

**RIIO-ED1 real price effects  
workshop**

16/09/2014

ofgem

# Agenda

1. **Introductions**
2. **Background**
  - a) Purpose of workshop
  - b) Summary of consultation
3. **Uncertainty mechanism assessment criteria**
  - a) Summary of proposed criteria
  - b) Discussion
4. **Options for RPE mechanisms**
  - a) Overview of ex ante allowance and indexation options
  - b) Discussion of merits and drawbacks of options
  - c) Discussion of application of indexation to different cost types
5. **Choice of indices for indexation**
  - a) Summary of the proposed criteria
  - b) Discussion of criteria
  - c) Discussion of proposed indices
6. **Summary and next steps**

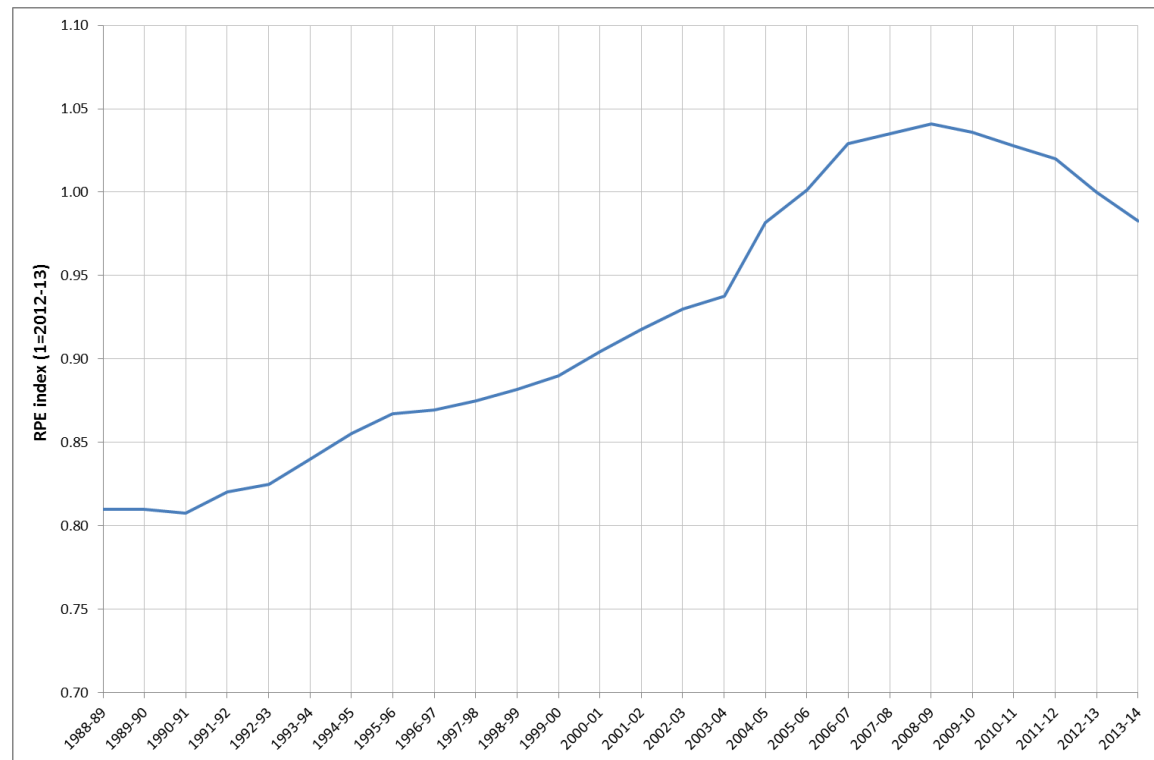
## Purpose of workshop

- Open discussion of our consultation on alternatives to an ex ante RPE allowance in the price control settlement for slow-track DNOs.
  - Opportunity for you to discuss the questions raised in the consultation and provide your views.
  - Opportunity to develop an understanding of the merits and weaknesses of different approaches.
  - Opportunity for us to hear your initial views prior to the consultation responses.
- **Not discussing draft determinations or ways of calculating an ex ante RPE allowance.** This workshop will focus solely on the consultation on the most appropriate mechanism for including RPEs in the price control.

## Summary of consultation

- In the draft determinations the DNOs' cost allowances included a fixed element for the expected impact of RPEs.
- We noted changes since 2003-4 in the movement of the indices we have used to set an allowance for RPEs (see figure).
- This cast doubt on the use of an ex ante allowance – therefore we're asking for views on whether there is a better alternative.
- The alternatives to an ex ante allowance we have identified are all forms of uncertainty mechanism applying indexation.

**Historical real movement in RPE index**



**Exposure to risk** – uncertainty mechanisms should adequately and equitably protect DNOs and consumers against risk

**Impact on incentives** – the incentive on DNOs to manage costs and invest efficiently should not be weakened.

**Balance of charges between current and future consumers** – ideally, input price changes should be reflected in allowances when DNOs are exposed to them so consumers pay for the services provided to them.

**Complexity and unintended consequences** – the design of uncertainty mechanisms should limit additional complexity in the price control.

**Resource costs** – the design of uncertainty mechanisms should limit additional costs on Ofgem and on DNOs.

- 1. Are these criteria appropriate and sufficient? Are there alternatives?**
- 2. Which criteria are most important or most heavily impacted by a change in mechanism for RPEs?**

## Ex ante allowance

Fixed element of DNOs' allowances, independent of movement in indices.

Forecast movement in prices from a fixed base year for a number of inputs



Forecasts for each input weighted together to create RPE indices



RPE indices multiplied by cost allowances to produce RPE allowance

## Uncertainty mechanism

We identified four options for indexation:

**A. One-year lagged RPE index** – set RPE value for next year using index data from past six months.

**B. Two-year lagged RPE true up** – true up allowance for outturn index data with two-year lag.

**C. True up at set window(s)** – true up allowance for outturn index data at set points during ED1.

**D. True up at RIIO-ED2** – set an RPE allowance and true up at the RIIO-ED2 for outturn index data.

Option of a deadband with any of these options – allowances only adjusted if movement in outturn data falls outside thresholds.

1. Are there any other options that should be considered?
2. What are the merits and drawbacks of each of these options with reference to the criteria?
3. Would a deadband be appropriate and how should the thresholds be set?

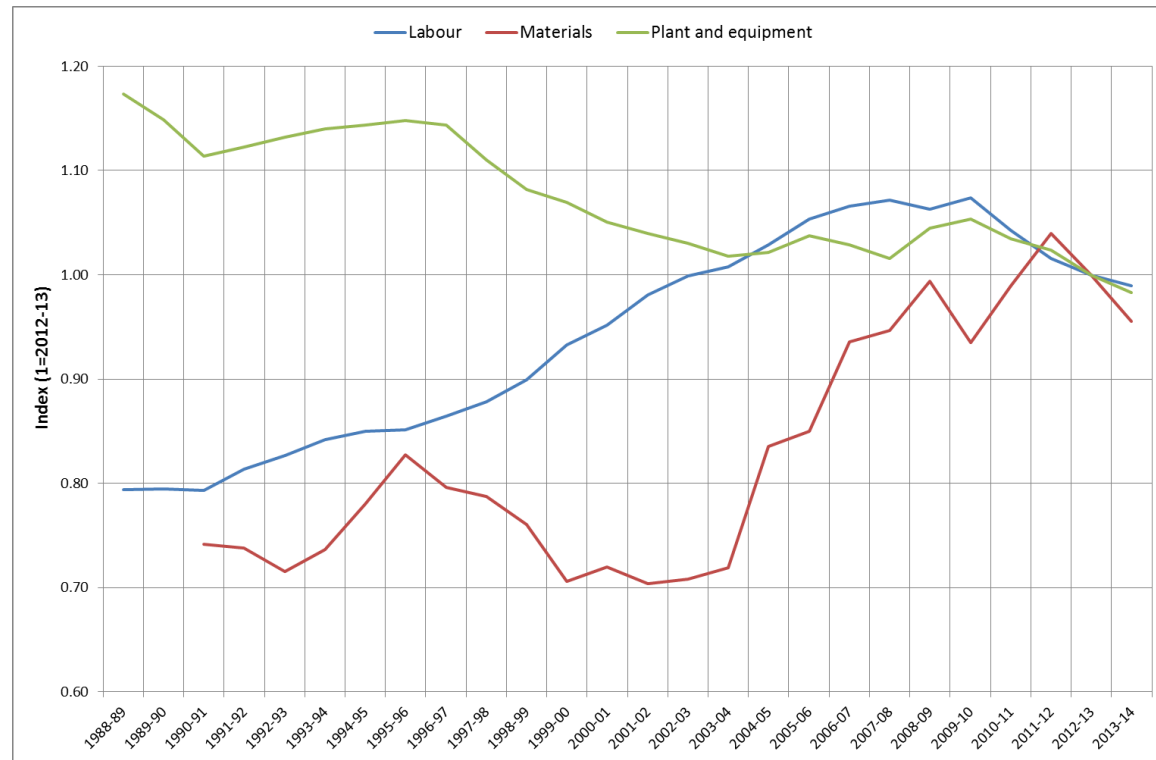
| RPE indexation  | Characteristics  | Assessment  |
|---|--|---|
| <b>Option A: one-year lagged RPE index</b>                | <ul style="list-style-type: none"> <li>No ex ante allowance for RPEs.</li> <li>Set RPE value for next year using index data from past six months</li> <li>Similar to the mechanism used in DPCR5 to set the RPI adjustment for DNOs.</li> </ul>  | <ul style="list-style-type: none"> <li>Protection for actual cost inflation is lower than under other options.</li> <li>Does not provide predictability of network charges - only gives four months' visibility of the revenue adjustment.</li> <li>Consistent with cost of debt indexation for RIIO-ED1.</li> </ul>  |
| <b>Option B: two-year lagged RPE true up</b>              | <ul style="list-style-type: none"> <li>We could set an ex ante RPE allowance based on our best view forecast impact of RPEs.</li> <li>The allowance will be trued up annually for outturn prices (as represented by the chosen RPE index).</li> <li>A two-year lag is required for actual outturn information to be available.</li> </ul>                  | <ul style="list-style-type: none"> <li>Greater visibility of the level of any RPE true up than under option A, ie know the magnitude of the adjustment up to 11 months before it happens.</li> <li>Impact on balance of charges between current and future consumers is minimal as the majority of costs remain with current consumers.</li> <li>Setting an ex ante allowance is likely to reduce volatility.</li> <li>Consistent with our approach to other mechanisms.</li> </ul> |
| <b>Option C: true up at set window(s)</b>                 | <ul style="list-style-type: none"> <li>We could set an ex ante RPE allowance based on our best view forecast impact of RPEs.</li> <li>The allowance will be trued up for outturn prices (as represented by the chosen RPE index).</li> <li>We set window(s) ex ante for any RPE true up assessment during RIIO-ED1.</li> </ul>                             | <ul style="list-style-type: none"> <li>Mitigates the impacts of charging volatility when compared to options A and B.</li> <li>As a two-year gap (so that actual data available), this would provide limited additional benefit to option B.</li> <li>Setting an ex ante allowance is likely to reduce volatility.</li> </ul>   |
| <b>Option D: true up at RIIO-ED2 price control review</b> | <ul style="list-style-type: none"> <li>We could set an ex ante RPE allowance based on our best view forecast impact of RPEs.</li> <li>The allowance will be trued up for outturn prices (as represented by the chosen RPE index).</li> <li>RPE true up will be calculated at the RIIO-ED2 review and included within DNOs' RIIO-ED2 allowances.</li> </ul> | <ul style="list-style-type: none"> <li>This creates the least volatility of all options.</li> <li>Greater imbalance between existing and future consumers than under the other options.</li> </ul>  |

## Application of indexation to different cost types

- Different cost types have shown different historical profiles and different recent trends.
- While this may indicate different mechanisms should be applied to them, we consider this to be contrary to the 'totex' approach under RIIO.

1. What can we determine from the figure about forecast uncertainty in different cost types?
2. Would a single mechanism or multiple mechanisms for different cost areas be most appropriate?

Historical movement in indices for disaggregated cost types





## Proposed indices

| Cost type                  | Index source | Index title/ reference                               | Forecast available   |
|----------------------------|--------------|--|--|
| <b>General labour</b>      | ONS          | Average weekly earnings, including bonuses (K54V)    | Published by HM Treasury (HMT) and Office of Budget Responsibility (OBR) |
| <b>Specialist labour</b>   | BEAMA        | Electrical labour                                    | Published by BEAMA, can also use general labour forecast                 |
| <b>Capex materials</b>     | BEAMA        | Basic electrical equipment                           | Published by BEAMA   |
| <b>Opex materials</b>      | BCIS         | FOCOS Resource Cost Index, infrastructure: materials | None directly relevant   |
| <b>Plant and equipment</b> | ONS          | Machinery and equipment: output PPI (K389)           | None directly relevant   |
| <b>Transport Other</b>     | ONS          | RPI (CHAW) adjusted down by 0.4 per cent per year    | Published by HMT and OBR   |

## Criteria

Availability of independent forecasts

Relevance of indices to DNOs' inputs

Index sample size and composition

Are these criteria appropriate and sufficient? Are there alternatives?

- We will review and consider the discussions today.
- The consultation closes on 26 September.
- Our decision on the mechanism and indices to use will be made as part of Final Determinations.
- Final Determinations are published on 24 November.

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