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Dear Martin,

## Financing Networks

SSE are pleased to provide a response to the joint Ofgem/Ofwat paper on financing networks. Our detailed responses to each of the questions raised in the discussion paper are attached as an appendix. However, as discussed at the recent industry seminar, we believe that the primary issue in ensuring that network businesses are adequately financed is ensuring that the cost of capital is set correctly. We are strongly of the view that provided the cost of capital is set at an appropriate level network businesses will be able to finance their operations, from either debt or equity as they see fit.

In our view, provided the allowed cost of capital is set correctly to allow returns for efficient companies i.e. in the range of 5.5% to 6% post-tax real including scope for out-performance, then there would be sufficient debt and equity investment available to the network businesses. However, getting the WACC right means not only estimating the cost of debt and the cost of equity, but also ensuring the level of gearing is appropriate. If the gearing assumptions are set too high then there is a risk that businesses would be over leveraged and we believe gearing assumptions in the range of 55% to 60% are appropriate in setting the cost of capital.

We believe that the stability of the regulatory regime for network businesses over the last 15 years has enabled significant improvements in efficiency and in quality of service to customers. This stability has come about because there have been no 'regulatory shocks' in the level of the cost of capital or in how the RAV is determined.

We are therefore very concerned about the concept outlined in the consultation paper of a split cost of capital, with debt financing on past investment and a premium return on the equity funding of future investments. In particular, the implied lower returns on past investments would, in our view, undermine the credibility and stability in the RAV that has been built up over the last 15 years. As a consequence, a premium would be applied to the allowed return on new investments to reflect the increase in perceived regulatory risk. Furthermore, a split cost of capital would reduce the financial flexibility of the network businesses, as they would be more restricted in the choice between different types of finance when raising new capital.

On this theme, we do not believe that regulators should be interfering with the funding decisions for network businesses. The appropriateness of index-linked debt as an option for financing business activities should be left to business managers. This also applies to the dividend policy within the constraints of existing financial ring-fencing arrangements.

We also believe that if the allowed cost of capital is set at the appropriate level to encourage equity investment, then in most circumstances any short-term cashflow issues should be capable of being addressed by flexing depreciation.

In summary, we believe that the existing regime works and has provided a stable regulatory environment over the last 15 years. We see significant practical issues with the proposal to split the cost of capital. We remain firmly convinced that as long as the cost of capital is set at the right level and the regulatory environment is transparent, then network businesses will be able to adequately finance their operations.

If you have any queries on any of the responses provided in this letter, please do not hesitate to contact me.

Yours sincerely,

Rob McDonald
**Director of Regulation**

## SSE Response to Ofwat/Ofgem Questions

***Key issue for discussion (1).*** **Should financial ring fencing arrangements be extended to cover all monopoly businesses and modified so that they all include cash lock-up provisions? How might the introduction of cash lock-up provisions affect existing financial structures including holding company debt? Are the current ring-fencing provisions sufficient to allow the activities of the licensed undertaker to be fully separated from other group entities? If not, what additional ring fencing provisions might be appropriate and what might be the costs and benefits of these?**

***SSE Response:*** In our view, the existing financial ring-fencing arrangements for the electricity sector, including cash lock-up provisions, are sufficient to allow the undertakings of the licensee to be separated from other group entities. The transfer of Midlands Electricity from Aquila to Central Networks proved the robustness of the financial ring-fencing arrangements. Since DPCR4 they have been strengthened further.

The introduction of similar financial ring-fencing arrangements in the DN gas transporter licences, upon their sale, provides the same assurance in the gas sector.

***Key issue for discussion (2).*** **Would the separation of past and future capital investment improve the incentives for investment, lower the overall risk of regulated businesses and reduce the cost of finance? Are there any practical implications if such an approach was adopted?**

***SSE Response:*** The consultation paper rightly identified that we are moving into a new era in the development of network businesses. Ageing assets, new environmental regulations and the growth in renewable generation are all contributing to increased investment in these businesses. It is therefore timely to consider the optimal way to finance network businesses.

We strongly believe that the business itself is best placed to make decisions on whether debt or equity investment is required. We believe that this will happen efficiently if the cost of capital has been set at the right level at the periodic price reviews. This model has been proven to deliver very strong results in the 15 years since privatisation with significant improvements in efficiency, strong incentives for efficient capital investment and improved quality of service to the end customer over the period. In our view these improvements have been achievable because of a stable regulatory regime with no 'regulatory shocks' in the key building blocks of cost of capital and RAV.

We are therefore very concerned about the concept of a split cost of capital and would be very concerned if such a radical change to the regulatory regime was imposed at this stage in the investment cycle.

We can see no practical or economic justification in seeking to apply a different cost of capital to past and future capital investment. From the practical standpoint, we believe that attempting to split the WACC would cause greater uncertainty and increase regulatory risk rather than lower it. Allocating a lower cost of capital to the RAV would mean that existing investors would have their expected returns reduced. This would mean greater uncertainty for future investors who would have to consider whether their expected returns would be reduced at some later time. This leads on to further practical issues that have not been addressed.

Firstly, it is not clear when such new capital expenditure should be included in the RAV. At whatever point this capital is included in the RAV it would earn the lower rate of return, which then impacts the actual rate of return that can be earned on an asset over its lifetime. Secondly, it is not clear how such assets should be treated operationally. For example, existing assets will require new investment for refurbishment and/or reinforcement and it is not clear which asset base this investment should go in to. It does not appear practical to us to separate the RAV in the manner proposed.

From an economic viewpoint, we believe that splitting the cost of capital would undermine the incentive to invest, as there is no objective means of estimating what extra return is required for new investment. Furthermore, splitting the cost of capital would reduce the financial flexibility of a business, as they would no longer be free to choose between different types of finance when raising new capital.

For these reasons we would not support the wholesale application of a split cost of capital for network businesses. Provided the cost of capital is set at an appropriate level, any concerns about performance against key financial ratios then become a cashflow issue. In most cases, these issues can be resolved by tilting depreciation profiles to provide more cash in the short-term, as was the case in the recent electricity distribution review. If there were any significant shortfall, equity injection from the owners of these businesses would be necessary. However, we believe that there will continue to be significant equity interest in utilities provided the cost of capital is set at an appropriate level. Nevertheless, a simplified approach of higher returns for new investment may work where financeability issues arise even after depreciation has been accelerated.

We have no doubt that there will be circumstances where regulators must continue to be flexible in addressing financeability issues. However, if the cost of capital is set at the right level, these should be the exception rather than the norm.

***Key issue for discussion (3).*** **Is there any evidence of a lack of regulatory commitment to regulatory asset values or equity funding and if so how might this be best rectified?**

***SSE Response:*** In our view there is no evidence of a lack of regulatory commitment. We believe that in recent price control reviews regulators have re-affirmed their commitment to RAV and are taking a longer-term view of the capital investment needs across the network industries.

Nevertheless, there are some relatively small reforms that could improve the market's perception of regulatory commitment further. Firstly, annual approval of the RAV would go a significant way towards removing uncertainty. Setting out the rules for defining the RAV and for any changes to it would help to provide clarity and set the limits on regulatory discretion.

Secondly, whilst CAPM is relatively simple to use and is well understood by UK regulators we believe that a range of measures should be used to estimate the cost of equity. For example, models such as the dividend growth model or some form of arbitrage pricing model such as Fama-French's 3-factor model can provide a useful check for regulators that the CAPM estimate is robust.

Thirdly, some improvements could be made to the existing theoretical models. For example, there is evidence that the use of long-term time series data provides more stable, statistically robust estimates for the risk-free rate, the equity risk premium and beta than the use of short-run measures.

We strongly believe that regulators should continue to use market evidence to supplement the theoretical models when coming to a final decision on the prevalent cost of capital. Finally, regulators must continue to have flexibility in assessing financeability requirements in order to address the problem of uncertain investments and/or significant short-term capital investment requirements.

***Key issue for consideration (4).*** **Should regulators assume that a proportion of debt is index-linked when setting price controls? Is access to the index-linked debt markets (or related instruments) available to all companies regardless of their specific financial/corporate structure? Are there longer-term implications for the companies' financial stability of adopting a significant proportion of index-linked debt? What is the demand for corporate index-linked debt and are there constraints on investors portfolios? Would it be more expensive?**

***SSE Response:*** Given the nature of RPI-X regulation, index-linked debt could be attractive to network utilities. However, we are not convinced that regulators should, as a matter of course, assume that a proportion of debt is index-linked when setting price controls. Historically, regulatory policy has been to leave the financing decisions on capital structure to the businesses and we see no practical reason for this to change.

Whilst index-linked debt is one of a number of market based options open to network utilities for financing their activities, it is not as readily available as other forms of debt financing. Therefore, we are strongly of the view that businesses should decide the level of index-linked debt required without it being 'hardwired' during the price control review process.

Furthermore, if such a proposal was imposed upon the network utilities, restructuring existing debt portfolios to include a significant proportion of index-linked debt would incur refinancing costs that would have to be taken into account during the next price control review.

***Key Issue for discussion (5).*** **Are there any changes that would be required to the regulatory regime in order to facilitate equity injections? What would be the implications for the highly geared companies?**

***SSE Response:*** In the UK, new equity issuance from utilities has been very limited. The main example has been United Utilities, where there was significant negative reaction from the market following announcement of its rights issue, although UU's share prices did recover reasonably quickly afterwards.

In our view, a rights issue will be successful if the company is successful. If the cost of capital is correct an efficient network utility would be able to attract the required equity.

***Key Issue for discussion (6).*** **Would it be reasonable for regulators to be more flexible in their approach to modelling dividends as a method for stabilising gearing and easing any financing constraints? Would such an approach require changes to the regulatory regime in order to increase certainty and if so what sort of changes would be most appropriate?**

***SSE Response:*** We are strongly of the view that the businesses should set dividend policy not the regulators. As noted in our response to Question 1 above, we believe that the existing financial ring-fencing arrangements are robust and will ensure that parent companies cannot pull money out of the network utilities in times of distress.

We believe that changing the regulatory regime would distort investment decisions, to the detriment of the market as a whole. Such micro-regulation tends to bring unintended consequences and we would contend that the existing arrangements work adequately and do not need further interference.

***Key Issue for discussion (7).*** **Should regulators adopt pragmatic definitions of ratios used by the credit rating agencies? Is the specific level of any particular ratios critical to credit worthiness? Is it the overall level and trend of ratios that is important? Would there be significant difficulties for companies if the majority of ratings were BBB?**

***SSE Response:*** In our view, regulators should always use their discretion in assessing a business' credit worthiness. Nevertheless, credit rating agencies are useful tools to aid regulators in their assessment.

With regard to BBB ratings, we do believe that this would cause problems for the industry. In our view this would increase the probability of companies being downgraded below investment grade and hence serve to increase rather than decrease the cost of capital. Therefore, we believe that the benchmark for a regulated business should continue to be A-.

***Key Issue for discussion (8).*** **If there are remaining issues of financeability what are the advantages and disadvantages of (a) revenue uplift (and should this be PV neutral) (b) accelerated depreciation (c) profiling returns on a nominal basis?**

***SSE Response:*** As discussed above, getting the cost of capital right will, in general, minimise any financeability issues. There is an optimal level of gearing for network utilities, above which there may be a real threat of financial distress. In our view, the current gearing assumption set at the recent distribution price control review is about right. This is borne out by the relative stability of the sector.

To reiterate, we believe that if the cost of capital is correct, network utilities will be able to adequately finance their businesses.  If there is then short-term concerns about performance against key financial ratios this becomes a cashflow issue, which can be addressed by any of the tools described.  We believe that in most cases accelerated depreciation can be used to address any such short-term financeability problems (as was the case in the recent electricity distribution price control review).  If there were a significant shortfall even after such adjustments then an equity injection would be required.  However, as noted previously, if the cost of capital is set correctly there will be adequate equity interest in the network businesses.