A Fair Return

Stakeholder workshop

24 October 2017

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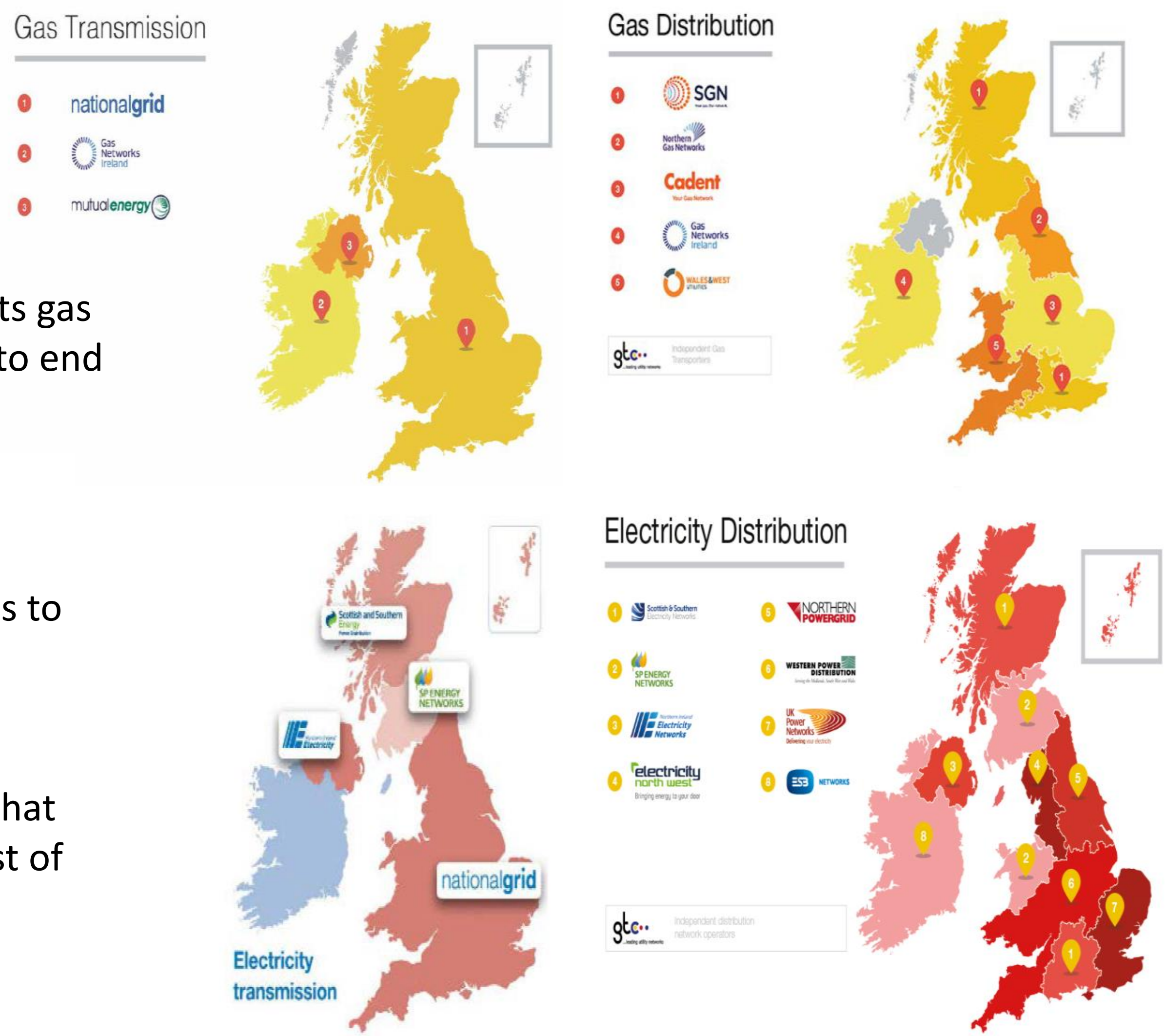
Agenda

Time	Item	Leading
13:30	Welcome and context	James Veaney
14:00	Stakeholder views	Centrica and Northern Gas Networks
14:30	An alternative approach	James Veaney
14:45	Breakout sessions	
15:45	Feedback from breakouts	
16:25	Wash-up and Close	James Veaney

Context and Background

Network Companies & Price Controls

- The infrastructure that transports gas and electricity from generation to end user is owned and operated by regional network companies
- Because these are monopolies, Ofgem regulate these companies to ensure consumer interests are protected
- This includes setting the prices that they can charge to cover the cost of their activities



Source: National Grid

RIIO-2

- The current suite of network price controls allow the recovery of nearly £100bn of revenue to ensure gas and electricity can be transported from point of generation to end user. 25% of the supply bill funds this investment

- Our approach to controlling the prices the network companies charges follows the RIIO model – where **R**evenue = **I**ncentives + **I**nnovation + **O**utputs

- The first round of RIIO price controls – gas distribution and gas/electricity transmission – end in 2021. Work on the price controls for these sectors will start next year.

- Before we launch into sectoral reviews, we want to understand whether any elements of the RIIO framework need to change

- In July we issued an Open Letter on the context for the development of RIIO-2. In February we plan to publish a consultation on the framework for the next round of controls

Why are you here today?

- In our open letter we set out our draft overarching objective detailing what we believe RIIO-2 will need to focus on, building on the RIIO framework and making changes where we have learnt lessons or where we will need to adapt to the future.

- We want to make sure that we are involving our stakeholders in this process

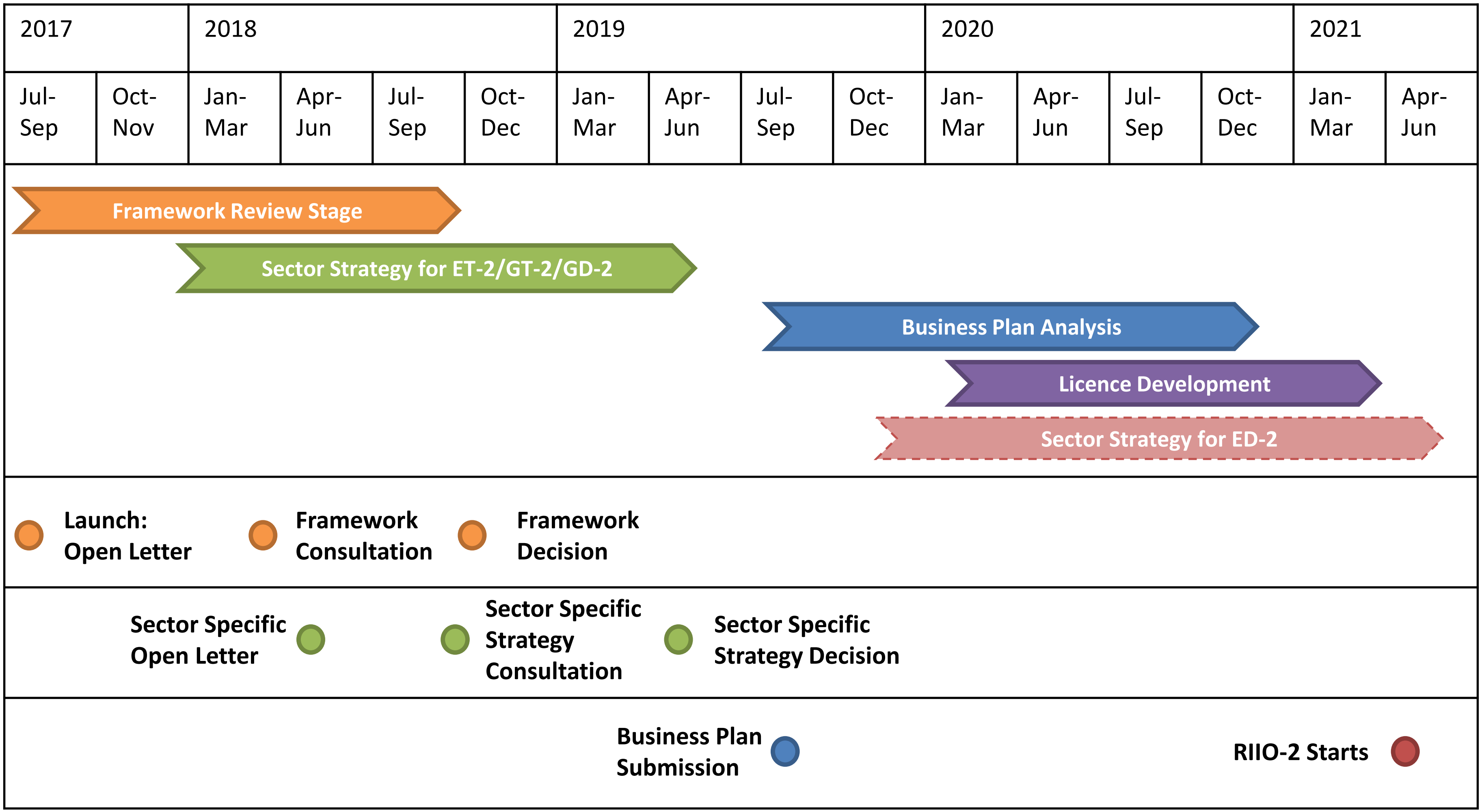
- Today is one of a series of workshops which we are holding over Oct and early Nov to get your views on some of the key issues we will be considering as part of our framework consultation.

To ensure regulated network companies deliver the flexible services that consumers want and need.*

RIIO 2 will aim to achieve this by:

- Giving consumers a stronger voice in setting outputs, shaping and assessing business plans;
- **Allowing regulated companies to earn returns that are fair and represent good value for consumers, properly reflecting the risks faced in these businesses, and prevailing financial market conditions;**
- Incentivising companies to respond in ways that benefit consumers to the risks and opportunities created by potentially dramatic changes in how networks are used;
- Using the regulatory framework, or competition where appropriate, to drive innovation and efficiency; and
- Simplifying the price controls by focusing on items of greatest value to consumers.

Timetable



This timetable is indicative. We will continue to develop our plans and milestones may change

Purpose of this workshop

- Share with you our initial thoughts on what can drive high returns and why this has the potential to raise concerns for RIIO-2

- Listen to your views on what we could do to ensure the returns earnt in RIIO-2 are fair for investors and consumers

- Get your thoughts on alternative approaches that we could consider and what the associated benefits or implications of these could be

- *(What we are not doing at this time is looking at the underlying costs of the network companies, the cost of capital for RIIO-2 or the level of return currently being earnt)*

- **The return a company earns should reflect:**
  - The need to be able to finance their activities
    - Returns in the market for low risk assets
    - The systematic risk that investors in the company face
  - The value the companies create for consumers
    - The extent to which they deliver outputs in the interests of current and future consumers
    - The efficiency with which they carry out their activities, allowing costs to go down over time
    - The extent to which the company allows us to set price controls across the sector that protect consumer interests
- **This has resulted in:**
  - A cost of capital, including a cost of debt and equity
  - Allowances set up front (ex ante) with incentives to find more efficient ways of meeting consumer needs
  - Rewards for good quality business plans and accurate forecasts
  - Outputs with incentives aligned to value to consumers
- **Combined, these provide a return on regulatory equity (RORE)**

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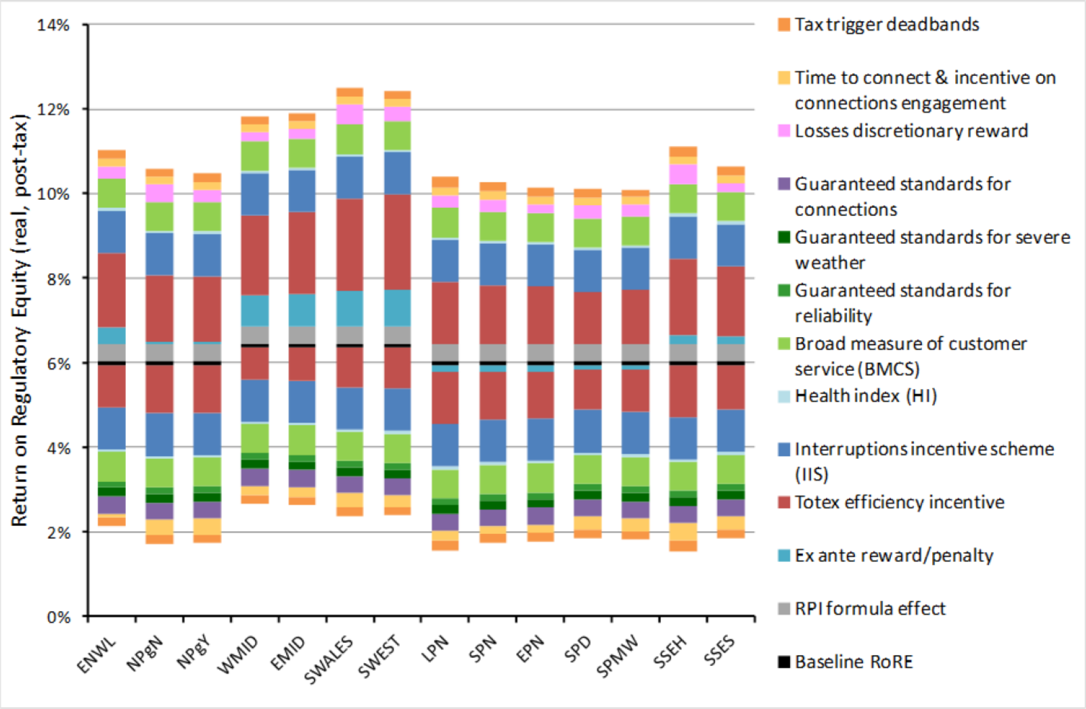
In principle

- RIIO-1 enabled a well performing company to earn higher than its cost of equity. In RIIO-ED1, with a 6% cost of equity a well performing company could earn double digit returns
- Should be stretching and require innovation, cost efficiency and good service. Poor performers should earn below their cost of equity. This should put investor pressure on management teams to improve.



In reality

- **Returns across each sector well above cost of equity.**
- **Driven by significant levels of underspend & output targets being met**

	Cost of Equity	8 Year RoRE Range	8 Year Sector Average	8 year forecast underspend (£bn)
ET	7.0%	9.4% - 11.5%	**10.1%**	1.8
GT	6.8%	8.4% - 8.4%	**8.4%**	0.0
ED	6.0%	7.2% - 11.6%	**9.0%**	0.9
GD	6.7%	8.9 – 12 %	**10.7%**	2.2

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centrica

Presentations:

1. Centrica
2. Northern Gas Networks

Northern Gas Networks

RIIO2 Framework

24 October 2017

centrica

Ensuring Fair Returns

- **Network companies need returns that are fair and seen to be fair**
  - Consistent out-performance brings legitimacy into question
  - Returns should reflect risk

- **Clarity over the *intent* of price control essential**
  - Trying to mimic competitive pressures
  - Distribution of returns

- **Different options over how to implement intent**
  - Deciding key questions early will aid implementation
  - Stakeholders can help with detailed design

What should the return a company earns represent

- **Cost of equity likely to need to be the expected return for the ‘average’ performing company to be seen as legitimate**
  – Distribution of returns to be based on expected actual performance
  – Incentives should not be a ‘back door’ method of increasing baseline return on equity

- **Other approaches will need full and transparent justification**
  – All networks being expected to outperform requires explaining

- **How does the expected actual performance affect the assessment of cost of equity**
  – How does the expected distribution of returns impact the baseline

How can we distinguish between good and bad performers

- **Incentive rewards/penalties should aim to reflect *relative* performance**
  - Mimics competitive pressures
  - Incentives should aim to be zero-sum
  - Difficult to achieve when fixing targets in advance

- **Alternative is to reward *improved* performance**
  - May be appropriate where comparators are not available
  - Encourages collaboration
  - Also has proved difficult to achieve when fixing targets in advance

- **Clear and explicit discussion and decision required**

How can we improve the framework to minimise 'undeserved' returns

Enhanced scenario analysis	Rolling targets/zero sum incentives	Shifted returns
When setting price controls take greater account of expected performance. Ensure distribution of expected returns is symmetric on this basis. Current incentive properties maintained. No 'hard' control on level of returns.	**Move to setting incentive targets on a rolling basis with zero sum rewards the expected outcome. Some incentives may be suited to a strict zero-sum approach.** Maintains ex-ante incentive properties. Adjusts targets as performance is revealed to keep appropriate.	**Price control runs as current. Returns are then shifted to be distributed around a rate of return assessed as fair.** Maintains ex-ante incentive properties. Certainty over average level of returns but introduces uncertainty over individual network returns.

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‘A Fair Return’

RIIO-2 Workshop – October 2017

Gareth Mills

Head of Regulation

Two key elements to this question:

- Base Level of Return
- Return for Good/Bad performance

Base Level of Return

Cost of Capital

Cost of Equity

- Long term Averages or current market rates?
- Indexation of RfR?
- Legitimacy?
- Risk & Beta - Uncertainty?
- Premia to RAV?

Cost of Debt

- Indexation?
- If so what period?
- Dealing with Efficient Embedded Debt?

Financeabl e

- Financial Package
- Gearing?
- Stranding of Assets – Depreciation.
- Dynamic Financeability assessment

Reward/Penalty based on Performance?

"…well performing GDNs can earn post-tax real double digit returns on (notional) equity".

Based upon the fundamental principle of RIIO and previous framework that strong incentives that target the deliver of the services and service levels that customers want and value will deliver long term benefit for customers.

Application of these Principles?

RIIO or RiIO?

Reward/Penalty based on Performance.

The Big 'I' must remain.

Application & Differentiation

TOTEX

- Retain IQI
- Use the Toolkit available
- Trust the analysis and judgement
- Genuine Differentiation
- Indexation
- Volume Drivers

Outputs/ Outcomes

- Identify & Specify correctly
- Identify Good/Bad and Exceptional performance

Financial Reward/ Penalty

- Incentives to drive value for customers
- Replicate competitive markets
- New types of incentive arrangements where appropriate.

Summary

- Principles of the framework are sound and have delivered consistent benefits for customers
- Some work to do to refine base return calculations and estimates.
- Application of the principles can be made to strengthen the impact of incentives on value for customers.

An alternative approach

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In reality

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Is there a problem with high returns?

- **We want companies to deliver outputs at least cost.** This benefits consumers now through delivery of outputs, and in the future through lower costs.
    - In a 'steady-state' world this results in unit costs reducing over time with consumers benefitting from better service
- **But setting price controls on an ex ante basis contains risks & these could be exacerbated in the future that isn't 'steady-state'**
    - What if the cost allowances were too generous?
    - What if the expenditure doesn't link to an output?
    - What if events transpired that allows companies to avoid/defer expenditure?
    - What if the output targets were too easy?
- **If the above apply, then companies might achieve a higher return, but no additional value is created for consumers**
- **We want to understand what we can do in the process of setting the price control to protect against high – and undeserved – returns.**

Enhancing existing approach

- **In setting a price control we will consider the following elements of the framework:**
  - Cost of capital
  - Incentives to submit efficient costs in business plans
  - Stretching cost efficiency and output targets
  - Company share of underspends (& overspends) and rewards for output delivery
  - Index costs to reduce forecast error where possible
  - Set allowances/output targets as close as possible to start of control period
  - Aim for a more complete regulatory contract with expenditure linked to outputs
- **Length of price control and uncertainty mechanisms** (reopeners, mid-period review, volume drivers) **can minimise the impact of 'known unknowns'**

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Prospect of high returns

- **Companies – collectively - nearly always manage to outperform and expenditure is usually well below forecast.**

- **This gives rise to concern that however tight the control appears to be, the process of setting a prices in advance provides an opportunity for companies to secure an advantage. If so, then there are issues associated with:**

    - Legitimacy – companies earning returns beyond the value delivered to consumers

    - Forecast error – out-turn performance could show that networks are beating cost allowances/output targets, without obviously innovating

    - Sector wide outperformance – higher returns being justified by the ability to meet stretching targets might indicate that only the best performers in the sector should meet this benchmark. When all companies outperform it might suggest the targets were not sufficiently stretching.

- **Depending on how we can manage the risk of the above - through enhancing existing arrangements - we want to understand what other options we could consider.**

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Alternative approaches

Enhanced legitimacy

Soft cap & floor

We restrict returns rising/falling outside of prescribed range, unless company is high-performing against consumer-centric measures and is demonstrably innovative.

Forecast error

Revenue adjustments

Reopener at the end of (or during) price control to adjust revenues to account for forecasts that were wrong or allowances that were unnecessary

Trust-based – we won't intervene if companies do the right thing

Sector wide outperformance

Anchoring Returns

We regulate the ex post sectoral average RORE to match the ex ante base cost of equity while maintaining dispersion of returns.

Pros and cons associated with each of these options

We want to use the break-out session to explore these in more detail & what other options we should be considering


The
Break Out
Session

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Wash-up and close