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Dear Geoff,

RIIO-T1: Consultation on values within the stakeholder satisfaction output arrangements

Scottish Hydro Electric Transmission plc (SHE Transmission) welcomes the opportunity to respond to Ofgem's consultation on values within the stakeholder satisfaction output arrangements. When developing the RIIO framework Ofgem highlighted the importance of increased engagement with stakeholders and, as part of the RIIO-T1 price control, Ofgem set a specific output, the stakeholder satisfaction output (SSO), to encourage transmission owners (TOs) to be more outwardly focused and responsive to changing stakeholder needs.

We have fully embraced stakeholder participation under RIIO; since submission of our RIIO-T1 business plan we have continued to develop and improve our stakeholder engagement practices, processes and procedures. In fact, in 2014/15, two years into RIIO-T1, we were the top-performing TO, measured across all the transmission stakeholder incentives. We believe that our performance in relation to these incentives is clear evidence that the stakeholder satisfaction output arrangement is driving the right behaviours.

Given this commitment and evidence of good performance we are very disappointed with the proposals outlined in Ofgem's consultation. Indeed, the proposals are of significant concern to us, representing, as they do, a worrying move to retrospective regulation and "hindsight bias" that can only serve to introduce uncertainty into the regulatory framework. We strongly oppose the proposals within the consultation: the timing and process employed for determining licence values; as well as the methodology proposed for setting baselines and weightings. Our concerns cover three primary elements:

- The process of setting baselines;
- Adhering to the policy intention; and
- The methodology for setting the baselines and weightings.

We discuss each of these areas further below, with more detail embedded in our response to the consultation questions found in Appendix 1 (attached).

Process of setting baselines

The process that Ofgem has adopted in setting the baselines is contrary to its previous decisions and, we believe, runs against regulatory best practice. Furthermore, Ofgem has failed to adequately set out why its choice of baselines is appropriate and why it has discounted the TOs' own proposals. Ofgem has stated that *"we propose to move away from this placeholder position to scores we consider best protect the interests of consumers and are consistent with the objective of the incentive"*. However, Ofgem does not justify these statements with any analysis and there is no evidence or rationale provided to support them. Ofgem indicates that it considered alternative approaches for setting baselines but fails to set out why these were disregarded, simply stating *"we have considered other potential values for the KPI baselines, e.g. the mean of the data with some exclusions, a higher baseline than the mean, or another basis. However, as for the stakeholder satisfaction survey, we have not identified a clear rationale for using any of these values."* We do not believe this is considering all alternative means for setting baselines.

Both of Ofgem's proposed options are deeply unsatisfactory and, if implemented, would set worrying precedents for regulated businesses. The original intention, and our expectation, was that Ofgem would look to set the incentive baselines shortly after the start of RIIO-T1 in April 2013. Delaying to set the baselines has introduced regulatory uncertainty and risk, exacerbated by the proposals in the consultation.

The methodology for setting baselines and weightings

Ofgem has not justified the proposed methodology set out in the consultation. Indeed, the proposals contradict recent regulatory decisions made by Ofgem and the final determination by the Competition and Markets Authority (CMA) in the British Gas Trading (BGT) appeal of RIIO-ED1. During that appeal, Ofgem chose not to use two years data, arguing that historical performance data was not a good indicator of future performance. This was supported by the CMA in its final determination where it stated:

In setting the customer satisfaction targets, GEMA used what we consider to be a credible external benchmark to set the target level of performance. There is a lack of evidence, on the basis of two years of recent performance data, that DNOs will systematically outperform the targets over ED1.

We set a high standard for stakeholder engagement, with work starting well before the price control was implemented (on 1 April 2013). We remain committed to maintaining a high level

of stakeholder satisfaction and believe that our performance to date is above the level of 'neutral' performance. We therefore believe that using an average of TO performance to date will generate a higher than 'neutral' baseline. This creates a worrying precedent and a potential disincentive for TOs regarding future incentives and policies.

With regards to weightings, the rationale for setting the values is unclear to us; Ofgem has not set out why the TOs proposals are considered inappropriate, despite TO external assurance, and have instead proposed alternative weightings with no supporting evidence or justification.

Adhering to policy intention

Our understanding of the original policy intent for the SSO was to reward companies who performed above a baseline 'neutral' performance level, and penalise companies below that baseline level. However, in the absence of an appropriately defined and justified reference point, the 'neutral' point selected by Ofgem could inadvertently penalise "good" performance and reward "poor" performance.

Additionally, Ofgem's proposals include retrospectively applying benchmarks using actual data which in essence is "hindsight bias". Ofgem has sought to avoid this in previous regulatory proposals e.g. when setting out its amended approach to assessing pensions reasonableness.¹

The alternative option proposed by Ofgem is to eliminate the application of the incentive in the first two years of the price control. This is completely unacceptable and, if implemented, would set a very worrying precedent. It would result in penalising companies who have, in good faith, based upon the agreed regulatory settlement, undertaken stakeholder activity based on the expectation of reward for good performance. Eliminating the incentive would create regulatory uncertainty, which could have a knock on impact on the cost of capital, potentially increasing costs to consumers.

In summary, we are very disappointed with the proposals in the consultation and cannot support them. We believe that Ofgem should revisit its suggested methodology and policy intent and undertake further analysis to identify the most appropriate 'neutral' reference point. We are concerned that Ofgem has not set out transparently why it does not consider that the TOs' proposals are appropriate. Ofgem's proposals are especially worrying as they would represent a move to retrospective regulation, something that the TOs and Ofgem have previously argued against and sought to avoid.

¹ Ofgem - Second Consultation on Ofgem's policy for funding Network Operators' Pension Scheme Established Deficits, March 2016

A detailed response to the consultation questions is provided in Appendix 1. In addition to this letter we would appreciate a bilateral meeting to further discuss our views prior to any Ofgem decisions.

Yours sincerely,

Malcolm J. Burns
Senior Regulation Manager

Appendix 1

This appendix sets out our detailed response to the consultation questions.

Question 1: *Do you agree with our proposal to use the mean of outturn data across TOs to set a robust baseline?*

Ofgem states that the average of the survey scores over the past three years is an indicator of 'neutral' TO performance. By achieving this level of performance TOs will be neither rewarded nor penalised. However, Ofgem does not provide adequate justification as to why the average of actual performance is an appropriate reference point for 'neutral performance'². Ofgem has not set out what the appropriate reference point should be nor why TO past performance is indicative of this reference point. In the absence of any evidence or analysis, Ofgem cannot reasonably assert that past TO performance cannot be considered above or below that reference point. Additionally, there is no presentation of third party evidence and Ofgem is relying on a small data set without any adjustments for outliers. We believe this is contrary to previous decisions by Ofgem, counter to its own previous arguments and decisions taken by other regulators, namely the CMA. The arguments that Ofgem are utilising are similar to that used by BGT in their appeal on RIIO-ED1 to the CMA. BGT argued, in relation to RIIO-ED1 incentives, that:

- (a) *the targets set by GEMA under the BMCS have been relaxed by comparison with the targets applicable under the last price control; and/or set at a level that was too low, when assessed against DNOs' recent performance; specifically:*
 - (i) *In the case of the customer satisfaction survey, the targets for the interruptions were set below the average level of performance of DNOs in 2013/14;*

By way of remedy, BGT requested that the stakeholder incentive scheme target should be recalibrated as follows:

- (a) *Customer satisfaction survey: the target starting point for each of the customer satisfaction survey elements should be set **at the average of DNOs' average performance in each category across 2012/13 and 2013/14 [emphasis added]**. To encourage improvements in performance, the target score should be increased each year on a straight-line basis from the starting point to the average of DNOs' upper quartile performance in each category across 2012/13 and 2013/14.*

² Ofgem consultation, page 14, "The intent in the licence drafting was for an absolute baseline of 'neutral' performance, across the whole period, rewarding/penalising good/bad performance about this point.

- (b) *Complaints metric: the target starting point for the complaints metric should be set at **DNOs' average performance across 2012/13 and 2013/14 with straight line improvements to the upper quartile as per the customer satisfaction survey [emphasis added].***
- (c) *Stakeholder engagement incentive: the scheme should offer a linear reward incentive between the **minimum reasonable performance of 6 and the maximum possible score of 10 [emphasis added].***

Ofgem challenged these requests as summarised in the CMA Final Determination.

5.79 GEMA made a number of general points regarding BGT's assertion that the targets that it had set for the BMCS would lead to systematic unearned rewards. The main points were:

- (a) ***historical performance data was not a good indicator of future performance [emphasis added].** This was because of the evolving nature of customer satisfaction, and the fact that the scope of the BMCS changed in RII0ED1;*
- (b) ***GEMA looked at data outside the electricity distribution industry in designing the BMCS to ensure that DNOs' customer service was good when compared with a national standard [emphasis added];***
- (c) *BMCS data for 2013/14 was not available at the time when GEMA set the targets, in December 2013; and*
- (d) *the aim of the BMCS was not in any case solely to incentivise improvements, but also to encourage DNOs to maintain good levels of customer service.*

In the final determination set out by the CMA, BGT's grounds for appeal on this element were dismissed on the following basis:

- (a) *5.85 We consider the context of the relatively recent introduction of the BMCS to be important. **This means there is very limited information on the historical performance of DNOs and there is therefore a limited basis for making a judgement about likely future DNO performance [emphasis added].***
- (b) *5.86 **In setting the customer satisfaction targets, GEMA used what we consider to be a credible external benchmark to set the target level of performance. There is a lack of evidence, on the basis of two years of recent performance***

data, that DNOs will systematically outperform the targets over ED1 [emphasis added].

For the SSO proposal, Ofgem appears to be replaying very similar arguments to BGT; arguments that Ofgem challenged and the CMA dismissed. On this basis we see no rationale, justification or precedent that would support Ofgem's analysis and proposals in the consultation. Additionally, in its MPR decision, Ofgem elected not to review Network operator's expenditure and revenue performance on the basis that "*reporting made available to date only covers the first 2 years of the price controls we don't think this should be used as the main tool to identify changes in output requirements for the eight-year period, which is the focus of the MPR*³". In this regard Ofgem is not relying on only two years of performance data to change output targets yet have decided to do so for the SSO.

As such, we see no evidence that the TOs' performance is indicative of 'neutral' performance and Ofgem has not set out clearly with analysis that its methodology is a suitable benchmark. Averaging actual performance is not an appropriate reference point as it is using data from after the incentive has been implemented. Furthermore, turning off incentives or changing targets with "hindsight bias" introduces regulatory risk which Ofgem has previously sought to avoid (e.g. its pensions reasonableness decision).

Question 2: Which of our two lead options for setting the survey baseline do you prefer?

We are not supportive of either approach for setting baselines for the price control and we believe that Ofgem needs to revisit the basis for its benchmark/baseline proposals. It also needs to consider whether such proposals undermine the price control (by eliminating the impact of the incentive) and whether this is appropriate for assuring regulatory certainty. In its decision for the MPR Ofgem stated that "*increasing regulatory risk in this way would lead to higher financing costs and costs to consumers*"⁴. We believe that the proposed options for the SSO introduce regulatory uncertainty, particularly in relation to setting a negative precedent for future incentives.

Question 3: Are there any other policy proposals for setting the survey baseline that you think are more appropriate?

We have set out our proposals for reconsidering Ofgem's approach to setting the baselines for all incentives above and we believe Ofgem must enter into a more inclusive, transparent and evidenced based process. We propose that a benchmark is set reflective of some form of independent third party evidence/assessment and is only set for the *remainder* of RIIO-T1. As such the incentives/penalties earned/incurred by TOs in the first two years of the price control

³ Ofgem, page 3

⁴ Ofgem, page 4

should be unchanged. We believe this approach is consistent with Ofgem's arguments in the BGT appeal to the CMA and supported by the CMA's decision. Ofgem's delay in determining benchmarks does not mean that these were inappropriately set for the first two years and, we believe, if they are reset now they would be subject to a form of "hindsight bias".

Additionally, as argued by Ofgem, customers or stakeholders expectations will increase over time thereby making it more challenging to achieve flat stakeholder satisfaction scores. Therefore, the baseline will be even more challenging in the future. In the absence of an appropriate third party benchmark or a robust methodology that does not utilise the actual in-period performance data, we believe the TOs proposed benchmark is more appropriate as a starting point.

Question 4: *Do you agree with our rationale for setting the baselines for the KPI component of the stakeholder satisfaction output arrangements?*

We have set out the substance of our response above for all changes in relation to the SSO. We do not believe Ofgem has justified an appropriate reference point for 'neutral' performance on which to reward/penalise TOs performance. The lack of third party information or an appropriate methodology to set the baselines is a significant shortfall and contradictory to Ofgem's previous position in the BGT appeal to the CMA and even in the MPR decision.

We recognise that the KPIs are distinctly different between SHE Transmission and SP Transmission. However, using the average of two for each to set the target as 'neutral' is not justifiable. Without an appropriate reference point it is not possible to distinguish 'good' performance from 'bad' performance. Using the average performance in the first two years by each TO in order to set their individual baselines can represent the average of 'good', 'bad', or 'neutral' performance, we simply do not know without a clearly justified reference point. A TO with 'good' performance in the first two years will therefore be penalised in the remaining years as the 'neutral' point is set using the average of 'good' performance, thus too high to represent 'neutral' performance, Conversely, a TO with 'bad' performance in the first two years will be rewarded as its 'neutral' reference point is actually based on an average of 'bad' performance.

Question 5: *Which of our two lead options for setting the KPI baselines do you prefer?*

We strongly believe that Ofgem's two options for the first two years of the price control, in particular "switching-off" the incentive, is against regulatory best practice, contrary to the policy intent, and introduces a worrying precedent that will increase regulatory uncertainty.

Question 6: *Are there any other policy proposals for setting the KPI baselines that you think are more appropriate?*

As we have set out previously, we believe further work is required to ascertain whether the benchmarks are appropriate and whether the KPIs remain suitable.

It is more appropriate to construct a 'neutral' reference point with third party evidence and clear analysis and rationale. We also believe that it may be more appropriate to continue to consider allowing KPIs that are appropriate to each TO but setting baselines on a more consistent, justified and independently supported methodology. Prior to undertaking this work, we believe Ofgem needs to set out why it has disregarded the TOs own proposals to understand any shortcomings or gaps in analysis in their work.

Question 9: *Do you agree with our proposals for the weightings for the component parts of the incentive for National Grid and the Scottish TOs? If you consider there to be an alternative and well-justified basis for setting the weightings, we welcome views on this.*

The justification for the weighting proposal is based on an unclear rationale. Ofgem states that changes to NGET's weightings is because Ofgem "have now seen the outturn data we now have more confidence that the stakeholder survey results are stable, so we do not think that a low weighting for the entirety of the price control is warranted on these grounds." Ofgem has not set out why it has more confidence other than the data for two years being available. The original policy intention was to have equal weighting between elements which neither of Ofgem's proposals achieve. In the absence of clear justification for deviating from policy, we do not believe these should be altered for any years of RIIO-T1. For the Scottish TOs the weightings are based on the importance Ofgem has placed on the Stakeholder Satisfaction Survey relative to the other elements of the incentive. At this stage we see no reason to object to a higher weighting for the survey although we do not believe the weightings selected have been considered in detail. We believe that the rationale should be set out more clearly in the decision and although we appreciate that this is an area of judgement, we believe that Ofgem should outline more clearly why it has reached that particular judgement.

Question 10: *Do you agree with our suggestion to use the weightings to effectively switch off the incentive should Option 2 be the preferred option?*

We have outlined our response to switching off the incentive above, and as such we do not agree with the weightings which implement this. We believe that there are clear procedural flaws and a lack of adequate justification to support this proposal. In addition, as noted earlier, the proposals appear to contradict earlier regulatory precedent.

Question 11: *Do you agree with our proposals to set the caps and collars for NG's and the Scottish TOs' stakeholder satisfaction survey at +/-1.6 around the baseline? We welcome views on any alternative and well-justified basis for setting these caps and collars.*

We do not see why these caps and collars have been set for National Grid. Ofgem should set out more clearly why these are appropriate caps and collars and whether these achieve the original policy intent.

Question 12: *Do you agree with our proposals to set the caps and collars for SHE Transmission's KPI at +/-11 around its baseline (i.e. 100 and 78 respectively)? If you consider there to be an alternative and well-justified basis for setting these caps and collars, we welcome views on this.*

Following our comments on the previous consultation questions, we believe that these caps and collars are not adequately justified.

Question 13: *Do you agree with our proposals to set the caps and collars for SP Transmission's KPI at +/-16 around its baseline (i.e. 85 and 53 respectively)? If you consider there to be an alternative and well-justified basis for setting these caps and collars, we welcome views on this.*

Following our comments on the previous consultation questions, we believe that these caps and collars are not adequately justified.