a stylized, cursive script.

Gary Baron

Interim Chief Financial Officer

Ring fence review: energy networks call for input – Cadent response.

1. Are there any weaknesses within the current ring fence conditions that we should consider in our review?

There may be some perceived weakness, and we understand Ofgem has identified some as highlighted in the Call for Input, for example, ensuring consistency across sectors and that obligations are clear. However, Ofgem has put forward some significant changes to enhance financial resilience in RIIO-2; and are consulting on further tightening through the RIIO-3 price control process.

We consider that the current ring fence licence conditions are operating effectively to meet the objectives set out on page 4 of the Call for Input document. This is demonstrated by the fact that, as acknowledged in the Call for Input document, energy network companies have weathered significant financial challenges including the energy crises in recent years, while maintaining strong financial resilience.

Ofgem has introduced some significant changes to regulation in RIIO-2 through enhanced Regulatory Reporting and are consulting on further enhancements through the RIIO-3 price control process. We recognise that these measures will take some time to “bed in” and test to see if they provide the additional controls and assurance Ofgem is seeking in light of the changing external expectations and environment. Any further changes at this stage would not be targeted or proportionate and are also likely to be counter-productive as it will prevent Ofgem from assessing the effectiveness of the changes already made / considering making as part of RIIO-3.

We agree with Ofgem that the responsibility for financial resilience lies with management and shareholders; and that we must act responsibly in this regard with respect to our customers and wider stakeholders. In order to effectively comply with this duty, we must be permitted to arrange ourselves and our finances in a way that is economic and efficient and not excessively restricted because of a perceived risk that has not materialised despite the significant financial and industry challenges that there have been over recent years.

If there are improvements to be made to ensure consistency across sectors or add clarifications in terms of how conditions should be interpreted, then this is welcome, if they are fair and proportionate and genuine clarifications rather than more significant changes. At this point, we have not identified any specific issues with the conditions and feel we have opportunity to raise any issues during licence draft working groups for RIIO-3 that have recently commenced.

2. Have we identified the issues and challenges network companies are facing accurately?

We see that the Call for Input refers to issues identified by Ofgem rather than issues being experienced by network companies. As explained in response to question 1, we consider that the current ring fence licence conditions are operating effectively at helping to ensure financial resilience.

Ofgem has introduced some significant changes to regulation in RIIO-2 through enhanced Regulatory Reporting and are consulting on further enhancements through the RIIO-3 price control process. We recognise that these measures will take some time to “bed in” and test to see if they provide the additional controls and assurance Ofgem is seeking in light of the changing external expectations and environment.

Introducing further conditions that are damaging to investability/financeability of the network could negatively impact investor confidence, which is already stretched in light of the risks posed by net zero transition.

We note that Ofgem highlight that there is some “evidence of the potential for consumer harm in the networks sector”. We welcome further engagement on this topic to understand the issues referenced here so that we can provide more constructive feedback.

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

We agree with Ofgem that networks have a strong track record of managing financial risks and this is supported by the currently proportionate regulation. This financial strength has not been seen in other parts of the value chain such as retail, or in other sectors. The ring fence protects networks, investors and consumers. The well capitalised and resilient nature of the network sector should not be used to cross subsidise risk that sits outside the ring-fenced businesses. For example, anything where cross sector risks are transferred from sector-to-sector e.g. The SoLR liquidity relief scheme, had to be very carefully managed to avoid additional risk.

One of the main risks to the operational and financial resilience of the ring fence is the ability of networks to operate within the price control parameters. Ensuring the regulatory outputs offer a fair bet to deliver the allowed return and appropriately fund network investment. Evidence from other sectors suggests that if this is not the case this can create a spiralling negative effect on financial resilience.

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

We believe that ruling out Option 1 might be premature for the reasons outlined, but we could support Option 3 so long as it is completed in a targeted and proportionate manner.

Following the additional controls put in place as part of RIIO-2 and being considered for RIIO-3, Ofgem should test and gain assurance over these enhanced measures before considering further interventions.

Considering each in turn and in more detail:

Although **Option 1** is considered not appropriate by Ofgem, we note that “Maintain Existing Approach” approach does not consider the significant enhancements that are being implemented in RIIO-2 and being considered for RIIO-3. Option 1 is not a “do nothing” approach. Ofgem note these enhancements in the “Known issues and proposed resolutions” and that these issues are being responded to already, however, it should not underplay the extent of these suggested changes. We recognise that these measures will take some time to “bed in” and test to see if they provide the additional control and assurance to give Ofgem confidence over their control of the ring fence activities.

We do not support Option 2; *“higher intervention approach to strengthening the ring fence”* as in places it is not proportionate to the risk identified, and it would increase costs to consumers and reduce the “investability” of the sector. Proposing “prohibiting” certain types of capital such as debt funded via Whole Business Securitisation “WBS” arrangements will increase costs, undermine the significant private investment expected in UK infrastructure, and long term be harmful to consumers. This would also materially impact our financeability and we would challenge this as not being fair or proportionate. The additional regulatory burden would be greater than any perceived benefit from these measures.

Option 3 is a “*Detailed Review and targeted approach to strengthening the ring fence*”. Given the changes that have been made to the ring fence in RIIO-2 and are already being proposed for RIIO-3, we do not consider that now is an appropriate time to be able to effectively conduct a detailed review. The existing and planned changes need to be implemented, tested and assured to assess their effectiveness. A targeted approach to strengthening the ring fence cannot be taken before an assessment of the existing and pre-planned changes have occurred. Any future detailed review could be supported, subject to it being proportionate and targeted to the risks that exist specifically for energy network companies, having assessed the benefit to consumers outweighs the additional regulatory burden. Any changes should be applied symmetrically across all networks / ownership groups.

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

Option	Measure	Views
Option 1	Maintain Existing Approach	<p>As we have noted in previous responses, existing protections have proven to be effective and robust in ensuring financial resilience.</p> <p>Ofgem has already identified what have been referred to as “known issues”. These were partly dealt with in RIIO-2 with a new requirement for financial resilience reporting (subject to certain credit ratings). These measures are being further enhanced through RIIO-2 additional reporting and proposed changes to the licence conditions for RIIO-3.</p> <p>Further improvements such as clarifying how disposals are to be treated within the context of a net zero transition and repurposing of assets does need significant work at a policy level and consequently this should include consideration of the ring fence conditions. This does need consideration, but the evolving policy work is the priority in the short to medium term. The ring fence conditions could be considered as part of this.</p> <p>Ensuring consistency across sectors may prove beneficial to stakeholders.</p> <p>Clarification of interpretation can be completed as part of standard licence drafting working group discussions.</p>
Option 2	Higher Intervention approach to strengthening the ring fence	
	- Reserve requirements	<p>Increasing reserve requirements could improve network credit quality and financial resilience, but it would come at a cost that would need to be appropriately remunerated via a long-term commitment to fund via the cost of capital, including any second order impacts on the cost of credit if existing lines are utilised against these reserve requirements.</p>

		<p>Existing ring fence provisions give comfort that networks must hold sufficient financial resources to manage their funding requirements.</p> <p>The current arrangements appear to be efficiently delivering the financial resilience required; however, this option could be investigated in more detail should there be evidence of increased risk to financial resilience and as such the cost of introducing these facilities be proportionate.</p>
	- Tighten dividend lock-up	<p>We understand that defining the lock-up mechanism to ensure it covers all forms of distribution may be appropriate. This can be considered as part of the RIIO-3 consultation process and licence drafting.</p> <p>In general, dividend lock-up mechanisms may adversely impact the pool of available capital and cost of equity.</p>
	- Prohibit specific risky activities (e.g. whole business securitisations and structures with debt issued above the licensee which is reliant on dividend flows)	<p>We do not support this element of Option 2 as it would increase costs to consumers and reduce the “investability” of the sector.</p> <p>Proposing “prohibiting” certain types of capital such as debt funded via Whole Business Securitisation “WBS” arrangements will increase costs, undermine the significant private investment expected in UK infrastructure, and long term be harmful to consumers.</p> <p>Whole Business Securitisation “WBS” financing platforms have supported significant investment in UK infrastructure, provide benefits to the operating company as enhanced covenants within these financing arrangements are designed to protect the ring fence business from high levels of gearing, and are well understood by the market delivering a low cost of capital. Ensuring that UK utilities remain an attractive place to invest at a low cost of capital is in consumers interests.</p> <p>Should these structures be prohibited it would be harmful to consumers. Any retrospective action would come at an immediate cost and any long-term changes could undermine the investment required to support an equitable net zero transition.</p> <p>Whole Business Securitisation (“WBS”) structures are typically designed to sit outside of the ring fence and as such it is not clear if Ofgem could undertake a change to prohibit these.</p> <p>Before any consideration of this nature is taken forward for further consultation or consideration, Ofgem should seek alternatives to give assurance over the ring.</p> <p>There are many ways investors can fund the ring-fenced businesses. Single investors who hold large stakes in public listed companies could borrow funds to invest and this would be no different from holding company financing via a WBS, just less visible and transparent. The MidCo structure we have is well understood, UK based with transparent public accounts.</p>

		The current asymmetry of scrutiny between private capital and publicly listed company positions is not constructive in a period where high network investment is required across sectors.
	- Closer scrutiny of ownership structures	<p>Ofgem must regulate in a targeted and proportionate way. It is only those investors with a controlling interest that may be able to influence the regulated company, with such influence already subject to their statutory duties as a director to act in the best interests of that company and undertakings provided by them that they will not cause the licensee to breach any terms of the licence, including the ring fence conditions.</p> <p>The benefit of requiring further details of investors with a minority interest in the company is not clear and is likely to just result in further regulatory burden. This would not be in the best interest of customers.</p>
Option 3	Detailed review and targeting approach to strengthening the ring fence	
Overview	<p>As explained above, we do not consider that now is an appropriate time to be able to effectively conduct a detailed review. The existing and planned changes need to be implemented, tested and assured to assess their effectiveness. A targeted approach to strengthening the ring fence cannot be taken before an assessment of the existing and pre-planned changes has occurred. Any future detailed review could be supported, subject to be it being proportionate and targeted to the risks that exist specifically for energy network companies, having assessed the benefit to consumers outweighs the additional regulatory burden.</p> <p>Any obvious gaps (note that we have not identified any) could be considered through the RIIO-3 licence drafting workshops in the usual way.</p> <p>Having said this, should Ofgem wish to pursue further consultation on Option 3, we note and would be open to the following:</p>	
	- Consistency of approach and identify gaps	We agree consistency should be applied as long as proportionate, targeted and symmetrical across ownership groups / networks.
	- Review regulatory submissions	We will work with Ofgem to ensure any feedback is considered appropriately as required.
	- review into licensees' corporate structures and accounts	<p>We are already providing this information and more via the regulatory reporting submissions.</p> <p>Requests should be symmetric. We note that there appears to be a focus on MidCo/HoldCo structures that could be argued to be more visible and easier to scrutinise than public company peers with more complex internal financing arrangements.</p> <p>Given this will add cost and "regulatory burden", there is a requirement for tight definitions of what this might entail to ensure requests are proportionate.</p>

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

Regarding, Option 1, we believe Ofgem should not under-sell the extent of efforts taken over recent periods and planned for future price controls. These have and will further enhance the ring fence protections. Time should be allowed for these to be tested prior to introducing new measures such as those considered under Option 3.

We generally do not see the benefit of Option 2 and see these as adding costs to consumers and creating investability constraints to the sector.

We ask that any changes are completed in a way that is symmetric and designed to add value to consumers, work “in the round” with a moving framework, and related licence conditions, whilst minimising costs to consumers. For example, under the RIIO-3 consultation, Ofgem is looking at requesting longer term financial resilience assurance statements from networks. If our assurance statement over financial resilience is to be robust to Ofgem, it must be supported by stable regulation. We ask that if any fundamental changes being considered to the licence that might impact financial resilience, for example., changing the timing of receipt and payment of cashflows through a price control (rather than at the start of a price control); that these are only considered for implementation outside of the window of time that a resilience statement has been completed.

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

We do not recommend any alternative options at this stage.