SSEN Distribution Response to RIIO ED2 - Draft Determination – Finance Annex

Consultation question on allowed return on debt

FQ1. Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?

No. The Finance Annex of our draft determination response to Ofgem's DD details our view supported by robust and detailed evidence as to why we strongly disagree with Ofgem's methodologies for setting allowances for debt costs.

Step 1 - Consultation question on risk-free rate and equity indexation

FQ2. Do you have any views on the model to implement equity indexation that is published alongside this document, (the 'WACC Allowance Model - RIIO-ED2 30th April 2022 update Alternative Wedge')?

We have set out in our Finance Annex response our view of RFR indexation in section 2.1. We note that the equity indexation is not appropriate and even if it were to be then this needs to be adjusted for the items noted in section 2.1 which supporting evidence is provided within the Oxera CoE Report[1] submitted by the ENA.

FQ3. In light of the upcoming change to the definition of RPI in 2030, should the RPI/CPIH inflation wedge be based on:

> **a) a single year (as shown in the WACC allowance model when: cell D2 is "year 5 forecast" and cell B5 is "01/04/2022"); or**
>
> **b) should it be based on 20 years of inflation forecasts (as shown in the WACC allowance model when: cell D2 is "20 year geometric" and cell B5 is "01/04/2031")?**

In order to make a decision on which methodology is more appropriate Ofgem would need to provide further clarity on assumptions it proposes to take when calculating the methodology.

Also based on our assessment of the two methodologies supported by Oxera, it highlights that under both methodologies Ofgem has understated the wedge by 30bps. In section 2.1 of our Finance Annex on the response to Ofgems DD supported by the Oxera CoE Report[2] submitted by the ENA we provide evidence that supports this understatement which Ofgem will have to address at Final Determinations.

[1] Oxera, Cost of equity in RIIO-ED2 Draft Determinations, (August 2022) - ENA

[2] Oxera, Cost of equity in RIIO-ED2 Draft Determinations, (August 2022) - ENA

Step 2 - Consultation questions on TMR

FQ4. Is there evidence that suggests we should change our approach to TMR for RIIO-ED2?

Yes. There is new evidence that highlights Ofgem has made errors within its approach to calculating the TMR range used in the RIIO-ED2 DD which will need to be corrected at Final Determinations. This evidence is set out in section 2.1 of our Finance annex response to the ED2 DD. This evidence is further detailed in the CoE report[3] and the CPIH Backcast report[4] prepared by Oxera on behalf of the ENA.

FQ5. Can stakeholders confirm their view on the trade-off between: the objectivity of using outturn averages (even though the results may be materially higher or lower in future price controls than current TMR expectations); versus the benefits of putting more weight on current expectations (noting the evidence from cross-checks and the associated risk of subjectivity)?

TMR should be reliant on long run historical returns as set out in the Oxera report and/or main finance annex. Use of short-term analysis risks introducing volatility and market risks thereby increasing the cost of capital to the detriment of consumers. Reliance on observable data over a long period outweighs any benefit of forecasting TMR or other parameters given academic evidence supports a stable TMR over the long term.

FQ6. Do stakeholders agree with our proposal to apply the same TMR for RIIO-ED2 (a mid-point of 6.5% CPIH) as we did for RIIO-GD&T2?

As per SSEN-FQ4 we do not agree with the proposal to apply the same TMR for RIIO-ED2 as RIIO-GD/T2 as new evidence has been published since the RIIO-GD/T2 determinations which Ofgem should account for in its calculations of the TMR range. We have further detailed this evidence in our Finance Annex.

Step 3 - Consultation questions on beta

FQ7. Do you believe that DNOs have a higher or lower level of systematic risk than the GD&T companies during their respective RIIO-2 periods?

See our main response set out in our Finance Annex to DDs. This shows that there is higher systematic risk in Energy Networks compared to UK Water. When considering the comparison with GD&T, we would consider the variability on RoRE, the asymmetric nature of ODIs, and the aggressive totex reductions as evidence that the RIIO-ED2 price control is greater risk. This is worsened by the financeability analysis which shows that there is a high probability of significant downgrades beyond one or two notches unless these errors are corrected.

FQ8. What are your views on the relative risk comparison shown in Table 10?

Ofgem's relative risk analysis is relatively simplistic and does not consider quantitative comparisons with other sectors including RIIO-ED1. As we note in our main Finance Annex and SSEN-FQ7, the risk

[3] Oxera, Cost of equity in RIIO-ED2 Draft Determinations, (August 2022) - ENA
[4] Oxera, Assessing the new ONS CPIH back-cast, (August 2022) - ENA

for RIIO-ED2 is significantly higher than UK Water and RIIO-ED1 while also being exhibiting material financeability pressures, totex reduction challenges and large asymmetric ODIs.

To characterise the risk of multiple billions of investment across millions of customers as "less complex" and "less lumpy" diminishes the work undertaken on the network and the fact it is a key enabler for NetZero.

FQ9. Do you have any evidence that suggests the beta for GD&T companies has materially changed since RIIO-GD&T2 Final Determinations in December 2020?

Yes, new evidence is available following the RIIO-GD/T2 determinations which highlights that the asset beta has materially changed. Since the RIIO-GD/T2 determinations Oxera have carried out an assessment on the risk exposure of the UK energy network companies relative to regulated European energy networks[5] which is summarised with the Oxera CoE report[6]. As per our Finance Annex this new evidence concludes that there are six European networks that are appropriate comparators for inclusion in the asset beta estimation which will give a more representative view of the risk that investors face within UK energy Networks. We have also set out in our Finance Annex evidence relating to the water sector and how the UK energy sector is considered higher risk, which highlights that Ofgem has put too much weight on the inclusion of the water sector. The Asset Beta estimate for final determinations should be updated by Ofgem to include this new evidence within its sample comparator.

This is set out in our Finance Annex fully alongside the supporting evidence provided by Oxera.

[5] Oxera (2022), 'Assessing the risks of GB energy networks', 22 March
[6] Oxera, Cost of equity in RIIO-ED2 Draft Determinations, (August 2022) – ENA

Step 2 - implied cost of equity consultation questions

FQ10. Do you agree with our interpretation of the cross-check evidence?

No. Please refer to Finance Annex section 2.1 (particularly section 2.1.4) of our main response to the DD outlining why we disagree with Ofgem's interpretation of cross-checks due to their reliance upon inferior cross checks. This is supported by evidence provided by Oxera[7] and Frontier Economics[8] covering ARP vs DRP and flaws in relying on MARs and OFTO data respectively (only Oxera reference OFTOs and ARP vs DRP cross checks).

FQ11. Do you agree with our updated MAR and OFTO cross-check techniques, in terms of drawing better inferences for RIIO-ED2?

As noted in our Finance Annex and above for SSEN-FQ10, MAR and OFTO data is unobservable, unreliable, and contains a series of interpretation errors by Ofgem. There are more reliable cross checks including the use of ARP vs DRP cross checks as supported by analysis from Oxera. Additionally, Fronter Economics provided their view of appropriate cross checks for which MARs and OFTO data was not considered one. In particular, MARs and OFTOs are unobservable and Ofgem have erroneously interpreted the impact of RAV growth, different asset classes and the presence of terminal values which more than explain returns or transaction premiums.

FQ12. Do you agree with the cross-checks we have used and are there other crosschecks we should consider?

As per SSEN-FQ10, please refer to the detailed analysis in Finance Annex section 2.1 (particularly section 2.1.4) of our main response to the DD regarding why we disagree with Ofgem's interpretation of cross-checks due to their reliance upon inferior cross checks.

Ofgem has erroneously placed too much weight on inappropriate evidence to force downward pressure on the CoE for RIIO-ED2. We also note that Ofgem has also made significant methodological changes to force down the cost of equity in error and should have been more reliance on observable and reliable market data, finance and academic theory and regulatory best practice.

FQ13. Do you consider we should put greater weight on cross-checks or reconsider our CAPM parameters in light of the adjusted cross-check results?

As per SSEN-FQ12 please refer to Finance Annex section 2.1 as to which cross-checks Ofgem should put greater weigh on as well as material errors Ofgem has made in the main parameters of the CAPM calculations.

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[7] Oxera (2020), 'Asset risk premium relative to debt risk premium', (Sept 2020) and
Oxera, Market to Asset Ratios as a cost of equity cross check, (Aug 2022) and
Oxera, Cost of equity in RIIO-ED2 Draft Determinations, (Aug 2022)

[8] Frontier Economics, "RIIO-ED2 Cost of Equity Cross Checks", (Aug 2022)

Step 3 - allowed return on equity consultation questions

FQ14. Do you agree that we should not adjust for expected outperformance when setting baseline allowed returns on equity?

Yes, we agree that Ofgem should not adjust for expected outperformance when setting baseline allowed returns on equity. We believe that adjusting the cost of equity for outperformance would be inconsistent with both economic principles and regulatory precedent and is not sound regulatory practice. As per the CMA Final Determination on the RIIO-GD/T2 price control the CMA concluded that Ofgem were erroneous in implementing an outperformance wedge within the cost of equity. The CMA decision highlighted the following points on the outperformance wedge:

- It is unnecessary
- it is not an appropriate or targeted way of addressing outperformance concerns
- It would undermine wider regulatory certainty and integrity
- Ofgem's analysis for introducing the outperformance wedge included various errors

In line with the CMA we believe it would be incorrect for Ofgem to implement any other form of mechanism for outperformance within its cost of equity allowance.

FQ15. Do you believe there is new evidence which would support an adjustment downwards (eg expected outperformance) or upwards (e.g. aiming up) that we have not yet considered?

We believe there is significant market and supporting evidence that supports Ofgem aiming up in the cost of equity when selecting the allowance. This is a well documented and respected academic and regulatory principle and Ofgem have continued to ignore the benefit of aiming up for consumers. This is included in previous evidence including the need to consider aiming up when price controls are asymmetric, there are financeability concerns, or there is a need to deliver high levels of investment. All characteristics are present in RIIO-ED2 and Ofgem have a suitable regulatory precedent in the CMA's decision on PR19. We outline these points further in our main Finance Annex.

Inflation and WACC consultation questions

FQ16. Do you think we should adjust our approach to allowed returns (noting our approach to expected inflation for WACC and outturn inflation for RAV as described above) so that outturn inflation does not permit the notional company to generate real equity returns that are materially higher or lower than our cost of equity allowance? What would be the consequences to consumers and DNOs of doing so?

We have set out our response to inflation in our Finance Annex.

FQ17. If you believe we should make such an adjustment, what is the best method for making it?

As per SSEN-FQ16 and as set out in section 5 of the Finance Annex of our response to the DD we fundamentally disagree that an adjustment should be made to the way inflation is considered in the approach to allowed returns.

Given the approach to inflation within the price control has been consistently applied historically and is fully embedded within the price control mechanisms, any proposed change to this approach would be a material deviation from a long standing commitment. It has not been appropriately assessed by Ofgem and there is no evidence that any adjustment is warranted. We outlined our full response in our Finance Annex.

FQ18. If you don't believe we should make such an adjustment, how should we ensure that the fairness of the price control is maintained to prevent ex post returns from deviating from ex ante expectations for both consumers and investors?

As per SSEN-FQ16 and SSEN-FQ17 we don't believe an adjustment should be made as we believe an adjustment could result in an asymmetrical risk between investors and customers, which will result in a damaging effect to the industry at a time when investment is crucial to meet Net Zero. There is no evidence that any adjustment is required in addition to the return to investors via the CoE and dividend yields have been set too low in RIIO-ED2. Any adjustment to inflation simply introduces another risk as we have set out in our Finance Annex which has not been reflected in the price control calibration or financeability analysis.

Consultation questions on financeability

FQ19. Do you agree with our approach to assessing financeability?

We have set out our response to Ofgem's financeability assessment in section 4 of our Finance Annex response. We have undertaken our own analysis with supporting evidence from Oxera[9] to evaluate Ofgem's approach. This analysis demonstrates that Ofgem's financeability assessment is flawed in a number of respects. As we explain Ofgem has made a series of errors that cause financeability issue caused by setting the cost of capital too low for RIIO-ED2. Additionally, we show that unrealistic totex reductions, underfunding of UMs and asymmetric incentives further worsen the credit ratios well below the target investment grade credit rating of Baa1/BBB+.

FQ20. Do you have any evidence that would enable us to improve our calibration of stress test scenarios?

Our response is set out in our Finance Annex section 4.

FQ21. Do you agree with the requirement to provide the Financial Resilience Report within 60 days?

We currently do not agree with Ofgem's proposal of a Financial Resilience report as Ofgem have failed to provide adequate information on how they see this proposal working in practice. As a result we are not in position to provide a view on whether or not we agree. A key issue for SSE Distribution regarding this proposal is that the two licensees under SSE Distribution are both part of the wider SSE Plc group. Our credit rating report is determined based on the overall SSE Group which also includes the Renewables and Transmission businesses and so the impact of credit rating falls may not be solely linked to the performance of the SSE Distribution companies.

Regarding a financial resilience report there are a number of reports that are currently produced which provide information on the licensees financial resilience including:

- Statutory accounts prepared on a going concern basis
- Availability of resources statement
- Viability statement as required by the UK Corporate Governance Code

All of which are independently audited by our external auditors on an annual basis. In order to provide a view on Ofgem's proposal for additional reporting we would need to understand what additional reporting would be required that the above does not already provide. There would need to be a justification of why this information is required and in what form and why it would be more valuable, reliable and appropriate than what is produced at the moment.

[9] Oxera (Sept 2020), 'Financeability of the RIIO-2 Draft Determinations', prepared for Scottish Hydro Electric Transmission

Consultation questions on corporation tax

FQ22. Do you agree with our proposals to make allocation and allowance rates variable values in the RIIO-ED2 PCFM?

Yes, we agree with the proposal to make allocation and allowance rates variable values in the RIIO-ED2 PCFM in principle. As we are accredited under the Fair Tax Mark, SSEN strongly believe that licensees should be fully funded for their actual tax costs so that consumers only pay for those actual costs.

FQ23. Do you agree with the proposed additional protections?

We do not agree with the additional protections proposed by Ofgem due to the significant reporting requirements. Ofgem has not provided supporting evidence as to why this level of additional reporting is required and of what benefit this level of detail provides.

We understand Ofgem have chosen to not to implement the Fair Tax Mark as a requirement for RIIO-ED2, however, as we are accredited under the Fair Tax Mark this should be a sufficient accreditation to substantiate the validity of our tax charge and therefore should be exempt from additional justification.

Tax reconciliation and tax review

A tax reconciliation is already currently included within the annual RFPR submission and expanding on this for a more detailed full reconciliation would create a significant amount of work with little or no value. The tax reconciliation sheet consulted on in GD&T[10] is inconsistent with Ofgem's information collection and reporting simplification objectives and again Ofgem have failed to provide any information on cost benefit analysis they have carried out to determine the benefit this information would provide to stakeholders.

Board Assurance Statement

SSE plc as with most large businesses are already required by HMRC to publish their UK tax strategy setting out details of their attitude to risk, relationship with HMRC, etc.

The amount of corporation tax paid by a license holder is unlikely to ever equate to the amount of their tax allowance and so it is also not the role of the board to be assuring whether Ofgem mechanisms, e.g. tax allowance calculation, are appropriate.

The complexity of the reconciliation will also make it extremely difficult for the Board to sign off due to the volume of data required and the lack of clarity around the purpose of variance calculations. As already stated we are accredited under the Fair Tax Mark - this should be a sufficient accreditation to substantiate the validity of our tax charge.

We also note that that HMRC[11] require a Senior Accounting Officer (SAO) to ensure the company establishes and maintains appropriate tax accounting arrangements to allow tax liabilities to be calculated accurately in all material respects. We therefore believe there is more than sufficient assurance and obligations placed on the company without adding further assurances from another third party not responsible for the tax affairs of companies.

[10] https://www.ofgem.gov.uk/publications/decision-modifications-regulatory-financial-performance-reportingrfpr-template-and-regulatory-instructions-and-guidance-rigs-riio-2
[11] https://www.gov.uk/hmrc-internal-manuals/senior-accounting-officers-guidance

In particular:

FQ24. Do you have any views on a materiality threshold for the tax reconciliation?

As per SSEN-FQ23 we disagree with the proposal to implement a detailed tax reconciliation.

If this were to be implemented an appropriate materiality threshold should be applied given the resource intensive nature of the work. That said, the threshold amount would appear to be too low. We see no reason why the materiality threshold should not be aligned with other re-openers, i.e. 1% of base revenue which would be aligned with statutory audit threshold levels. Aligning with a materiality threshold (0.33% of base revenue or 1% corporation tax change) related to a mechanism that has minimal resource implications, does not seem a reasonable approach.

FQ25. Do you think that the "deadband" used in RIIO-ED1 is an appropriate threshold to use? If not, what would be a more appropriate alternative?

As per SSEN-FQ24 we feel a more appropriate level for materiality should be aligned with statutory audit levels i.e. 1% of base revenue.

FQ26. Do you have any views on our proposals relating to the Tax Trigger and Tax Clawback mechanisms? In particular, do you have any views on a proposed "glide path" for the notional gearing levels used in the tax clawback calculation?

We agree with retaining the Tax Trigger and Tax Clawback mechanism from RIIO-1.

Consultation question on Return Adjustment Mechanisms

FQ27. Do you agree with our proposals for the RAM thresholds and adjustment rates?

We do not agree with Ofgem's proposal for the RAM thresholds and adjustment rates as the Return Adjustment Mechanism is more likely to cause harm than good to consumers in RIIO-2. Ofgem have failed to set out the long-term impact of this mechanism and whether or not there is any proven advantage to consumers, investors or companies. Based on the draft determinations, Ofgem have introduced negative weighted incentive proposals and stripped away the opportunity to outperform and therefore the mechanism is almost irrelevant and will provide no or little value.

As highlighted by Ofgem in the ED2 DD in order to trigger the RAM mechanisms licensees would have to max their output incentives cap or collars this would account for circa 200 bp out of the 300bp in the RAM mechanism and underspend on their totex allowance by circa 8% in order to trigger the mechanism. Due to the DD removing the ability to outperform on totex through extensive totex cuts and introducing asymmetric incentives, the level of out/underperformance in both incentives and totex required to trigger the mechanism would be highly unlikely this would be reached and so questions why an additional mechanism needs to be added to the price control that will add little value. Ofgem's own analysis illustrates this in Figure 8 of their Finance Annex for their RoRE analysis which shows more downside potential than upside potential with a significant gap to the RAM cap and collar.

Consultation question on indexation of the regulatory asset value (RAV)

FQ28. What are your views on the technical implementation of the switch to CPIH as set out in the attached PCFM? I

We agree with the technical implementation of the switch to CPIH which is aligned with RIIO-GD/T2 . As discussed in section 4 of the Finance Annex, Ofgem should ensure the analysis of an immediate switch is more appropriate to a phased transition and that an immediate switch is not just being utilised to mask financeability problems.

Consultation question on regulatory depreciation and economic asset lives

FQ29. Do you agree with our proposal to set depreciation policy on RAV additions in the RIIO-ED2 period to 45-years straight line, based on the average economic life of the assets?

We agree with Ofgem's proposal as per our ED2 business plan[12], believing that the most appropriate asset life profile is 45 years which spreads the cost of investment over the anticipated period assets will last while keeping charges lower when compared to other options available.

[12] https://ssenfuture.co.uk/wp-content/uploads/2021/12/24645-SSEN-ED2-Final-Business-Plan-Website.pdf

Consultation question on capitalisation rates

FQ30. Do you agree with our proposal that we should set different capitalisation rates for ex ante allowances and re-openers and volume drivers?

We agree with Ofgem's principle to set different capitalisation rates for ex ante allowances and re-openers and volume drivers however disagree with Ofgem's proposed capitalisation rates. Our assessment of Ofgem's calculations has highlighted inaccuracies in their categorisation of spend into capitalisation rate pools which will impact the capitalisation rates proposed by Ofgem for Certain view and UM expenditure.

Ofgem's RIIO-GD/T2 Final Determinations[13] states that the capitalisation rate set for SSEN Transmission (85%) was the outcome of Ofgem's judgement which attempted to "avoid over-capitalisation, as this could result in less fast money than might be reasonable, which could hamper company investment and consumer interests." It is illogical therefore that in RIIO-ED2 Ofgem set a UM capitalisation rate significantly higher than RIIO-T2, directly contradicting Ofgem policy.

The Transmission Operators (TOs) are more capital intensive than the Electricity Distribution (ED) networks as evidenced by the RIIO-T2 certain view (baseline or ex-ante) capitalisation rates being higher on average than Ofgem's proposal for ED (80% versus 74%). It is inconsistent for Ofgem to set a capitalisation rate for re-openers greater than that for TOs as this would imply Distribution re-openers are more capital intensive. Also, in GD2 and T2, Ofgem set fixed capitalisation rates for re-openers (85% for T2, 70% for GD2 as shown in Table 1 below), however each DNO has been allocated different capitalisation rates for re-openers. In RIIO-GD/T2 Ofgem made the decision to set UM spend below the natural split to aid equity investment in high investment periods. The proposed RIIO-ED2 capitalisation rate for re-openers follows neither the natural split nor the regulatory precedence in RIIO-GD2/T2. The lack of funds generated by fast money to cover associated operating costs will result in DNOs being required to raise significant equity funds.

Table 1 – capitalisation rates for RIIO-GD/T2 and proposed capitalisation rates for RIIO-ED2

ED			T			GD			
	Cap rate 1	Cap rate 2		Cap rate 1	Cap rate 2		Cap rate 1	Cap rate 2	Repex
ENWL	73.2%	98.4%	SPTL	84.0%	85.0%	East	29.0%	70.0%	100.0%
NPgN	73.5%	98.5%	SHET	77.0%	85.0%	London	20.0%	70.0%	100.0%
NPgY	74.9%	98.9%	NGET	78.0%	85.0%	North West	27.0%	70.0%	100.0%
WMID	78.3%	98.4%				West Midlands	25.0%	70.0%	100.0%
EMID	79.0%	98.3%				Northern	34.0%	70.0%	100.0%
SWALES	78.5%	98.4%				Scotland	41.0%	70.0%	100.0%
SWEST	79.7%	98.0%				Southern	33.0%	70.0%	100.0%
LPN	70.9%	96.8%				Wales & West	31.0%	70.0%	100.0%
SPN	71.3%	95.9%							
EPN	71.6%	96.5%							
SPD	71.6%	98.8%							
SPMW	70.6%	98.2%							
SSEH	68.4%	94.3%							
SSES	68.2%	97.1%							

Source: RIIO-GD/T2 Final Determinations and RIIO-ED2 Draft Determinations

Ofgem state in RIIO-ED2 Draft Determinations that "baseline capitalisation rates would be set based on the natural rate and uncertainty mechanism capitalisation rates based on the best available

[13] Ofgem GD/T RIIO-2 Final Determinations – Finance Annex (REVISED), (December 2020) https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_-_finance_annex_revised_002.pdf

estimated of the likely natural rate." However, Ofgem has failed to provide analysis supporting the accuracy of its proposed capitalisation rates. Our analysis shows the natural capitalisation rate for UMs is between 85-90% which is materially lower than 98%. We believe Ofgem should set the UM capitalisation rate at the bottom end of this range, if not lower to be consistent with RIIO-T2 policy. meaning Ofgem has set the capitalisation rate **above** the natural rate, which is completely the opposite of what was done for RIIO-T2. This is a material error and inconsistency.

We propose that Ofgem retain its policy position in RIIO-T2 and apply this in RIIO-ED2 when setting the capitalisation rate for UMs. This therefore should be in the region of 75-85% based on equity requirements for a high totex case which will require significant equity investment. It is also below the natural rate by around a similar margin for RIIO-T2[14].

Separately, RIIO-ED2 capitalisation rates vary each year for both certain view and UM expenditure however Ofgem's RIIO-T2 and RIIO-GD2 Final Determinations[15] states for TO and GD licensees Ofgem "decided not to set annual rates. Doing so could imply a degree of accuracy that may not materialise. Further, annual rates are not sufficiently different from the average to warrant further complexity." Ofgem's decision to set annual rates in ED2 introduces the unnecessary complexity and lack of accuracy which Ofgem deliberately avoided in RIIO-GD/T2 and is a further material error and inconsistency.

FQ31. Do you have any evidence that would enable us to improve our estimates of regulatory capitalisation rates?

As per SSEN-FQ30 the capitalisation rate is based on the above answer.

[14] In RIIO-T2, the natural rate for UMs was closer to 100% whereby Ofgem set the capitalisation rate at 85%. If RIIO-ED2 is around 85-90% then reducing this by 15% at the bottom of the range would be consistent.
[15] Ofgem GD/T RIIO-2 Final Determinations – Finance Annex (REVISED), (December 2020) https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_-_finance_annex_revised_002.pdf

Consultation question on RAV opening balances

FQ32. Do you have any views on the use of forecast RAV opening balances for the start of RIIO-ED2, which will be trued-up following RIIO-ED1 closeout?

We agree with using forecast RAV opening balances for the start of RIIO-ED2, which will be trued-up following RIIO-ED1 closeout

Consultation question on transparency through RIIO-ED2 reporting

FQ33. Do you agree that additional corporate governance reporting described (including on executive director remuneration and dividend policies), will help to improve the legitimacy and transparency of a company's performance under the price control? If not, please outline your views in relation to the rationale provided for these additional requirements, including consumer protection.

We disagree with Ofgem's proposal regarding additional corporate governance reporting. Ofgem has disregarded legitimate and serious concerns raised by SSEN Transmission (and others) on this matter during RIIO-T2 consultation and failed to undertake its own policy evaluation and impact assessment prior to implementation. Our objections centre around the following issues:

1. Lack of Evidence and Justification of Benefits to Consumer

Due to a lack of policy evaluation and impact assessment, Ofgem has failed to provide sufficient evidence or justification of the benefits to consumers of additional reporting on executive renumeration on an itemised basis and making that information public and instead appear to have determined this policy arbitrarily, without a clear evidential basis.

Ofgem's policy evaluation appears to be largely (and perhaps solely) based on a report undertaken by the Citizen's Advice Bureau ("CAB") in 2017 in support of the policy, despite Ofgem noting that DNOs expressed concerns in their responses to RIIO-ED2 SSMC and that "Issues were raised in response to the RIIO-2 RFPR consultation…for GD&T companies" regarding additional reporting.

We are not aware of any other reports or analysis carried out or relied on by Ofgem to support and justify this policy and how publication of it will be of benefit to consumers. Ofgem refers to principles of transparency and legitimacy throughout the consultation but fails to provide any evidence, such as by way of policy evaluation or any evidence-based research, to support its high level principle-based assumptions.

We are not aware of Ofgem undertaking any impact assessment of the policy and/or the consequences of applying it to the distribution electricity market.

2. Lack of clear Data Protection Assessment by Ofgem

The policy is much more than a simple exchange of information, personal data relates to any information which could directly or indirectly identify an individual. This concerns individual's personal incomes and pensions which, combined with other information, would identify an individual and therefore be deemed personal data. Directors are still employees, and we have a professional duty to protect the personal data of our employees. There has been a noticeable and concerning lack of specific engagement and assessment by Ofgem on the data protection aspects flagged and how Ofgem has (presumably) reconciled the detail it is requesting against complex data protection considerations such as the protection of data subject's rights (i.e. the executive directors) under UK GDPR and the Data Protection Act, and obligations relating to the collection, storing, data retention and publication of the additional executive remuneration information.

3. An overreaching policy

Statutory Financial Statement - As Ofgem is aware, (plc shares aside which are discussed further under "Discriminatory Application") the total aggregate remuneration of all Directors is already

provided by SSEN Distribution as part of its Statutory Financial Statement for the SSE Networks Companies, such statements being prepared under statutory accounting frameworks and also being subject to external audit under the ISAs

4. Corporate Governance

Ofgem will of course be familiar with corporate and board structures, however, this decision appears to be conflating and oversimplifying the issues. The reality is that the board has a wider role across the SSE Networks businesses which is not wholly specific to SSEN Distribution. This, in turn, means that it is not as simple as this would suggest determining the value to SSEN Distribution of services for members of the board who have a wider remit across the SSE Networks businesses.

In light of this decision, SSEN Distribution are at risk of misrepresenting executive remuneration for SSEN Distribution due to Ofgem's failure to recognise that governance and board structures are not as clear cut as this policy suggests.

SSEN Distribution are essentially being required by Ofgem to communicate incomplete and / or inaccurate information to stakeholders which we do not believe to be Ofgem's intention.

Ofgem noted that due to concerns raised, the requirements were not implemented in 2018-19 or 2019-20 and so it is not clear what has changed. Further, we note that a reason Ofgem decided to proceed to implement the policy in the RIIO-T2 Final Determinations was because network companies had "not provided anything substantively new to justify why we should not introduce this". Due to the significance of this matter, SSEN Transmission (and others) have been engaging with Ofgem for years on their concerns and therefore it is unreasonable of Ofgem to say that because network companies have not provided Ofgem with any new concerns that the policy should be implemented and especially when concerns already raised have not been adequately addressed.

On the above basis, and in the absence of any further information, we do not consider that Ofgem has identified a clear legal and regulatory basis for the amendment, and that policies of this kind should be subject to a more rigorous assessment of the perceived benefits and impacts prior to being tabled let alone implemented.

Questions on consolidated reporting and calculation of allowed revenue

FQ34. What are your views on the proposed consolidation of the revenue RRP and PCFM, or applying a fully dynamic concept of allowed revenue?

We agree with Ofgem's proposed consolidation of the revenue RRP and PCFM provided this in line with RIIO-T2 consolidation and a full consultation process will be conducted. If the proposal is to follow the format of the RIIO-GD/T2 PCFM we would also expect any issues identified during that process to be resolved ahead of implementation for ED2.

Questions on licensee self-publication of allowed revenue

FQ35. What are your views on allowing licensees to self-publish the PCFM with their charging statements, rather than relying on an Ofgem publication or direction to determine allowed revenue?

Provisionally we do not have any objections, however we will need to review in more detail as we progress through the licence drafting process. Currently in RIIO-1, the MOD is published on the 30th November, following which the licensees go through internal governances processes ahead of final tariffs being submitted in January. We support moving towards a 'self publication' but would need to ensure the timing of this aligned with tariffs being submitted for final tariff submission. This would ensure all internal governance processes have been completed and signed off following the finalisation of the AIP process and setting the final tariffs. If publication were to happen at the finalisation of the AIP process on the 30th November this would be ahead of governance sign-off of final tariffs and runs the risk of differences between what will have been published in the AIP and what is submitted for tariffs. This would currently align with 25th of January in advance of Regulatory Year t and not before that date. We believe this is timely for stakeholders and would allow TOs to comply with DAG obligations.

Questions on best vs reasonable endeavours in charge setting

FQ36. What are your views on having a best endeavours obligation for charge setting: "The licensee must, when setting Network Charges, use its best endeavours to ensure that Recovered Revenue equals Allowed Revenue"?

We do not agree with having a best endeavours obligation for charge setting. As noted in paragraph 10.130 of Ofgem's Finance Annex, the DNOs have raised concerns with Ofgem's proposal to require licensees to use best endeavours rather than reasonable endeavours in setting network charges to ensure that recovered revenue equals allowed revenue. Our concerns in this regard are that the use of 'best endeavours' may require DNOs to take significant additional steps in forecasting charges that may be disproportionately onerous or cut across other customer objectives. In addition, we are concerned that a DNO will always risk breaching this licence condition if the actual charge does not reflect the forecast, given a DNO is obligated to use best endeavours to forecast accurately. As Ofgem is aware, there are a number of significant necessary uncertainties when we set our tariffs, which are exacerbated by the requirement to set our tariffs 15 months in advance. The volatility in allowed revenue over the last 3 years, much of it caused but regulatory interventions, is important context for this.

We note Ofgem's comment that 'a DNO would do its best if it were to act as a prudent, determined, and reasonable DNO acting properly in its own interests…'. Our view is that acting as a prudent and reasonable operator is an existing overarching requirement for DNOs, but that the use of 'best endeavours' places an additional burden on DNOs to undertake additional activities in forecasting tariff setting that may result in additional costs (ultimately to consumers). As set out in the joint DNO response, if Ofgem is intent on the use of best endeavours, we would require an exhaustive list of actions in the guidance document specifying the action that DNOs should undertake to meet the standard, and the best endeavours obligation should be subject to this guidance. Please also see our response to the licence drafting progress update on this matter.

Consultation questions on the appropriate time value of money

FQ37. What are your views on applying a single time value of money to all prior year adjustments, based on nominal WACC?

The WACC is the most appropriate given the nature of investment and funding of cash flows over the RIIO-2 period. It is likely adjustments will last for more than one year given the two year lag and likely impact of reopener decisions on allowances and expenditure requirements. These adjustments and funding requirements would therefore not be fully funded by short term debt and would in essence rely on longer term funding over the period and the associated buffer or cost of carry. SONIA may be seen as a proxy for the risk free rate, however this is below the rate which we would be able to borrow making the SONIA option inappropriate.

Question on forecasting

FQ38. What are your views on our proposed approach to using forecasts within RIIO-ED2?

We do not support dynamic forecasting. A forecast based approach would still involve an element of forecasting and so, there is no guarantee that it would reduce the magnitude of future true ups. Such an approach does not reflect the reality of a price control, would be likely to lead to more volatility in tariffs and would be more difficult to understand. The introduction/retention of key uncertainty mechanisms should help to reduce volatility as opposed to complex forecasting exercises.

Questions on forecasting penalty mechanism

FQ39. What are your views on the proposed charging penalty mechanism?

Whilst the approach is consistent with RIIO-ED1, we believe a larger recovery threshold is appropriate for RIIO-ED2 given the current economic crisis. Forecasting 15 months in advance poses an increased volatility to the recovery position anyway, but this is exacerbated by the difficulties DNOs face in forecasting energy use in the current climate, particularly for the remainder of 2022-23. DNOs should be protected and Ofgem should waive the penalty by direction, where the error was caused by factors outside the reasonable control of the licensee.

FQ40. What are your views on the proposed revenue forecasting penalty mechanism?

We are not in support of this approach and believe a monitoring-only regime would suffice. Forecasting revenue will be much harder moving into RIIO-ED2 and whilst Table 22 indicates the average change in ED1 was 3.17%, this should not be used as a gauge for future performance. As with Q39, we would seek an increase to the recovery threshold as a minimum, if the penalty is not removed entirely.

Consultation question on incentive lags

FQ41. What are your views on removing lags from incentives?

Provisionally we do not have any objections, however we will need to review in more detail as we progress through the licence drafting process.

Consultation question on baselines for ODI incentive rates, caps, and collars

FQ42. What is your view on using RoRE as a general baseline for describing ODI caps, rather than base revenue?

We agree in principle with Ofgem's proposal on using RoRE as a general baseline for describing ODI caps, rather than base revenue however disagree with Ofgem's implementation. As outlined in section 5D of Oxera's Financeablity report[16] 'Ofgem's proposed balance of rewards and penalties related to ODIs is asymmetric, (i.e. it implies a greater risk of losses than rewards for the DNOs). More specifically, the overall balance of rewards and penalties is skewed downwards, as the maximum allowed penalty (-4.0% of RoRE) is 2.05% of RoRE higher than the maximum allowed reward (+1.95% of RoRE). We believe this asymmetry should be corrected made symmetrical or Ofgem should aim up on the CoE in line with the regulatory precedent[17] and best practice which we note in our Finance Annex.

FQ43. What is your view on fixing the potential £m 20/21 value of incentives using one number for all years, based on a forecast of RIIO-ED2 at Final Determinations (an approach similar to RIIO-ED1)?

We disagree with Ofgem's proposal on fixing the potential £m 20/21 value of incentives using one number for all years, based on a forecast of RIIO-ED2 at Final Determinations. This approach is unsuitable during a period of significant investment/growth as the incentives would not increase proportionately. Additionally, this approach does not take into account any under/over spend or UM expenditure. Instead, we believe incentives should be based on actual RoRE and not a fixed value.

FQ44. What is your view on the method of calibrating incentive caps in RoRE terms, or the overall proposed incentive caps?

We disagree with Ofgem's method of calibrating incentive caps in RoRE terms, or the overall proposed incentive caps. Ofgem's approach of calculating an average RoRE impact is inappropriately skewed by DNOs with materially high capitalisation rates dragging the overall average down. Instead, we believe the median value should be used to calibrate incentive caps which would remove the impact of outliers and increase the RoRE impact to 0.405%.

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[16] Oxera, Financeability of the RIIO-ED2 Draft Determinations (August 2022)
[17] CMA Decision on PR19 aimed up by 0.25% to account for asymmetry in the price control and financeability reasons.

Consultation question on bad debts

FQ45. What are your views on our proposal to remove the Bad Debt terms from the pass-through licence condition?

We have no concerns with the proposal to exclude the bad debt terms from pass-through and adjust the Recovered Revenue term.

Section 10.201 of the Finance Annex to Ofgem's RIIO-ED2 Draft Determinations sets out proposals for the treatment of future Supplier of Last Resort (SoLR) costs. Whilst no questions were associated with this, we understand this was an omission and a response is requested. From the text in this section and further clarification from Ofgem, we understand the intent is for DNOs to forecast a level of likely future SoLR payments when setting prior tariffs at least 15 months in the future; to then pay out the full amount of any claims received by 31 December over the following financial year; and to subsequently true up any difference in future year tariffs through the ADJ term. We also note Ofgem's intent to base this on the current drafting on RIIO-GD2 licence conditions.

As events over the last 12 months have shown, it is not possible to forecast SoLR costs with any accuracy. Any forecast is likely to be wrong and could risk significant tariff disturbances through future years as forecasting differences are corrected - particularly given the 15 month notice required for electricity distribution tariffs. In the long run, we would like to believe SoLR costs will reduce and once again become a rare occurrence and, as such, it would be better to adopt an approach which does not rely on forecasting but, in the rare occurrence this is needed, requires simple tariff adjustments timed to match cost recovery with payments made.

SoLR costs are not influenced or controllable by DNOs and we do not consider it acceptable that licence drafting would leave potential for DNOs to be exposed to a duty to make payments whilst being unable to recover the costs for a considerable period (potentially extending to 27 months depending on timing and circumstance). Whilst we accept smaller claims can be managed without tariff disruption (i.e. claims below a defined materiality threshold, as in ED1) - we do not see any justification for Ofgem's approach to remove a defined mechanism for ensuring DNOs are not exposed to material cash risks that result from Supplier failures.

We also note that the current drafting of RIIO-GD2 licence conditions may not be consistent with Ofgem's proposals either.

We consider that further work is required to develop appropriate drafting and to avoid inappropriate transfers of risk.

Consultation question on revenue profiling

FQ46. Should Ofgem allow proposals to re-allocate or re-profile revenue throughout the RIIO-ED2 period and what profiles could be considered in the customers' interest?

We do not propose to re-allocate or re-profile revenue throughout the RIIO-ED2 period. Bills are relatively stable over the period and therefore any re-profiling may inadvertently move costs between consumer groups i.e. future and current consumers.