

RIO-3 Draft Determinations

Executive Summary of our response

August 2025



Navigating our response

Cadent's response to Ofgem's RIIO-3 Draft Determinations is structured as follows.

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Ofgem Question Reference	Annex Reference	Annex Title
		No annexes referenced alongside questions in this document

About this document

This document provides an Executive summary of our response to the Draft Determinations.

To help Ofgem navigate the rest of our response, the summary of our response document provides a fuller explanation of our key proposed changes to the Draft Determinations across all the key documents. The other documents then provide our detailed response to all of the specific questions in each Draft Determination document. To support our response, we have also provided annexes with key evidence and analysis such as additional engineering information and expert consultant reports.

Executive Summary

Cadent's gas distribution networks play a critical role for the UK

The Draft Determination (DD) rightly acknowledged the importance of the gas distribution networks in providing a safe and resilient service, which underpins domestic heating and cooking; industrial and commercial businesses; and supports the power sector.

Notwithstanding this - and rightly recognising some longer-term uncertainty in the precise role of the networks - the draft RII0-3 proposals themselves fall well short of providing the necessary revenues and expenditure to deliver a safe and reliant service.

The DD proposals in their current form, are over-constraining the investment required to manage the networks in the best interests of both current and future customers - and setting unrealistic efficiency challenges. **The net result is to remove £1.7bn of totex from the robust and constrained plan that we submitted, reducing spending levels to £500m below levels seen in RII0-2.** This has echoes of the recent experience in the water industry, as highlighted by the Cunliffe review.

The DD proposals also adopt policy positions, such as on further accelerating depreciation, which we believe are not required at this stage, and will have a detrimental impact on current customers' bills. The proposed approach in this space has an upward pressure on bills of around £10 - equivalent to £1bn worth of totex. It seems incongruous to be seeking to constrain investment so much, whilst at the same time increasing bills to customers.

We need to ensure the practical reality that there will be a long-term requirement to provide gas services well beyond RII0-3 and up to and most likely beyond 2050. The imperative to consider this has been seen in other countries such as Italy, the Netherlands and Canada where the importance of the gas networks' role in the transition to net zero has been recognised and actively supported (for example in supporting the expansion of biomethane resources and options for hybrid heating solutions).

There are nevertheless some positive proposals in the DD, and we welcome the continued commitment to support customers in vulnerable situations. There is also the opportunity to enhance the DD to make a real difference in the management of leakage, expansion of biomethane production into the gas networks, and to get the most value out of gas networks in supporting strategic net zero planning.

In this summary, we set out some of the key issues arising from the DDs and what we believe needs to be done for Final Determinations which is explained further and evidenced in our detailed responses to each of the DD annexes.

Cadent is now a leading performer in the sector

We have worked relentlessly to transform our business and put customers and communities at the centre of how we operate and deliver. This could not be more important to us. We are now amongst the top network performers on customer satisfaction and continue to have

networks setting Ofgem's industry efficiency benchmark (with the corrected DD results showing two of our networks setting Ofgem's catch-up efficiency benchmark, as they also did in RIIO-2).

In addition, our track record now shows we are leading the sector's ambition and performance on supporting vulnerability, environmental action on zero emission vehicles, and innovation on advanced leakage detection. **Despite this high-performance level, our investors are not receiving their base cost of equity in RIIO-2 (i.e. we are expecting an operational return on regulatory equity (RORE) which is 90 basis points lower than the base allowed return of 5.1%),** due to the unrealistic efficiency expectations set in the RIIO-2 price control settlement, and the application of uncertainty mechanisms not fully recompensing additional costs we have incurred within the control. This is important context for how Ofgem should be assessing the framework for RIIO-3 and ensuring that the control attracts the required investment for the benefit of customers.

The DD proposes an inaccurate and unrealistic reduction to our totex

Building on this strong performance foundation, our customers and stakeholders have worked with us to set out an ambitious, but achievable plan, and we were therefore very surprised by Ofgem's initial response to it, as set out in the DD. The cost challenge proposed in the DD is unachievable and unrealistic. As stated above, the proposed £1.7bn reduction to our planned expenditure, which proposes spend over £0.5bn less than we will spend in RIIO-2 (against a backdrop of inflationary pressures over the RIIO-2 period) is neither in customers' short, nor long-term, interests.

Regrettably, some of the cost challenge proposed in the DD is as a result of a significant number of material errors, including basic computational errors (from data, arithmetic and misapplication of the stated methodology). The correction of these makes a material impact to Ofgem's assessment of the relative network efficiency rankings; the calculation of the catch-up efficiency benchmark; the allowances that then flow from that; and the outcome of Stage B of the Business Plan Incentive assessment.

These computational errors, however, only explain a relatively small proportion of the proposed totex disallowances. The additional totex disallowances reflect the adoption of a cost and workload assessment methodology that is not robust, including the proposed removal of critical workload; an unjustified lack of allowance for evidenced regional factors; and errors in the calculation of ongoing efficiency.

The combination of these computational, methodological and policy errors present us with an **unworkable and unfinanceable plan**.

In its current form, the DD **does not enable Cadent to finance the services we are delivering and need to continue to deliver for our customers, and the activities we are obligated to deliver under the licence and our statutory requirements.**

We summarise our concerns with the proposals, below:

A. Material errors have been made in the cost assessment and business plan incentive

There are material errors underpinning the cost assessment which, in a similar way to what we saw in RIIO-2, has made it difficult for us to understand the base position within the DD.

We welcome that Ofgem confirmed with us that computational errors have been made and provided us with - a corrected cost assessment; cost allowances; and business plan incentive outcomes - by fixing the majority of the errors we, and other networks raised with them by early August. This creates a more understandable picture of what the 'real' outcome of the DD's proposals is, with for example a cluster of networks including two of Cadent's networks now setting the frontier and Ofgem's catch-up efficiency benchmark. This is something we think Ofgem might reflect on in considering the fairness and proportionality of the Business Plan Incentive Stage B rewards (for RIIO-3). For example, whether all the BPI rewards should go just to the network placed first or should be spread over the three most efficient networks who set the catch-up benchmark.

By correcting computational errors, we hope this will now allow Ofgem to fully consider the matters of substance on the DD proposals and the evidence behind them.

It is vital that Ofgem does not continue to make errors in the Final Determination (FD) leaving no route to correct these other than referral to the Competition & Markets Authority (CMA). This unfortunately was where we ended up in RIIO-2 with unnecessary costs incurred on all sides of appeals to the CMA and a lack of a consistent outcome across the sector and, as a result, this was detrimental to end customers.

B. The totex disallowances are not credible to deliver a safe and reliable network and support a transition to net zero

When we developed our business plan, we gave active consideration to the need to constrain totex, to keep bills at acceptable levels. We reduced the level of totex by £0.5bn from the draft plans we submitted to Ofgem in July 2024. In several instances, we have proposed workloads which were maintained at RIIO-2 levels. A 22% reduction in totex by Ofgem on a well-evidenced, efficient plan which had already constrained investment requirements for affordability is simply not credible.

Ofgem's unjustified disallowances follow from two key factors: the rejection of key workloads and additional efficiency stretch beyond the plan. We discuss each of these briefly in turn, below.

Critical workload to meet statutory obligations and ensure a safe and resilient network needs to be included in the Final Determination

We acknowledge and welcome that Ofgem have indicated a desire for further dialogue on investment needs across network asset health, replacement and cyber and physical security resilience. It is essential, however, that critical workload to meet our safety and resilience obligations are included in the FD. For example, as well as core asset health related capital

spend, Ofgem needs to modify its position on risk-based proactive interventions on Multiple Occupancy Buildings (MOBs) (including polyethylene risers) and the Health and Safety Executive's (HSE's) expectations on gas safety service disconnections. Collectively these critical workload gaps are material with expenditure summing to over £600m. We have provided the information requested and believe that this should enable Ofgem to now include this work in the FD.

Our London network is materially discriminated against on costs and outputs

The DD proposals systematically discriminate against our London network, which make it unfinanceable as a standalone network. The DDs reject considering density factors in the totex regression modelling (that other regulators have included in their determinations). This places a significant emphasis on ensuring the pre-modelling adjustments on regional and company-specific factors are accurate and robust in the DD's proposed methodology.

Evidence which we provided in our plan for regionally differentiated costs, which are outside our control - on 'Nature of Streets' and 'Network Specific Factors' - have been disallowed when analogous evidence and claims were accepted for UKPN in RIIO-ED2 who operate a similar geography, and who based key parts of their evidence on gas network data. Such a different approach across two sectors is not defensible. In addition, our evidence on improvements to Ofgem's regional labour adjustment has not been considered properly.

Furthermore, common output targets have been set for the industry which make no allowance for the unique customer base that London serves and the large number of MOBs and complex buildings (which are not classified as MOBs) in the London area. This presents much more risk for London than other networks.

Analysis on Return on Regulatory Equity (RORE (undertaken for us by Economic Insight) suggests that London's opportunity to earn its base cost of capital is materially worse than all of our other networks and materially different from the evidence presented in Ofgem's own analysis for the sector (our analysis shows a mean expectation of 4.15% vs Ofgem's expected 6.04% against the DD proposals).

Ongoing efficiency of 1% per annum proposed is unjustified

The ongoing efficiency proposal of 1% per annum for RIIO-3 has not been justified from the evidence that has been provided and Ofgem has failed to properly consider this evidence. In doing so Ofgem makes selective use of Ofgem's own commissioned evidence to justify a higher estimate than a more balanced review would merit. This very much seems a case of 'policy-based evidence' rather than 'evidence-based policy'. Whilst by its definition the estimate of ongoing efficiency is a significant challenge, it is important that the outcome is achievable and justified from a sound and robust evidence base. This is not the case with the DD estimate, and a more realistic estimate needs to be set for the FD in line with the wealth of evidence, and the approach to the analysis in our Business Plan, that points to 0.5% per annum as being a more justified estimate. The consequences of getting this wrong are that well-performing companies will not be able to meet their allowances and hence put at risk the

confidence of investors in the sector (as we have seen in the water sector and our experience of RIIO-2).

C. There is an opportunity to further embrace the benefits of our innovation to ensure the maximum benefits to customers on supporting the transition to net zero and make a positive impact on the environment

We have led some truly pioneering innovation in advanced leakage technology in RIIO-2 that will transform the sector going forward by moving from reliance on a reactive based approach to emergency response and repair from public-reported escapes to a proactive asset intervention approach. We welcome the support in the DD for the wider rollout of advanced leakage detection and digital analytical technology. We believe, however, that Ofgem should look again at our Advanced Leakage Intervention Plan proposals. These aim to optimise the benefits of using new technology to proactively target the leakiest assets, reducing safety risk and managing a deteriorating asset health and delivering the maximum environmental benefits in a no regrets way (with all options driving a positive benefit within the economic payback for investments proposed by the DD of 11 years). Our proposals are 'justified' according to Ofgem's guidelines. We recognise that Ofgem may consider it is appropriate to reduce beneficial investments to reflect affordability concerns, nonetheless, the options and analysis we set out in our plan drive the maximum benefit to customers. We consider Ofgem should reassess the DD position on this programme. There is again resonance with the water sector here of constraining investment, which is of benefit to customers.

In addition, we have set out proposals for how the biomethane use it or lose mechanism proposed in the DD could be aligned with our proposed entry connection charging changes to facilitate the maximum amount of biomethane production and ensure a consistent approach to renewable embedded electricity generation. This is a critical aspect of ensuring the gas networks can play a leading and active role in the delivery of net zero.

We also are keen to help ensure our gas networks play an active role in supporting local area energy planning and the National Energy System Operator (NESO) in assessing regional strategic energy plans and developing engineering policy whilst supporting our customers with the transition to net zero. Our response hopefully clears up any confusion about the scope of our role and that of NESO and will enable Ofgem to support our approach as they have done previously for electricity distribution network operators (DNOs) in RIIO-ED2.

Our proposed changes will help Ofgem satisfy its net zero and growth duties by helping make a material impact on the environment and promoting indigenous industry and technology.

D. The Business Plan Incentive Stage C assessment on quality is illogical and inconsistent in how it has treated the ambition, and industry leading nature of our business plan commitments

We welcome the DD's acknowledgement of the clarity and coherence of our plan, but we believe the merely 'acceptable' assessment of the quality of the commitments of our plan is flawed and fails to reflect the clear ambition, innovation and industry leadership the plan evidently shows. We are being penalised in the assessment for putting forward innovative

plans on advanced leakage management (that elsewhere in the DD is praised as sector leading innovation) and for a lack of ambition on leakage reduction when the plans we presented had the largest potential reduction in leakage and would greatly enable the sector to move to observed leakage from modelled (a goal Ofgem has set out they would like for RIIO-4). Elsewhere in the assessment, we are also penalised for putting forward proposals supported by our customers and our Customer Challenge Group, which we are 'self-funding', (in other words, that have no impact on customer bills) and for pushing stakeholders to engage in the collaborative streetworks incentive as encouraged in Ofgem's Sector Specific Methodology Decision. Indeed, as a result of our further stakeholder engagement, Ofgem has changed its position on the incentive and now proposes to extend it to the whole of the country. The DD proposals are therefore inconsistent and not reflective of the evidence presented, and we ask that the assessment be corrected for FD to more accurately reflect the clear ambition and industry leadership we are showing.

E. The output, incentive and uncertainty mechanism proposals should be refined to better meet the needs of customers and investors

Ofgem should remove the proposal for a penalty only repair response incentive as it is based on flawed evidence on leakage benefits and is measuring something that is already monitored by the HSE. Also, as proposed, it makes no allowance for London network factors which results in discrimination (as repair times are longer due to the nature of streets and difficulty to access assets), which is acknowledged elsewhere in the control.

In addition, the proposed unplanned interruption common targets for non-MOBs make no allowance for the unique customer base in London and hence further discriminates against the London network by giving a greater risk of penalty than any other network. We suggest Ofgem revert to network-specific targets as are proposed for MOBs.

We have proposed some changes need to be made to Uncertainty Mechanism scopes to ensure no systematic underfunding on costs related to streetworks and MOBs and to ensure the intent of excluding reinforcement costs from the baseline funding.

There is significant work needed on the Network Asset Risk Metric (NARM) methodology, in advance of the FD, to ensure the rules are clear, transparent and practicable. The DD proposals in this area are not easy to understand and therefore difficult for us to provide robust commentary on.

We are also question whether the real price effect indexation proposed at DD will reflect cost driver profiles in gas distribution and have identified areas that should be reviewed.

Finally, the DD proposes to introduce a revenue forecasting penalty incentive which we do not think it justified or proportionate given that the volatile factors in revenues forecasting are all outside of our control. Introducing this incentive will add risks to networks with no gain for customers.

F. We continue to believe that there is no need to accelerate depreciation any further at this stage

Whilst we recognise that the DD proposes the most cautious of the options put forward in the Sector Specific Methodology Decision (Option 4), we still see no evidence or other justification for accelerating depreciation in RIIO-3. There is compelling evidence that there is still significant uncertainty over the speed at which gas usage may change and that there is an expectation the gas networks will continue to play an essential role up to and beyond 2050. By introducing this policy, Ofgem would be materially changing the regulatory model which investors relied upon – accelerated depreciation creates different risks; investors face the prospect of no capital growth and returns falling over time (despite retaining the risk of operating a network which will not reduce in size in proportion to the regulatory asset value (RAV), or reduction in customer numbers).

We therefore do not think that setting out a policy which signals an end date for depreciation of 2050 will support driving the most efficient financing costs for the ongoing investment required. We are also concerned that this will force a material and avoidable adverse impact on current customer bills (+£10 per annum).

G. Financial parameters need to be set correctly, and the risk of the overall control needs to be properly balanced

The DD rightly stresses the need for an investable gas sector and hence it is critical that the cost of equity and debt reflect the risks and realities of investing in the gas sector.

The RORE range in the DD does not present a ‘fair bet’

The analysis presented in the DD for the RORE range is incomplete and inaccurate. Using a more complete and balanced approach undertaken by Economic Insight, our analysis shows that the return expectation is not, as presented in the DD, a ‘fair bet’ but that the proposed control would give a mean expectation of a return of 5.35% c.0.7% lower than the proposed base cost of equity of 6.04%. The DD contains a very constrained and negatively skewed output delivery incentive range but the imbalance in the range is predominantly driven by the cost assessment methodology proposed. Hence, addressing this with our proposals (for example on regional factors and ongoing efficiency) is the key for the FD to deliver Ofgem’s intent for an even risk/reward balance on cost performance as presented in the DD. This will be critical to ensure an investable package.

The context for Cadent is that we have not been able to earn the base rate of return in RIIO-2 despite leading the sector on overall output delivery and in setting Ofgem’s catch-up efficiency benchmark (as shown in the revised efficiency rankings following the outcome of the CMA appeals for RIIO-2). Our risk analysis of the DD proposals suggests that the proposals do not create a ‘fair bet’.

Our London network is disadvantaged by the DDs

As discussed above the DD will result in a particularly difficult situation for our London network which, from the Economic Insight analysis, would face an almost certain inability to

earn its base rate of return from the DD's proposals as a standalone basis (a range of expectation of a return between 3.19% to 5.18% with a mean expectation of 4.15% is nearly 2% lower than the proposed base cost of equity).

In addition, there are some output incentives and uncertainty mechanisms that need to be corrected to avoid a repeat of problems from RIIO-2 and to not discriminate against our London network.

There are errors in how the cost of equity has been calibrated

If the imbalances in the cost assessment and output incentives are not addressed, then the risk to investors is higher than the DD methodology implies and this would drive a rationale for 'aiming up' in the range Ofgem has provided. Notwithstanding this, there are a number of other factors that would suggest the range for the cost of equity is higher than is set out in the DD. The range currently does not reflect the difference in systematic risk faced by the gas distribution sector. The systematic risk has been recognised by Ofgem in the allowed return on debt, but not within the allowed equity return. Rating agencies have also recognised that gas networks no longer sit at the lower end of the utility risk spectrum and hence gives further evidence this should be reflected in Ofgem's cost of equity assessment.

We also provide further evidence on appropriate cross checks for Ofgem to benchmark its allowed equity return as well as our view on the application of the risk-free rate, beta estimates and the total market return. All of this points to the DD proposals being below what might constitute a fair return, and we present an updated cost of equity range based on this updated underlying evidence of 6.2% to 7.4% with a revised midpoint of 6.8% which is within the range that Ofgem has said can be justified in the DD.

The notional dividend policy is inadequate

We present additional evidence supporting a higher underlying dividend yield closer, if not equal, to the cost of equity, which is more reflective of a price control package that provides no capital growth. This dividend yield should be distinctly separate from the return of capital through Ofgem's proposed acceleration of depreciation. Ofgem's current proposal to only allow the notional company to return capital when it reaches 55% gearing does not result in an efficient use of capital, effectively trapping equity.

The proposed cost of debt methodology could be refined to better align with forward looking risks in the gas distribution sector

We have provided evidence in our response as to why a 10-year trailing average of the iBoxx Utilities 10+ index provides a better match to sector debt costs, and results in a lower calibration adjustment which mitigates the risk of divergence through the RIIO-3 period. We also show how the proposed uplift for new gas issuances should be higher than has been provided to reflect real data from recent transactions and forward-looking risks into RIIO-3. We share analysis on the additional costs of borrowing which indicates the current levels of funding are insufficient.

The financeability tests approach will need to reflect the best available information on latest rating agency behaviour for the FD

Ofgem should re-perform the financeability assessment to take account of updated changes in the risk for the gas sector for the FD. As part of its proposal to introduce accelerated depreciation, Ofgem should perform a more robust long term financeability assessment and test bill affordability in future periods to ensure there are no unintended consequences to introducing this policy for future price controls.

Finally, we continue to believe the **existing financial resilience protections have worked well** in the past for the energy sector and ensure an efficient level of financial resilience, **so we do not feel any strengthening is required.**

We are keen to work with Ofgem on the process going forward to achieve the right outcome at Final Determinations

There is a considerable amount of work to do in a constrained timeframe to resolve the issues we have raised above. We welcome that Ofgem has acknowledged the data and computational errors we have identified and have reissued the resultant analysis. We must ensure a process that prevents these types of errors from being repeated at the FD. We welcome the opportunity that has been afforded to engage further on the engineering assessments and to discuss the cost assessment methodology. The outcome of these discussions is key to ensure a robust, fair and proportionate set of proposals in the FD that will deliver the critical work necessary to meet the needs of our customers and enable us to finance our activities effectively.

We believe the proposed changes to the DD we have articulated in our response would deliver these outcomes for our customers - and we are keen to offer every assistance we can to help Ofgem achieve this.