

**Reference**

Cadent Response to ED3 Sector Specific Methodology Consultation

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Dear Steve,

**ED3 Sector Specific Methodology Consultation**

We are responding to Ofgem's ED3 price control Sector Specific Methodology Consultation (SSMC) as there are important areas of read-across and interaction between the framework for the next electricity distribution price control and future gas price controls. In addition, the process for setting the RIIO-3 price controls, which we are currently going through, has revealed a number of key issues with the current framework. It is important to raise these so that they can also be considered in the context of ED3 and following future price controls.

Over the past three years we have engaged with Ofgem to set the RIIO-GD3 price control for Gas Distribution Networks (GDNs), which started with Ofgem's Future Systems and Network Regulation (FSNR) consultation. A key outcome from the FSNR consultation, was that moving forward it is likely that different regulatory models will be needed for different sectors. Fundamentally, the requirements for each sector are changing and so the methods used to regulate must evolve so that they are well positioned to deliver them.

Whilst the RIIO-GD3 framework makes minimal changes to the existing RIIO-2 price control framework, many proposals in the ED3 SSMC signal a departure from this model making significant use of the 'Plan and Deliver' archetype as well as detailed consideration of how strategic energy planning (national and regional) interfaces with the control. Plan and Deliver itself, initially being proposed in FSNR to support expansion of the electricity grid – a requirement needed under the prevailing views on net zero futures. We are pleased to see this evolution in Ofgem's thinking and believe Ofgem should be mindful of the need for changes for gas networks when developing ED3 to ensure a consistent whole-system regulatory approach. However, on archetypes, we do question whether Ofgem has sufficiently considered how greater application of the 'Freedom and Accountability' archetype (as reviewed in FSNR) could bring benefits in ED3, and through use potentially for future price controls in gas.

In addition, our experience of setting the RIIO-3 price control, has highlighted several material issues with the RIIO framework, which should also be reviewed and evolved as part of the ED3 price control and for future gas price controls, so that we can ensure networks can deliver their changing requirements to deliver net zero. Below we provide further thoughts on these topics.

**The case for change in the overall structure of future price controls**

Alongside electrification, no matter what the ultimate shape of the energy transition, the gas networks will be needed to keep people warm and fuel industry and commerce for decades to come, whilst playing a key role in helping deliver net zero. We acknowledge that time and effort must be devoted to

growing electricity networks, but this must not come at the expense of gas networks – which must be able to invest so they can deliver a resilient and reliable service to our customers now and in the future.

Whilst continuing to support the important role of the gas networks, as we move forward there are also two fundamental changes which mean the regulatory framework will need to adapt for subsequent price controls to RIIO-3:

- The **introduction of strategic energy planning at a national and regional level requires** networks to be coordinated across sectors, with regional planning bodies and NESO. The mechanisms to support collaboration, however, remain nascent and there is no strategic plan for gas networks (both transmission and distribution) to ensure all deliver what is needed for our transition to net zero. The regional nature of planning also requires a more company/network-specific approach to regulation to understand specific network needs and issues – which is severely limited in the current RIIO-3 framework. For ED3 and future price controls it is essential that strategic and regional energy planning take a whole-system approach across electricity and gas and are specific to the areas being served.
- The activities that GDNs deliver will also undergo major change post 2032 as **the Iron Mains Risk Reduction Programme (IMRRP) for small diameter mains and services comes to an end**. To date, the RIIO framework for GDNs has placed a large amount of proportionate emphasis on this activity in both approaches to setting cost allowances and outputs as well as in monitoring performance. Moving forward, greater focus in the framework will be needed on new proactive approaches to managing remaining network risk and supporting network resilience through bespoke asset health related capital investments. This will ensure alongside supporting greater electrification through ED3, that energy is kept flowing and people are kept warm as we transition to net zero.

## Material issues with the operation of the RIIO framework

Our experience of the setting the RIIO-3 price control has revealed several key issues, which should be assessed for change at ED3 and for future price controls. We are concerned in the case of gas, that they together, could risk the sector's ability to meet its objectives moving forward. Key points are:

- **further increases in regulatory process and burden** – FSNR sought to simplify price control setting and administration for RIIO-3 controls. Whilst some aspects of the setting of the control have been streamlined, the monitoring of the regime has in practice involved less focus on core outputs and more closer review of 'inputs' for companies. This risks increasing costs to customers and reducing agility for delivering our changing requirements;
- a continued **lack of recognition for the power of positive incentives** – at Draft Determination, the RIIO-3 framework for gas networks, in contrast to other sectors, continues the trend of reducing the level of positive incentivisation for companies in the framework. This risks missing opportunities for customer benefits driven collectively across the sector as requirements change through the energy transition;
- **over-reliance on comparative network-level statistical benchmarking for the setting of efficiency targets** – ensuring the cost to serve is efficient across companies is of paramount importance. However, the methods used to do so are imprecise in nature, lack sufficient recognition of regional cost pressures, and by construction, imply that some companies always will receive an efficiency challenge (no matter if they are at 'the frontier'). This

continually risks financeability for some companies and their ability to operate effectively. As a result, there is a clear need to review how sensible cost efficiency targets are set; and

- **Business Plan Incentives risk driving the wrong behaviours** – in a regime of little positive incentivisation, these specific incentives can lead to companies creating plans to optimise their chance of ‘winning’, rather than putting together plans that are solely in the interest of their customers. With cost efficiency elements of these incentives being linked mechanistically to cost benchmarking outcomes this also encourages gaming of the regulatory contract.

The result of these issues together, if not fully considered, is a framework which favours one or a small group of networks performing well, but **risks sectors as a whole sliding precipitously close to a financing challenge in future**, with investors continuing to have an inability to earn fair returns for risks faced. This, in turn, in a broader market where there are ample infrastructure programmes competing for investor capital, could put yet further pressure on the cost of capital and costs for customers.

There are also important lessons from other sectors, most notably water, where lack of evolution in the regulatory framework has led to significant negative consequences for asset health, service delivery, instability and the environment. The Independent Water Commission led by Sir Jon Cunliffe is now recommending significant change for the model of regulation used in water, with many parallels to the issues we have identified above. It is important, therefore, that the energy sectors – including gas – seek to address these issues upfront so each sector can deliver its vital role and avoid clear risks for the future.

## **The way forward**

We are pleased to see some of themes we have set out above already reflected in the ED3 SSMC. As we now enter the RIIO-3 period we will continue to engage in the ED3 process where appropriate as well as consider how the regulatory framework for gas networks could evolve to address the clear case for change we have outlined above in future price controls. We are keen to engage with different teams within Ofgem on the issues and potential solutions highlighted as well as with other key industry bodies.

Alongside our views on the evolution of the broader regulatory framework for ED3 and beyond, in the accompanying Appendix to this letter we also provide responses to specific questions raised in the ED3 SSMC.

We consent to our submission being published and would be happy to assist further. Should you or the ED3 team have any questions regarding our views on the future regulatory framework, or the particular responses we have made to specific consultation questions, please let us know.

Yours faithfully

**Dr. Tony Ballance**  
**Chief Strategy and Regulation Officer**

***By email***

# Appendix - ED3 SSMC

## Cadent Response to Specific Consultation Questions

December 2025



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# Response to Ofgem's Core Document

## Long-term integrated network development plans

### **Q7. What are your views on the need for national consistency in the delivery of proactive unlooping programmes?**

We support the need for national consistency in the delivery of proactive unlooping programmes to ensure a broadly consistent experience and avoid a 'postcode lottery' for customers. The customer must be at the heart of this process and the experience they receive should be measured and assessed using a similar customer satisfaction (C-SAT) survey as is proposed for gas disconnections to ensure quality of delivery by DNOs. In addition, as well as supporting the need for national consistency in the delivery of the unlooping programmes, we believe these should also be integrated with other works undertaken by utilities in close proximity to customers' properties so that disruption and cost are minimised. For example, there is a clear need for whole energy system coordination to minimise the impact of DNO's proactive work on GDNs disconnection activities. Without coordination and balanced incentives, DNOs and GDNs will not deliver an optimal experience to energy customers, and each will be potentially exposed to poor customer satisfaction scores due to excess disruption.

## Broad measure of customer service

### **Q35. Do you agree with our proposals to retain the complaints metric as a penalty-only incentive and to leave the weightings applied to each category unchanged? Why?**

We agree with the proposal to retain the complaints metric as a penalty-only incentive. We also agree that a specific complaints survey should not be introduced as part of the CSS part of the BMCS. We agree that this would lead to double counting of responses and potentially triple penalisation for a single interaction (initial enquiry survey, complaint handling satisfaction survey and complaints metric). We support the proposal not to introduce a metric on the volume of complaints. Introducing such a metric could incentive companies to take as narrow interpretation of a complaint as possible to reduce volumes. This would be to the detriment of customers' experience and potentially remove feedback and learning opportunities that would enable the companies to further improve their service offering. Ultimately, companies should welcome understanding any and all expressions of dissatisfaction as this will enable them to better support their customers moving forward.

### **Q37. What is your view on the PSR Reach metric and whether this should form part of the AVR as a reputational incentive? If we were to continue this metric as a financial incentive, do you think it should continue as a reward/penalty or penalty only and should we change the weighting?**

The PSR Reach metric should continue (as a minimum percentage of the customer base) as it ensures that there is a strong focus on ensuring all eligible customers are on the register and supported when required. The Reach incentive should be consistent across all DNOs as a way of ensuring measurement and consistency of approach for all DNOs and customers. We would support keeping the incentive approach as offering both a reward and penalty as this has clearly delivered good outcomes in RIIO-ED2 (with all DNO's outperforming targets) and ensures that the effort that is put into signing up PSR customers is rewarded for those that perform well. Ensuring that there is a split out of C-sat for non-PSR and PSR customer is also important to ensure that those most vulnerable are supported the most.

**Q38. What are your views on the Social Value metric and the CSS elements of the CVI incentive. Are there any areas you think we should amend or adapt for ED3?**

Social Value metrics must include qualitative measures and not just those that can be quantified to ensure a holistic assessment of benefits can be made. As part of this, it is also important that measures considered should also build on and add to “traditional” measures, already captured, where possible.

### **Accountability for consumer outcomes**

**Q50. Do you agree that we should proceed with the development of a Consumer Value Framework for ED3 and if so, do you agree with the principles set out above as the basis for developing a CVF?**

We support the development of a Consumer Value Framework (CVF) for ED3. This could provide a useful tool that enables Ofgem to explain the holistic value that companies are proposing, and more crucially have delivered, to customers and stakeholders. Consideration should be given to expanding this development to other sectors. In doing so, this approach could become increasingly useful where there are differing regional energy pathways leading to more diverse business plans and delivery requirements across different networks. The proposed principles for a CVF outlined are appropriate as the basis to begin its development, however we would expect that these would evolve through development and if the framework was to be expanded to other sectors.

### **DSO network planning**

**Q61. How should DSOs best coordinate with other parties (e.g., NESO, local authorities, IDNOs, gas networks) to deliver whole-system outcomes through network planning? Are there specific governance or data-sharing arrangements that should be strengthened?**

We believe that the continuation of DSO coordination with the gas networks around the Local Authorities' Local Area Energy Plans (LAEP) is essential to successful multi vector planning, being mindful of the areas and roles covered by RESPs. Challenges we currently see that should be actioned to support strengthened regional planning include:

- lack of recognition of actual uptake of low carbon technologies (LCT) in planning activities – governance is needed to ensure actual LCT deployment is considered in DFES and future planning scenarios, so that there is a tieback to ratify reduction in the size of the gas networks in some areas; and
- difficulties in sharing specific industry data between parties – often in attempting to share data to support cross-vector regional planning, information is classed as protected under Section 105(1)(a) of the Utilities Act 2000. Clarity that the exemption under Section 105(4)(bb), which allows disclosure “*for the purpose of facilitating the performance by NESO (ISOP) of any of its functions*” is sufficient for network protection would help to reduce this barrier.

### **Network Asset Risk Metric (NARM)**

**Q86. What are your views on setting outputs on additional asset classes not currently reported in NARM?**

We recognise the potential advantages of broadening the NARM framework to include a wider array of asset classes. However, we believe this expansion should only proceed if robust mechanisms are established to facilitate effective trading between asset categories, thereby supporting optimal investment decisions. At present, certain network assets classified under NARM categories A2 and A3, are excluded from the NARM UCR target due to their unique drivers or funding arrangements. We

must stress the importance of conducting assessments at the individual asset class level to ensure that any expansion of the framework is applied appropriately and delivers intended outcomes.

Within the gas distribution sector, we continue to drive for consistency in the approach to engineering assessments, with standardised comparisons of intervention impacts routinely performed as part of NARM audit activities across all GDNs. We are actively engaged in ongoing initiatives to further harmonise the application of categories A1, A2, and A3, with a particular focus on enhancing long-term risk quantification and standardising key documents such as the Information Gathering Plan and the Engineering Guidance Document.

**Q87. What are your views on our proposed approach to increasing our reporting on non-NARM assets to improve our understanding of asset health?**

We recommend that asset health should always be assessed within the broader context of associated risk, wherever possible. The NARM Framework already incorporates asset health—considering factors such as age, condition, and failure or fault rates—when evaluating the probability of failure for an asset system. This holistic approach is currently reflected in the Health Index (HI) bandings within NARM. Network assets that fall outside the A1 category (such as A2 and A3 assets) can also be evaluated using NARM models to determine their probability of failure (PoF). Any new asset models introduced should follow the same failure modes effects analysis (FMEA) principles, ensuring that PoF remains readily extractable. We caution that if asset condition is considered in isolation as a measure of health, it will not provide a realistic picture of either the current failure rate or the projected rate of future deterioration. Therefore, a comprehensive, risk-based approach is essential to accurately understand and report on asset health.

**Q89. What are your views on introducing subsidiary targets in NARM to hold DNOs accountable to their Business Plans? Are there other ways we could hold DNOs accountable?**

We believe that the current approach of maintaining a Network Level target and deadband within the NARM framework should be retained, as it supports effective risk trading and aligns with the core objectives of NARM. Introducing more granular subsidiary targets would risk undermining these objectives by adding unnecessary complexity and potential cross-over between mechanisms.

The NARM Funding Adjustment already incorporates processes for identifying and justifying under- or over-delivery, which, although acknowledged by both networks and Ofgem as imperfect, currently enables programme-level assessment. Therefore, rather than introducing subsidiary targets, it may be more effective to refine existing mechanisms and ensure clear, transparent accountability at the programme level.

**Q90. Do you agree with our approach to enabling the future effects of climate change on asset deterioration to be modelled in NARM?**

We support modelling climate change effects in NARM as a long-term principle. An iterative roll-out in doing so is essential to manage complexity and avoid unintended consequences. For example, we are conscious of the regulatory burden of implementing these requirements, so confirming additional data capture and modelling is reflected in the benefits achieved will be important. We urge caution on speed and scope of roll out to ensure benefits are realised quickly for an appropriate level of effort. We also need to ensure that the scope targets the most appropriate assets where climate change will have material impact on the security of supply. Consistent sector-wide modelling will also enable calibrated risk views and informed investment decisions, which we welcome.



## Climate Resilience

**Q91. What are your thoughts on our phased approach to stress testing which seeks to provide greater clarity on investment costs and rationale whilst building up capabilities to support government in setting national resilience standards/goals?**

In our view, vulnerability-led scenario modelling is an appropriate way to evaluate climate risk, as it allows an immediate assessment of the scale of climate risk posed to energy companies. The phased roll-out of stress testing will help infrastructure operators build climate vulnerability assessment capabilities, address priority gaps, and support government in setting national resilience standards. This approach enables lessons to be learned, avoids unintended consequences, and accelerates learning to inform future direction. Additional comments we have on its application are that:

- we welcome the phased approach to stress testing and this aligns with our own climate resilience strategy of refinement of capabilities through continued learning whilst addressing gaps;
- we urge caution on the approach of using historic information as there is risk in having sufficient data consistency and clear linkage between asset failure and climatic events to achieve the intended purpose. In our view this data could be validated or triangulated against technical studies which may enable more consistent application;
- we would like to better understand whether an FMEA will be established to derive the assets in scope and the failure modes. We foresee challenges having consistent outputs if a structured approach is not undertaken to evaluating risk, especially if translating the framework across gas networks in future; and
- we also welcome directionally the alignment of stress testing to adaptive funding mechanisms (such as Uncertainty Mechanisms) to support the delivery of no regret, critical adaptations whilst the long-term climate metrics and evaluations are developed.

**Q94. Do you agree that strengthening the rationale for investments is required to allow for differences in local contexts between networks and that our proposed approach to improve guidance for climate resilience strategies and business plans is the best way to do this? Do you agree that we need a clear link between CRS and LINDPs and what are your thoughts on how we can do this?**

We believe it is necessary to ensure that energy operators have a consistent mechanism to assess risk and support investments for uncertain events such as climate. This comes at a time when there is both uncertainty over the pace and scale of climate change and the long-term future of the energy system. Strengthening guidance will better guarantee that network operators can consistently integrate climate risk into their business plans and will provide better consistency in doing so. Our view is that guidance should outline a common risk framework for climate as a sensible first step. Standardising guidance across sectors would also aid in longer term interdependencies and cascading risks assessments between gas, electricity and with other sectors (e.g. highways, canals & rivers, dam operators, water utilities). We also believe CRS and LINDPs reporting mechanisms should be aligned where possible to avoid duplication.

## Reliability

**Q100. Do you agree that a formal mechanism should be introduced to recognise and address the experiences of customers significantly impacted by short interruptions? If so, what form should this mechanism take (eg enhanced reporting, adjustments to existing incentives, or alternative mitigation approaches)?**

We agree that a formal mechanism should be introduced to recognise the impact of short interruptions. Whilst not as impactful as longer interruptions, in a world of increased electrification

even a short interruption can have a material impact on a customer's ability to go about their daily lives. As such, a metric should be introduced to measure the frequency of these short interruptions. Whilst this could be in the form of a reputational ODI, we believe that a new financial ODI (reward and penalty) would be more likely to drive the focus required. This could be of a lower value, and asymmetrical towards the reward, whilst the metric is established during ED3, with the value increased, but made symmetrical for subsequent price control periods once an improved level of performance has been achieved and "locked in" for customers.

## Re-openers

### **Q120. Do you agree that we should consider incentivising DNOs to reduce costs associated with business rates? Why?**

We do not support the proposal to incentivise DNOs to reduce business rate costs via the Totex Incentive Mechanism (TIM) or similar. Business rates are largely uncontrollable, determined by external factors such as government policy and valuation practices. Incentivising reductions risks unintended consequences, adds regulatory complexity, and lacks clear consumer benefit. The current RIIO-2 approach, treating business rates as a pass-through cost, remains appropriate and consistent with regulatory precedent. We recommend maintaining this treatment and focusing incentives on areas within DNOs' control.

## Business Plan Incentive

### **Q125. Do you agree with our proposals to retain Stage A of the BPI as per RIIO-3 BPI? Why?**

We agree with retaining minimum requirements as a stage of the Business Plan incentive to ensure DNO Business Plans cover the areas required for customers, stakeholders to understand what networks will deliver for them and so Ofgem can make an informed assessment of plans.

### **Q126. Do you consider that an asymmetric incentive for Stage B, weighted towards rewards, would deliver the greatest benefit for consumers, as per RIIO-3 and if not, do you consider that BPI Stage B should be removed?**

The proposed Stage B of the Business Plan Incentive (BPI) for ED3 is intended to largely replicate the purpose of Stage B of the RIIO-3 price controls. Specifically to assess: "*whether the costs submitted as part of the business plan are adequately justified and efficient*".<sup>1</sup> Based on our experience of how this part of the BPI has been applied at RIIO-3 Draft Determination for gas distribution networks we think there is a key issue with its design that should be considered for change for ED3.

We believe that Stage B rewards for comparatively assessed costs should be shared between all networks *influencing* the setting the efficiency benchmark if there is close clustering of efficiency scores. Following correction of significant errors in its Draft Determination for RIIO-GD3 our West Midlands network set the efficiency frontier. However, it was only ahead of the GDN ranked second by a small amount, with the top three networks – who all influence the setting of the 75<sup>th</sup> to 85<sup>th</sup> percentile catch-up challenge – being tightly clustered together. As a result, this enforced a 'winner take all' outcome where:

- 1<sup>st</sup> place received a 40bps reward.
- 2<sup>nd</sup> place received a marginal reward.
- 3<sup>rd</sup> place received a penalty.

As set out in response to Q10 of the Cadent Annex in our RIIO-GD3 DD response, such an outcome is clearly illogical as:

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<sup>1</sup> Ofgem (2025), "RIIO-3 Draft Determinations Gas Distribution Annex", para. 5.331

- a GDN would be penalised to a significantly greater extent under the BPI assessment than it is under the comparative benchmarking; and
- with such fine margins it is very likely that the resulting small differences in efficiency scores do not actually reflect efficiency differences in networks and may amount to statistical noise or errors within the modelling. Ofgem itself has itself acknowledged the imperfection of its statistical models as a reason for setting the benchmark at a lower level than the 100<sup>th</sup> percentile (at RIIO-GD1 for instance the 75<sup>th</sup> percentile):<sup>2</sup>

*“We defined efficient costs equal to the upper quartile (UQ) GDNs’ costs rather than the frontier allowing for other factors that may influence the companies’ costs. We also assumed that GDNs would close only 75 per cent of the assessed gap between their forecasts and the UQ. The use of the UQ is identical to previous price reviews (e.g. GDPCR1, and more recently the electricity distribution price review, DPCR5). Our proposed approach to closing the gap and the use of the UQ rather than the frontier acknowledges that a part of the difference in costs across the GDNs relates to factors other than GDNs’ relative efficiency (e.g. statistical errors).”*

Given this, we propose that the total reward offered by BPI stage B for comparatively assessed costs for ED3 is shared equally between the networks which influence the setting of the benchmark. In RIIO-GD3, this would be the top three networks. Such an approach would be fair, proportionate and ensure the outcomes of the BPI assessment are reflective of the cost assessment. It would also ensure that the total amount of reward available to networks remains the same as when networks have more disparate efficiency rankings.

In addition to this, we think it is also important that any BPI Stage B reward is used to assess the efficiency of *forecast business plan costs*, as opposed to historical costs. Basing any BPI reward for cost efficiency previously achieved would: (i) make no logical sense as the purpose of BPI Stage B is to assess and incentivise efficiency of business plan costs, not historical ones and (ii) as this would duplicate incentives and rewards achieved historically by driving reduced costs within previous regulatory periods (with networks being rewarded for cost efficiency delivered in-period via the Totex Incentive Mechanism).

**Q127. Do you agree with our proposed changes to Stage C of the BPI, including our approach to seeking early proposals and the principle of deferred rewards? Why?**

We believe that it is important that Stage C of the BPI continues to recognise the need for both stretching commitments and clarity in how plans are set out and written so they can be understood by stakeholders. In respect of early proposals on commitments we think this could be helpful as it would (a) allow for consistent approaches to be applied across the sector in setting commitments and incentives and (b) create time for proposals to be properly assessed and not to be ‘timed out’ due to complexity or the need for enabling work to be undertaken (which can be challenging in fixed price control setting processes. However, this needs to be carefully considered as:

- the current proposed framework could stifle collaboration and networks ‘compete’ for rewards early on in the process rather than collaborate on proposals where there is most merit; and
- the outcomes of the process could result in additional regulatory burden due to the need for additional monitoring and administration by Ofgem and networks.

At a high-level we do not oppose only rewarding commitments that are delivered, however, the outputs to be delivered and rules for making rewards at a deferred date or clawing them back ex-post must be clear at the time the price control is set. There is a risk if outputs or rules are too broad or unclear this could create uncertainty for companies and Ofgem regarding what must be delivered for a reward to be achieved.

<sup>2</sup> Ofgem (2012), “RIIO-GD1: Final Proposals – Supporting Document – Cost Efficiency”, p. 7.

# Response to Ofgem's Cost Assessment Annex

## Regional and company-specific factors

### CAQ33. Do you agree with our proposed ED3 criteria for normalisation?

The ED3 SSMC proposes to maintain the criteria for normalisations, including for regional and company-specific factors, to that used for RIIO-2 price controls, including being mindful of the approach taken for RIIO-3 price controls. At a high-level this is an appropriate starting point. However, given that the SSMC draws on the approach taken by Ofgem for RIIO-3 Draft Determinations, it is important to set out the error made by Ofgem in how it applied the materiality threshold for company-specific factor claims at this point in the process. As set out in more detail below, it is important Ofgem builds on its RIIO-ED2 precedent in relation to this materiality threshold and consistently apply this for RIIO-3, ED3 and future price controls.<sup>3</sup>

At RIIO-ED2, Ofgem set the criteria that the value of company-specific factor claims should be in excess of 0.5% of gross unnormalized network totex. When applying this threshold at RIIO-ED2 Ofgem set new regulatory precedent by applying its materiality threshold to a *single* company-specific factor claim for 'Network Specific Factors' proposed by UK Power Networks (UKPN) that contained six elements it incurs from operating a network in a dense urban environment. Having passed materiality Ofgem then approved the claim noting that "*these factors affect operating in London disproportionately*".<sup>4</sup> At RIIO-3 we made a similar *single* 'Network Specific Factors' claim to UKPN's for our London GDN with the six elements in UKPN's *single* claim being directly analogous to an element of the *single* claim we proposed for RIIO-3. However, in our case, Ofgem did not follow the precedent it set and rejected almost all individual elements of our claim on the grounds of materiality.

The approach Ofgem has provisionally taken for RIIO-3 is a clear and demonstrable error. Ofgem has failed to consistently apply its own regulatory standards across different industries and has discriminated unduly against our GDNs operating in London by preventing them from recovering the efficient costs they incur, while allowing electricity DNOs to recover costs that are directly analogous (and in some cases identical – e.g., costs incurred due to prevailing transport schemes such as the congestion charge). There is no reason why the approach taken as regards UKPN's claim in RIIO-2 is not equally applicable to our RIIO-3 claim or claims made by DNOs for ED3 and future price controls.

Furthermore, as set out in our RIIO-3 Draft Determination response, the approach taken by Ofgem in the Draft Determination is also inconsistent with that which it is employing for its assessment of RIIO-2 re-openers.

Given these issues we have experienced so far in the setting of the RIIO-3 price control, in the case of both RIIO-3 Final Determinations and the ED3 SSMD, it is important that Ofgem corrects its interpretation of its materiality threshold against claims and maintains the precedent it has set at RIIO-ED2.

### CAQ34. Do you agree with our proposed ED3 methodology for each factor?

Ofgem's ED3 SSMC proposes to build on precedent established from previous price controls when accounting for regional and company-specific cost factors, including being mindful of RIIO-3 decisions. Whilst we consider that many of these factors (not including regional wage pressures) are best controlled for by including a density variable within the regression model(s) as a clearly superior alternative to making only pre-modelling adjustments, without prejudice to this position, if Ofgem does

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<sup>3</sup> For further detail see our response to Ofgem's RIIO-3 Draft Determination Gas Distribution Document, specifically GDQ36 – here: [Cadent RIIO-3 Draft Determination Response Gas Distribution Annex](#)

<sup>4</sup> Ofgem (2022), "RIIO-ED2 Draft Determinations – Core Methodology Document", para. 7.59.

not include a density driver in regressions, it is important Ofgem apply both its accepted company-specific factors proposed by UKPN for RIIO-ED2 relating to ‘Network-Specific Factors’ and ‘the Nature of Streets’. <sup>5</sup>

In our RIIO-3 Business Plan, we proposed applying analogous Network-Specific Factors and Nature of Streets adjustments to replace Ofgem’s existing urbanity factors used at RIIO-GD2 due to their superiority over these methods (if Ofgem does not include a density driver in the regression).<sup>6</sup> However, Ofgem rejected applying these adjustments in favour of ‘rolling over’ its existing (RIIO-GD2) adjustments in its RIIO-3 Draft Determination.

Our Network-Specific Factors claim was rejected largely due to a clear error in how Ofgem applied its materiality threshold. It is important that Ofgem corrects this error both for RIIO-GD3, and ED3.

In respect of rejecting the Nature of Streets adjustment for RIIO-GD3, Ofgem noted that there was “*an existing, well-established methodology for urbanity adjustments for the Gas Distribution sector*”.<sup>7</sup> In making this preliminary decision, Ofgem did not offer any further rationale as to why a Nature of Streets adjustment, which is based on workload evidence from gas networks itself, might be acceptable for electricity networks which Ofgem regulates under ED2, and not gas networks it regulates under RIIO-GD.

In the absence of further explanation, as we show in our RIIO-3 Draft Determination response, Ofgem’s decision for the RIIO-GD3 Draft Determination can only be construed as a clear error in the approach taken, since:

- the failure to replace its existing urbanity adjustments with our proposed Nature of Streets adjustment ignores recent regulatory precedent on a directly analogous adjustment made at RIIO-ED2;
- Ofgem’s existing urbanity adjustments are unlikely to reflect the true level of additional cost networks incur when constructing and maintaining underground network assets in London due to significant methodological and calculation errors; and
- our proposed Nature of Streets adjustment is based on more recent and reliable evidence than Ofgem’s proposed approach.<sup>8</sup>

Given the significant error Ofgem has made in relation to not following its own precedent and adopting the Network-Specific Factors and Nature of Streets adjustments (if not using a density driver in regressions) so far for RIIO-GD3, it is important for both RIIO-GD3 Final Determinations and the ED3 SSMD that Ofgem rectifies this and confirms that it will adopt both these factors in its modelling approach.

## Real price effects and ongoing efficiency

### **CAQ38. Do you agree with the key principles we propose to inform our assessment of ED3 OE targets?**

The key principles that Ofgem propose to inform their assessment of ED3 OE targets are:

1. Regulatory precedent alignment
2. Considerations of historical, current and potential future macroeconomic conditions
3. Considerations of the characteristics of the energy sector

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<sup>5</sup> For further detail see our response to Ofgem’s RIIO-3 Draft Determination Gas Distribution Document, specifically GDQs36/37 – here: [Cadent RIIO-3 Draft Determination Response Gas Distribution Annex](#)

<sup>6</sup> This is described in length in Appendix 3 to our Business Plan: Cost Assessment and Benchmarking Approach, Section 4 (here: [appendix\\_03](#)) and in our RIIO-3 Draft Determination response to Ofgem’s Gas Distribution Document, specifically GDQ36 (here: [Cadent RIIO-3 Draft Determination Response Gas Distribution Annex](#))

<sup>7</sup> Ofgem (2025), “RIIO-3 Draft Determinations Gas Distribution Annex”, para. 5.102.

<sup>8</sup> For further detail on all these points is contained in our response to Ofgem’s RIIO-3 Draft Determination Gas Distribution Document, specifically GDQ36 – here: [Cadent RIIO-3 Draft Determination Response Gas Distribution Annex](#)



We agree that all of these – at a high level – have some merit. However, noting that Ofgem’s SSMC proposals also seek to build on RIIO-3 decisions, it is important to point out several more detailed issues with these principles and their application, based on approaches Ofgem has made in its RIIO-3 Draft Determination. Two issues with the principles themselves are:

- When setting out the meaning of **Regulatory Precedent Alignment**, Ofgem states that “*the OE target should be consistent with best practices and decisions made in comparable regulated sectors*”.<sup>9</sup> Whilst we accept that the *methods* used previously by Regulators and other bodies for setting OE challenges are an important consideration – these should be applied to the appropriate, updated data. Relying on only the *outcome* of precedent, as suggested in Ofgem’s SSMC is clearly erroneous.

In its RIIO-3 Draft Determination, Ofgem explicitly relied heavily on the specific *outcomes* of OE analysis undertaken for RIIO-GD2 and RIIO-ED2 price controls, and the view taken by Ofwat in the PR24 price control (which we note at the time of writing, is itself currently under CMA redetermination) to propose setting a 1% per annum OE challenge. As set out in our RIIO-3 Draft Determination response, using regulatory precedent outcomes to justify a ‘right answer’ represents a departure from good practice, since, in doing so, it uses a process obviously designed to ignore new economic evidence that a better assumption is available. Further, relying on the outcome of a previous decision as precedent is:

- illogical, if the precedent is interpreted as the target, then, to the extent that one places weight on that, the target would always remain the same. The target would not change over time in response to changes in economic conditions, new evidence and other factors; and
- inconsistent with Ofgem’s approach to other areas of the price control, where they correctly start from the evidence before coming to a conclusion on the outcome, for example, Ofgem’s approach to the cost of capital.<sup>10</sup>

These points equally apply for ED3 in purely relying on the outcome of RIIO-3 Final Determinations and assuming the outcome of this (or any subsequent CMA appeal on this topic) is ‘right’ for the electricity distribution sector.

- When discussing the **Characteristics of the Energy Sector** as a key principle, Ofgem only refers to the sector broadly, not acknowledging there is likely to be a difference between the potential for ongoing efficiency gains between energy vectors (electricity and gas). In setting the OE challenge Ofgem should instead focus on the particular sectors’ price control being set. Given uncertainties over the role of some energy vectors in the transition and the type and scale of investment needed, there may be materially less scope for OE gains for network companies in some sectors compared to others.

In addition, in considering the characteristics of the sector whose price control is being set to determine the OE challenge it is important that Ofgem takes a balanced assessment of factors which could increase or decrease the potential for productivity gains, and robustly justify any inferences made, rather than asserting their presence and validity. At RIIO-3 Draft Determinations Ofgem only recognised qualitative arguments to rationalise ‘aiming up’ on the ongoing efficiency challenge within a benchmark range, with little robust justification of the assertions made and no consideration of incentives and arguments to the counter.

Alongside these issues with the principles set out, it is important that when undertaking/commissioning analysis to inform the setting of its OE challenge Ofgem ensure that the key principles set out above, and methodological principles outlined more fully in the SSMC documentation are actually put into practice. In its RIIO-3 Draft Determination there were clear errors in analysis commissioned from Grant

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<sup>9</sup> Ofgem (2025) ED3 Sector Specific Methodology Consultation – Cost Assessment Annex, P.93

<sup>10</sup> For further detail see our response to Ofgem’s RIIO-3 Draft Determination Overview Document, specifically OVQ19 – here: [Cadent RIIO-3 Draft Determination Response Overview Document](#)

Thornton, some of which contradict methodological principles in the ED3 SSMC document. For example, in the SSMC document, when discussing Growth Accounting analysis Ofgem state that “a *robust approach is to assess the average productivity growth over a complete business cycle*”.<sup>11</sup> However, in their report commissioned by Ofgem to inform the RIIO-3 OE challenge, Grant Thornton omits several years’ data from its analysis, assuming that these are outlier years of very low productivity, with little justification – in doing so directly contravening this statement. As shown in our RIIO-3 Draft Determination response correcting for these omissions materially reduces the estimated potential OE range below the 1% per annum set by Ofgem.<sup>12</sup>

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<sup>11</sup> Ofgem (2025) ED3 Sector Specific Methodology Consultation – Cost Assessment Annex, P.94

<sup>12</sup> For further detail see our response to Ofgem’s RIIO-3 Draft Determination Overview Document, specifically OVQ19 – here: [Cadent RIIO-3 Draft Determination Response Overview Document](#)

# Response to Ofgem's Finance Annex

## Allowed return on debt

### **FQ3. Do stakeholders consider it reasonable to adjust our long-term CPIH inflation forecast to the latest OBR assumption?**

We do not support Ofgem's proposal to adjust the long-term CPIH inflation forecast to reflect the OBR's illustrative 0.4% CPI-CPIH wedge. We believe this adjustment introduces unnecessary uncertainty, lacks evidential robustness, and risks undermining the consistency and predictability of the regulatory framework. Further detail is set out below.

#### **1. The 0.4% wedge is based on illustrative projections, not formal forecasts**

The OBR's long-term CPIH projection is part of its broader fiscal sustainability analysis and is not a statutory forecast. These projections are designed to support long-term modelling and are not subject to formal accuracy evaluation. By contrast, the OBR's Year 5 CPI is a formal forecast prepared under statutory duty and has historically been used by Ofgem in price control determinations. It is more reliable and appropriate for use in estimating long-term inflation assumptions and typically aligns to the Bank of England's long term 2% target.

If Ofgem intends to use a CPIH forecast rather than CPI forecast for deflation purposes, it should use the OBR's year 5 CPIH forecast which is subject to formal accuracy evaluation and currently implies a wedge of 0.09%. This approach ensures consistency with existing regulatory practice and avoids embedding speculative long-term assumptions into the framework.

#### **2. Historical data does not support a stable or predictable wedge**

Analysis of CPIH-CPI differentials since the adoption of the 2% CPI target in 2003 shows that the wedge has been highly variable, with the majority of observations being zero or negative. A 0.4% wedge would represent an extreme outcome relative to historical norms, well above the 90th percentile of observed data. Embedding such a wedge into the regulatory framework risks overstating inflation expectations and misaligning the cost of debt allowance with actual market conditions.

#### **3. The 0.4% wedge relies on optimistic and untested assumptions**

The projection assumes nominal earnings growth of 3.8%, which is significantly above historical averages and not supported by current economic conditions. Over the past two decades, average earnings growth has been closer to 2.6%, and structural challenges such as low investment, skills shortages, and post-Brexit impacts suggest that future productivity growth will likely be lower than assumed. These assumptions lack a track record of reliability and should not form the basis of long-term inflation expectations in a regulatory context. Adopting a higher inflation assumption would reduce the real cost of debt allowance, potentially underfunding actual debt costs and exposing consumers to volatility.

## **Recommendation**

We recommend that Ofgem retain its current methodology, using the Year 5 CPI forecast to estimate long-term inflation. This approach is grounded in formal forecasting, supported by historical data, and avoids reliance on speculative long-term projections. The proposed 0.4% wedge lacks sufficient evidential weight and could introduce volatility into the cost of debt allowance mechanism. Maintaining the current approach ensures consistency, predictability, and fairness for consumers and investors. If

Ofgem decides to change its approach and use a CPIH forecast, it should as a minimum, retain its current methodology of using the 5<sup>th</sup> year OBR forecast.

## Allowed return on equity

### **FQ11. Do stakeholders agree with our proposed set of cross checks in Step 2?**

We do not agree with Ofgem's proposed set of cross checks in Step 2. As mentioned in our RIIO-3 Draft Determination response, while we support the principle of using cross checks to validate the CAPM-derived cost of equity, we believe the current set is too narrow, inconsistently applied, and excludes several robust and relevant sources of evidence. This results in a downward bias in the implied cost of equity and undermines the investability of the price control.

### **A broader and more balanced set of cross checks is required**

In our Draft Determination response, we highlighted that Ofgem's current approach places disproportionate weight on a limited number of cross checks, such as Market Asset Ratios (MARs), while dismissing others, including Dividend Growth Model (DGM)-based TMR estimates and hybrid bond spreads, despite relying on similar methodologies elsewhere. This selective treatment introduces inconsistency and weakens the credibility of the cross-checking process.

We believe a more balanced approach is needed, where all cross checks are assessed on their merits and limitations, and used collectively to inform the final cost of equity. This includes the below cross checks which are not currently used by Ofgem:

- Debt-based cross checks (e.g. hybrid bonds, ARP–DRP comparisons, Inference analysis)
- Bid implied IRRs / Infrastructure IRRs
- Profitability metrics
- Multi-factor models (MFMs)

Equity investors have a range of options to choose from, each with its own balance of risk and return. When deciding where to put their money, they often compare these with lower-risk alternatives like debt, which typically offers more predictable returns. Given the higher risk profile of equity – due to subordination in insolvency, limited control rights in the event of distress, and discretionary returns – the expected return must meaningfully exceed that of debt to attract capital. It therefore follows that debt based cross checks provide a meaningful cross check and should not be dismissed. The CMA in their redetermination of PR24 also recognised the importance of debt based cross checks and used this real-world market evidence to deviate from the mid-point.

In our Draft Determination response, we set out in more detail the merits and limitations of these cross checks supported by expert reports. Each of these provides valuable insight into investor expectations and market pricing of risk, and collectively when applied, they point to a higher cost of equity than the traditional CAPM midpoint.

### **Recommendation**

We recommend that Ofgem:

- Expand the set of cross checks used in Step 2 to include debt-based, profitability, and multi-factor evidence.
- Apply consistent standards when evaluating cross checks, avoiding selective dismissal of relevant methodologies.
- Use the full suite of cross checks to inform the final cost of equity, recognising the strong case for aiming towards the top end of the CAPM range.

This approach will ensure the cost of equity is robust, evidence-based, and aligned with investor expectations, supporting a fair and investable price control.

It is clearly better to rely on a wide set of information, rather than placing weight on a small number of cross-checks. By considering a wider range of evidence, Ofgem would be better equipped to set the cost of equity at an appropriate level which mitigates investability risks and protects customers accordingly.