3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

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Impact of high inflation on the network price control operation

We believe that regulatory intervention is required to protect consumers' interests. The additional returns driven by high inflation are not justified and the potential scale of detriment is too large for no action to be taken. A regulated asset value (RAV) inflated by up to £3.4bn would result in consumers paying more for the full 45-year asset life, meaning consumers paying an extra amount that is a multiple of the increase in RAV.

Intervention is also required because we believe the current approach, in practice, is asymmetric in favour of the network companies and so against consumers. This is because, as outlined in the consultation, Ofgem are likely to have felt compelled to intervene had inflation fallen significantly below long-term expectations. This could be to address financeability concerns but may also result from the lobbying that would reasonably be expected from the companies. We have previously noted our concerns with the ability for regulated companies to successfully argue for additional revenue, such as with relation to the retail price cap[1]. Additionally, the scale of potential out- or under- performance is also likely to be skewed with the extent of significant outperformance (such as the recent/current period) likely to be more than significant underperformance (which would require negative inflation).

We are mindful of the importance to regulatory stability and predictability to the long-term interests of consumers. However, we do not believe that expectations of returns increased to this extent by inflation are either legitimate or reasonable. We are not convinced that the possibility of this outperformance will have been factoring into investor decisions. It is well established that, where returns are viewed as excessive and unjustified, action can be taken. Recently, for example, the government has introduced

[1] Citizens Advice: Future Fantastic pg 10 'A lobbyist's charter'

Patron HRH The Princess Royal **Chief Executive Clare Moriarty**
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the electricity generator levy[2]. So, taking action is consistent with regulatory stability and predictability as long as interventions are well designed.

We believe that a combination of all the proposed options is required and can be calibrated to deliver that well-designed intervention.

Answers to selected consultation questions are provided below.

Yours sincerely,

Andy Manning

Principal Economic Regulation Specialist

2 Electricity Generator Levy

Responses to selected questions

2. Have we adopted an appropriate approach to the quantitative assessment?

A shorter-term timeframe focusing on the RIIO-2 period is most appropriate. It is problematic to look across price control periods. Each price control is a 'reset' for which performance in the previous period provides essential context and influences arrangements for the next period. So, performance in one period can be viewed as being implicitly reflected in the next and so the periods cannot be viewed as independent.

We would note that the RIIO-1 period is now generally accepted as being generous to the companies[3]. To now use selected RIIO-1 evidence to potentially provide better outcomes for the companies would not be sensible in that context.

3. What are stakeholders' views on the policy options outlined and the associated benefits and risks associated with each option? Are there areas where the policy options outlined could be optimised?

The first option (no policy action) should be ruled out. We believe that regulatory intervention is required to protect consumers' interests. The additional returns driven by high inflation are not justified and the potential scale of detriment is too large for no action to be taken. A regulated asset value (RAV) inflated by up to £3.4bn would result in consumers paying more for the full 45-year asset life, meaning consumers paying an extra amount that is a multiple of the increase in RAV.

We support an out or underperformance true up (the fourth option). An adjustment should be made at the end of the RIIO-2 price controls to allow for licensees' actual out or underperformance. The evaluation period should be defined as RIIO-2 for the reasons given in our response to question 2.

The detrimental impact on consumers is potentially too large and too long-lasting for no action to be taken. We do not believe that taking corrective action in itself is inconsistent with, or harmful to, regulatory stability and predictability. It is well established that, where returns are viewed as excessive and unjustified, action can be taken. Recently, for example, the government has introduced the generator levy. In this case, we do not believe that expectations of returns being increased to this extent by inflation are either legitimate or reasonable. We are not convinced that the possibility of this

[3] NAO report - conclusions on value for money

outperformance will have been factoring into investor decisions. So, it appears reasonable that the increased returns under discussion are unjustified and could be excessive.

We are mindful of the importance to regulatory stability and predictability to the long-term interests of consumers. Care will need to be taken when calibrating the adjustment to ensure its extent reflects the degree to which returns earned exceed legitimate and reasonable expectations.

The second and third options are worthy of further consideration but are not sufficient by themselves as they do not address the direct issues caused by the current period of high inflation. In particular, making forward looking changes but not addressing the current situation presents a significant risk to consumers. It is possible a period of low inflation could follow the current period of high inflation. If the companies are protected from impact of low inflation, by making prospective changes, but keep the gains resulting from high inflation, the longer-term aggregate position is likely to mean consumers paying more.

The fifth option relies on the companies making voluntary commitments to share the benefits of outperformance with consumers. This would be welcome, but does not appear to involve any regulatory involvement and so, in practice, is the same as the 'no policy action' option. We expect the companies to be considering sharing the benefits of outperformance, regardless of the source of outperformance. So, this option can sit alongside and in addition to making an adjustment. If companies do choose to accelerate or increase investment full transparency is required to ensure this is properly accounted for at the next set of price controls.