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Dear Maxine,

Response to consultation on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators

Thank you for the opportunity to respond to Ofgem's consultation regarding the treatment of real price effects (RPEs) for RIIO-ED1 slow-track electricity distribution network operators (DNOs), as dated 28 August 2014.

Our understanding of the scope of the consultation is to determine whether a change in the treatment and estimation of RPEs is warranted against set criteria for an uncertainty mechanism. We also note that the criterion for an uncertainty mechanism is a consultation question.

This response addresses our concerns on the timing of the consultation and our response to the specific questions posed in the consultation.

We also support the response to this consultation submitted by the ENA.

Timing

We recognise the desire for Ofgem to conduct a consultation on the appropriate treatment of RPEs, however we are not supportive of the timing of the consultation so late in RIIO-ED1 price control process. We believe the complexity of any new mechanism could undermine the stability of the ED1 process, particularly the timing of such a fundamental change in the RIIO framework. We are at the latter stages of RIIO-ED1 with final determinations due to be published late November 2014. This leaves a mere six weeks from the end of the consultation for Ofgem to design the mechanism and process it through internal approvals in time for publication.

The RIIO methodology has been developed and debated over three years during the ED1, GD1 and T1 price control processes. We do not believe that there is any new evidence or significant developments that justify a material diversion in the methodology. 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.

For the avoidance of doubt, we do not believe the proposal to adjust the Cost of Debt (CoD) index mechanism is comparable to the consultation on the treatment of RPEs. The CoD amendment amounts to a slight adjustment to a well understood, simple concept. The potential change to RPE treatment would be a material deviation using a highly complex, untried, untested and undefined uncertainty mechanism which would introduce material risk for DNOs and customers.

Correcting the Ex-ante Approach

Although we believe the ex-ante approach to RPEs is more appropriate for customers and DNOs, we have outlined in our consultation response to the Draft Determinations that Ofgem have made several errors in their assessment of appropriate ex-ante allowances. Our endorsement of an ex-ante approach is made on the expectation that Ofgem will amend their RPE proposals, recognising the considerable evidence included within the consultation response.

We have outlined comprehensive and compelling evidence to justify a change to Ofgem's ex-ante approach for Final Proposals, aligning allowances more closely with DNO actual costs pressures while continuing to encourage effective management of RPEs throughout ED1.

Conclusion

We believe that it would be unjustified for Ofgem to move away from the existing RIIO RPE ex-ante methodology which has been used in all recent regulatory price controls. We are not supportive of such substantive change at this stage of a price control review. Amendments to regulatory strategy as significant as the treatment of RPEs does not fit within the later stages of a price control review and risks development of poorly constructed mechanisms to address material issues.

We do not believe there is sufficient time to construct a mechanism that can be appropriately designed, assessed and consulted on prior to Final Proposals. We also note that no other regulator has adopted a similar RPE mechanism which eliminates the opportunity to adopt best practice and learn from experience.

Based on the uncertainty mechanism criteria outlined in the consultation, we believe it is clear that the ex-ante approach offers the most appropriate solution for the treatment of RPEs for DNOs, customers and other stakeholders. The incentive-risk trade-off between DNOs and customers is more effectively balanced to control costs and bills and there is significantly greater certainty on charges for suppliers.

Our response to the Draft Determinations demonstrates that the current methodology used by Ofgem for an ex-ante allowance suffers from a number of judgement errors and inconsistencies. Once corrected, the ex-ante allowance for the industry is in line with comparable benchmarks done in previous price controls and for the CMA decision on NIE.

A failure to address the material issues raised in our consultation response to Draft Determinations will leave DNOs with a choice of a flawed ex-ante estimate for RPEs or a new untried, untested, undefined uncertainty mechanism that introduces charging volatility, risk to DNOs and customers, impacts adversely on the balance of charges between current and future customers and undermines incentive properties for DNOs to manage costs efficiently.

We conclude that it is inappropriate for Ofgem to introduce a new uncertainty mechanism for RPEs at this late stage of the RIIO-ED1 process and the ex-ante approach to the treatment of RPEs is a more effective mechanism than an indexation uncertainty mechanism.

Yours sincerely,

Aileen McLeod
Regulation, Networks

Response to Consultation Questions

We have set out our views on each consultation question below.

Uncertainty Mechanism Criteria

1. *Do you think these criteria are appropriate and sufficient? If not, please explain why and justify any alternative assessment criteria.*

After considering each criterion individually and collectively, we consider them to be both appropriate and sufficient for assessing an uncertainty mechanism. It is worth highlighting that the appropriateness is dependent upon including all relevant factors within one or another of the criteria, something which we believe is achievable based on discussion at the Ofgem RPE consultation workshop.

We strongly believe that Ofgem reflect all criteria in their assessment but we also advocate applying a weighting of importance to each criteria. In the context of affordability of bills and investment, we believe that the management of risk, impact on incentives (to encourage cost savings) and the volatility of charges are the most prominent elements of the criteria.

Although we recognise that due consideration must be given to the other remaining criteria, in particular, the complexity and unintended consequences and the balance of charges between current and future customers, we believe the decision should be primarily informed by the risk-incentive trade-off and balance between DNOs and customers.

Favoured RPE approach

2. *Which of the RPE approaches (including the current approach of a fixed ex ante allowance, or any not explicitly discussed in this consultation) do you favour and why? Please justify with reference to the criteria.*

We have provided a table summarising our rating for each proposed option, including the ex-ante approach.

Critera	Ex-ante	Option A	Option B	Option C	Option D
Exposure to Risk (including volatility)	🟢	🔴	🔴	🟡	🟡
Impact on Incentives	🟢	🟡	🟡	🟡	🟡
Complexity and Unintended Consequences	🟢	🔴	🔴	🔴	🔴
Balance of charges between current and future customers	🟡	🟡	🟡	🟡	🟡
Resource Costs	🟢	🔴	🔴	🟡	🟡

We believe that the ex-ante approach yields the most appropriate mechanism for the treatment of RPEs. We have briefly outlined our reasons under each criterion below.

Exposure to Risk

All indexation approaches demonstrate a significant weakness in regard to risk, in particular Option A and B. This is primarily due to the impact of short term movements in indices increasing the risk to DNO revenues and ultimately charges to customers.

We do not believe an ex-ante approach suffers from this degree of risk since judgements can be made at the outset and it is less likely that DNOs will suffer any material deviation from a well design ex-ante approach. At the moment Ofgem's ex-ante approach is flawed so selection of an ex-ante approach is dependent on Ofgem correcting for errors we have highlighted in our consultation to the Draft Determinations (DD) for Slow Track DNOs (as highlighted in section 3 below).

The introduction of risk leads to an unintended consequence for DNOs by way of aligning DNO allowances and thereby revenues with economic cycles. This has the effect of at least conceptually introducing systematic risk which would allude to a higher cost of equity (through an increased equity beta). Although Ofgem asserts that the equity beta of 0.90 is too high for DNOs, we have presented evidence as part of our response to the DD which disproves this notion. As such we believe the introduction of a pro-cyclicality mechanism will increase the cost of equity for DNOs further above 6.4%.

The level of risk is directly related to the selection of appropriate indices and application of a robust methodology. Any incorrect selection of indices or the construction of a poor mechanism in general increases risk significantly. We outline our view on indices selection below, but it is clear that to mitigate needless risk for DNOs and to ensure customer's charges are representative of DNO actual cost pressures, the indices and methodology needs to be very industry specific. This has negative implications on incentives if not balanced appropriately.

Impact on Incentives

Under an ex-ante approach, the incentive for DNOs to manage costs and invest efficiently is stronger than under an uncertainty mechanism. The incentive is through the Totex incentive mechanism, where DNOs share any cost savings with customers. However, under a poorly designed RPE indexation mechanism, indices that do not reflect DNOs actual cost pressures can encourage inconsistent outcomes by either;

- penalising DNOs with allowance reductions despite improving underlying performance against actual cost pressures; or,

- penalising customers with increase in charges in excess of DNOs actual cost pressures.

If an RPE indexation uncertainty mechanism were developed and adopted based on a suite of indices that accurately reflected DNO cost pressures throughout ED1, in itself a significant challenge, then this would result in a direct pass-through of costs to customers. Therefore an uncertainty mechanism removes the incentive for DNOs to manage such costs more effectively. This is not in the interest of customers as DNOs are better placed to manage the risk of RPEs and sharing the returns with customers.

Complexity and Unintended Consequences

Not withstanding the RPE issues we have raised in our Draft Determination consultation response, an ex-ante approach provides the most stable platform for determining RPE allowances. It is the output of an intensive review and challenge process conducted at the outset of and then through a price control review. This minimises distortion of both performance and Return on Regulatory Equity (RoRE) for DNOs. We have highlighted this above in the impact on incentives where re-calibration of incentives would be required to ensure *best performing DNOs* can achieve low double-digit RoRE as outlined in Ofgem's Strategy Decision for RIIO-ED1.

With regards to suppliers, we believe they are less concerned with volatility if there is certainty in charges. By introducing an indexation approach there is increased uncertainty alongside increased volatility. As Ofgem notes in the 4 October 2013 consultation on the timing of a decision on electricity distribution network revenue,

"Suppliers have indicated that volatility in network charges, the way each DNO recovers the cost of operating its system, is a key concern. Some suppliers have indicated that in order to manage the risk of unexpected changes in revenue they include a risk premium in consumers' energy bills to compensate them for bearing this risk. We agree that the ability to predict charges with a degree of accuracy is important for suppliers and ultimately energy consumers."

The introduction of an RPE uncertainty mechanism would work against the best interests of suppliers and customers. We believe Options A and B suffer most from this given the timing of true-ups, although, we believe Options C and D also suffer similarly as suppliers seek to set charges for pro-longed periods. The ex-ante approach does not suffer from this and therefore is preferable in this regard.

It is also unclear how an RPE uncertainty mechanism would impact on cost re-openers and other RIIO mechanisms. Any mechanism appears likely to amplify any complexity across a number of areas within the RIIO framework.

Balance of charges between current and future customers

Depending upon the design of the uncertainty mechanism it will result in the balance of charges being shifted from current to future customers. We believe, from discussions at the Ofgem RPE workshop, that it will be difficult to mitigate volatility and uncertainty in charges without shifting any true-up in RPE allowances into a future regulatory period, either late ED1 or into ED2. We note that under the proposed uncertainty mechanisms Options C and D mitigate this issue more effectively than A and B. However the an ex-ante approach is still more effective at aligning costs with the appropriate customer generation.

Resource Costs

This is a minor consideration in the context of the other criteria. Conceptually, an uncertainty mechanism will require investment in resources to support it throughout ED1, both for DNOs and for Ofgem. This will be particularly pronounced if Ofgem adopt this approach for other RIIO reviews in future.

Deadband threshold

3. *If we use indexation with a deadband, at what value should the thresholds be set?*

We believe a deadband should be applied to any uncertainty mechanism consistent with other uncertainty mechanisms and re-openers in RIIO. However, we would advocate a cumulative deadband to ensure any lag between actual DNO costs and indices is captured throughout ED1. This will have the effect of trying to reduce and condense volatility.

Appropriateness of Indices

4. *If we use indexation, do you think the proposed indices are appropriate? If not please justify alternatives.*

As outlined above, selection of indices and application of an appropriate methodology is paramount to the design of a strong and effective uncertainty mechanism. Any methodology must be mechanistic to avoid subjective changes throughout ED1 and the contention it brings. However, to achieve this objective, industry specific indices and methodology must be created that accurately reflects DNOs actual cost pressures. Failure to do this would otherwise introduce unnecessary risk to DNOs and charging volatility that are unrepresentative of the industry.

As a result we would strongly advocate a basket of indices that reflect DNOs actual cost base that use the longest data series possible to ensure they are aligned.

We would also be supportive of benchmarking indices against DNO union pay deals to ensure cost pressures are closely matched while ensuring that DNO incentives to reduce costs are retained accordingly.

Single vs. Multiple mechanisms

5. *Do you think that using a single mechanism covering all cost types is more appropriate than multiple mechanisms? If you think multiple mechanisms would be appropriate please justify which one you think should apply to each cost type.*

We believe that only a single mechanism should be used if an uncertainty mechanism is adopted. A single mechanism automatically introduces additional complexity into the price control framework without supplementing this by use of multiple mechanisms. The only case we would advocate multiple mechanisms is in a situation where no appropriate indices were available that would reflect DNO cost pressures accordingly, or where DNO actual information on RPE effects was available, such as benchmarking union pay deals for labour costs (the CMA adopted this approach in their decision on NIE).