Scotia Gas Networks

SSE

Regulating energy networks for the future: RPI-X@20 recommendations

In general, SSE supports the amendments to the regulatory framework that are proposed in the 'Regulating energy networks for the future: RPI-X@20 recommendations' consultation. In particular, enhanced stakeholder engagement, outputs-led regulation and a greater focus on innovation represent timely and sensible developments to the GB regulatory approach. However, we continue to strongly disagree with Ofgem's proposals to change how it assesses the financeability of network licensees and the apparent disregard of cash flow issues and investor's needs in respect of dividend payments as well as long term returns. If implemented, it is our view that these proposals have the potential to seriously undermine investors' confidence in the sector. Accordingly, we fail to see how Ofgem's proposals are in any way consistent with the stated aim of ensuring that network companies are in a position to deliver the extensive investment programme that is necessary for the delivery of a sustainable energy sector. In our view, Ofgem's financeability proposals would, if implemented, stifle both investment and future large scale innovation.

Financing efficient delivery

While, in general, SSE supports the recommendations of the RPI-X@20 review, we continue to have grave concerns over the proposed changes to assessing network financeability. If adopted, we believe that these proposals would have a serious adverse affect on the industry's ability to secure the investment that is needed to ensure that the gas and electricity networks play a full role in delivering a sustainable energy sector.

We set out our concerns in more detail below.

(i) Inter-generational issues

We reject Ofgem's hypothesis that there is an "inter-generational" issue that needs to be addressed. It is evident that, generally, the RAVs of the network businesses are rising, in some cases significantly, thus storing up bigger bills for future customers. In other words, with rising RAVs and hence rising bills for future customers, it is difficult to assert that current customers are paying "too much". The facts do not, therefore, substantiate Ofgem's theoretical assertion that current customers are in some way disadvantaged.

Against this background of disagreeing that there is evidence of a problem that needs to be addressed, we also disagree with Ofgem's proposals to address this perceived problem. These proposals essentially replace one set of assumptions with a new set of assumptions, for no apparent benefit and, in our view, some very clear disbenefits.

Ofgem's proposal to attempt to try and get a "correct" depreciation period with respect to asset lives is flawed when the RAV to which the depreciation number will be applied is a financial construct. As we describe below, the existing RAV of network businesses is a purely artificial construct and is far removed from the actual value of the physical assets. This is a consideration that has not been taken into account in Ofgem's proposals.

Following privatisation, and in order to introduce network price controls, the network RAVs were created based on a number of market assumptions; importantly the RAVs were not directly related to the actual value of the assets at the time. Furthermore, since the creation of those initial financial RAVs, Ofgem has made various decisions that have further influenced the network RAVs. For example, by applying different depreciation periods to address financeability issues and where Ofgem has purposefully "sculpted" the RAV of some of the gas distribution networks at the time of the network sales.

Accordingly, if going forward depreciation is to more accurately reflect the actual life of the assets then so should the RAV and, to achieve this aim, Ofgem would need to revalue the RAVs to a current cost basis.

Furthermore, if the intent is to achieve a "correct" RAV, then we do not understand Ofgem's proposal to set the depreciation period based upon the economic life of the assets connecting to the networks (e.g. windfarms) – and not the economic life of the networks themselves. Again, we believe that this would compound erroneous assumptions. To illustrate, the example quoted by Ofgem for electricity relates to the asset life of a wind turbine. Even if a windfarm has say, a 20-year planning horizon we have no idea of the actual lifespan of the windfarm site given the potential for, for example, re-powering. In this case, the network assets would still be utilised and not "stranded" as presumed by Ofgem. In practice, therefore, any assessment of "useful life" will be a calculated guess, and probably no more "accurate" than the current financial arrangement. It also suggests "bespoke" depreciation of specific assets, in part based on the estimated life of connected customers, which would be practicably impossible to implement and maintain.

To summarise, we believe that Ofgem's proposals are aimed at solving a problem with inter-generational pricing that does not exist and which, even if it were an issue, these proposals on depreciation would not resolve.

(ii) Cashflow issues and equity injection

Ofgem's proposals to apply a "correct" depreciation period would take away their current discretion to make adjustments to depreciation to address cashflow / financeabililty issues. Using this approach, and the asset lives proposed by Ofgem, our initial analysis shows that (for electricity distribution in particular) Ofgem's proposals will significantly reduce cashflow during the next few price control periods – resulting in a shortfall in the licensees' ability to finance their functions. The size of this "gap" is such that any likely change to capitalisation policies will not suffice to close the gap and, in any event, Ofgem's ability to use this tool is inhibited given the intention that capitalisation policies would be fixed according to the actual split of costs currently.

An increase in the allowed rate of return is a possibility to address this funding gap. However, we note that there has been no indication from Ofgem that this is what is intended. And, again, Ofgem's ability to use this tool is inhibited given the intention that more than half of the WACC calculation will be reduced to a formula following the introduction of debt trailing.

To summarise, Ofgem's proposed approach to setting the depreciation period combined with its proposals for mechanistically setting the cost of debt significantly restricts the suite of tools available to Ofgem to address financeabililty and cashflow issues.

We can only conclude that Ofgem's proposals are predicated on the, in our view dangerous, assumption that any short to medium term cashflow issues will be "plugged" by equity injection. At heart, this assumes that as long as the overall return is acceptable in the long term, capital will flow into the sector. We do not agree that this is, or will be, the case.

We are very concerned that a period of prolonged negative cashflows will be very unattractive to many equity investors for whom the dividend is an important consideration in the investment decision. A business that does not pay dividends in the medium term, but requires large amounts of capital in the short to medium term, is very unattractive to such investors. Our views in this respect are supported by key investors. If network businesses are to attract investment, they need to be able to compete on returns and dividends with the various other investment alternatives. We fail to see, therefore, how Ofgem's proposals will secure the investment that is required to enable networks to play a full role in delivering a sustainable energy sector. Indeed, we would go as far as to say that if Ofgem were to pursue this course of action network investment will be positively constrained.

Ofgem do acknowledge that there might be a need for "transitional arrangements" and we accept that this may assist at the next round of price reviews (depending on the circumstances). However, this is not an enduring solution to a problem that Ofgem are creating to address an issue which does not exist (i.e. the suggested inter-generational cross-subsidy).

Given the above, we firmly believe that Ofgem needs to reassess its proposals and we believe there are two main ways of doing this:

(1) Ofgem could make it clear that parameters including WACC, depreciation and capitalisation policies will, as in previous reviews, be calibrated as part of an overall package and not pre-determined before the review according to a formula or specific pre-set methodology. These parameters will need to be calibrated as part of the overall assessment of RORE under Ofgem's new approach. Other aspects of the RPI-X@20 recommendations, such as the greater role for customer engagement, would go ahead as outlined in the document.

(2) Ofgem could deal with the concern that cashflow will be impaired by a specific approach to each of the affected business areas:

   (i) Given the unique situation of Scottish Hydro Electric Transmission (potentially £2 billion of capex on a £400 million RAV with allowed revenue of circa £70 million annually), Ofgem should make clear that special measures (over and above RIIO) are likely to be needed for that business;

   (ii) For gas distribution, Ofgem should make clear that they would not expect any new depreciation or capitalisation policy to make the gas DNs any worse off from a cash perspective. The various RIIO documents have hinted at this and the market would welcome clarity on Ofgem's position; and

   (iii) This leaves electricity distribution, where the issue is much larger and this could start to influence investment decisions now in anticipation of a future problem. Ofgem should resolve this issue by stating now that it is the intention that the depreciation policy would not result in a "cliff-edge" in cashflow, even if financeability issues are not apparent. Ofgem could, for example, make clear that if depreciation was to move from 20 to 40 years it would be the intention to introduce this progressively with a maximum of, say, 5 years reduction in the 2015 price control.

   This approach would need to be clearly set out in Ofgem's final proposals.

(iii) <u>Cost of Debt</u>

We do not support Ofgem's proposal for trailing debt. It is evident that this approach would remove the "in the round" element to calculating the WACC which, hitherto, has always been a key part of the process. To set the cost of debt mechanistically will, in our view, risk driving network company financing strategies, since deviating from the Ofgem formula becomes more risky. In other words, Ofgem's proposals will inevitably and effectively dictate the companies' optimal treasury strategies which is wholly inappropriate. We note that the CC has recently opined on this issue under the Bristol Water referral and, we believe, concluded that an approach that did not set the cost of capital for the specific price cap period would be inconsistent with the duties of the regulator.

Notwithstanding these fundamental issues, the implementation of Ofgem's proposals to mechanistically determine the cost of debt on an annual basis would pose significant practical difficulties. Again, this has not been a consideration taken into account in Ofgem's proposals.

Finally, if Ofgem are determined to micro-manage corporate treasury policies in this way, then consideration should be given to whether spot averages should be used rather than the ten-year trailing average, to reflect current market conditions.

Longer term price controls

In principle, we support Ofgem's proposals for a longer term price control period and Ofgem's desire to incentivise network companies to focus on long term planning. That said, it is vital that Ofgem recognises that in doing so, it introduces significant additional risk that must be addressed. We expand on this further below.

In order to successfully implement this approach, the regulatory settlement must recognise and have in place mechanisms to manage the resultant additional risks that networks will face. With the uncertainty around the changes needed to meet carbon targets and the increasing security of supply issues, UK energy policy is changing and is likely to continue to change significantly in the coming years. Furthermore, rapid advancements in technology and innovation will, in all likelihood, have dramatic impacts on demand (and these impacts could be either positive or negative) and, therefore, key network drivers. Combined, these and other factors mean that network companies face considerable uncertainty going forward and, therefore, compiling an eight year forecast with any reasonable degree of accuracy will be extremely difficult – particularly since the majority of these changes are outwith the control of network companies.

There are recent examples of changes in the environment in which network companies operate that have resulted in relatively sudden and unpredictable changes to costs. An example is the Traffic Management Act (TMA), where new legislation was introduced mid term in a price control. In this instance, the timing of network expenditure and the five year review process allowed a re-opener to be included in the licence to mitigate networks' exposure to the unforeseen and subsequent costs. However, moving to an eight year price control will significantly increase the likelihood of unforeseen legislative changes being implemented mid term; and extend the period of risk to which the network (and customers) is exposed to consequential additional costs. Similar issues would be associated with a glitch or a manifest error in the methodology of the price review process identified mid term in a price control.

In order to address these risks associated with extending the price control period, Ofgem has proposed a mid term review. This is a welcome proposal. However, clear rules are needed for the operation and scope of such a mid term review. It will be important to both avoid a "mini review" (creating a four-plus-four settlement) and a "cursory glance" (that does not address substantive issues because they are considered outwith scope).

The consultation document states that the mid term review would only seek to address potential changes to the agreed output measures, and that any associated changes to costs would only be considered if they were deemed to be significant. Whilst currently changes to costs and drivers tend to be borne by the network companies, it is clear that over an eight year period there is significantly more potential for exogenous influences on input prices and/or drivers to change and for the aggregate impact of several individually hitherto "insubstantial" increases to have a material impact. Hence, we strongly believe that changes to input prices and/or drivers should be within the scope of the mid term review.

Ofgem has confirmed that a network could refer a mid term settlement proposal to the Competition Commission. While this is true for any proposal brought forward by Ofgem, it again relies on a clear set of rules for the mid term review. For example, it does not encompass circumstances where Ofgem opts to not bring forward mid term proposals (e.g. where licensees are concerned about significant increases in input costs). The scope of the mid term review must include issues that are significant from the perspective of both the customer and the regulated business.

Based on the above and our support, in principle, to extending the price control period, we believe that, in addition to the proposed mid term review, Ofgem should introduce one or more generic price control "re-openers" that would include re-opening for legislative change (see also our comments below in respect of managing uncertainty). In addition, if the mid term review does not encompass changes to input prices and/or drivers, then there should be a re-opener for "significant" changes in inputs which would capture individual inputs as well as the aggregate effect of multiple less significant changes. This could be achieved for example by having a threshold trigger level.

An alternative to an eight year control plus mid term review, and arguably a more proportionate and appropriate measure, would be to only extend the price control period for elements that are better defined and are in the direct control of the network companies. An example would be the GDN repex programme where workloads are known, in general, a long way ahead and a longer term settlement might be efficient and allow more flexibility. This would mean some elements of the companies' activities being subject to an eight year (or longer) price control and other elements being subject to a "conventional" five year control.

Again this approach would require a periodic review of costs, or some other mitigation mechanism, to appropriately manage networks' exposure to input prices and/or drivers outwith its direct control. In this regard, we note that Ofgem intends to treat high value projects differently; and we agree with this approach. In transmission, we have found the Transmission Investment for Renewable Generation (TIRG) mechanism and more recently the Enhanced Transmission Investment Incentives mechanism to be effective ways of addressing the uncertainty that can often be associated with long term, large-scale projects; a similar approach could be considered in other network areas.

Managing uncertainty within the price control period

We agree with Ofgem's high level principle that uncertainty mechanisms should only be applied due to changes outside a network company's control where the consequence of which could significantly impact on its costs. Consistent with this principle, it is evident that Ofgem's recommendations significantly increase the level of uncertainty as a result of the extended length of the control period (see above). Accordingly, we conclude that the importance and use of uncertainty mechanisms within the RIIO framework will have to be a key feature of future price control settlements.

As now, uncertainty mechanisms will also be crucial where, within a price control period uncertainly surrounds the appropriate timing and, therefore costs, of large network investment projects. This is a current and particular issue for the electricity transmission companies that will need to be managed in the future regime and where, in our view, consideration should be given to the extension of the existing Enhanced Transmission Investment Incentives mechanism – the principle of which is to allow for incremental adjustments of revenues to support clearly defined projects as and when certain criteria are met.

Finally, we agree with Ofgem's proposal to retain RPI as the appropriate inflation index. At present, RPI better reflects movement in networks' cost base than the alternatives and it is a well understood and established index.

Greater role for third parties in delivery

We broadly welcome Ofgem's proposals for third parties involvement in the delivery of network services and, in particular, the proposal to refer the case to the Competition Commission where there are competition concerns rather than compelling network operators to sell or lease their assets. We believe that this is right and appropriate.

Ofgem's proposals for a greater role for third party delivery essentially fall into two categories. The first involves network companies using other parties to assist them in delivery, whilst retaining responsibilities for delivery and ownership of assets. This could involve "market testing" so that the network can demonstrate that its business plan proposition provides "value for money" or, alternatively, it could lead to the network outsourcing some of its activities. This aspect of Ofgem's proposal is not a new concept within the regulatory environment, with the addition that Ofgem would be able to require a network to undertake a competitive tender/process for the delivery of part(s) of its business plan proposals. We are broadly comfortable with this proposal.

The second aspect of Ofgem's proposals would allow Ofgem the option to hold a competitive process for the delivery and subsequent licensed operation of large, separable enhancement projects (akin to the OFTO process). In considering this option, Ofgem has set out the criteria that would need to be met which, in our view, appear reasonable. In most circumstances, we consider these criteria would preclude a competitive process. One issue that Ofgem has highlighted with this proposal is the need to create a practicable and workable solution at the interface of the existing and new licensee. In this regard, Ofgem considers that situations could arise whereby an existing network operator would be required to transfer some existing asset to a new licensee. As Ofgem will appreciate, this could raise some concerns and therefore any proposals in this respect would need to be clearly understood and considered in more detail. In particular, such consideration must address the regulatory risk to the existing licensees; their price control settlement; and, accordingly, their financing arrangements.

Stages of the price control review process and "fast track"

Throughout the RPI-X@20 review we have been supportive of Ofgem's commitment to take a proportionate approach to price controls and, consistent with this aim, we welcome the proposals for a fast track process that would enable a network to reach a settlement with Ofgem within 12 months or so.

We understand that Ofgem intends to expand on this aspect of the RIIO proposals in the initial price control review strategy document later this year through which we would hope to reach a better understanding of the nature of the settlement that could be fast tracked. In particular, we look forward to better understanding how setting key parameters such as the cost of capital and the strength of the incentives will link to the price controls of other networks being agreed at a later date (if at all); and the real incentive for a network to seek to embark upon a fast track process. On this latter point, and linked to our comments above about longer term price controls, fast tracked network companies could be exposed to decisions made up to ten years before the end of the relevant control period and, hence, be exposed to more regulatory risk than a non-fast tracked company and this will need to be factored into any agreement.

Setting outputs and incentivising delivery of outputs

We support the general principle of setting outputs as part of an enhanced ex ante framework and believe it is a natural progression of the regulatory framework to date. Ofgem has identified six high level output categories that would, at this stage, seem to provide an appropriate balance of interests. However, as Ofgem has identified, the relative importance of these categories will vary and, therefore, the scope for, and significance of, any associated incentive will also vary. For example, we agree that it is not appropriate to incentivise performance under the proposed safety output category.

It is likely that there will be a number of interactions associated with the primary outputs (e.g. connections and customer satisfaction; environment and connections) and primary outputs will also be effected by external uncertainties. Therefore, as Ofgem has acknowledged, when seeking to develop incentive arrangements it will be important to understand these relationships to ensure that, as far as possible, there are no perverse consequences. Furthermore, we are mindful that the introduction of incentives necessarily adds complexity to the regime and therefore, in the interests of transparency, it will be important to ensure that the incentives are well defined and easily captured within the licence regime.

We also agree with the broad principles of setting primary outputs proposed by Ofgem. That is, material (i.e. few and meaningful); controllable; measurable; applicable; compatible with promotion of competition (where appropriate); and legally compliant. However, we believe qualification is required for the principle of outputs being "comparable". Carefully consideration is required before seeking to use the output measures for comparative efficiency/benchmarking between networks in the same sector. It will not always be the case that such comparisons will be comparing "like with like". All output targets must be relevant to the network in question based on historic and forecast levels of performance. We would be very concerned if Ofgem sought to compare performance where this was not appropriate and where the "starting" points are very different. In other words, when setting outputs and performance targets it will be important to recognise that one size does not always fit all.

In principle, we support the inclusion of secondary deliverables where it can be shown that they add value. However, with such secondary deliverables comes the scope for increasing intervention and the potential risk of micro-management by Ofgem. Furthermore, they come with an administrative "cost" to set up and maintain/monitor/report against going forward and, therefore, it will be important to ensure that the inclusion of secondary deliverables is meaningful and adds value.

Well justified strategic business plans and stakeholder engagement

We recognise and agree that well justified business plans are a key component of Ofgem's new regulatory framework. In particular, we welcome the scope it provides in enabling networks to propose a more bespoke settlement than has hitherto been possible. In our view, this enhancement to the existing framework is particularly relevant in facilitating innovative solutions and enabling the companies to differentiate themselves. It also provides scope for recognition that both between and within sectors a uniform approach (or one size fits all approach) is not always the most efficient outcome.

Notwithstanding the above comments, we note that the more "bespoke" the price control settlements become, the more difficult it will be for Ofgem to undertake the benchmarking and comparative analysis that has been a cornerstone of the RPI-X approach. Comparative benchmarking has worked well in driving out cost efficiencies to the benefit of consumers and therefore, going forward, it will be necessary to ensure that the new framework preserves these incentives for efficiency. The challenge will be to ensure that any future analysis ensures the comparison is against like-with-like scenarios/costs and reflects genuine differences in companies' circumstances.

As stated in previous responses, service is one of our core values and as such we are fully supportive of Ofgem's proposal for increased stakeholder engagement throughout the price control review process. However, it should be noted that stakeholders will hold different views and a balance will be required to be made between taking in to account stakeholder views and licence obligations to operate and maintain an economic and efficient system.

Third Party Modification Requests

The risks associated with a third party right of appeal have been highlighted by a number of industry parties, including Ofgem, during the RPI-X@20 review. Most importantly, this brings a strong element of uncertainty into the price control review process, with the potential for significant delays to implementation of all or part of the price control. The requirement for the third party right of appeal is also unclear, given the RIIO proposals for increased focus on stakeholder engagement and a requirement for network companies to demonstrate that they have taken stakeholders' views into account.

Recognising these issues, we agree with Ofgem's decision not to introduce a more formal right of appeal for third parties as a balanced conclusion. The proposed guidance criteria appear reasonable and should help to mitigate the risk of frivolous appeals.

The timeline detailed in the document for modification requests to be processed does, however, raise further concerns around delays in implementation due to an appeal. We note that under the Electricity Act 1989 and the Gas Act 1986 (as amended) a reference to the Competition Commission (CC) must specify a date, no longer than six months from the date of the modification reference, within which a report on the reference must be made. However Ofgem's timeline does not include a restriction on the length of time taken to submit a modification reference to the CC. As this date is effectively when the clock starts on the six months allowed by the CC, and in order to minimise any delays as a result of a third party modification, we think it is important to include a tight deadline by which the initial Ofgem modification reference must be submitted. We believe that Ofgem should give further consideration to this issue before reaching a final decision.