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Reasons for our decision on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators

Supplementary annex to RIIO-ED1 overview paper

Publication date: 28 November 2014

Contact: Joanna Campbell

Team: RIIO-ED1

Tel: 020 7901 7094

Email: RIIO.ED1@ofgem.gov.uk

Overview:

This supplementary annex is part of our decision for the settlements (final determinations) for five electricity distribution companies (DNOs) for the next price control (RIIO-ED1). It reflects our decision to retain an ex ante allowance for real price effects (RPEs).

In February 2014 we settled the price control of one group early (fast-track). The remaining (slow-track) companies submitted revised business plans in March. In July we consulted on our draft determinations, based on our analysis of these plans. This was followed by a consultation in August on the treatment of RPEs in the final determinations for slow-track DNOs. Our final determinations take into account stakeholders' responses to both consultations.

We will publish a statutory consultation on the licence conditions to implement these final determinations in December 2014.

Associated documents

RIIO-ED1: Final determinations for the slow-track electricity distribution companies – Overview
https://www.ofgem.gov.uk/publications-and-updates/riio-ed1-final-determinations

RIIO-ED1: Final determinations for the slow-track electricity distribution companies – supplementary annexes

- RIIO-ED1 business plan expenditure assessment
- RIIO-ED1 final determinations RPE methodology decision
- RIIO-ED1 final determinations Financial Model
- RIIO-ED1 final determinations detailed figures by company

The supplementary annexes are on our website:
https://www.ofgem.gov.uk/publications-and-updates/riio-ed1-final-determinations

RIIO-ED1: Draft determinations for the slow-track distribution companies
https://www.ofgem.gov.uk/ofgem-publications/89076/riioed1draftdeterminationoverview30072014.pdf

Decision to fast-track Western Power Distribution
https://www.ofgem.gov.uk/ofgem-publications/86375/fast-trackdecisionletter.pdf

Assessment of RIIO-ED1 business plans and fast-tracking
https://www.ofgem.gov.uk/ofgem-publications/84600/assessmentofriio-ed1businessplansletter.pdf

Timing of decision on electricity distribution networks' revenue for 2015-16
https://www.ofgem.gov.uk/ofgem-publications/86768/ed1revenuechangedecision.pdf

Decision on our methodology for assessing the equity market return for the purpose of setting RIIO-ED1 price controls
https://www.ofgem.gov.uk/publications-and-updates/decision-our-methodology-assessing-equity-market-return-purpose-setting-riio-ed1-price-controls

Strategy Decision for RIIO-ED1 – Overview
https://www.ofgem.gov.uk/publications-and-updates/strategy-decision-riio-ed1-overview

Contents

1. Introduction

1.1. This supplementary annex to our RIIO-ED1 slow-track final determinations is our decision to retain an ex ante allowance for real price effects (RPEs) for the slow-track electricity distribution network operators (DNOs).

1.2. Our decision (Chapter 2) is in line with most of the responses to our consultation. There was limited support for introducing RPE indexation in the RIIO-ED1 price control.

Background

1.3. DNOs' allowed revenues are indexed by the Retail Prices Index (RPI) as part of the price control framework. We expect some of the costs faced by DNOs during RIIO-ED1 to change over the period at a different rate than the RPI measure of economy-wide inflation. These differences in cost changes are RPEs.

1.4. The RIIO-ED1 draft determinations for slow-track DNOs provided a cost allowance for each DNO which included the forecast impact of RPEs. In the draft determinations we recognised that there may be increased uncertainty in a forecast of RPEs. We therefore decided to consult on whether we should use a different method for reflecting RPEs in the cost allowances for the slow-track DNOs during RIIO-ED1.

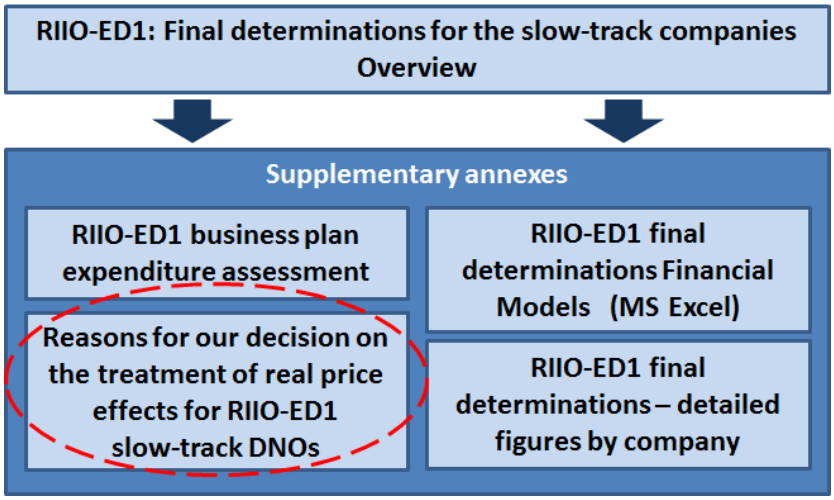
1.5. In August 2014 we published our consultation.[1] It asked for views on the merits of the current approach and options for applying RPE indexation to cost allowances. We also asked for views on the input price indices we should use to create an RPE index if we were to apply RPE indexation. We held a workshop in September to discuss these issues.

1.6. We received eight responses to the consultation from all the slow-track DNOs, the Energy Networks Association, a gas distribution network operator and an energy supplier. A summary can be found in Chapter 3.

1.7. Figure 1.1 shows all the RIIO-ED1 documents we have published today. There are links to these documents in the 'Associated Documents' section at the top of this document.

[1] Our consultation and responses can be found at: https://www.ofgem.gov.uk/publications-and-updates/consultation-treatment-real-price-effects-riio-ed1-slow-track-electricity-distribution-network-operators

Figure 1.1: Map of the RIIO-ED1 final determinations documents



2. Our decision

Summary of our decision

2.1. We have decided to retain an ex ante allowance for RPEs:[2]

- At this stage of the price control process we think there is a significant risk of unintended consequences. This is due to the challenges of designing an RPE index and appropriately addressing its interaction with other areas of the price control settlement.
- In our consultation we noted the importance of stable regulation. We said that at this late stage in the price control review, we would make a change only if there was a strong case for it. We do not think this case can be made.

2.2. RPE indexation could have some benefit. Applying our ex ante approach risks the forecast being wrong. But the RIIO efficiency incentive means the risk of actual costs being higher or lower than forecast is shared between DNOs and consumers.

2.3. We will explore alternatives to the current approach at future price control reviews.

Reasons for our decision

2.4. Our consultation included criteria for introducing uncertainty mechanisms. We used these to assess the options.

2.5. Some responses suggested that we weight the criteria. We don't think it is possible to apply specific weights. However, we think the most significant criteria are exposure to risk, the impact on incentives, and complexity and unintended consequences. This is reflected in our decision.

2.6. We explain the reasons for our decision against each criterion. This includes summaries of the consultation responses and our thinking on them. The majority of responses supported keeping the ex ante approach for RPEs. A supplier and one DNO supported RPE indexation.

Exposure to risk

2.7. In our view two types of risk need to be considered. First, the risk of forecasting error and whether RPE indexation would reduce this. Second, whether introducing RPE indexation changes the overall riskiness of the price control framework. For example, RPE indexation could be considered to increase DNOs'

[2] The ex ante RPE allowances for the slow-track DNOs is described in Chapter 4 of our final determinations overview.

systematic risk.[3] A DNO may expect compensation for this through an increase in their rate of return, which would be paid for by consumers.

2.8. There is inherent risk in setting an ex ante allowance because it is a forecast. Forecasting error could result in DNOs making windfall gains or losses which would affect what consumers' pay for their electricity. This risk is likely to be reduced by using an index for RPEs. But the size of the reduction relies on our ability to choose input price indices that appropriately reflect changes in DNOs' costs. Some stakeholders questioned whether this could be done. We think that it is possible.

2.9. Some DNOs thought that applying RPE indexation would move risk from DNOs to consumers. This would be inappropriate as DNOs are best able to manage this risk. We don't agree. As stated above we consider that forecasting risk is likely to be reduced for all parties when indexation is used.

2.10. DNOs have suggested that the input price indices we proposed to use for RPE indexation do not reflect their cost pressures, making risk greater using RPE indexation than the current approach. A supplier said RPE indexation would reduce overall risk and that we should therefore reduce the allowed cost of capital. We stand by our view in the consultation that there would be limited impact on the overall systematic risk of the RIIO-ED1 price control framework. Therefore, we expect that the cost of capital would be unaffected by applying RPE indexation.

Impact on incentives

2.11. It is important that DNOs are incentivised to be efficient. RPE indexation could reduce this incentive if DNOs' costs can influence the index used. For example, if an index reflects only the movement in the DNOs' input costs, it will increase if a DNO pays higher prices. Responses noted this and added that the risk of this happening is higher at this point in the price control review because there would not be sufficient time to design and consult on an appropriate index.

2.12. We think it is possible to adopt input price indices that appropriately reflect the movement in DNOs' costs while not being inappropriately influenced by the actions they take. We think this is true of the indices we have used to set the ex ante allowance. We therefore don't consider that the incentive on DNOs to seek efficiencies and reduce costs would necessarily be weakened by applying RPE indexation. However, we recognise that at this stage in the price control process it would be difficult to choose an index that we were confident fulfilled our other criteria and was not also unduly influenced by DNO costs.

2.13. On the other hand there may be a greater incentive on DNOs to seek cost efficiencies under the current approach. This assumes that the ex ante allowance provides greater certainty for DNOs to plan and optimise their procurement and contracting strategies.

[3] The risk that is inherent to the entire market and which cannot be diversified through a portfolio of investments.

2.14. In our consultation we reflected that indexation may improve transparency. Under indexation, cost savings driven by the DNO finding efficiencies may be more clearly separable from cost savings due to the ex ante RPE allowance being set too high. This transparency could improve DNOs' decision making, as the impact of management decisions could be more visible. This benefit depends on whether an appropriate index can be set, ie how closely the index tracks DNOs' costs. On reflection, and given the stage we are at in the price control review, there is a risk that the indices may not be sufficiently robust or applicable and therefore these benefits may not be realised.

Volatility and predictability in network charges

2.15. We think charges would become more volatile and less predictable if RPE indexation was introduced. This view is shared by DNOs in their responses.

2.16. Charging volatility affects suppliers' ability to charge their customers accurately. The supplier that responded to our consultation thought the negative impact of increased volatility would be outweighed by the benefit of reducing the forecasting risk inherent in setting an ex ante allowance.

2.17. We considered a range of indexation methods, with differing impacts on volatility and predictability. Our current view is that we would prefer an approach that minimised the number of changes to revenues and charges.

Balance of charges between current and future consumers

2.18. Applying RPE indexation would introduce a lag between the change in input price indices and its impact on DNOs' allowances. The length of the lag varies between indexation options and we could pick an option that limits the impact on the balance of charges.

Complexity and unintended consequences

2.19. We consider that RPE indexation would increase the complexity of the price control framework, relative to an ex ante allowance. In our consultation we proposed that this complexity could be reduced by using an index comprised of a small number of input price indices. Most stakeholders disagreed and felt that more indices would diversify the risk. Based on our current assessment of the available indices, we agree.

2.20. Regardless of the number of indices used, we would need to develop a robust governance framework to deal with material changes to indices during the price control. This would add to complexity - particularly if more indices are used. In addition, without substantive development and testing of the RPE indexation mechanism, this complexity could increase the risk of unintended consequences.

2.21. The RPE consultation highlighted areas of the price control settlement that indexation would impact, including, the licence, uncertainty mechanisms and the Information Quality Incentive (IQI). These interactions could be managed but at this

stage in the price control review we would not be able to consult on the resulting changes.

Resource costs

2.22. As stated in the consultation, we think introducing RPE indexation would add cost for us and the DNOs. However, since the RPE indexation options we proposed could operate automatically we think these costs would be small.

3. Summary of consultation responses

3.1. Eight stakeholders responded to the consultation – all five slow-track DNOs, the Energy Networks Association (ENA), a gas distribution network operator and an energy supplier. Below we summarise the responses to each of our questions.

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

3.2. Stakeholders were broadly content with the criteria. Comments focused on details within each criteria including:

- that the development and implementation of RPE indexation should be considered alongside constraints from the RIIO-ED1 timetable
- the importance of considering financeability within the criteria
- that the criteria for exposure to risk should explicitly consider which party is best placed to manage the risk.

3.3. Some responses suggested we weight the criteria. In general, they thought that the most important criteria were exposure to risk, impact on the volatility of charges and impact on incentives.

Question 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.

3.4. Network companies broadly favoured retaining the ex ante allowance approach. However, the slow-track DNOs and the ENA did not agree with the ex ante allowance we proposed in draft determinations. These responses thought RPE indexation would:

- increase DNOs' exposure to risk because:
  - the costs DNOs are allowed to recover may diverge from the actual costs they face in a more uncertain way than under the current approach
  - it would add systematic risk to the price control (revenues would be increased when the economy is in growth and vice versa), potentially increasing the cost of capital (a point noted by a couple of DNOs)
- put more risk on consumers, even though DNOs are better placed to manage this risk
- reduce DNOs' incentive to minimise costs, eg by de-risking procurement strategies
- increase charging volatility
- increase complexity and the risk of unintended consequences given the limited time to consider and consult.

3.5. There was also support for RPE indexation from the supplier and also one DNO noted some support. The supplier said the ex ante approach had resulted in

windfall gains for network companies and argued that the risk of this would be greater now the price control is longer. It presented its own analysis which suggested that since 2008 the ex ante approach had added £35 to each household's bill. It also considered that RPE indexation would reduce the DNOs' risk and did not agree with our view that this would have no impact on the cost of capital.

3.6. The DNO that gave some support to RPE indexation said that setting an ex ante allowance was still appropriate, but accepted that a true-up of this allowance may help protect consumers if the allowance turns out to be incorrect.

3.7. The consultation presented four options for RPE indexation (options A to D). Option B (two-year lagged RPE true-up) was favoured by the energy supplier as it would mitigate its concerns with the current approach and would balance the impact on volatility with inter-generation charge distortions. If we did introduce RPE indexation, another DNO favoured option C or D (RPE true-up at set windows or at the RIIO-ED2 price control review). This is because, these options, offer the most predictable charges.

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

3.8. There were mixed views on the use of a deadband. Some thought it would be beneficial as it would provide some protection to DNOs and consumers while preserving the incentive for DNOs to find efficiencies. Others were against it because it could create a step change in allowances, add to complexity and reduce the effectiveness of indexation in managing uncertainty.

3.9. One suggestion was to set the deadband threshold at one per cent of revenue because this is consistent with other RIIO uncertainty mechanisms. Another stakeholder suggested that the deadband should be cumulative.

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

3.10. The energy supplier had no firm view on our choice of indices. Most of the network companies were in favour of having more and, in some cases, different indices than the ones we proposed. Points raised included that:

- a larger set of indices would be less volatile and make the overall index less sensitive to potential changes in the composition of individual indices
- we should revisit our choice of labour cost indices
- we should consider regional indices.

Question 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.

3.11. All respondents supported using a single mechanism for RPEs. A move to multiple mechanisms was seen as inconsistent with the totex approach under the RIIO framework and could risk distorting DNOs' behaviour.