RIIO-GD3 Board Assurance Statement

December 2024

1. Board Assurance Statement

Executive Summary

We, the Board of Directors of SGN, including our Sufficiently Independent Directors, confirm our collective ownership of the strategy and direction outlined in the Business Plan. We take full responsibility for ensuring that the plan is both complete and of high quality, and that its associated costs and financial package have been appropriately challenged for accuracy, ambition, efficiency, customer interest and financeability.

We have been integral to the governance surrounding the submission. Throughout the development of the plan, we have been directly involved in defining the assurance processes used to assess and verify it and have then reviewed and discussed the key findings.

The Business Plan has been shaped by extensive consultation with customers and stakeholders. During the GD2 period, this was a continuous process and for GD3 has been significantly expanded, taking a tailored engagement approach to ensure that we continue acting in the interests of society as a whole. The plan is designed to maintain the high levels of safety and reliability our customers rely on, while enhancing the overall customer experience, including through a targeted strategy to address consumer vulnerability.

We established a rigorous risk-based four-line assurance framework, utilising the expertise of specialists in key areas to review the plan, including the supporting appendices, data and tables. Experts have also been engaged to assess the financeability and investability of the plan, using a variety of methods, including stress testing, to assess its long-term sustainability and resilience.

After our thorough involvement in the planning process, the finalisation of the Business Plan, and the successful completion of the assurance programme, we confirm that, to the best of our knowledge and after conducting appropriate due diligence, we have rigorously reviewed and are satisfied that the GD3 Business Plan is complete, high quality, accurate, ambitious, efficient, and aligned with the interests of our customers.

Our assessment of the financeability of the GD3 Business Plan, based on the approach set out in Ofgem's Business Plan guidance, has shown that SGN licensees should be able to achieve an adequate investment grade rating under Ofgem's working financial assumptions under both the notional and actual capital structures and retain an investment grade credit rating in the stress tests undertaken. Our assessment highlights several risks that are outside of the licensees' control and limit our confidence in these conclusions, which include the response of the credit rating agencies to changes in Ofgem policy and the response of the investor community to a decision on heat policy anticipated in 2026.

There is some uncertainty around these conclusions due to the lack of guidance from credit rating agencies around the treatment of cash advancement in GD3 arising from the proposed introduction of accelerated depreciation and semi-nominal WACC. An assessment based on "neutralising" these cash benefits shows that the SGN licensees can still meet the licence requirement of an investment grade rating but with limited financial headroom.

The Board concludes that the SGN Business Plan is financeable and investable in GD3 assuming that an appropriate allowed return on capital is set which captures gas sector specific risks and financing costs. To this effect, we have submitted in our plan alternative estimates of the cost of equity and cost of debt.

The financeability assessment of the GD3 Business Plan should not be limited to the analysis of debt credit metrics in GD3, but also consider the implications of uncertainties around the long-term development of the sector, and how this reflects on the current investment environment. Industry stakeholders and investors are seeking stability and predictability in the regulatory framework and, in the face of growing uncertainties around the long-term viability of the sector, are already pricing in higher-risk premia in debt markets. Therefore, we have also assessed the investability of the GD3 plan and extended our analysis to consider long-term financial projections and scenarios, recognising the need to maintain appropriate investment for safety and the safe operation of the network.

The Board considers that the Business Plan may also be financeable in the longer term in the presence of a clear regulatory commitment in the GD3 determinations to full recovery of investment in the RAV and ongoing network costs over the long term; the design of a new business and regulatory model over the medium term to address issues faced by a network operator with a declining RAV and customer base; and design of recovery mechanisms for costs in relation to the disconnection and decommissioning of the gas network.

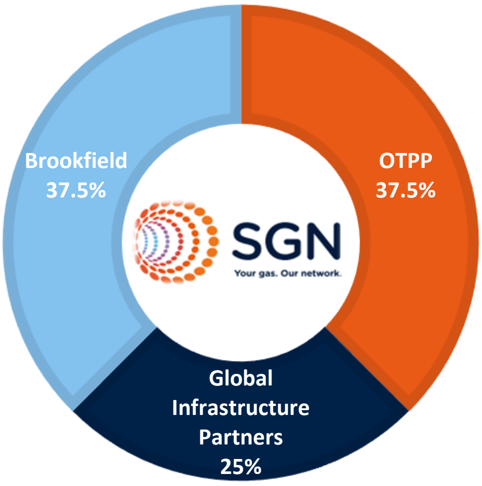
The remainder of this Board Assurance Statement provides an overview of SGN's governance structure (section 2), assurance framework (section 3), challenge and review process (sections 4 and 5), and evidence and assurance provided to us (section 6), upon which we relied to reach the above conclusions.

2. Governance

Ownership

SGN has three supportive shareholders in place. They oversee the three regulated operating companies in Scotland, southern England and Northern Ireland as well as the holding company and a number of unregulated operating companies.

Figure 1: SGN Ownership



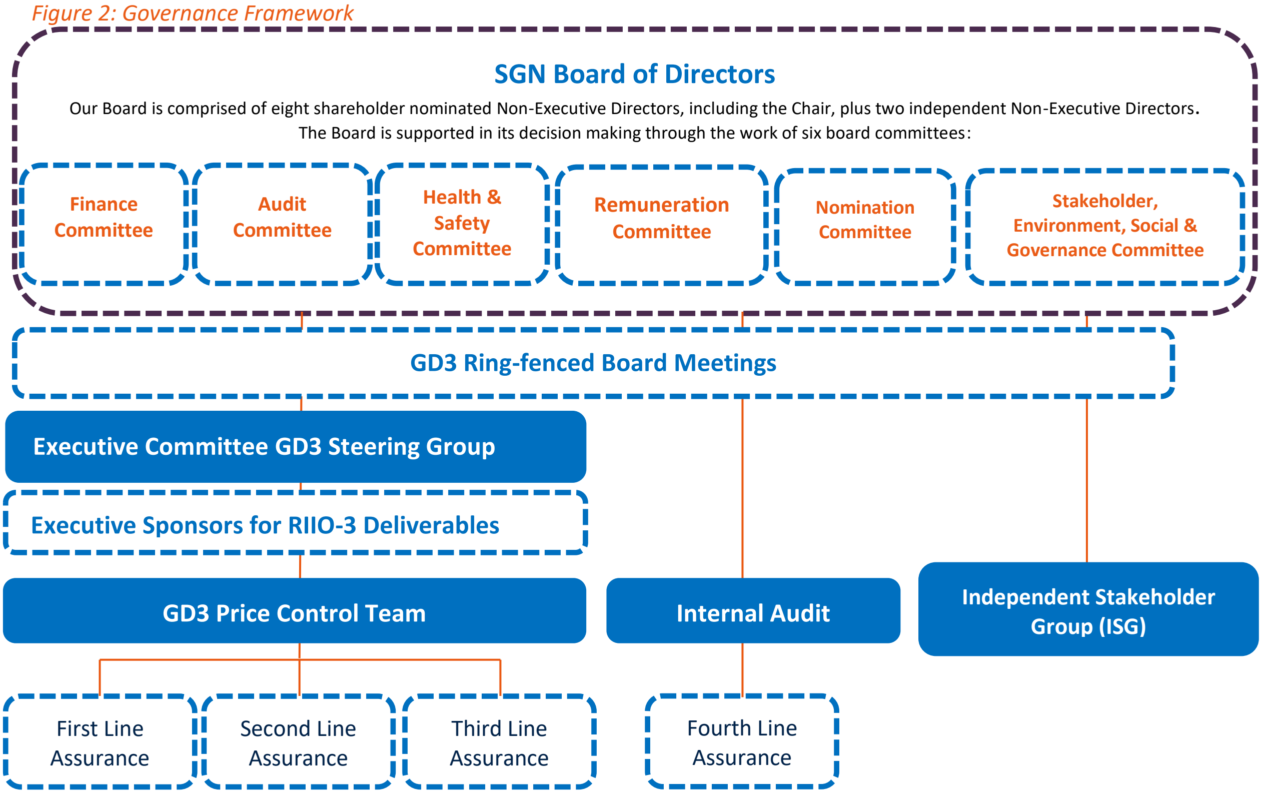
Board Composition and Governance

SGN operates in line with the Wates Corporate Governance Principles for Large Private Companies and has in place a well-established and effective set of policies and procedures that cover corporate governance, internal control, and risk management.

The Board comprises eight shareholder-nominated Non-Executive Directors, including the Chair, plus two independent Non-Executive Directors with specific oversight of the licensed operating companies, to ensure that the balance of responsibilities, accountabilities and decision making across the Group is effectively maintained. Our Independent Stakeholder Group (ISG) engages directly with the Board.

The Board is collectively responsible for the long-term success of the Group and for setting a clear purpose, vision and sustainable strategy which creates value for existing and future customers, stakeholders and shareholders.

Figure 2: Governance Framework



Additional details about our governance structure can be found on our website[1] and in our Annual Report [2].

3. Assurance Framework

Our GD3 Business Plan Assurance has been designed to provide comprehensive coverage across all our business planning activities, ensuring robust scrutiny and oversight throughout the process. An Internal Assurance team was established to review, challenge, and coordinate the assurance approach.

In line with Ofgem's Data Assurance Guidance (DAG), SGN has implemented risk-based controls to verify the accuracy and reliability of the information included in the Business Plan.

The activities carried out under this framework are fully aligned with Ofgem's Data Assurance and Business Plan Guidance, ensuring that our approach meets regulatory standards and promotes transparency. At the core of our assurance programme is the application of a four lines of Assurance model, providing a structured and systematic approach to risk management, oversight, and assurance.

At the **first line of assurance**, management was responsible for the day-to-day development of the Business Plan, ensuring it is aligned with strategic objectives, regulatory requirements, and customer interests.

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[1] SGN website
[2] SGN Annual Report 2024

We have conducted our most extensive customer and stakeholder engagement to date, using insight from more than 11,000 engagements to inform our decisions and shape our plan. Our industry-leading approach to engagement has been recognised by the Market Research Society and shortlisted in its annual awards.

Also, SGN has an existing internal Data Assurance Process for all submissions to Ofgem, which it has complied with as part of the first line assurance. This is managed within a dedicated compliance application (i-comply) where a record of all authorisations and supporting documentation are held for audit purposes. This existing Data Assurance Process is audited by our Internal Audit team on an annual basis to ensure that it is operating effectively.

The **second line of assurance** involved Executive management oversight, review, and sign-off. The Executive team played a vital role in scrutinising the development of the plan, ensuring it remained aligned with both immediate objectives and long-term strategic goals. This line also included regular reviews to assess the quality, ambition, and feasibility of the plan as it evolved.

The GD3 Price Control team played a central role in overseeing the development of the Business Plan, ensuring alignment across all departments and functions. They facilitated collaboration across teams, promoting consistency throughout the process. Additionally, the team coordinated the first, second, and third lines of assurance, ensuring all necessary reviews were conducted in line with the DAG process. They also ensured that feedback from key stakeholders, including management, the Board, and external consultants, was effectively incorporated.

The **third line of assurance** involved external experts and specialist advisors, engaged by management to provide support and assurance throughout the development of the plan. These experts reviewed key aspects of the plan, such as financeability and asset management, ensuring that the plan adheres to best practices and regulatory expectations.

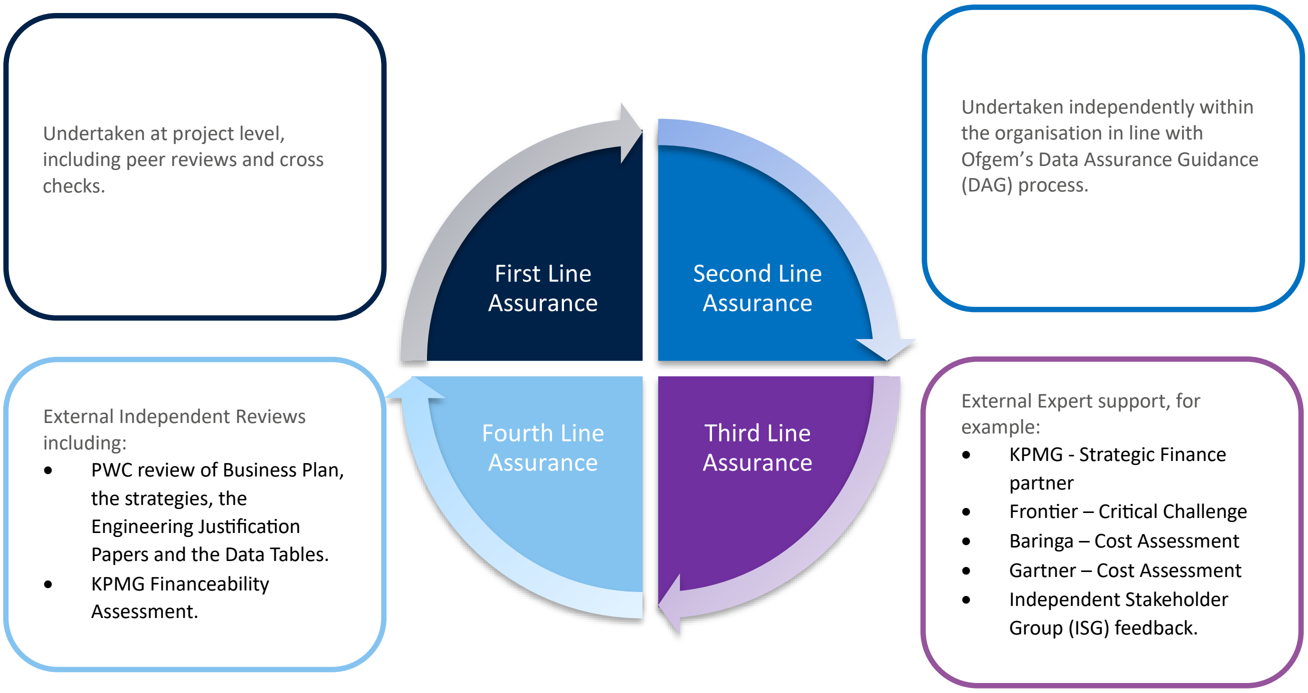
Internal Audit also conducted a review of GD2 Lessons Learned and how these have been incorporated into the development process and/or the plan itself.

Additional challenge was provided by the Independent Stakeholder Group (ISG), which assessed whether the plan accurately reflected stakeholder and customer insights gained during the consultation process. The ISG report is available to view on SGN website.

The **fourth line of assurance** was provided by independent consultants and specialists through objective reviews of the plan, considering quality, accuracy, ambition, efficiency and customer interest, focusing particularly on the higher-risk elements, as well as financeability. The purpose of the independent assurance was to provide specialist review and independent feedback; with this being used to provide us with assurance and confidence in the overall quality of the submission.

The Internal audit team coordinated the fourth line assurance to ensure independence, objectivity and transparency.

Figure 3: Assurance Framework



A comprehensive summary of the assurance activities undertaken throughout the development of the plan is attached at **Appendix 1**.

This structured, multi-layered approach to assurance ensures that the business plan is thoroughly scrutinised. Through updates from the assurance programme, the Board, including our Sufficiently Independent Directors, has been able to review the findings and, as a result, confirm their approval and commitment to the plan.

4. Assurance Approach

In developing our Business Plan, we have applied a comprehensive risk-based methodology to assurance, ensuring that we prioritise areas of highest risk while maintaining a robust and transparent approach to governance and compliance. We have also incorporated lessons learned from GD2 to strengthen our assurance processes.

The Board played an integral role in providing strategic oversight throughout the entire process ensuring that the Business Plan aligns with our long-term objectives and regulatory obligations. Regular engagement with stakeholders at all levels helped to maintain transparency ensuring that we can deliver on our commitments to the regulator and our stakeholders.

5. Board Challenge and Review

During the development of the Business Plan, the Board attended 23 dedicated GD3 Board meetings.

As part of our final review of the Business Plan, the Executive team, senior management responsible for delivery, and fourth line external assurance providers attended a dedicated assurance Board meeting, to present and discuss the work undertaken.

The review and challenge process led by the Board focused, in particular, on the following questions:

- **Is the Business Plan in the interests of customers?**
- **Is the Business Plan complete, accurate, and does it contain high-quality information?**
- **Is the Business Plan ambitious?**
- **Is the Business Plan efficient?**
- **Are the Business Plan and quality assurance processes robust? Including assurances to guarantee that investments proposed and funded by customers under GD1 or GD2, but not completed, will be delivered during GD3.**
- **Is the Business Plan financeable on a notional and actual basis, using Ofgem working assumptions?**

6. Overview of the Assurance Provided

An overview of the evidence and assurance provided in response to these questions is set out below. A comprehensive summary of the assurance activities undertaken throughout the development of the plan is attached at **Appendix 1**.

6.1 Is the Business Plan in the interests of customers?

Our Business Plan has been developed with a primary focus on safety and the interests of our customers, ensuring that our proposals represent good value for money while addressing their evolving needs and maximising customer and employee safety. This plan has been shaped by our most extensive customer and stakeholder engagement to date, drawing on insights from over 11,000 engagements. Our industry-leading approach to engagement has been recognised by the Market Research Society and shortlisted for its annual awards, reflecting the depth and quality of the consultation process.

Throughout the engagement, we have heard from a broad cross-section of our customer base, including domestic customers – many of whom are in fuel poverty – small businesses, large industrial users, future customers, and local, regional, and national stakeholders. While there are inevitably differences in views, we have carefully triangulated the feedback we received, collaborating closely with our Independent Stakeholder Group (ISG) to ensure that the final plan reflects a balanced approach that meets the diverse needs of our customer base. Chapter 2 of our Business Plan provides additional details on how we engaged with customers and stakeholders.

We have started to share our research and engagement reports on an external website sgnengage.co.uk

Our plan reflects our customer priorities which are closely aligned with the four key outcomes identified by our regulator Ofgem. The commitments we have made reflect our customers' expectations and are ambitious in the areas that are most important to them:

- High-quality service from regulated firms;
- Secure and resilient supplies;
- Infrastructure fit for a low-cost transition to net zero; and
- System efficiency and long-term value for money.

Further details on our customer-focused approach can be found in Chapter 3 of the Business Plan.

We have set out how we will meet our safety requirements and how we have balanced a complex set of trade-offs, including stakeholder and customer expectations, different investment options, and affordability. We have rigorously evaluated these factors to ensure that each investment decision delivers maximum benefit for our customers while maintaining long-term sustainability. More details on the investment decision-making process are outlined in Chapter 7 of the Business Plan.

ISG feedback: "A huge amount of work has been done through 23/24 on the consumer engagement and we welcome the transparency of the SGN team and their readiness to take on board our feedback."

6.2 Is the Business Plan complete, accurate and does it contain high-quality information?

Our Business Plan is complete, accurate and contains high-quality information that meets the expectations of our stakeholders, and the regulatory requirements set by Ofgem. The plan has been developed through a rigorous internal process, with contributions from across the business to ensure that all data, assumptions, and projections are robust and aligned with the needs of our customers.

The planning and drafting of the Business Plan were overseen by a dedicated GD3 Price Control Team, which ensured continuous alignment with Ofgem's Business Plan Guidance (BPG). Cost estimates were developed with the assistance of third-party experts to verify their accuracy.

In developing the Business Plan, we have prioritised clarity and transparency, presenting complex information in a straightforward and accessible way. Our commitments are clearly defined, providing stakeholders with a clear understanding of the rationale behind our decisions.

The plan focuses on key outcomes, ensuring that the information is concise, comprehensive, and easy to follow. It reflects our commitment to transparency, customer-centric decision-making, and regulatory compliance, while delivering information that aligns with the expectations of our customers and stakeholders.

The preparation of the Business Plan was governed by the DAG (Data Assurance Guidance) process, with subject matter experts preparing papers in line with documented methodology statements. These were reviewed and signed off by management, and all completed submissions were approved by the responsible Executive Sponsors, ensuring a thorough and consistent review process.

An independent review of papers was then conducted following a risk-based approach, including Engineering Justification Papers (EJPs), Cost Benefit Analysis (CBAs), Appendices and the Business Plan to ensure that information had been accurately translated from the technical papers to the Appendices, through to the Business Plan and that there are no inconsistencies between papers.

All Business Plan Data Tables were risk assessed by external consultants (PwC). A total of 82 tables were identified as high priority and independently reviewed by the consultancy in two stages. The initial stage focused on assessing the processes used to complete the tables and ensuring compliance with Ofgem requirements, with the goal of identifying potential areas for improvement ahead of the second stage. The second stage involved verifying the accuracy of the data within the tables and evaluating whether the accompanying commentary met Ofgem's reporting requirements and definitions.

6.3 Is the Business Plan ambitious?

Safety, reliability, and resilience are at the heart of our plan. We have prioritised these elements to ensure our network remains capable of delivering the essential services our customers rely on. We are committed to minimising disruption, ensuring operational continuity, and providing a network that can withstand future challenges.

In areas that matter most to our customers, we are setting more ambitious goals to meet their expectations and deliver meaningful outcomes.

We are committed to ensuring that all our investments generate tangible value for our customers and contribute to greater social value for the communities we serve, while addressing their long-term energy needs in a sustainable and affordable way.

This Business Plan outlines our strategic vision for the future of our network. We have taken a balanced approach, ensuring that our proposals adapt to the evolving energy landscape, while prioritising the safety, resilience, and reliability of our infrastructure.

We have set out an ambitious plan for GD3, focusing our delivery on the areas that will have the greatest impact on the transition to net zero. This includes the early adoption of low-carbon technologies and addressing key sectors of the economy – such as industrial and commercial consumers – to support a just transition to net zero. Over the course of GD3, we will significantly increase access to green gas, accelerating decarbonisation and enabling our customers to access sustainable energy solutions.

Our commitments are supported by robust delivery plans, with funding secured through the allowances requested in our GD3 plan. Detailed information on how we will implement these commitments is provided in Chapters 4 to 7 of the Business Plan and our supporting strategy documents.

6.4 Is the Business Plan efficient?

Our priority for GD3 is the efficient operation of a safe and reliable gas network and this is what our customers expect. We have committed to being ranked in the top three for efficiency for both our networks, in a well-calibrated cost assessment that reflects the efficient costs of working in our network areas. We will deliver more than £89m of operational savings through core innovation across GD3.

Through GD2 we have conducted both internal assessments and engaged external consultancy support to embed a programme of process improvements to help counter the cost pressures we have experienced in GD2 and ensure that we are entering GD3 as efficiently as possible.

We have set out how we will meet our safety requirements and how we have balanced a complex set of trade-offs, including stakeholder and customer expectations, different investment options, and affordability. We are confident that it provides value for money for our customers.

More detailed information on our efficiency strategy and cost assessments can be found in SGN-GD3-BP-00 Business Plan, Chapter 7 and Chapter 9 and SGN-GD3-SD-08: Cost Assessment and Benchmarking.

6.5 Are the Business Plan and quality assurance processes robust?

Our Business Plan has undergone a comprehensive and rigorous review process to ensure its robustness. Extensive internal challenge from the Executive team was paired with external independent assurance to ensure that our commitments are realistic and aligned with our strategic goals.

Business teams were specifically challenged to set realistic targets and assess potential risks that could impact the plan's deliverability. They also worked collaboratively across departments to ensure that each element was feasible at the operational level.

The GD3 Business Plan does not include proposals for any investments that were already funded by customers under GD1 or GD2.

Furthermore, the plan underwent a four-line assurance process, incorporating internal reviews, expert consultations, and external validations from experts like PwC, KPMG and Gartner.

Our Assurance Framework gives us confidence that all points raised by the Independent Stakeholder Group (ISG), and all the feedback received from the independent external consultants were recorded, considered and, where appropriate, amendments made to the Business Plan.

While the Business Plan has been thoroughly scrutinised, we will continue to monitor its progress, incorporating feedback from stakeholders and adjusting for any unforeseen challenges.

6.6 Is the Business Plan financeable on a notional and actual basis, using Ofgem working assumptions?

The determinations for the GD3 price controls are coming at a time of unprecedented uncertainty for the regulated gas industry, as the government considers the long-term strategy for the decarbonisation of the UK economy. The government is expected to issue its strategic decision on the role of hydrogen for heat in 2026, which will have a significant impact on the future role of gas networks.

Under a number of decarbonisation scenarios reflected in the 2024 Future Energy Scenario (FES), gas networks will face a decline in customer numbers in the upcoming decades, ceasing operations and being decommissioned at the end of the transition to net zero targeted for 2050. At the same time, recent trends in the decarbonisation of the heat sector highlight a slow uptake of low-carbon technologies. This level of uncertainty is unprecedented across UK regulated industries.

Notwithstanding this, a significant programme of capital expenditure and ongoing operational costs will need to be funded to maintain a safe and reliable network across all decarbonisation scenarios.

In this context, we consider that the GD3 decision will have consequential effects on the long-term viability of the regulatory framework, and we recognise that Ofgem is faced with the significant challenge of designing a regulatory framework fit for purpose to deal with very different potential outcomes and material long-term challenges. Industry stakeholders and investors are seeking stability and predictability in the regulatory framework, in the face of growing uncertainties around the long-term viability of the sector. These are already creating a cost to UK energy consumers, as for example investors are pricing higher sector risk premia in debt markets.

A robust approach to the financeability assessment of the GD3 Business Plan also needs to consider the present context of uncertainty and how this reflects on the investment environment. Issues around sector investability, bill affordability, RAV and cost recovery in the long term are central considerations of current investment decisions in the gas sector. As such, we have incorporated these into our Board assurance process as key aspects of our financeability assessment of the plan.

Financeability assessment

The Board has undertaken an assurance process in relation to the Business Plan in compliance with Ofgem's Business Plan guidance, which has involved an assessment of financeability for the Business Plan in GD3 under Ofgem's Sector Specific Methodology Decision (SSMD) working financial assumptions. The assessment has primarily focussed on whether the SGN licensees are able to finance the Business Plan at strong investment grade credit rating under the notional and actual capital structures and retain an investment grade credit rating under Ofgem's working assumptions.

Furthermore, as outlined in section 2 of the Finance Annex, the financeability assessment set out by Ofgem in its guidance has been refined and enhanced taking into account:

- Extension of the assessment horizon beyond GD3, to provide necessary insight into potential financeability challenges that GDNs may face across the next 10-15 years, and which need to be considered as part of today's decision-making.
- Additional downside scenarios on Totex and debt financing performance, to capture the most material risks for SGN in GD3, and different pathways to net zero in relation to customer numbers.
- Potential evolution of credit rating agencies' views, in particular around the impact on rating assessment from semi-nominal WACC and accelerated depreciation and their assessment of the stable and predictable regulatory environment for gas networks.
- Equity investability tests, to assess whether the equity return proposed by Ofgem is competitive when compared to other opportunities to deploy capital, such as lower risk debt markets.
- Suitability of Ofgem's notional company assumptions in light of GD2 experience.

The assessment of credit metrics, under the current rating guidance, in GD3 has shown that the SGN licensees should be able to achieve an adequate investment grade rating under Ofgem's working assumptions under both the notional and actual capital structures. The SGN licensees should also be able to retain investment grade status in the stress tests undertaken and therefore meet the related licence requirement. This result is also obtained under the application of revised credit metrics thresholds as a sensitivity to test for potential future revisions to credit metrics thresholds that may (in part or in full) "neutralise" the short-term cash flow benefits arising from Ofgem's policy changes on semi-nominal WACC and accelerated depreciation.

However, although debt credit metrics in GD3 are within the set targets, underlying dividend yields (excluding accelerated return on capital) achieved by the notional and actual companies under Ofgem's working assumptions are well below the SGN assessment of the appropriate cost of equity for GD3. This provides a reasonable benchmark for the required yield on an investment with no material growth prospects. This pressure on projected cashflows prevents consideration of alternative capital structures such as lower gearing to address the financeability challenges identified.

In addition to the GD3 financeability assessment carried out in line with Ofgem's guidance, we have conducted a long-term assessment focussed on the analysis of financial metrics beyond GD3 and on the affordability of domestic bills required to recover RAV and ongoing costs under the Ofgem working assumptions, in the context of a declining customer base. As set out in Section 2 of the Finance Annex, the following medium to long-term challenges have emerged:

- There is a risk that, as the RAV falls to low levels in the 2040s against a broadly stable level of Totex, the equity risk buffer will be insufficient to compensate for the scale of Totex risk faced by the company.
- As the gas network customer numbers decline significantly along the decarbonisation pathway, bills will raise to unaffordable levels such that RAV and ongoing costs cannot be recovered from network charges.
- Under scenarios where customer numbers fall significantly, network charges may not be sufficient to cover operating costs. Even with a significant reduction in the current customer base, the company will still be required to operate the full network and therefore need to maintain Totex to operate the system.
- It should be noted that the analysis of cost and RAV recovery has not included network disconnection and decommissioning costs, which are material, and Ofgem has indicated are likely to need government intervention (e.g. for a recovery mechanism spread over all energy consumers).

Finally, investability tests are conducted to verify whether the assumed cost of equity provides an adequate balance between risk and return for equity investors in the gas distribution (GD) sector and is competitive with respect to alternative investment options. In the round, Ofgem's cost of equity working assumption (estimated using the Capital Asset Pricing Model (CAPM)) does not appear to provide an appropriate balance of risk and return for the GD sector. It is not considered investable, as its constituent CAPM parameters are estimated largely on the basis of GD2 methodologies and do not appear to reflect gas sector specific risk on a forward-looking basis, and it is not supported by alternative estimation models used as "cross-checks". Moreover, it does not provide sufficient headroom for equity investors to maintain a strong investment grade credit rating in downside scenarios.

Financeability Board Assurance Statement

Overall, the Board considers that the financeability assessment demonstrates that the SGN licensees can achieve adequate investment grade credit metrics in GD3 under the Ofgem working assumptions and maintain investment grade rating in the stress tests under both the notional and the actual capital structure, although with very limited headroom against credit metrics adjusted for cash flows arising from accelerated depreciation and semi-nominal WACC. On this basis, the Board can provide assurance that the Business Plan should be financeable at Ofgem's financial assumptions under the notional and actual capital structures, under the approach to financeability outlined in Ofgem's Business Plan guidance.

However, the Board retains significant concerns over the financeability and investability of the sector over the longer term, which need to be considered as part of the GD3 financeability assessment.

In particular, the Board considers that the methodology set out in the SSMD does not currently provide confidence on the recovery of the RAV and ongoing network costs over the long term. While Ofgem suggests that the decision to introduce accelerated depreciation (AD) will enable full recovery of the RAV in the long term, the Board considers that, on the basis of the analysis and evidence presented in the Finance chapter, AD on its own cannot provide that confidence on cost recovery, if the network customer base reduces significantly and to zero by 2050. In this scenario, RAV and wider cost recovery will ultimately rely on customer bills rising to unaffordable levels and as a result cannot be relied on with any certainty, without additional policy changes such as sharing the costs of energy transition with all energy users.

The Board considers that the longer-term financeability of the framework has in turn implications for the financeability of the shorter-term GD3 period, as both debt and equity investors will consider the long-term financeability of the company a critical consideration in relation to their investment in GD3. As such, investors will only be willing to commit capital in the GD3 period when they possess legitimate expectations that they will be able to earn an adequate remuneration over their full investment horizon, which will be well beyond the confines of GD3.

Our analysis shows that with Ofgem's SSMD assumptions the Business Plan would meet credit metric thresholds in GD3 and consequently the financeability criteria under the SSMD guidance. It may be financeable and investable in the long-term in the presence of a clear regulatory commitment to developing mechanisms providing for affordable bills, RAV and ongoing cost recovery in the long term. Crucially, appropriate conclusions for both the GD3 period and the long-term horizon are essential for Ofgem to appropriately discharge its duties in relation to current and future consumers, including vulnerable consumers.

Notwithstanding the interrelations between long-term financeability and investability considerations, and an assessment of financeability and investability for the GD3 period, the Board considers that the Business Plan is financeable and investable in GD3 on a standalone basis if the following measures are implemented in the GD3 determinations:

- The allowed return on capital needs to capture, among other important factors, sector-specific risks and financing costs. The Board recognises that Ofgem is considering some changes to its cost of equity methodology at the Draft Determinations to better reflect gas sector risk in its assessment. However, Ofgem is not considering at this stage to set a gas sector specific cost of equity and as a result the SSMD working assumptions do not sufficiently remunerate the risks faced by equity investors in the gas sector. We have submitted in our plan an alternative estimate of at least 6.7%, with an upper range of 7.4% for allowed return on equity (as opposed to the SSMD's 5.4% midpoint), which is based on an assessment of CAPM parameters, including sector risk exposure and cross-checks with alternative estimation approaches. A cost of equity in the upper range needs to remain an option if the final determination does not address asymmetric risks identified in our plan.
- It is critical that the sector is fully remunerated for all efficient debt costs a GDN is expected to bear, which necessitates that the allowed return on debt considers gas-sector specific trends on the cost of new issuances. These trends include increases in GDN debt spreads

which are likely to expand through GD3. To facilitate recovery of efficient costs, the cost of debt funding mechanism should have uncertainty measures in place to ensure that all efficiently incurred gas premia are fully funded. In parallel, the appropriateness of the iBoxx Utilities index used to calibrate ex-ante allowances should be reviewed.

The cost of debt must also include an allowance for appropriate additional borrowing costs of 43-58bps, as opposed to SSMD's 25bps, to reflect recent market evidence, with a small company premium for Scotland (10-14bps).

The Board recognises the need to maintain appropriate investment for safety and the safe operation of the network in the longer term and considers that the Business Plan may be financeable and investable over the longer term in presence of a clear regulatory commitment to address the following concerns:

- The development of new regulatory mechanisms is needed to ensure that, in a scenario of declining customer base, bills are maintained to affordable levels and investment in the RAV and ongoing Totex is fully recovered in the long term;
- Notwithstanding that AD on its own cannot provide the necessary confidence on long-term sustainability of bills and RAV recovery, an accelerated depreciation policy represents part (but not all) of the solution. There is an urgent requirement to have assurance that RAV and ongoing Totex costs will be recoverable, and to set out the principles for a sustainable regulatory structure;
- Ofgem needs to link depreciation of the regulated assets with the actual customer base of the gas distribution network, to avoid locking in a depreciation policy that would not be appropriate if the expected customer switching does not materialise and therefore limit potentially unnecessary short-term increase in cost to consumers from front-loading of RAV recovery;
- A commitment to the design of an alternative business and regulatory model over the medium to long term needs to be clearly signalled with the principles established as a part of the GD3 final determinations. Such wider reform is needed to address potential funding and financeability issues which could arise from a network with a declining customer base. This is particularly the case where under some scenarios network charges may not be sufficient to cover company operating costs; and
- This new model should also envisage funding mechanisms outside the GD3 framework for grid user disconnection costs, that cannot be sustainably recovered from a declining customer base, and network decommissioning when no customers remain.

We consider that potential solutions for these long-term issues could consist of mechanisms such as sharing the costs of energy transition (including user disconnection and network decommissioning costs) with all energy users. We consider that such measures would require government decisions and are therefore ultra vires for Ofgem at this stage, and would necessitate collaboration between Ofgem, DESNEZ and the Treasury.

Stress test analysis on Ofgem's working assumptions has been conducted on the notional and actual structures to identify key downside risks and proposed mitigating actions. Key risks which emerged from the analysis are underperformance on Totex, in particular for the Southern network, and cost of debt. We also considered that performance on incentives is not a key risk in the gas sector and therefore we have not attached significant weight to the stress test analysis of the RoRE sensitivity on incentives proposed by Ofgem. Proposed mitigations (in addition to an adequate level of allowed return) are a sharing factor appropriate to protect investors from uncontrollable Totex risk, together with the implementation of a transformation programme at Southern.

In relation to the actual structure, de-gearing is not considered an effective measure to reduce interest costs in GD3 and is not necessary as a gearing level at around 65% is supportive of an investment grade rating and not excessive compared with the 60% notional level. An increase in the proportion of inflation-linked debt or use of derivatives at the actual structure has also been excluded, as the current ILD share is broadly in line with the notional 30% (slightly above taking into account actual company gearing) and credit rating agencies are likely to increase focus on nominal interest cover ratios in the future.

The Board considers that the GD3 decision will have consequential effects on the long-term viability of the regulatory framework. As such the Board concludes that the Business Plan may be financeable and investable on a long-term basis, provided that its concerns are addressed and having taken into consideration the current highly uncertain environment. In particular:

- The development of Ofgem's detailed regulatory policy for GD3 is at a relatively early stage in a number of areas. Ofgem has signalled in the SSMD several methodological changes that it may introduce at Draft Determinations (for example, on the assessment of asset beta and investability testing) but these are not reflected precisely in its SSMD "early view" financial assumptions. We are putting forward alternative assumptions on the basis of Ofgem's indicated 'minded-to' position and on the balance of the available evidence;
- Credit rating agencies are yet to clarify the treatment of short-term cash flow benefits from the semi-nominal WACC and accelerated depreciation. Therefore, our financeability assessment has considered current target metrics but also, as a sensitivity, alternative, more stretching target metrics "neutralising" the impact of semi-nominal WACC and accelerated depreciation changes. As a conservative approach, the financeability analysis has assessed whether the notional and actual companies can pass the higher hurdle provided by the "neutralised" thresholds;
- Equity remuneration solely through a return on the RAV may not be appropriate in the longer term, as the asset base declines compared to more stable network operational and maintenance costs. With reduced financial headroom to absorb negative cost shocks, equity investors face increasing risks of not recovering the allowed return and therefore changes to the funding framework, such as pass-through of efficient costs and/or additional remuneration outside of the RAV, may be appropriate in the longer term;
- The gas sector is facing inherent medium to long-term uncertainties in relation to the decarbonisation pathway of the UK economy and the associated evolution of the gas network customer base. These also relate to strategic policy decisions, such as the awaited 2026 Government heat decision, that are expected to drive the future role of the gas network, the transition to net zero and hence investors' assessment of sector risk exposure. With lack of clarity on the gas sector's pathway and evolution of its customer base, there is a degree of uncertainty on the sustainability of unit charges needed to maintain a safe and reliable network, which will continue to be needed for decades to come but could not be reasonably recovered from a reduced number of customers;

  This uncertainty could increase costs to customers. For example, debt markets are already factoring in higher risk to gas network, as evidenced by an increase in spreads over and above the benchmark index and could result in a long-term increase in borrowing costs, shorter debt maturities and reduced access to the debt markets, and ultimately higher costs to consumers. The current regulatory framework assumes long term tenor at issue (10-14 years); however, this could introduce a mismatch if gas networks need to issue shorter debt in the context of AD. We have considered long-term dynamics, Totex and RAV recovery issues in relation to the viability of current debt and equity investment decisions; and

- Further uncertainties relate to funding of network disconnection costs and decommissioning costs as the energy system transitions away from gas consumption. Customer disconnection costs could not be sustainably recovered from a declining customer base, necessitating a funding mechanism outside of the RIIO framework. The expected costs for decommissioning the gas network (when no customers remain) are unprecedented and the sector needs clarity on how these would be recovered. Investors need assurance from the GD3 decision that they can confide in a stable and predictable regulatory environment, and they will not be adversely impacted by the recovery of these very material costs over the longer term. Ongoing uncertainties are likely to further increase sector risks and incentivise the current trend of shortening debt maturities and higher financing costs, and ultimately increase cost to consumers.

7. Signatories

After due and careful consideration, taking account of all of the above, we passed a resolution at our Board meeting on 5 December 2024 to approve our Business Plan and its submission to Ofgem.

Sufficiently Independent Directors

Signed by: Joanna Whittington

Signed by:
7E0A72623D91496...

Date 08-12-24 | 5:39 PM GMT

Signed by: Paul Jeffery

Signed by:
D7D150876EF041F...

Date 09-12-24 | 6:05 AM GMT

Board of Directors

Signed by: Rebecca Lumlock

Signed by:
2144166FECE4429...

Date 09-12-24 | 11:49 AM GMT

Signed by: Michael Botha

DocuSigned by:
D26F8751F56C4BF...

Date 06-12-24 | 2:14 PM EST

Signed by: Jeff Rosenthal

DocuSigned by:
66F30F3B2D914E2...

Date 06-12-24 | 10:24 AM PST

Signed by: Charlotte Brunning

Signed by:
Charlotte Brunning
ABAEB9A1853B423...

Date 06-12-24 | 4:38 PM GMT

Signed by: Nick Salmon

Signed by:
Nick Salmon
B044CB5BCEE1453...

Date 06-12-24 | 6:07 PM GMT

Signed by: Martin Catchpole

DocuSigned by:
EFECB33F06C44D6...

Date 07-12-24 | 1:03 PM GMT

Signed by: Paul Trimmer

DocuSigned by:
5751CFD4EFA645A...

Date 06-12-24 | 7:11 PM GMT

Signed by: Michael Smart

DocuSigned by:
EE26BA1B3921401...

Date 06-12-24 | 8:39 AM PST

Senior Management Team

Signed by: Simon Kilonback
(CEO)

DocuSigned by:
6876EE8E523D427...

Date 06-12-24 | 3:22 PM GMT

Signed by: Nicola Shand
(Company Secretary)

DocuSigned by:
812D87E00D78491...

Date 09-12-24 | 4:59 AM PST

Signed by: Darren Elsom
(Chief Operating Officer)

Signed by:
0B8BB7958F07442...

Date 06-12-24 | 3:46 PM GMT

Appendix 1 - Summary of assurance activities undertaken throughout the development of the plan

The Business Plan, Business Plan Data Tables (BPDTs), the Strategies (Appendices) and associated Engineering Justification Papers (EJPs) have all been subject to a consistent First Line and Second Line assurance process in line with Ofgem's Data Assurance Guidance (DAG).

First Line Assurance	Second Line Assurance
- Use of internal subject matter experts. - Workshops. - Peer reviews and cross validations.	- Senior Management review and sign-off. - Executive Sponsor review and sign-off - Executive Committee review and sign-off on 3 December 2024.

The Business Plan was rigorously reviewed at multiple stages throughout the development process, with feedback being systematically incorporated at each stage. In addition to the first and second line assurance, a comprehensive third and fourth-line assurance process was conducted to ensure the accuracy and robustness of the plan. The table below outlines the detailed assurance activities performed:

Third Line assurance provider	Scope of activity
BRG	Strategic advisor
Independent Stakeholder Group (ISG)	Review and challenge
Fourth Line assurance provider	**Scope of activity**
Linklaters	Legal advice
PwC	Review against Ofgem's minimum requirements, plus quality of the documents, using Ofgem's assurance requirements to guide the review (Customer Interest, Accuracy, Ambition, Efficiency and Robustness)

BPDTs, Appendices and associated EJPs have all been subject to a robust third and fourth line process as follows:

Third Line assurance provider	Scope of activity
Aqua Consultants	Review of Network EJPs
Baringa	Cost Assessment
Bearing Point	Emergency and repair volumes
BRG	Support in the development of the strategy
Deecon	Cost Assessment
Deecon	Repex

Deloitte	Cost Assessment
DNV	Scenario analysis and impact assessment, volume of workload, assessment of network condition and failure forecasting
EMCOR UK	Asset health and condition model
EU Skills	Future of workforce
Frontier	Critical challenge and feedback
Gartner	IT investments assurance
GEP	Procurement
Guidehouse	Cost benefit analysis
Hydrock	Climate resilience risk assessments and mitigation strategies
InCon	Integrity assessment
Independent Stakeholder Group (ISG)	Review and challenge
Jacobs	Feasibility studies
Jigsaw	Deliberative customer research programme
Kelton	Metering
KPMG	Strategic finance partner
LEK	Workforce
Macegreen Consulting	Cost Assessment
MCKJ LTD	Redaction and writing
MJM	Repex
PIE	Review of needs case
PM Group	Feasibility studies
WSP	Feasibility Study and Conceptual Design

Fourth Line assurance provider	Scope of activity
KPMG *(independent team)*	Financeability and investability assessment
KPMG *(independent team)*	Risk analysis
Linklaters	Legal advice
PwC	Reviewed the Business Plan, Annexes and EJPs against Ofgem's minimum requirements, plus quality of the documents, using Ofgem's assurance requirements to guide the review (Customer Interest, Accuracy, Ambition, Efficiency and Robustness). Undertook an independent assessment of the Business Plan Data Tables (BPDT).