Consultation on the mid-period review of RIIO-T1

Citizens Advice formal response

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citizens advice

Summary

Citizens Advice welcomes the opportunity to offer views on Ofgem's minded-to positions on its RIIO-T1 mid-period review. Within the narrow context of a review into RIIO-T1, we welcome the steps Ofgem are taking to deliver consumer benefit. Detailed comments follow, but our principal comments are:

- Consumers stand to benefit by **£185.4m** from the reductions Ofgem proposes. This robust action from the regulator in recovering consumers' money for outputs that are no longer required is extremely welcome.

- In the wider context (over the remainder of the price control), in excess of **£1bn** of transmission and gas distribution networks' future outperformance will be due to price changes, which is not justified on the basis of innovation and efficiency savings. While RIIO is an important step forward for network regulation, it is still not working optimally for consumers.

General comments on RIIO

Our position starts from a broader view than the regulatorily narrow confines of this mid period review. The forecast rate of return on regulated equity for the three transmission companies averages at 9.3%[1]. However, transmission networks are fundamentally low-risk assets[2] and this is well in excess of what we believe is appropriate for low-risk investments. For all networks, the era of extraordinary returns for run-of-the-mill performance should come to an end.

In our previous consultation response on whether to hold a mid period review for T1 and GD1[3], we argued strongly that they should be an opportunity to conduct a bottom-up analysis of how RIIO-T1 and RIIO-GD1 have functioned to date and to identify where there are opportunities to deliver better value for consumers. We are pleased that this is being acted on to some extent, through the additional work Ofgem are conducting on output accountability, filling gaps in the RIIO framework and improving RIIO's operation. However, we remain disappointed that the opportunity for a root-and-branch review is being missed.

We would particularly welcome Ofgem's attention in two areas. Firstly, we do not believe that the Weighted Average Cost of Capital is appropriately calibrated. As we argue in *Many happy returns*[4], Ofgem should consider the following:

a) Ofgem currently benchmarks the cost of debt to real world corollaries. This should be extended to the estimation of the risk-free interest rate, using the return on government gilts as a proxy; and
b) Ofgem should shorten the time horizon of the cost of debt index from 10 to 5 years, to more accurately track market prices.

Secondly, Ofgem should reconsider indexation of real price effects (RPE), that vary in ways not tracked by RPI. In the 2014-15 RIIO-T1 annual report and the 2013-14 RIIO-GD1 report (the RPE impact forecast was not updated for 2014-15), Ofgem identifies that a significant proportion of companies' future outperformance under RIIO will accrue in virtue of expected prices changing at lower rates than Ofgem forecasted. This amounts to £462.3m in RIIO-T1 and £600m in RIIO-GD1[5], combining to over £1bn across transmission and gas distribution companies over the remainder of the price control. This outperformance is not earned through companies increasing efficiency. It is due to wider market conditions over which exert have little or no control.

[1] RIIO Electricity Transmission Annual Report, Ofgem, 2014-15.
[2] Many happy returns, Citizens Advice, 2015.
[3] Citizens Advice formal response: RIIO-T1 and GD1 Mid-Period Review, Citizens Advice, 2015
[4] Many happy returns, Citizens Advice, 2015.
[5] RIIO Electricity Transmission Annual Report, Ofgem, 2014-15 & RIIO Gas Distribution Annual Report, Ofgem, 2013-14.

We recognise there are complexities in indexing RPEs and that Ofgem had to make a number of finely balanced judgements under uncertain conditions when it designed the first iteration of RIIO. As Ofgem stated in the final decision on RPEs in RIIO-ED1[6], 'RPE indexation could have some benefit. Applying our ex ante approach risks the forecast being wrong' but concluded that the risks of unintended consequences were high and introducing it at that stage of price control development would lead to regulatory instability.

However, sufficient data about price effects is now available. The current approach to forecasting costs is not working in consumers' interests and leads to considerably higher bills. Ofgem needs to learn these lessons for future iterations of RIIO.

The mid-period review analysis

Before considering the mid-period review's subject matter itself, we offer comments on the quality of the analysis presented. The consultation inadequately demonstrates how Ofgem has reached its decision to allow or disallow particular revenue for transmission companies. While we expect that very detailed discussions have taken place between the transmission companies and Ofgem regarding an appropriate allowance, this does not seem to have happened in the clear light of day. We do not think that the process has been designed with the needs of transparent, external scrutiny in mind.

For example, this is the most detailed analysis provided on why NGET's requested allowances were amended[7]:

Output area	NGET's funding request (2009/10 prices)	Our proposed allowances (2009/10 prices)
ITPR activities	£16.92m	£15.00m
SBR/DSBR	£4.56m	£4.50m
DSR	£2.10m	£2.02m
Total allowance impact	**£23.58m**	**£21.52m**

[6] Reasons for our decision on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators, Ofgem, 2014
[7] Impact assessment for the mid-period review (MPR) of RIIO-T1, Ofgem, 2016

This offers insufficient detail of the specifics of NGET's funding requests, the business case behind them, or the reasons for Ofgem varying the allowance. In future, Ofgem and network companies should make much more detailed information accessibly available. We detail how this has prevented us from offering firmer views on certain matters below.

Gas Transmission

Question 1: Do you have any views on our proposals to remove the pipelines output and allowances?

The Avonmouth pipelines were originally included to address safety and security of supply issues but due to lower demand forecasts over the period of the price control, NGGT has concluded they are no longer needed and has not made a case for alternative investment.

In this context, Ofgem is adopting the correct approach. Allowed revenue should be reduced by the amount allocated to the Avonmouth pipeline (£168.8m). This is precisely the issue that a mid-period review is designed to address and Ofgem are taking necessary steps which are in consumers' interests. We also strongly agree that the output should be removed at this stage, rather than allow NGGT to continue to recover this money from consumers and return it to them at the end of the price control.

We welcome that NGGT have been upfront about their changing forecasts and the impact this has on necessary output expenditure. We note their argument that as they will have accrued approximately £86.6m from consumers by the end of the mid-period review, to recover this money would represent the retrospective action Ofgem promised not to undertake.

This is unjustified. Even if there were ambiguity in the regulatory framework on this point, a publicly spirited company would not seek to charge consumers for something they did not build. In their consultation response regarding a potential mid-period review[8], NGGT argued that while the required output was 'defined as a pipeline solution' in the Final Proposals, this has 'created some confusion' and the output required by consumers is to effectively manage the 'capacity reduction from the decommissioning of the Avonmouth LNG facility'.

However, the output NGGT believe meets users' needs is not the actual output which was funded. Network companies cannot, with good reason, retrospectively redefine outputs in this way. If they believed this is how the output should have been defined, then they should have made that case as part of the original settlement. As Ofgem rightly notes, the mid-period review permits Ofgem to decide outputs are no longer necessary and revenues follow output delivery. It would be improper for Ofgem to take any other decision.

[8] Consultation on a potential RIIO-T1 and RIIO-GD1 mid-period review, Network companies responses, NGGT, 2016

Electricity Transmission

Question 1: Do you have any views on our proposals to allow funding for NGET's enhanced SO activities?

ITPR project

In principle, we welcome the Integrated Transmission Planning and Regulation project as a way of increasing competition for the building of major transmission assets. We agree that funding for this project is necessary.

As argued above, it is difficult for us to offer a view on the appropriateness of the level of funding given the paucity of the analysis presented as to why the funding is being set at £15m. This is particularly important when considering a project aimed at fostering competition. Competitive processes are valuable only insofar as the benefits they deliver outweigh the costs of running them. A cost-benefit analysis that detailed the value case for this project, given the level of funding requested, would have been welcome.

We also accept that, given the proximity of the licence changes to the mid-period review, funding this output through this review is appropriate. However - particularly if the System Operator function is formally separated from NGET - we believe there is a case for conducting a thorough review of the funding for all SO operations.

New balancing services

We note that the new balancing services were not specified as a potential new output in the 2015-16 consultation on a potential mid-period review. It is best-practice to consult on the outputs that are being considered in advance of reaching a minded-to position, especially when the level of analysis presented in this consultation does not illuminate the need case or the business case for this level of funding. While there may well be excellent cases for the level of funding suggested for both these new outputs, it is not possible for us to support it on the basis on the evidence presented.

Demand-side response

We are unconvinced that a case has been made for funding to support 'efforts on demand-side response services'. While we recognise the £2m additional funding over the remainder of the RIIO period is modest, we are both unclear on the value of what consumers are being asked to fund and whether it is genuinely outside of the System Operator's 'business as usual'.

From the website referenced in the consultation response for Power Responsive[9], the service it is suggested that consumers fund, we are not sure what ‘a framework for turning debate into action…a practical platform to galvanise businesses, suppliers, policy makers and others’ actually means. It *seems* as if what is intended are opportunities for interested parties to discuss demand-side response. Opportunities for industry collaboration on DSR are valuable, but markets for energy conferences and seminars already exist. Moreover, we would expect the SO to be undertaking this engagement as part of its normal activities. We therefore do not support this additional consumer expenditure, on the basis of the evidence that has been presented.

Question 2: Do you have any views on our proposals to reduce the fault level output and funding for NGET?

Question 3: Do you have any views on our proposals to declassify the shunt reactor output and make no adjustments to allowances for NGET?

As with the Avonmouth pipeline, we welcome transmission operators’ up-front approach to identifying when outputs are no longer needed - in this case, only needing to protect one of nine original sites against rising fault currents, with a current allocation of £39.5m. We therefore agree that Ofgem should remove the £38.1m of this allowance that is not required and return this money to consumers, in the same way as they propose for the Avonmouth pipeline.

NGET is currently funded to provide 11 shunt reactors and has an allowance of £53.3m for this output. It now forecasts that there is a higher need for voltage control than expected and therefore needs to increase its spend to £112m. However, we note that NGET do not make this case for increased necessary spend in their consultation response on a potential mid-period review, in which it was content for a mid-period review not to be opened.

We strongly agree with Ofgem’s proposal to declassify shunt reactors as an output, given there are other ways voltage can be controlled and require NGET to control voltage within the existing allowance. NGET should seek the most efficient way of meeting its voltage control requirements with the existing funding that has been allowed. NGET has not made the case that this cannot be achieved with the current funding available; in any case, this is a risk that is appropriate for them to bear.

[9] http://www.powerresponsive.com/