



**Response to**

**Assessment of Potential Financing Options for Utility Networks**

18 January 2010



# **Assessment of Potential Financing Options for Utility Networks**

## **Introduction**

SSE welcomes the opportunity to respond to the Authority's discussion paper on the Assessment of Potential Financing Options for Utility Networks. We welcome the Utility Regulator's decision to explore the scale and approach to management of costs borne by customers and to publish this discussion document. The ideas it contains for reducing costs are certainly attractive on first reading, but we see a number of significant issues that would need to be addressed if the idea were to be pursued further, notably;

- unrealistic simplification represented by "3-business" concept that ignores; loss of economy of scale and scope; impact of perverse incentives; framework of legal responsibilities; subjectivity of allocating activities between businesses
- lack of detailed analysis, such as company betas over time, for utilities in GB and other markets, to understand whether investor approach to risk has changed, or if perception of GB utility risk is converging with that of investors in other markets, or if risk perception is influenced by regulatory activity, such as development of price controls
- the curious choice of E&W water and sewerage companies' flotation equity to compare with that of NIE's T&D business, when the discount to true value perceived by commentators at the time, means that the stated equity valuation at flotation is probably understated and not directly comparable with the market-determined equity value in 2010.

## **Oversimplification of the "3-business" Model**

Superficially a breakdown of a networks business into O&M, Expansion and Debt Servicing components is attractive. However there would be practical difficulties in allocating certain projects and risk between operation and project businesses. Is there a materially different level of risk between 20 projects of £2m and one of £40m? Arguments could be made either way. Similarly, if only a project with the scale of a new interconnector would be

sufficiently large to be allocated to the project business, then would such business have sufficient scope for a sustainable future? Perhaps there would be no need for a Projects business in a stable network configuration.

If all capacity expansion were to be allocated to the Projects business, rather than just developments above a certain cost threshold, then over time virtually the entire Operations business would transfer to Projects, unless all completed projects are transferred to Operations on completion. However the transfer cost would presumably reflect the higher cost of financing construction risk and so would implicitly transfer the cost of this risk into the theoretically lower risk Operations business.

The discussion paper does identify one flaw in the asset transfer model; that there is no long-term incentive to ensure the design and construction process actually delivers the required system performance. However no evaluation is made between the choice of allowing one business to evolve into the other, or to manage the risk resulting from transfer of sub-optimal assets to the Operations business. A key question is whether risk can ever be truly ringfenced? No satisfactory answer is provided.

This is a fundamental issue, because all assets that are developed, whether described as being in the RAV or not, inherently include a value component that reflects the perceived risk of their delivery. Even if a capital recovery business can take on refinancing and repayment responsibility for assets that have been de-risked as a consequence of having been delivered, capitalisation of interest during construction would mean the value that has to be financed will be higher than if there had been no risk premium applied to the development finance. Therefore, although the cost of capital for a capital recovery business may be lower than for a projects business, the total capital amount will still reflect construction risk.

Other issues, such as the additional overhead cost of maintaining separate facilities and maintaining a secure and co-ordinated overall system when major developments are designed by third parties, are not even considered. Perhaps an overall design authority would be envisaged in addition to the three businesses described. But then the decisions of

that organisation would impact on the freedom of projects businesses to deliver project designs they consider appropriate. Who would be the final arbiter and what would be the impact of such a structure on costs associated with bidding for projects? Some analysis of the extent to which PFI clients actually end up with the projects and value they expected would be a useful yardstick for comparison, as there would be some similarity of procurement process.

## **Risk quantification**

Lack of anything other than circumstantial data to underpin the suggestion of sub-optimal financing is unfortunate if the case is to be convincingly made for function-splitting to deliver optimal risk pricing. A puzzle is posed as to why companies that were privatised with little or no debt "have since gone on to accumulate billions of pounds in borrowing as a result of significant capital programmes over the last 20 years". Although posed adjacent to the apparent conundrum as to why the need for equity has increased dramatically since privatisation, there is no consideration of the possibility that privatisations were fundamentally mispriced and that subsequent investment and borrowings have arrived at an optimal pricing structure, given the current mix of interest rates, market risk premium and balance between projects in development and operational assets. Arguments based on "could be" and "a customer might wonder" are no substitute for a rigorous analysis of any relationship between changing asset mix, real risk premium and gearing levels over time.

## **Conclusion**

This is an interesting paper, but it is let down by its reliance on a "stylised economic view", suggestion rather than rigorous analysis and snapshot numbers that may reflect different political priorities for privatisation of different industries at different times, rather than provide evidence of sub-optimal pricing. A key, but unasked and unanswered question is whether risk can ever be as is clearly ringfenced and efficiently priced as suggested and if it can, do we know the correct values to assign to each risk or how to deal with changes in the real cost of these risks over time?.

Apart from advocating proper reflection of the various assets and their lifecycle risks in the regulated WACC, the extent to which understanding of optimal risk financing of real utility networks is developed by this paper is unclear.