Scottish & Southern Electricity Networks

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25 September 2019

Dear, RIIO2 Team,

RIIO-2 Sector Specific Methodology Decision and further consultation - Electricity System Operator

Scottish & Southern Electricity Networks (SSEN) welcomes the opportunity to respond to this decision and consultation. As a GB onshore transmission owner SSEN has a strong relationship and engagement with the ESO to make our network available, allowing the ESO to balance the GB electricity system. We also provide key services in respect of network connections and investment planning. These arrangements are defined in the System Operator/Transmission owner industry code (the "STC").

We support the partnership approach with the ESO which provides the best outcomes for customers, stakeholders and consumers as our respective services typically work in tandem to deliver outputs. It is therefore important to us that the future ESO financial framework supports this approach. In respect of Ofgem's decisions on the ESO's financial framework we would like to make the following observations:

- Allowed returns methodology
- Approach to financeability
- Inflation index for WACC allowance and for RAV adjustments
- Revenue collection, financial resources and the working capital facility
- Other finance issues

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In addition to the comments within this response, the SSE Group may respond separately to questions 15 to 28 by 9th October. I would be happy to discuss further if you would find that helpful.

Your sincerely,

Sajidha Iqbal

Networks Transmission Regulation Team

Appendix 1 – Responses to Consultation - RIIO-2 methodology for the Electricity System Operator

Cost of Debt Questions

Q1. Do you agree that full indexation for the Cost of Debt allowance is appropriate for the ESO?

We agree that full indexation of the Cost of Debt is appropriate for the ESO. From our experience, this has worked well for the Transmission Operators (TOs) and Distribution Network Operators (DNOs) during RIIO-1 and we would expect that these principles would work well for the ESO also. However, we believe Ofgem should continue to keep its options open and await until final determinations before concluding on the exact construct of an index. This is in line with Ofgem's approach during RIIO-ED1 as evidence was considered during the period up to the decision point.

Q2. Do you agree with the proposal for a bespoke debt indexation mechanism for the ESO?

We agree that a bespoke debt indexation mechanism is appropriate for the ESO based on its business profile. A bespoke mechanism was implemented for our TO, SHE Transmission, during RIIO-1 for similar reasons and we would support bespoke mechanisms for operators where justified. The mechanism must ensure there is adequate justification and that the ESO can raise efficient debt during the period. We also believe the costs associated with raising debt need to be considered as part of setting the index. This is something which Ofgem has not yet considered fully for RIIO-2.

Q3. Do you have a view on whether the options set out in 3.10 for a bespoke debt indexation mechanism are appropriate for the ESO?

We do not have any specific views on the options set out. Any bespoke mechanism should consider the bespoke properties of the operators and this appears to be considered with reference to the shorter term debt. We believe if Ofgem is adopting this approach based on shorter asset lives then it should adopt a longer term index for TOs

and DNOs who have longer asset lives. This would ensure consistency in applying the rationale of a policy to cost of debt funding. Ofgem should also consider additional transaction and liquidity costs that should be factored into borrowing from capital markets.

Allowance for equity finance questions

Q4. Do you agree with our proposed approach to use the three-step methodology to assess baseline allowed returns to equity?

We agree with the use of the CAPM and using relevant cross-checks. We do not agree with Step 3 – Expected versus Allowed returns. The cost of equity should not be set based on any expectation of future performance, it should be set using an evidence based approach which does not include arbitrary adjustments for 'expected outperformance', which in itself is very difficult to forecast.

We would also highlight that Ofgem's financeability assessment is undertaken on an economic basis where rating agencies opt for an accounting basis. Therefore, financeability cannot be reliably assessed on the "gross" allowed cost of equity prior to adjusting for an "outperformance wedge". This has obscure incentive properties and we do not believe it is in line with regulatory precedent or regulatory best practice.

Please refer to the SSEN RIIO-2 Sector Specific Methodology Consultation (SSMC) Response for more detail on our views around this area.

Q5. When estimating equity beta, which listed companies should we consider?

We have set out in our previous response, alongside supporting evidence from Oxera, that the benchmark for equity beta should be based on the appropriate methodology for asset beta and debt beta. In doing so we consider European comparators and Water, whereas Ofgem so far has ignored European comparators without appropriate justification. We have not changed our view of this evidence since our SSMC response.

Q6. Do you agree with our proposal to update the allowed returns on equity for changes in the risk-free rate, as described in the SSMD Finance Annex?

Cost of equity indexation using the risk free rate is a new regulatory innovation and should follow the same high bar set for cost of debt indexation if implemented. Please

refer to the SSEN RIIO-2 Sector Specific Methodology Consultation Response for more detail on our views around this area.

Methodology for considering additional funding questions

Q7. Do you believe that we should categorise ESO risks into seven categories (see our taxonomy at Appendix 2) for the purposes of assessing additional funding claims?

Ofgem has set out risks it believes the ESO is exposed to and a methodology for assessing that risk. This has not been done for the TOs or Gas Distribution Networks (GDNs) to evaluate risk and whether this has been reflected in the underlying cost of capital. We believe this is a step forward in considering risks and being remunerated accordingly. We believe this should be performed for each regulatory mechanism whether that is Real Price Effect (RPE) indexation, the introduction of Return Adjustment Mechanisms (RAMs) or allowed vs expected returns.

We note that several of these risks would be "mitigated" by way of transferring risks to customers or TOs instead of eliminating the risk altogether. In doing so, Ofgem should consider the transfer of that risk and how that would impact on the TOs or customers accordingly. This is in particular the case for transferring revenue risk to TOs compared to the ESO which would then need to be considered practically during the price control, alongside the impact on financeability. An impact assessment of transfer of these risks needs to be undertaken holistically.

Q8. Do you believe that the three tests we propose are suitably comprehensive?

As we note above, these tests are a step forward but we would highlight that an impact assessment and holistic review of transfer of the risk on TOs should be considered as part of that assessment. A similar assessment, albeit more comprehensively, should be undertaken for TOs and GDNs as well as for DNOs when ED2 commences.

Q9. What are your views on the ESO's additional funding assumptions, as summarised above (from its July 2019 submission)?

We are not able to assess the volatility and variability of the ESO's funding assumptions and risks as we are not in possession of the information that the ESO used to undertake its assessment. We believe any assessment should be evidenced based and not focused on exceptions or future expectations in isolation.

Financeability questions

Q10. Do you agree the above metrics are relevant for consideration of financeability of the ESO? Are there any other metrics that should be added?

We believe that the assessment of financeability should be based on obtaining a strong credit rating in line with Ofgem policy during RIIO-1. Ofgem has not sufficiently justified why it has deviated from this policy position for RIIO-2 and at this stage appear to believe marginal investment grade is considered appropriate. We do not believe Ofgem should undertake their assessment of financeability without relying on the methodology and thresholds adopted by rating agencies. Capital markets and investors will not rely on Ofgem's assessment of financeability and therefore Ofgem should not rely on this or on its own qualitative and quantitative assessment or methodology. This policy position therefore needs clarified both for the ESO and for other regulated networks including TOs, GDNs and, in due course, DNOs.

Inflation indexation questions

Q11. Do you agree that the ESO RAV indexation and WACC allowance should follow the approach decided for the networks, i.e. immediate switch to either CPIH or CPI from RIIO-2 onwards?

We agree that it makes sense for the ESO indexation approach to follow that decided for the networks so that all sectors are consistent in their application of indexation. This should not be used as a means to inflate short term cash flows and therefore financeability metrics. In the long term, transition to CPIH or CPI from RPI shows a deterioration in cash flows and financeability metrics which is therefore inconsistent with Ofgem's statutory obligations on financeability.

Revenue collection questions

Q12. Do you agree that it could be more efficient if Transmission Network Owners bear TNUoS revenue collection risk, to reflect respective variances between allowed and actual revenue?

We do not agree that the passing of revenue collection risk to Transmission Owners (TOs) is more efficient than the risk sitting with the ESO. Firstly, TOs would need to understand the ESO charging methodology as the proposal effectively asks the TOs to take on a risk which they have no control over (as they are not involved in the passing

on of the charges to the end customer). Further, it is unclear how the allocation of the risk would work. Based on current arrangements, the ESO will not know its exposure until the charging year has passed and hence, there would be a lag in passing the over/under recovery onto the TOs, meaning the risk would initially still sit with the ESO. Any amount passed onto the TO would in effect be built into future tariffs and make its way back to the ESO. This proposal would also introduce volatility to TO revenue as this currently equals what is charged to the ESO and does not have any additional timing differences. It would be expected that timing differences would occur if collection risk was passed onto the TO. Further detail would need to be provided in order to explain the proposed mechanism as, at the moment, we cannot see how the risk will be effectively passed onto the TO and do not see any benefit to this proposal.

If this is undertaken, the transfer of risk would need to be fully understood, potentially restricted, and appropriate return arrangements reflected for the TOs, including any cash or liquidity costs. As outlined above a holistic impact assessment needs to be undertaken prior to the transfer of risks.

Q13. Do you agree that, to the extent not funded through other mechanisms, WCF costs could be passed-through? Could this arrangement be limited to arrangement fees, extension fees and commitment fees?

This appears reasonable based on ESO specific risk. However, care must be taken to ensure pass-through costs are efficient, particularly for areas that can be at least controlled in part, such as Business Rates, which is a licence condition for TOs, GDNs and DNOs.

Question on other finance issues

Q14. Do you agree with adopting the same approach for the ESO to the other finance issues as was proposed in the SSMD Finance Annex for the networks?

We agree that it is appropriate to adopt the same approach as the networks for the other finance issues.