Scottish and Southern Energy
Power Distribution

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10 January 2014

Dear Hannah,

Consultation on our methodology for assessing the equity market return for the purpose of setting RIIO price controls

Thank you for the opportunity to respond to Ofgem's consultation regarding a change in the methodology for assessing the equity market return for RIIO price controls, in particular for RIIO-ED1, as dated 6 December 2013.

Our response provides a summary of our view on the consultation, a response to the specific questions asked in the consultation and finally addresses one item that is not a requirement of the consultation but is pertinent to a complete response, namely the consultation's Appendix two.

We are also supportive of the response to this consultation submitted by Oxera on behalf of the ENA (excluding WPD).

1. Summary

Our understanding of the scope of the consultation is to determine whether a change in equity market returns methodology is appropriate for RIIO-ED1. This is following a recent draft determination from the Competition Commission (CC) on the appeal in the Northern Ireland Electricity (NIE) price control settlement. We note that Ofgem have clearly stated the consultation only relates to the methodology used in ED1 and excludes earlier price controls, i.e. Gas Distribution (GD), Transmission (GT) and Electricity Transmission (ET).

We recognise the need for Ofgem to conduct a consultation on the draft CC determination. However, we have a number of concerns due to the selective nature of the consultation and the very tight timescales for stakeholders to provide a response. We outline our main concerns in this section of our response.

In summary, we are strongly of the opinion that it would be highly inappropriate and unjustified of Ofgem to adopt an alternative methodology for assessing the cost of equity at this very late stage of the ED1 process. The RIIO financial methodology has been developed and debated during the ED1, the GD1 and the T1 processes over the past three years and we do not believe that there is any new evidence or significant developments in capital markets during this period that would justify changing the methodology for assessing the equity market returns. Indeed we firmly believe that a change in methodology at this stage would reflect poor regulatory practice which would result in an undue increase in regulatory risk and would therefore serve to discourage investment in the ED sector.

1.1 A Stable Regulatory Environment

RIIO has provided a predictable, stable and transparent approach to price controls that is valued by licensees and stakeholders. Ofgem have consulted since 2009 on all financial and operational elements to ensure there is a robust regulatory framework that delivers value to consumers whilst attracting the required investment in networks, an approach for which we have been supportive. We believe that the RIIO philosophy of a broad, transparent and structured consultation process enabled an effective and constructive dialogue amongst various stakeholders has resulted in this robust framework. Our investors see a stable and independent regulator as a critical determining factor when it comes to making investment decisions, particularly in this current political environment and period of broad energy industry change.

However, we believe that changing the methodology both at this late stage and in the way that is being proposed significantly undermines the benefits created in the RIIO process over the last three years. It will lead to a material increase in the regulatory risk perceived by investors and we assert this is increasing our cost of equity which is counter to the supposition of this consultation.

During the 7 January workshop held to discuss this consultation, we noted that Ofgem have had dialogue with other utility regulators. It is our concern that the affordability of energy debate and recent decisions of other regulated sectors may discourage investors if

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they believe political influence impacts how energy networks are regulated. We believe that Ofgem should ensure it is independently assessing network operators in accordance with its statutory requirements and independent of external pressures as it has done in the past. The strong reference at the workshop to other sectors with different regulatory frameworks to RIIO and at a different stage of their regulatory process gives us a significant degree of concern.

We are also concerned over the selective nature of this consultation in identifying one aspect of the RIIO financial parameters and comparing it with the CC draft determination which is company specific in a different regulatory framework without considering any other differences in the financial package. By essentially reviewing one single element of WACC, Ofgem appears to be taking no account of the consequential impact on the cost of debt, the impact on gearing ratios or the correlation with the market (Beta) which is theoretically incorrect. Additionally, other elements of the RIIO framework such as the opportunity for incentives and asset lives and depreciation rates have been fully consulted on throughout the process and have been considered collectively alongside Ofgem's existing methodology in assessing equity market returns.

We also do not believe anything has occurred in the capital markets since the conclusion of earlier price controls, namely GD, GT and ET that indicate such a change is required to the RIIO Financial Framework. This is reinforced by the level of engagement and debate between Ofgem and stakeholders during the ED1 process which, in the absence of such new evidence, has resulted in the majority of stakeholders accepting the financial parameters and methodologies that were principally settled in the previous RIIO reviews.

Additionally, regulatory best practice and previous price controls dictate that maintaining a consistent approach amongst the price controls, particularly under a new framework, will allow them to bed into the industry and create a stable climate for investment.

It is our view that compared to the RIIO process to date, the current consultation on the methodology for assessing equity returns is narrow and overly time constrained. This consultation introduces a concern of selectivity by Ofgem by focusing on one specific component part of the WACC. If taking into account responses to this consultation, Ofgem concludes that adjustments to its methodology warrants further consideration, we would expect detailed industry consultation before implementation.

1.2 Use of Contemporary Evidence

The use of contemporary evidence as an appropriate proxy for the cost of equity raises several points.

It is clear that at any point in time or even over a set time period the historic *realised* market returns is not the same thing as an Investor's *expected* return. Realised returns should not be used in isolation when determining the cost of equity, although they can inform an indication for investor expected returns. Investors in NWOs, including our own investors in SSE plc, tend to be long term investors who recognise the long term nature of network assets. Such investors' return expectations are set over a long time horizon in order to avoid the impact of short term fluctuations particularly negative impacts. The RIIO framework ensures that the financial package widely supports investment whilst aiming to deliver value for money for consumers and the primary risk around returns on investment in regulated businesses, we believe, should be based on the operational performance and management of that business within the price control framework and should not be contingent on short term equity market returns.

There is clearly a significant difference between the 3.5 year price control period in NIE and the eight year period that applies in RIIO-ED1, which also does not commence for another 15 months. It is theoretically incorrect to view short term market returns as an accurate proxy for expected returns in the next 10 years particularly considering that the last 10 year returns are materially different from those expected given the domestic and global economic issues and macroeconomic policies at play today.

Although we note that nothing has changed in the capital markets since the conclusion of RIIO for GD, GT, and ET that indicate a change is required in the RIIO financial framework, in the past six months the issue of affordability of energy bills amongst other structural changes in the energy market has increased the risk of companies operating in this area whilst applying a downward pressure to future cash flows. This is evidenced by the current political debates and dialogue between the industry and ministers seeking to address affordability of energy for consumers. For example, Moody's[1] noted on several occasions that there is increased political risk to utilities which is to the detriment of credit ratings. If industry specific changes were considered in determining the basis of contemporary evidence then the cost of equity has actually risen.

Therefore we assert that the use of contemporary evidence can arguably be used to increase the cost of equity as well as consider a decrease depending on the range used, industry specific factors, and the future outlook. Even ignoring the fact that investor's *expected* return is not the same thing as the historic *realised* market returns, this gives rise to the conclusion that longer term evidence will mitigate volatility in equity markets around particularly stressful or buoyant periods. This would appear to be supported by academic experts and formed part of the view expressed by Stephen Wright, Birkbeck Colllege, at the 7 January Ofgem workshop.

1.3 Impact on Consumers

It is broadly accepted that the RIIO price control approach provides a stable long term framework which enables Network Operators (NWOs) to provide value for money to consumers whilst attracting the investment required in the networks. Slides presented by Ofgem at the cost of equity workshop on 7 January estimated that a change in cost of equity methodology for ED1 would give rise to a £2 reduction in the average household bill which we have not sought to verify. However, the long term impact on consumers of

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[1] Moody's (20 November 2013), 'Concerns About the Affordability of Energy Policy Increase Political Risk to the Detriment of Credit Quality'
Moody's (30 September 2013), 'UK Opposition Labour Party Pledge to Freeze Energy Tariffs Is Credit Negative for Utilities'

changing the cost of equity methodology was not estimated due to difficulty and complexity of the issue and short timescales of the consultation. We do, however, believe there is sufficient indicative evidence that a change in the cost of equity methodology this late in the RIIO process will increase the regulatory risk resulting in a downward pressure on cash flows, an upward pressure on cost of debt and a reduction in gearing, thereby negatively impacting on necessary investment. This negative long term impact of a reduction in the cost of equity would not need to be materially large to easily outweigh the short-term benefit to consumers.

Therefore, we find it difficult to conclude that a consumer should accept a £2 saving now when it is unclear of the long term impact, although, it will most likely be an adverse impact on their future bills. Detailed analysis would need to be undertaken to enable an informed decision for consumers which in turn would require a full consultation.

1.4 Other Influencing Factors

The timing of the consultation is unfortunate as the CC's review of the NIE is only provisional and the final determination may not be made until April 2014 thereby placing the onus on Ofgem to conclude before the CC has reached their final determination. This timing should result in only limited reliance being placed on the draft determination at this stage as echoed by analyst comments[2].

A publication is expected from Ofwat in late January that will express their view of the cost of equity methodology. We have a concern that this publication will inform Ofgem in their final decision on the consultation, however, the network industry and other stakeholders will have no opportunity to comment.

Both of these factors clearly pose a risk of distortion of Ofgem conclusions which unfairly disadvantages the industry and broader stakeholders.

2. Response to Consultation Questions

In addition to our general responses above, some of which are pertinent to the specific consultation questions posed, we have set out supplementary views for each consultation question below.

2.1 A direct translation of the Competition Commission's estimates to DNO cost of equity allowances

- *Do you agree with our direct translation of the CC's equity market return estimate to DNO cost of equity allowances?*

There are several reasons we do not agree with Ofgem's direct translation of the CC's equity market return estimate to DNO cost of equity allowances. Primarily the selective and narrow focused approach in re-estimating the cost of equity is against regulatory best practice and the process previously adopted in RIIO as well as the feeling it should be explored theoretically.

Firstly, Ofgem have assumed no changes in the RIIO financial framework except for a change to reflect the CC estimate of equity market returns when translating to a new DNO cost of equity allowance. This feels theoretically incorrect on several levels. Ofgem have assumed that there are no changes in debt beta which implies there are no changes to interest rate risk. However, this is counter to the analysis that DNOs will need to de-gear to maintain credit rating ratios and the statements made by Moody's that this consultation in itself is already credit negative to companies. Even if it were the case that the debt beta did not change, then the asset beta must change due to expected changes in gearing levels over the course of the eight year price control, for example, changing the gearing by 10% would increase asset beta above the 0.38 selected by Ofgem. This pushes up equity beta which in turn increases the cost of equity and re-opens question of appropriate beta and other academic debates closed in the previous RIIO price control consultations.

Secondly, the CC has provided a higher cost of fixed debt to NIE and a higher asset beta with lower gearing and to assume that there are no changes in risk profile due to changes in either gearing or cost of debt allowances compared to the market rates is theoretically incorrect. Also, a significant element of the cost of debt assumed for NIE by the CC relate to the actual cost of debt. The impact of the RIIO cost of debt index in ED1 will mean that the cost of debt received will not directly related to the actual cost of debt being incurred by DNO's to the same extent as NIE. This increases the level of risk faced by DNO's.

Thirdly, Ofgem have selected the mid-point estimate for equity market returns from the CC posed range which appears arbitrary and we believe the consultation is targeted at the methodology of using contemporary evidence compared to long-term evidence of returns. The appropriate range is dependent on the source and cut-off period for the dataset and given RIIO-ED1 does not commence for 15 months the actual source and cut-off period will need to be fully consulted separately. This is excluding the fact that contemporary evidence is materially affected by significant turbulent macroeconomic factors and that in previous CC decisions the CC has used point estimates at or near the top of the range based on capital market volatility and the costs of underinvestment[3].

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[2] Credit Suisse Analyst note (25 November 2013), "UK Utilities – A warning on lower equity returns for grids" states the '*The timing of OFGEM is unfortunate, in our view. The CC's review of NIE is only provisional, and is out for consultation. While the CC's final determination could come as early as February 2013, it may be that it comes later; at the end of April 2014. But OFGEM's consultation must come by the end of February (so that WPD can be fast-tracked). OFGEM has therefore been compelled to take a few themselves, even if the CC's forecast of long-term returns is reversed for the CC's Final determination.*'

[3] Oxera (10 January 2014), 'Response to Ofgem's consultation on the methdodology for assessing the equity market return in RIIO – Note prepared for the ENA (excluding WPD)

2.2 Implications for risk

- *Can you provide evidence on the impact of giving greater weight to contemporary market evidence on perceived systematic and regulatory risk?*

As we have outlined, there is increased regulatory risk as a result of a change in the cost of equity methodology proposed by this consultation through statements by rating agencies' (for example Moody's) of it being credit negative and applying pressure on returns through lowering cash flows and encouraging a reduction in gearing.

Contemporary evidence introduces more short term volatility risk which is market driven and could conceivably increase the systematic risk but it is difficult and potentially impossible to empirically prove or disprove a causal relationship between systematic risk or Beta and a regulatory methodology.

There is a marked increase in political risk to utilities (including network operators) which is being ignored in this consultation despite being pertinent as an industry specific factor for the use of contemporary evidence and implies an increased cost of equity and indeed debt. Since there is an undeniable increase in the business risk it is inappropriate not to consider all factors, particularly the impact on cost of debt as a result of changes to the risk profile of DNOs when considering the use of contemporary evidence.

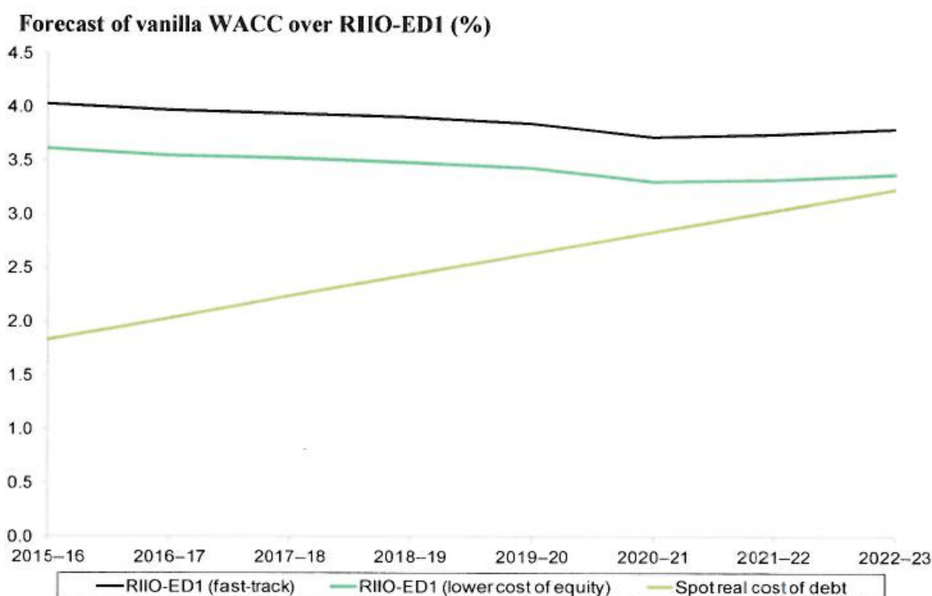
2.3 Financing issues

- *Do you think changing our methodology for the equity market return would impact on interest costs for DNOs? If so, how would this need to be accommodated in our approach to the financial package or the regulatory package more widely?*

It is our opinion that at the recent workshop on this consultation and in other publications, there are clear statements being made and market sentiment amongst analysts, rating agencies and investors that this consultation is credit negative as it points to applying pressure on cash flows at a time when there is an increase in political risk driven by the energy affordability debate. To conclude that this does not and would not have an ongoing impact on interest costs for DNOs would be incorrect. We note that a reduction in gearing would increase the overall WACC therefore in theory this would drive a change in the notional gearing set in the price control financial parameters and it would be inappropriate to reopen this element at this late stage of the process. We also note that a reduction in gearing would mitigate the pressure on credit ratios from the fall in cash flows but it is not unreasonable to assert that interest costs would increase, at least temporarily, while the industry adjusted. This is ignoring the fact most DNOs hold embedded more expensive debt than the current index and will take time to re-finance.

We also note that the longer term impact on WACC through the price control will fall even if the debt index rises (shown below) where it is assumed for illustrative purposes the debt index increases by 20bps per annum. This exacerbates the problem by showing the increase in interest costs is not fully compensated by the long term falling debt index assuming the DNOs could raise new or replace maturing debt at the indexed spot rate which may not be possible if credit ratios are still under pressure during any de-gearing process.

Figure 1 **Forecast of vanilla WACC over RIIO-ED1 (%)**



Note: The trajectory of vanilla WACC over the price control period is estimated assuming that corporate debt costs rise annually by 20bp. The trajectories are shown for illustration purposes only. The spot real cost of debt represents the annual average of the deflated iBoxx indices used by Ofgem to set the cost of debt allowance.

Source: Oxera

2.4 Investment incentives

- *How do you consider that the choice of methodology for determining the appropriate equity market return impacts on investment incentives? Is there any evidence that you can provide?*

Since the publication of Ofgem's consultation there have been several analyst[4] and rating agency commentaries that view the potential change in methodology as increasing the level of perceived regulatory risk. Investors perceive the stable regulatory regime as a critical factor in investment and are willing to accept lower returns with the lower risk. However, by applying pressure to the returns generated by these long term assets operated by DNOs (and the current heightened political risk), there is a concern investors may divert their investment into higher returning assets with similar risk profiles. Although we acknowledge that this can always occur if there are suitable alternative investment opportunities, we believe the pressure being applied makes the probability of this event occurring greater (as evidenced by some analyst notes[5]). It would also appear to us to be illogical to apply a different methodology to one part of the regulated energy network industry (ED) and apply a different methodology for the remainder of the sector. This may create a distortion between the sectors that require investment over a very similar long term time period.

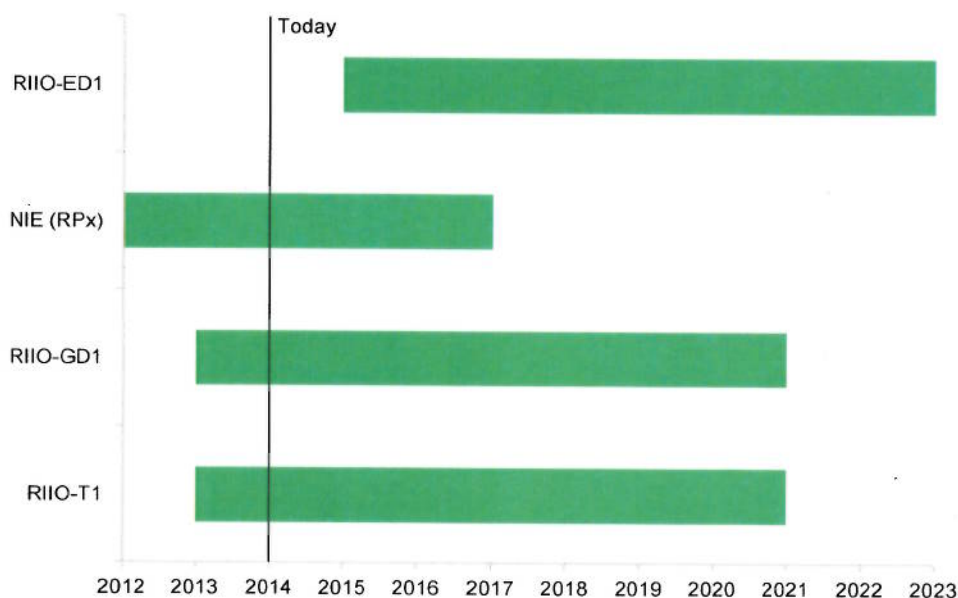
Ofgem in the workshop held on 7 January Ofgem quoted high premiums to RAV in recent M&A transactions as evidence of strong incentives to invest in the industry and therefore there was a suggestion the returns are excessive for the risk being taken in the industry. However, it is difficult to conclude this is the case when there are a small number of infrequent transactions and there are a number of factors that determine the price paid. It is also difficult to determine whether any transactions are at fair value or not, something which is not possible to properly assess until a number of years after the transaction occurred.

2.5 Eight-year RIIO price control period

- *To what extent do you think the merits of the alternative approaches to the assessment of the equity market return are affected by the eight-year RIIO control period?*

As outlined previously, the eight year price control period is not directly comparable to the NIE period as illustrated by the graph presented by Oxera at the workshop (re-produced below). An eight year period cannot be compared to a 3.5 year period especially when forecasting the cost of equity using contemporary evidence. This introduces the risk of estimation errors particularly given in the NIE case it will be reset in 3.5 years compared to almost 10 years under RIIO-ED1. Also, there is no new evidence to suggest that short term returns are a better estimate of equity returns and in fact using long term returns iron out surprises and would appear more appropriate for the long term assets to which they apply. To mitigate the risk of misestimating equity returns (including elements such as risk free rates) at future price controls long term returns are a more suitable proxy.

Figure 2 NIE control period compared to RIIO control periods



Source: Oxera

4 Credit Suisse Analyst note (25 November 2013), "UK Utilities – A warning on lower equity returns for grids" states the *'Cost of equity consultation has raised a new risk'*.

5 J.P.Morgan Cazenove (29 November 2013), "JPM Utilities Weekly", states *'Overall, we prefer the Italian regulated utilities (Snam and Terna) to the UK because we see regulated returns as more sustainable.'*

3. Response to Items Not Part the Consultation

3.1 RPI Formula Effect

We are concerned about the inclusion in the consultation document of Appendix two – the RPI Formula Effect. Appendix two of the consultation outlines that following an ONS decision in January 2013, index linked gilt yields dropped 0.4% and therefore suggests this implies that investors return expectation on index linked assets decreased by 0.4%. As a result Ofgem have reduced the real risk free rate by 0.4% to 1.6%. The DNO's business plans (except ENW) submitted a proposed cost of equity of 6.7% and the consultation appears to indicate that the cost of equity should be 6.3% and the debate is around dropping this further by up to 0.8% as a result of the proposed methodology change. Indeed this consultation does not seek any specific responses on this assertion and the potential impact of the RPI effect. This in our view is against regulatory best practice, increases the risk and undermines the RIIO process to date.

Regulatory best practice stipulates that any proposed change of this nature based on a specific event should be fully consulted on. Given there has been almost a year since the ONS decision with no consultation issued by Ofgem it clearly indicates a selective approach being adopted. If there is a true concern surrounding the RPI measure then this should have been consulted much earlier and wider and it is entirely inappropriate to make a change of this nature at such a late stage of the RIIO process. If Ofgem believed this impact was relevant than it should have been discussed and incorporated in the March 2013 strategy decision document. The RPI is a statistic that feeds into many parts of the price control, including, for example, the calculation of the debt index and forecasting of efficient TOTEX. If the impact of RPI on the allowed real return on equity were to be adopted it would be necessary to assess and consult on the implications for other areas of the price control where RPI is used as well

The translation of the RPI effect for RIIO is also inconsistent with the RIIO financial framework. For example, spot rates are not used in setting the risk free rate in RIIO and instead a long run view of evidence is used. Taking one day's worth of data and a large element of judgement to make such a material adjustment is in our opinion contrary to the RIIO and other regulatory best practice. Attributing the movement on one day to one event is difficult and an open, transparent debate would be required on such a subject, particularly given that the CC is silent on the RPI formula effect and to our knowledge it is not widely documented as an accepted interpretation.

4. Conclusion

In conclusion, we strongly believe that it would be unjustified for Ofgem to alter the existing RIIO methodology on assessing the cost of equity that has been broadly debated and consulted on over the last three years.

The draft CC determination raises a question on only one specific part of the overall cost of capital calculation and methodology adopted by Ofgem. The CC draft determination for NIE is specific to one company in a different regulatory framework and timeframe to the rest of the UK DNOs and therefore cannot be directly read across using one single element in isolation. The stable regulatory environment experienced to date under the RIIO framework would be undermined by a change to one specific factor and ignoring other interdependent elements at this late stage which we believe increase regulatory risk and deter investment within the Electricity Distribution sector.

We do not believe there have been any significant developments in capital markets over the last three years that would support a move to the use of contemporary evidence in assessing equity market returns.

We would have serious concerns if the RPI formula effect discussed in Appendix two of the consultation is used in assessing the level of cost of equity given the lack of previous consultation and the absence of any issue being addressed in the March 2013 Ofgem Strategy Document.

Overall we conclude that it is inappropriate for Ofgem to alter any methodology of financial parameters at this late stage of the RIIO-ED1 process.

Yours sincerely,

Steven Kennedy
Director
For and on behalf of SSE Power Distribution plc