Cadent
Your Gas Network

Appendix 1

Assurance Statement

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RIIO-3 Board Assurance Statement

The Statement below has been approved by our Board.

Testing our plan

To support our plan we, the Board have:

- supported the development of our ambition and reviewed and challenged the outcomes we are seeking which align with the company's purpose of keeping people warm while protecting the planet;
- challenged our emerging thinking through workshops, dedicated reviews of key topics and Board discussions;
- reviewed and challenged costs and outputs set out in our plan;
- challenged the Executive Team to build our confidence that the plan is stretching but deliverable;
- overseen a robust governance structure to ensure we maintained oversight of our plan and any emerging issues in relation to our plan;
- reviewed and commented on successive drafts and the final versions of our plan; and;
- put in place suitable assurance processes that have supported our plan and its data.

Alongside this, Members of the Board have participated in meetings with our Independent Stakeholder Group.

In giving this statement, we are acting as one Board, including the Sufficiently Independent Directors.

We have delivered a dynamic and risk-based assurance programme, which has benefitted from the lessons we learned from the RIIO-2 assurance programme. It is based on the internationally recognised 'three lines model' to verify that our plan is accurate and efficient. Where appropriate, specialists have also been engaged to provide assurance that: our plan is robust in the approach we have taken to asset management, and provides value for money to customers through cost benchmarking. KPMG has also been engaged to provide assurance in relation to the financeability[1] of our plan through a number of techniques including stress testing analysis. In addition, our internal assurance team have also reviewed the robustness and deliverability of our commitments.

We are satisfied that our plan meets Ofgem's minimum requirements. This has been reviewed both for completeness and quality by our specialist provider Complete Strategy and through sample testing conducted by our second line assurance team.

We have high expectations for what we want to achieve, and we have challenged all aspects of our plan throughout its development, including our cost and efficiency projections. We have commissioned independent assurance of those projections and are satisfied that our plan uses efficient and robust expenditure forecasts.

The integrity of our data is a priority for us as a Board and essential to deliver an accurate Business plan. We have applied the principles of Ofgem's Data Assurance Guidance for Electricity and Gas Network Companies to the information contained within our plan and in the Business Plan Data Templates, Network Asset Risk Metrics tables and Cost Benefit Analysis Templates. The data in our plan has been subject to assurance by our internal, independent assurance team, and we have reviewed the outputs of the assurance work with them. We have taken all reasonable steps to test the accuracy of the data in our plan, including reviewing the work carried out by external assurance providers.

We, as a Board, are satisfied that our plan demonstrates the right degree of ambition, accuracy, and efficiency for the business to deliver for current and future customers.

Signed by Sir Adrian Montague on behalf of the Board

Statement approved by the Board on 20 November 2024

[1] Our financeability assessment has assumed base return on equity of 6.3%

We have a robust assurance process, and our Assurance Framework is based on best practice and is tailored to us

Our Board is committed to our purpose of keeping people warm, while protecting the planet. A high quality RIIO-3 business plan is integral to achieving our purpose. Therefore, our Board has been heavily engaged in the development of our business plan, challenging management on all aspects of its development through dedicated challenge sessions, Board meetings and focused reviews.

Our Board has provided an assurance statement in line with Ofgem's expectations, which has been submitted alongside our plan. We have a robust assurance programme which has tested that our plan is accurate, ambitious, efficient, deliverable, financeable and in the interests of both current and future customers. This underpins the assurance statement that our Board has made. This programme is based on the internationally recognised ‘three lines model’ which is deployed across Cadent.

The criticality of robust assurance to deliver a robust, efficient, ambitious, and accurate plan has been recognised by the establishment of a dedicated Assurance Workstream within the RIIO-3 project team. Our approach to assurance has been designed to be dynamic, enabling us to respond to changes in risks as they occur and was developed by our internal assurance team.

Learning from our RIIO-2 submission, which received praise from Ofgem’s Challenge Group, we have further improved our assurance approach for RIIO-3. We have achieved this through the greater utilisation of Cadent’s internal assurance team, leveraging the team’s knowledge of Cadent’s business processes, experience with regulatory reporting, and expertise on Ofgem’s Data Assurance Guidance (DAG) framework to focus assurance on critical risks. This change in approach ensured that the assurance conducted was more holistic, more insightful, and more efficient than in RIIO-2.

The assurance plan was designed to provide assurance across all our business planning activities. To enable the assurance programme to be delivered effectively, we split the plan into four key areas:

- Accuracy and robustness – we considered both risk themes, for example, data quality, as well as the minimum requirements applicable to each area of our plan.
- Financeability – as a driver of our continued viability this was identified as a key risk area.
- Deliverability – we needed assurance that, by changing how we operate and taking advantage of technological developments, we could make the step change in performance to achieve the ambitious and stretching commitments set out in our plan.
- Project connectedness and governance – this considered strategic risks such as the degree to which the RIIO-3 project team were aligned with the wider business, for example Operations and innovation projects, when drafting investment strategies. Importantly, it also considered whether there was appropriate governance in place to ensure the appropriate and timely escalation and Board involvement and challenge.

Across these four areas, we adopted a risk-based approach to developing our assurance framework, which is shown in Figure 1 below:

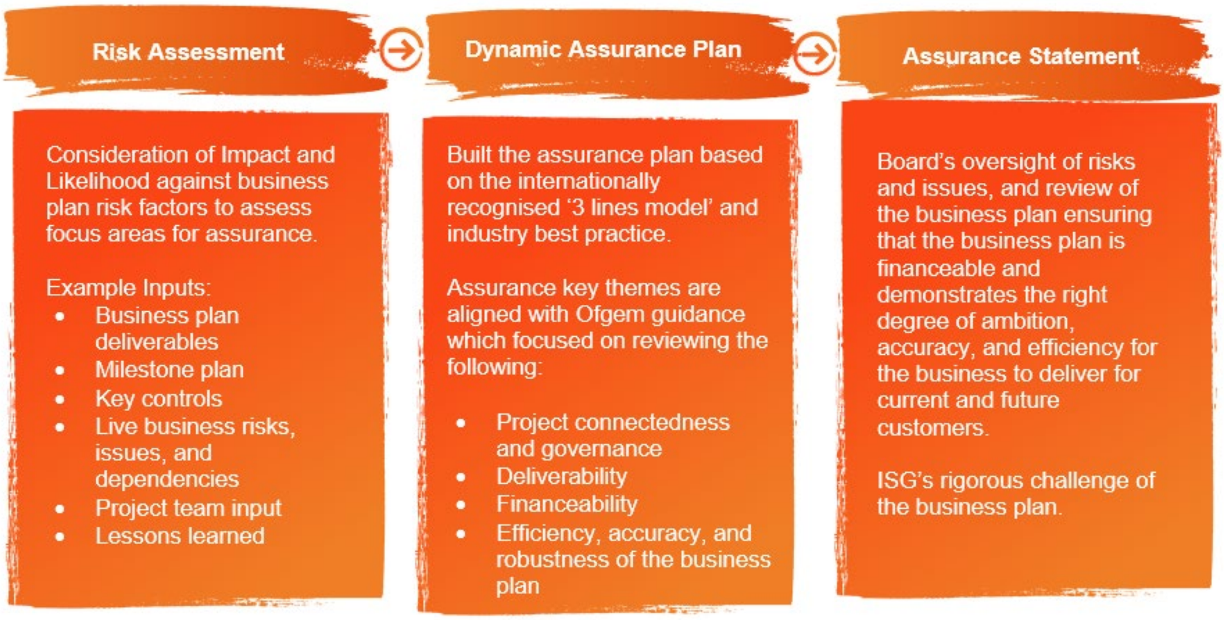

Figure 1: Our assurance approach

The first step in our risk-based approach was forming an assurance plan. We used a broad set of inputs to perform a 'top-down' risk assessment to identify the key areas to be assured. This was carried out against the risk factors set out in the table below.

The risk factors build on the DAG framework, but also reflect the specific characteristics of the business planning process (e.g. the greater level of uncertainty in forecast, rather than historic data) and draw on lessons learned from the past. They also reflect the need to have compelling evidence to support our proposals and the potential reputational impact of errors.

Criteria	Considerations
Complexity	By seeking to identify areas of potential complexity, we focused our assurance to ensure that the appropriate controls had been established. Through second line assurance 'process walkthroughs', followed by more detailed sample testing, we sought to ensure that the controls identified had been applied appropriately. For example, in relation to our approach to asset management. Where areas were particularly complex, we engaged specialist third party assessors to validate that, for example, our models were operating appropriately and in line with Ofgem guidance.
Change	We have calibrated our assurance to take account of areas that have been or will be subject to change as we pursue our purpose. By understanding where change has or could have the greatest impact on the lives of our customers, our operational environment, and our ambitions to improve, we have focused our assurance where there are greater levels of uncertainty about change into the future.
Roles & Responsibilities	We have targeted our assurance to increase its focus on areas where individuals were newer to roles, or less experienced.
Subjectivity	We have increased our assurance in areas where the assumptions that underpin our plan are based on engineering judgement and expert opinion, commonly due to a relative lack of quantitative data. Assurance in these areas has challenged the basis of opinions and ensured they have been reviewed and validated by those qualified to do so both internally and externally.
Value	We have concentrated assurance on items with a higher financial value, as these present greater risk (even small errors can result in a material impact to our plan). High value items, such as our Repex plan, were therefore subject to more assurance than lower value parts of our plan.
Customer / Stakeholder impact	We recognise that we are in a privileged position, to serve our customers and stakeholders, as the deliverer of critical infrastructure services. It was therefore of the upmost importance that our risk assessment should directly consider the impact that our plan could have on the customers and stakeholders we serve.

Broader regulatory considerations	It is vital that we continue to meet our legal and regulatory obligations, as well as work with our regulators such as Ofgem, the Health and Safety Executive and the Environment Agency to respond to an ever-changing world. We have given due weight to the need to discharge all our obligations when targeting our assurance.
Reputation	We are committed to be a trusted company, and so it is important that we develop and maintain our reputation with customers and stakeholders, including our regulators. We have undertaken additional assurance where we face risks that might damage our reputation. For example, assurance has been provided over the deliverability of the commitments we have made to ensure they are clearly defined and stretching, yet still capable of being delivered.

Table 1: Risk assessment factors

A more detailed 'bottom up' risk assessment was then used to focus testing on high-risk investment cases to assess whether the control, although well designed, was being implemented effectively.

This approach also allowed us to identify areas of our plan, such as our approach to asset management and investment costing where it would be more appropriate for specialists, with a greater understanding of industry good practice to provide this assurance than our internal assurance team.

In the case of the data tables that accompany our plan, we have performed our risk assessment in line with the principles of Ofgem's DAG. The DAG requires companies to assess the inherent risk of data errors and the extent to which these inherent risks are altered by the controls that the company operates. This has allowed us to combine a top-down and bottom-up risk assessment to form our more detailed assurance plan.

Our framework was dynamic in nature. In addition to adapting to emerging requirements, this meant that the assurance adapted to the project as it progressed and responded to the assurance findings as they emerged. As the assurance programme developed, the lessons learned and feedback were used to iteratively develop the control framework and target more detailed assurance activity. Consequently, assurance was not a 'one size fits all' exercise, with assurance tailored to the specific subject matter, risks, controls, and business plan requirements.

Alongside the execution of our assurance plan, detailed risk assessments were performed on each of the Business Plan Data Tables (BPDTs).

Business Plan Data Table Assurance

Our Board is committed to producing a robust and accurate Business Plan. As such, they have ensured that a strong assurance and governance framework, which follows the DAG principles, was established in relation to BPDTs. The process was aligned to the way in which we assure our annual Regulatory Reporting Pack (RRP), to leverage established processes, roles, and governance.

Key features of the assurance and governance frameworks for the data tables are summarised below:

- Programme Management Oversight – The RIIO-3 Programme Management Team established a governance structure which ensured there was clear responsibility for producing and assuring each data table. Requirements were clearly set out through monthly programme meetings early in the project and reinforced through training sessions for those involved in data table production and assurance. Progress was closely managed with the data table assurance providers through regular 'hubs' and 1:1 meetings with the relevant workstream leads, which also acted as an escalation route for issues to be raised to the Programme Management Team and the Programme Management Board if required.
- Risk Assessment – A risk assessment was undertaken for each data table in line with the DAG criteria. To ensure consistency this was performed by an individual with extensive RRP experience across all data tables. The results of the risk assessment determined the level of assurance applied to each table.

Reviews were performed by each role listed below. Our internal assurance team performed a review of all the tables, and the Internal Audit Team has also conducted an additional review of all high-risk data tables (as identified by the DAG risk assessment).

- Data Providers – responsible for populating the data and reviewing it to ensure that it is accurate.
- Business Experts – key business stakeholder with responsibility and expertise for the particular area, reviewed the data to ensure it is correct and in line with expectations.

- Independent Reviewers – members of staff with knowledge of the business area, provided an objective and independent review.
- Workstream Leads – senior members of the RIIO-3 project team who hold overall accountability for the data set. Reviewed the data set and ensured that all assurance has been appropriately undertaken and documented before providing final sign off.
- Internal assurance team – walked through the process of how the data sets sampled were produced and traced a subset of data back to source data files and ensured that the DAG process (outlined above) had been adhered to, and there was appropriate evidence of review and approvals in place.

External Assurance

Our initial assessment identified the need for specific external assurance which has been provided by independent experts over the following areas:

- Financeability, including stress testing of the Business Plan.
- Engineering and cost methodologies.
- Cost Benchmarking

The table below summarises the external third-party assurance which supports our plan.

Independent Stakeholder Group (ISG)	
Scope	The extensive input and challenge from our Independent Stakeholder Group (ISG) is set out in Appendix 12.
Findings	Please refer to the ISG Statement, Appendix 12
Complete Strategy	
Scope	Review of plans and strategies and their compliance with Ofgem's minimum requirements and Business Plan Guidance. Review of BPDTs in line with Ofgem's DAG methodology.
Findings	Complete Strategy reviewed our plan against Ofgem's minimum requirements and assisted in second line data table reviews. As issues were identified they were fed back to the workstreams to address. Management have confirmed that all material items have been addressed. Thematic trends in relation to BPDTs included the need to better articulate rationales and ensure supporting documentation was clearly sign posted to support submission documents.
NERA	
Scope	Technical review of a CBA methodology and sample testing of CBA models to ensure they complied with Ofgem's guidance and expected good practice.
Findings	NERA found that "Cadent has addressed our initial comments appropriately. Thus, we find that Cadent's updated CBA modelling has been performed to a high standard and is in conformance with Ofgem's guidance on performing CBA analysis".
Economic Insight	
Scope	Review of internal cost assessment, modelling suite and spreadsheets underpinning regional factors cost submission and review of cost assessment BPDTs against Ofgem guidance and expected good practice.
Findings	Economic Insight confirmed "Based on our independent review of Cadent's cost assessment analysis, we confirm the analysis we have reviewed has been conducted to a high standard. We find no areas of concerns with the efficiency modelling that feeds through to Cadent's Business Plan, nor its inputting of Regional Factors, Cost Exclusions and Ongoing Efficiency into its BPDTs."
KPMG	
Scope	Technical review of our methodology and asset management approach to investment planning and technical review of our approach to investment costing, including an assessment of our compliance with Ofgem's guidance and expected good practice. This included the detailed review of 4 Engineering Justification Papers (EJPs), 1 Major Project Justification Paper (MJP) and the underpinning Network Asset Strategy and Internal Cost methodology documents.

Findings	Overall, KPMG confirmed "that there is evidence to show that each of the minimum requirements for the RIIO-3 Business Plan should be covered by the documents being prepared by the Cadent Gas Ltd team."
KPMG	
Scope	Financeability of our RIIO-3 Business Plan under notional and actual structures based on our forecasts. Stochastic risk modelling and scenario analysis to analyse financeability and financial resilience under downside risk scenarios and against Ofgem guidance.
Findings	Please refer to the financeability section of this appendix.
Gartner	
Scope	Benchmark of overall Business As Usual (BAU) Information Technology and Telecoms (IT&T) Opex costs against industry comparators as well as specific investment initiatives to determine whether the estimating conducted for the proposed delivery of the IT&T investments is in line with external reference points to ensure that costs are efficient.
Findings	The review of investment initiatives found the majority to be within the Gartner range. The benchmark was used to help refine forecasts from the draft July submission to bring those reviewed either within, or below the benchmark expectation. The assessment of Cadent's BAU Opex forecast relative to industry peers helped identify the need for cost reduction. As a result, significant reductions in IT opex have been included in the final business plan submission.
Internal Audit	
Scope	Internal Audit reviewed a number of areas including the Environmental Action Plan (EAP), Cyber Resilience, and reviews over the second line assurance work on the high-risk BPDTs.
Findings	Overall, the processes associated with the governance, deliverability, ownership of the plan, commentary, and compliance with Ofgem's Minimum Requirements in relation to the EAP, High Risk BPDTs and Cyber Resilience were found to be satisfactory. A number of findings and minor recommendations have been communicated to the workstream leads throughout the audit, largely in relation to internal learnings and communication and as a result, actions have been taken and improvements have been made.

Table 2: Summary of external assurance

We have built confidence around our ability to deliver our plan

Our business plan includes our proposed investment programme. It is critical we develop a view on our ability to deliver our proposed investment programme. At the same time, we must operate our critical national infrastructure in a safe way and provide energy which millions rely on to heat their homes. It is paramount that we are confident we can continue to meet our regulatory obligations and deliver our proposed investment programme for the RIIO-3 period. We set out below how we have provided assurance on our delivery capability to our operational business leaders and to our Board – this should provide Ofgem with confidence that we will be able to deliver the proposed investment programme.

In our main business plan document and supporting documentation, we set out the commitments which reflect our customers' priorities and what we are committing to deliver in RIIO-3.

Our RIIO-3 business plan is aligned to our current delivery and performance levels. This has allowed us to focus on specific delivery risk areas and challenges to ensure we can deliver against proposed schedules in an efficient manner, whilst ensuring we continue to meet our legislative obligations in full.

Our RIIO-3 deliverability programme reflects a series of deliverability assessments considering resource availability, supply chain, activity time frame and the interface of investment activities with our procurement and commercial functions. These assessments culminated in a long list of business readiness actions which are to be completed between Business Plan submission and commencement of the RIIO-3 price control, to ensure we are ready to deliver from day 1 of the price control.

To support the development of our plan, we appointed a Head of Deliverability (HoD). It is their role to test our emerging thinking on deliverability challenges with our operational teams and devise cross-functional strategies to tackle any deliverability concerns ahead of RIIO-3 commencing. The initial focus of this work has been on identifying areas that might carry significant delivery risks, for example, because delivery:

- May require a major change to the competency and/or volume of our workforce;
- Identifies a set of requirements which cannot be met via our existing procurement frameworks;
- May go beyond our current operational or technological solutions;
- May be unrealistic against the proposed activity timelines given potential internal and external constraints; and/or
- Might challenge our ability to comply with our obligations.

The HoD was also responsible for undertaking delivery risk assessment surveys and developing high level reports which have been validated by our operational teams. This activity was completed alongside the building of the plan to ensure it was deliverable. Our Board has also had exposure to these plans and has had the opportunity to challenge the relevant operational teams, giving them opportunity to build confidence around our business's approach.

Our Approach to assuring that our plan is deliverable

Our starting point was to build on our general approach to assurance, which has been based on the 'three lines model', the application of which is summarised below:

1st Line of Assurance

Our senior management and business leaders are best placed to assess our ability to deliver the key commitments we have set out in our RIIO-3 Business Plan.

Engagement with Network operations and the teams that will deliver on our commitments

- During the design and refinement of our commitments, there has been consultation with operational delivery teams coordinated by the HoD. This has been at both the working level with subject matter experts and more strategically with our Network senior management teams.
- The focus has been on identifying areas that are expected to see a step change in delivery or may face specific barriers to delivering parts of our Business Plan. Such areas of focus included:
    - Major changes to the competency of our workforce. A lot of the work our teams undertake require specific skills which are assured by standard industry qualifications. Some of these qualifications require extensive (more than 5 years) training and are not easily procured through our supply chains. Where we are expecting a notable increase in work volumes requiring such skillsets, we are likely to be constrained in what can reasonably be delivered across the RIIO-3 period;
    - Areas where our existing frameworks and supply chain are likely to be under external pressures (for example competition for resources from other large scale infrastructure programmes) which would result in delivery challenges;
    - Lessons learned from managing projects where complexity and timelines have been underestimated historically; and/or
    - Regulatory Changes where Regulator expectations are ever changing.
- Leaders across our four network teams have reviewed our RIIO-3 plan to inform a balanced view of deliverability.
- The Board have had regular engagement with senior management teams where it challenged how these seek to deliver on our commitments.

For specific delivery challenges, we have undertaken operational trials of new technologies such as our underground governor module modification trial, which will allow for an efficient way to remediate complex challenges and ensuring safe and resilient supplies.

2nd Line of Assurance

Our 2nd line assurance focused on reviewing the work that has been done through 1st line assurance, focusing on the following:

- Ensuring the approach for 1st line assurance of deliverability is relevant and robust;

- Ensuring the completeness of our deliverability assessment (i.e. validating that all critical areas have been included in the review and that commitments, particularly those that are new for RIIO-3, have been included in the assessment);
- Ensuring key factors forming part of our deliverability assessment (such as track record, resource, supply chain, systems, and processes) have been covered by the assessment criteria to facilitate a robust and consistent risk assessment approach;
- Assessing the effectiveness of controls of our delivery governance (e.g. Board reviews, Network delivery plan reviews; and
- Ensuring the delivery assessment was undertaken using broad sets of robust data and information from across the business.

3rd Line of Assurance

It is difficult for an external assurance organisation to be able to provide a positive opinion that a commitment is deliverable or undeliverable as detailed plans are still being developed and there are external factors at play which may be beyond Cadent's control. Accordingly, we focused on our 1st and 2nd lines of assurance.

Ongoing delivery assurance of our RIIO-3 commitments

Following the outcome of the price control, we will ensure that delivery of our commitments are monitored through our business as usual governance arrangements, with risks and issues being monitored and escalated as appropriate.

Our RIIO-3 submission is made fifteen months before the commencement of the new regulatory period. This places limitations on our ability to assure future activities. However, our deliverability assessments have identified risk areas which we will continue to plan and adapt, or establish the required systems, processes, capabilities, and supplier changes needed to safeguard the delivery of our commitments. Further details of some of these specific risks, for example in relation to building and retaining critical skills and capabilities, both internally and through our broader supply chain, are set out in Appendix 17[2].

The focus will now move to ensuring business readiness, where the HoD will work with teams across the business to build tactical site level plans, tracking progress of RIIO-3 investments which have been allocated enabling funding on a no regrets basis, whilst also mobilising other mitigations which may be required as tactical level plans are developed. This will ensure all required actions are completed ahead of day 1 of RIIO-3 across all affected business areas, including network operations teams.

In parallel, the HoD will focus on developing mitigations against deliverability challenges identified during the deliverability assessment. They will also work closely with our Procurement and Commercial teams to ensure supply chain and resource capacity is secured in line with expected needs.

We have assured ourselves that our plan is financeable

Board Financeability assurance statement

Key messages

- The gas sector is facing significant uncertainty around long-term demand at RIIO-3 in relation to the decarbonisation pathway. This uncertainty is already manifesting in debt markets, where gas networks are unable to raise new debt efficiently at longer tenors (over 15 years) and face a premium to both the tenor-adjusted iBoxx Utilities index and cost of debt in the electricity sector. Consequently, a financeability assessment as part of RIIO-3 needs to consider both RIIO-3 and the longer-term, including equity investability – that is the ability to retain existing equity capital and attract new equity, as required.

- The Cadent Board considers that the credit metrics under our business plan meets the current thresholds for a BBB+/Baa1 credit rating in the base case, before considering any adjustment in respect of accelerated cashflows in RIIO-3 and is therefore considered financeable for the RIIO-3 period under

[2] Workforce and Supply Chain Resilience Strategy, section 3.3, page 12 and section 6.6, page 33

the notional and actual structures. However that does not consider uncertainty in relation to the analytical treatment of accelerated cashflow (accelerated depreciation and the move to a semi-nominal WACC) in RIIO-3 by credit rating agencies.

- For the Board to be comfortable that the RIIO-3 price control is financeable in the longer-term, the Board must also take into account whether the company is investable. This requires consideration of a time period much longer than the upcoming price control.
- The Board believes there is a credible path to ensuring the company is investable. However, there are significant uncertainties around the energy transition, including the degree of customer attrition from gas in the medium-term and the impact on demand in future price controls. Ofgem must consider these uncertainties when implementing regulatory mechanisms in RIIO-3.
- In particular, Ofgem's proposals on accelerated depreciation need careful implementation to ensure they achieve the desired policy outcomes. Those outcomes include the commitment to full RAV recovery, which accelerated depreciation does not fully mitigate under all potential scenarios. Where there is any credible risk of non-recovery of RAV without sufficient mitigation, the sector would de facto not be financeable.
- Analysis of downside scenarios reveals that the company may have limited financial resilience using Ofgem's financial assumptions, particularly under more severe scenarios
- **The Board therefore provides assurance that our plan is financeable for RIIO-3, subject to sufficient mitigation of shorter and longer-term financeability challenges identified and an appropriate risk allocation, such that the company is investable in the long term. In the view of the Board, these include:**
    - An appropriate allowed WACC: Setting the correct WACC allowance is critical to ensuring the financeability of our business. In light of the market evidence and data that points to higher interest rate and an increasingly risky sector, our requirement for the WACC evolves from RIIO-2. The cost of equity should be as a minimum at the upper end of Ofgem's range in light of sectoral risk and could move higher if interest rates continue an upward trajectory or emerging risks increase. The cost of debt allowance must reflect the margin and duration that we can borrow efficiently. It is critical that there is an appropriate spread between the cost of equity and cost of debt in view of the risks borne by equity.
    - Accelerated Depreciation: We do not believe accelerated depreciation resolves the concerns that Ofgem seeks to address, particularly given the risk of raising bills in RIIO-3 unnecessarily and challenges around feasibility of longer-term affordability. Furthermore, it introduces additional challenges in respect of both financeability and investability as the current proposals could imply implausible long term bill levels which could, in turn, create circular circumstances where the level of customer bills could drive further customer loss and further asymmetric risk exposure for investors. If Ofgem were to introduce accelerated depreciation at RIIO-3, we believe option 4 (depreciation of only new assets by 2050) would have the least adverse impact on affordability in RIIO-3 and investability in the longer-term. The Board would welcome further engagement with relevant stakeholders, including Ofgem and the Government to resolve the potential for negative longer term impacts to consumers and investors.
    - Credit rating agency treatment of new regulatory features: At the time of business plan submission, there is no definitive guidance from rating agencies on the analytical treatment of accelerated cashflow in the gas distribution sector. In a recent note, Fitch set out that they

      "…could therefore introduce new credit metrics to better reflect some project finance-like features, or adjust the PMICR (Post-Maintenance Interest Coverage Ratio) calculation, or place greater reliance on net debt/RAV and networks' financial policies[3]."

      In view of precedent and the economic substance of accelerating cashflow, the Board expects that the credit metric agencies will adjust metric thresholds. Consequently financeability has been assessed against both current thresholds and adjusted thresholds.
    - Consideration of longer-term issues: Given that investment horizons extend well beyond a single price control period, the Board believes it is critical to consider the long term, in particular

[3] Fitch Ratings. What Investors Want to Know: RIIO-3 Sector Specific Methodology Decision, 14 November 2024

investability. The business plan for RIIO-3 has been prepared in the context of material uncertainties in the long term, some of which could have a significant impact on the attractiveness of the sector to investors. These include:

- Management of demand risk and transition: The Board does not expect any significant decline in customer numbers or demand during RIIO-3. However, it is not possible to consider financeability and investability of the company without taking into account the longer-term impacts to the company that could arise in the context of decarbonisation and Net Zero, if the Holistic Transition pathway – or similar – were to transpire. Depending on the specific accelerated depreciation mechanism implemented, the company could be exposed to demand risk in a way which is not intended under the regulatory framework, which could have implications for its ability to raise capital, both debt and equity.

- Protections for investment recovery: The RAV model is predicated on the assumption that efficiently-incurred investment will be recovered in full. Any perception that may not be the case, whether grounded or ungrounded, could significantly impact investability and undermine the company's ability to retain existing equity capital. The risk to investors is asymmetric, where they have no possibility of over-recovering income, but could be exposed to some risk of under-recovery in the absence of appropriate mitigations. This risk is not currently priced into the regulatory framework, nor could it be, given that it is not a risk that could be borne by investors. Policy with respect to the energy transition should consider both depreciation policy and other protections that could be available, for example a government commitment to full RAV recovery or wider socialisation of costs currently borne by gas customers.

- Sufficient investor return: RAV balances in future periods may decline or grow at a slower rate (in real terms) following completion of the Repex work to deliver the Iron Mains Replacement Programme, and as a result of Ofgem's accelerated depreciation proposals, dependent on implementation. In such a scenario, even if customer numbers were to decline in line with the Holistic Transition scenario, totex would be expected to remain relatively stable. In those circumstances, a regulatory framework which remunerates equity based on an asset heavy business model may no longer be appropriate as operational risk exposure would not reduce accordingly, and consequently the equity buffer may be insufficient. The Board considers it is crucial in this context to differentiate between return of capital through depreciation and return on capital. The sector would only be investable if both factors were appropriately calibrated.

- Funding of disconnection and decommissioning costs: the company faces disconnection costs that could be very significant should customers transition away from the network in line with future energy scenarios. In addition to this, end-of-network or repurposing may require significant resources to deliver at an indeterminate point in time. The Board notes that our RIIO-3 business plan does not contain any decommissioning costs, in line with Ofgem's guidance. It may be necessary to consider alternative funding mechanisms in the context of a declining asset base, as opposed to the RIIO framework which relies on costs being recovered immediately through revenue or through the RAV. It is crucial to avoid circumstances where the expected costs for disconnections or decommissioning have no credible route to recovery.

Assessing financeability in RIIO-3

The gas sector faces unique considerations and challenges and therefore requires a holistic assessment of financeability which should include investability.

The Board welcomes that Ofgem have recognised that investability is applicable to the gas sector through an incorporate of 'retention of equity' as well as growth capital within the framework. The Board considers that the concept applies equally to gas distribution as to sectors planning for higher demand, as we must retain equity in the face of material uncertainties. It is therefore as critical that Ofgem ensures all companies are investable.

The financeability assessment for RIIO-3 has focused primarily on whether the credit metrics for the notional and actual capital structures are commensurate with a strong investment grade credit rating.

The Board has considered the following metrics:

- Moody's: Adjusted Interest Cover Ratio, Gearing.
- Standard & Poor's: Funds From Operations /Net Debt.
- Fitch: Nominal PMICR (as the Cash PMICR and Gearing metrics are calculated on a similar basis to the equivalent metrics for Moody's).

The Board considers that the appropriate target rating is BBB+/Baa1 in the base case, which is a comfortable investment grade rating consistent with licence conditions and the financial resilience measures set out in the RIIO-3 Sector Specific Methodology Decision.

There is significant uncertainty around the analytical treatment the credit rating agencies are likely to adopt in respect of accelerated cashflow in RIIIO-RIIO-3, arising from accelerated depreciation and the move to a semi-nominal WACC, however some degree of adjustment to thresholds is expected in view of precedent. For the purpose of assessing financeability, the Board has considered the credit metrics relative to: i) current thresholds, and ii) adjusted thresholds such that the impact of accelerated cashflow is neutralised (on the basis that it does not fundamentally improve credit quality). The company is considered financeable under the base case if it can achieve credit metrics commensurate with the target rating under both thresholds.

The Board recognises that Ofgem's focus is on the upcoming price control, and the Board has hence considered whether the company is financeable in RIIO-3 as necessary. However, it is not possible to delineate the RIIO-3 financeability assessment from the longer-term, particularly when considering investability. Debt and equity investors in the gas sector do not typically invest for a five-year investment horizon. The Board has therefore considered a holistic investability framework which analyses qualitative and quantitative aspects relevant to investors, including customer bill profiles and the prospect of full RAV recovery. In line with the qualifications noted above, some aspects are uncertain at this stage.

The Board considers that Ofgem's duty to ensure the company is financeable cannot be limited to RIIO-3 only, particularly given Ofgem sets the cost of capital based on a long-term investment horizon. It is not realistic for investors to retain and invest capital in the business, or the sector, if they consider the regulator has not addressed long-term structural issues and they do not believe they can earn an adequate return, recover their investment, or both.

Base case assumptions

The Board has assessed the base case under three sets of financial assumptions:

- Ofgem's base case: in line with RIIO-3 Business Plan Financial Model guidance, including the assumption of a 5.43% cost of equity, a 2.90% cost of debt, a semi-nominal WACC inflation approach and adopting accelerated depreciation based on option 2.
- Ofgem's status quo: Ofgem's base case including the RIIO2 approach to WACC (a fully real approach) and depreciation.
- Cadent's base case: as set out in our Business Plan, including a 6.30% (CPIH real) cost of equity, a 3.23% average cost of debt, (CPIH real) adopting accelerated depreciation based on option 4, and a higher dividend yield of 6%.

Under the notional structure and using Ofgem's assumptions, the Board notes that the company achieves robust credit metrics in RIIO-3, commensurate with the target credit rating of Baa1/BBB+, when assessed against current thresholds. If thresholds are adjusted as the Board expects in respect of accelerated cashflow, headroom would reduce significantly, such that there would be limited or no headroom at the target rating, which the Board considers an appropriate cross-check that Ofgem's proposed WACC is insufficient. Headroom would improve modestly under the notional structure when using Cadent's assumptions, principally driven by the higher WACC.

Under the actual structure, there is greater headroom in RIIO-3 to credit metric thresholds due to the lower actual cost of debt. However, headroom reduces significantly over time as existing debt is refinanced with new debt raised at higher current and projected market rates. The Board considers this provides additional evidence that Ofgem's proposed WACC is not sufficient.

Stress testing

The Board has considered stress testing under three approaches:

- Assessing Ofgem's prescribed downside scenarios under both Ofgem's base case and Ofgem's status quo assumptions.
- Reverse stress testing to assess the resilience to plausible combinations of totex and RoRE underperformance.

- Assessing downside scenarios developed by the company to reflect its view of plausible downside risk exposure:
  - A ‘low’ inflation scenario with 0% CPIH (with RPI-CPIH wedge unchanged from the base case), lower cost of debt and 2% RoRE underperformance (which the Board considers plausible and could be driven by a combination of factors including totex underperformance, regulatory penalties, or financing underperformance).
  - A ‘high’ inflation scenario with 8% CPIH (with RPI-CPIH wedge unchanged from the base case), higher cost of debt and 2% RoRE underperformance (which the Board considers plausible and could be driven by a combination of factors including totex underperformance, regulatory penalties, or financing underperformance).

Under the most severe scenario prescribed by Ofgem (low RoRE), credit metrics for the notional company under Ofgem’s base case assumptions would only be commensurate with a Baa3 rating, based upon adjusted thresholds to neutralise the impact of accelerated cashflow in RIIO-3. Under other, less severe scenarios, headroom to those thresholds would be very modest.

Analysis of severe, but plausible, combination downside scenarios reveals that even a relatively modest combination of totex and other RoRE underperformance would see the notional company unable to achieve the Baa1/BBB+ target rating under Ofgem’s base case assumptions. That analysis is confirmed by consideration of the downside scenarios developed by the company, which see the notional company unable to achieve the target rating.

Those conclusions remain unchanged under Ofgem’s status quo assumptions, and the Board considers that the assessment of downside scenarios reveals a lack of financial resilience in RIIO-3, inconsistent with the intent behind Ofgem’s proposed policies in that area.

Under the most extreme downside scenario, mitigations in the form of dividend restrictions were tested, but did not suitably resolve the relevant metrics and reflected a dividend yield which would be well below relevant benchmarks.

Longer-term considerations

In the context of longer-term investability, considered crucial to support financeability at RIIO-3, the Board has identified a number of concerns based on analysis undertaken:

- Assuming implementation by Ofgem of accelerated depreciation option 2 and that the Holistic Transition customer profile transpires, implied residential customer bills in later periods are very high, such that they may not be economically feasible. That could imply a material exposure of the company to demand risk.
- Absent other regulatory or policy mechanisms, if customer bills in later periods are not considered to be feasible, investors may perceive greater risk in relation to full RAV recovery, which could undermine financeability and investability. Evidence from debt markets shows that investors may already be pricing in some uncertainty in relation to long-term risk exposure.
- In the longer-term, in a scenario where RAV and customer numbers decline but totex remains relatively stable (due to the unstructured nature of customer loss and requirement to maintain and operate a safe network), the equity risk buffer (based on the allowed equity risk return) to absorb operational risk may decline.
- Taken together and formalised through the application of an investability framework considering a range of factors, the Board considers that the retention and commitment equity capital to the gas sector may be perceived unfavourably, particularly when compares to other sectors and asset classes.

We have engaged with our Board and our ISG every step of the way

The assurance plan has developed to deliver fast feedback to ensure issues can be addressed and assurance is provided as risks change. It was aligned to the overall project plan to ensure that assurance activities coincided with project milestones.

We established a reporting and governance framework to ensure that there was appropriate oversight of risks and issues and that our senior leaders and Board remained informed of emerging issues, including the challenges raised by our ISG. This is depicted in Figure 2 below.

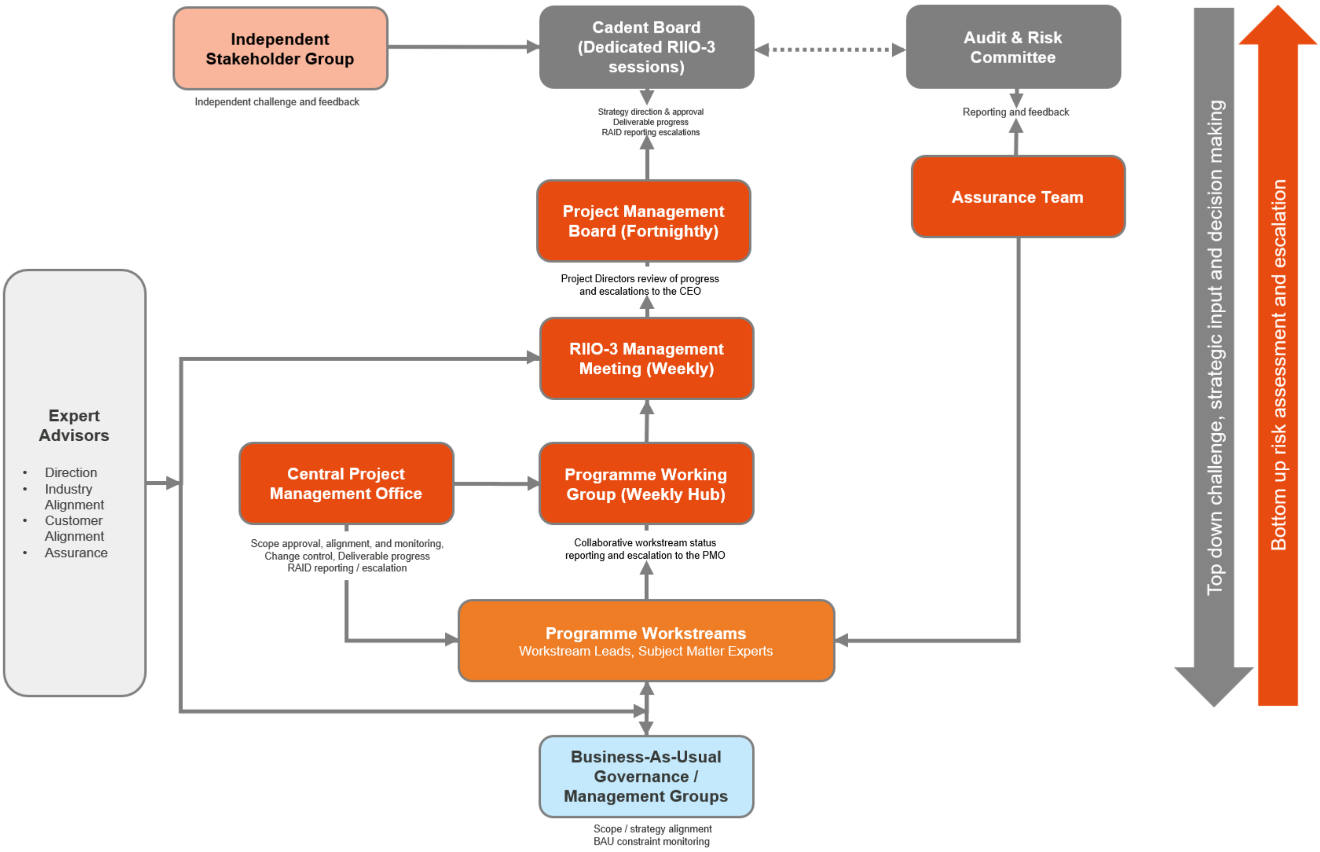

Figure 2: Reporting lines and governance framework

Our Board has been involved throughout the development of our Business Plan. The Board has:

- supported the development of our ambition and reviewed and challenged the outcomes we are seeking which align with the company's purpose of keeping people warm while protecting the planet;
- challenged our emerging thinking through workshops, dedicated reviews of key topics and Board discussions;
- reviewed and challenged costs and outputs set out in our plan;
- challenged the Executive Team to build our confidence that the Plan is stretching but deliverable;
- overseen a robust governance structure to ensure we maintained oversight of our Plan and any emerging issues in relation to our plan;
- reviewed and commented on successive drafts and the final versions of our plan;
- put in place suitable assurance processes that have supported the plan and its data; and
- had the opportunity to review the detailed reports prepared by our external assurers.

The governance framework and assurance plan were designed to ensure that the Board retained close oversight of the development of our plan and a high level of assurance over the business plan. The Board have also had visibility of the output of our assurance programme which has enabled the Board, including our Sufficiently Independent Directors, to confirm their approval of and commitment to the business plan.

The Audit Committee Chair has also played an important role on behalf of the Audit and Risk Committee and Board by receiving updates from the Head of Risk and Assurance, overseeing and reviewing the development of the assurance programme and acting as a point of escalation to the Board.

As well as input from management and external assurance teams, the Board has also received feedback from our ISG who have rigorously challenged our plan to ensure it has been appropriately developed with consideration of our customers at its heart (see Appendix 12 for further information about the work of the ISG).

Glossary

Term	Definition
BAU	Business As Usual
BPDT	Business Plan Data Tables
CBA	Cost Benefit Analysis
CPIH	Consumer Prices Index including owner occupiers' housing costs
DAG	Data Assurance Guidance
EAP	Environmental Action Plan
EJP	Engineering Justification Paper
HoD	Head of Deliverability
ISG	Independent Stakeholder Group
IT&T	Information Technology & Telecoms
MJP	Major Project Justification Paper
NARM	Network Asset Risk Metrics
PMICR	Post-Maintenance Interest Coverage Ratio
RAV	Regulated Asset Value
RoRE	Return on Regulated Equity
RRP	Regulatory Reporting Pack
RPI	Retail Price Index
WACC	Weighted Average Cost of Capital