



St. Lawrence House
Station Approach
Horley
Surrey
RH6 9HJ

Mr J Brearley
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

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Dear Jonathan

SGN RIIO-2 Sector Specific Methodology

We welcomed the opportunity to respond to the Sector Specific Methodology Consultation and address the questions raised with your team, who have remained constructive and engaged through out.

It is our view that RIIO-1 has worked to delivered strong consumer benefit alongside improvements in safety, customer service, efficiency and clarity of outputs. We are keen to ensure in RIIO-2 that any issues with RIIO-1 are appropriately addressed through an evolutionary approach consistent with the regulatory principles of proportionality, accountability, consistency, and transparency and that we continue to deliver our shared ambitions for all our customers and stakeholders.

We also recognise that there are unique challenges that need to be addressed with the decarbonisation of heat and the respective role of electricity and gas networks in delivering decarbonisation. We are encouraged by the Chancellor's confirmation that proposals will be bought forward to increase the proportion of green gas on the network, and the Scottish Government's Vision for Networks focusing on the role of networks and increased blending of decarbonised gases.

Progressing towards a decarbonised future will introduce new regulatory challenges and pressures. We recognise that it is important to ensure that consumers are protected from poor forecasts whilst network companies are able to continue to invest at the scale required. We therefore support the discussion on whole systems but recognise that determining the decarbonisation pathway needs to remain a priority for the gas networks.

We recognise that some changes are required and have been very supportive of improved indexation, the move to the five-year price control and the recalibration of the price control mechanism that we think will go a long way to resolving some of the legitimacy concerns of RIIO-1.

We also recognise that there is a limited amount of time to introduce changes of the scale and scope proposed by the sector specific methodology consultation. The move to RIIO took two years of prior planning and detailed consultation to ensure that appropriate process issues and legal challenges were addressed.

The complexity of these challenges is greater now that half of the gas distribution network is dominated by one company, Cadent, that has recently been sold and financially restructured. Cadent's structure is now a-typical of the sector with a particularly low cost of debt and the accompanying high transaction costs. The risk of unintended consequences when determining the cost of debt index or calibrating

return adjustment mechanism is therefore particularly high. This risk of unintended consequences is magnified by the speed at which new structures are being considered and progressed for RIIO-2, coupled with the scale of the change proposed in the Sector Specific Methodology. Changes such as the cashflow floor, the introduction of a wedge for expected returns as different from allowed returns, the introduction of dynamic incentive mechanisms, the introduction of asymmetric risk and increasing penalties. These changes are a substantial move away from the RIIO principles and are being progressed in an extraordinarily compressed timeframe with a very short consultation period given the extent of the proposed changes compared to the two years of discussion and debate in the run up to RIIO.

We will continue working to support Ofgem with this. In our consultation response we have encouraged Ofgem to really consider which of the changes drive the most benefits to consumers. It is our view that the existing RIIO tools can be recalibrated to achieve the outcome that Ofgem is looking for. There are so many layers of control proposed that the marginal contribution of each is diminished and the complexity and interactions are magnified.

Rather than looking to deliver all these changes in a very short time-period, we would like to work with Ofgem to improve the regulatory structure, in preparation for RIIO-3, when there will be greater clarity on the decarbonisation pathway, and greater clarity of the whole system interactions that will arise.

Finally, we would like to refocus all our attention on delivering better customer outcomes from amongst the substantial changes put forward in the sector specific consultation. We are concerned that the focus on securing a better consumer outcome through incentivisation and innovation has been lost. There is a risk that the regulatory structure proposed in the Sector Specific Methodology will not deliver for customers; rather the proposed structure risks stifling ambition by focusing on penalties.

As you will be aware, SGN benefits from the long-term commitment and vision of our shareholders who provide quality long-term capital and recognised the importance of legitimacy. It is for this reason that they were alone among the gas distribution networks to put forward a substantial voluntary contribution of £145m in RIIO-1. These investors value the principled and robust regulatory structure that the UK has enjoyed to date and are concerned about the attractiveness of the sector at a time when the country as a whole is struggling with investor credibility.

We remain committed to supporting Ofgem in finding the right balance of change for RIIO-2 and supporting the change agenda after RIIO-2 to ensure that consumer protection remains as we move into a period of rapid change. We have attached a copy of our executive summary that brings out some of the main points and would be happy to discuss any aspects of it with you.

We look forward to continuing a positive relationship with your teams and I am sure that David and Mike will continue to support Akshay, Simon and Michael and their teams as we progress towards our business plan submission in December.

Yours sincerely



John Morea
Chief Executive Officer

cc'd to Akshay Kaul