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RIIO-2 Framework - Information Revealing Devices (IRDs) & Return Adjustment Mechanisms (RAMs)

Network companies workshop #2

9 May 2018

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Aims and agenda for today

Business plans assessment and further discussions on RAMs

The primary aim of today's workshop is to explore ways for assessing and rewarding business plans, and to further discuss the impact of our RAMs and IRDs proposals on network companies

Key areas we wish to explore with you in today's sessions:

- Introduction to a number of topics in Business Plans (BPs) assessment – mainly around categorisation and rewards
- Further discussion on RAMs:
  - Presentation of SGN and SPEN proposals
  - Follow-up on RAMs discussions from the previous workshop

Agenda

Time	Item	Leading
10:10-10:40	Introduction	James Veaney
10:40-11:20	Assessment and rewarding of business plans	Shai Hassid
11:20-11:40	Assessment of RAMs	David Handley, SGN
11:40-12:00	Unspent totex clawback mechanism proposal	Stephanie Anderson, SPEN
12:00-12:45	Discussion: Return adjustment mechanisms	James Veaney
12:45	Concluding remarks	James Veaney

A recap of where we got to last time and why we are here today

In the last workshop on the 28th of March we:
- Described the reasoning behind our proposals to make changes to IRDs and introduce RAMs
- Introduced and discussed various aspects of the IQI and introduced the Ofwat PR19 proposal
- Described in further detail our RAMs proposals

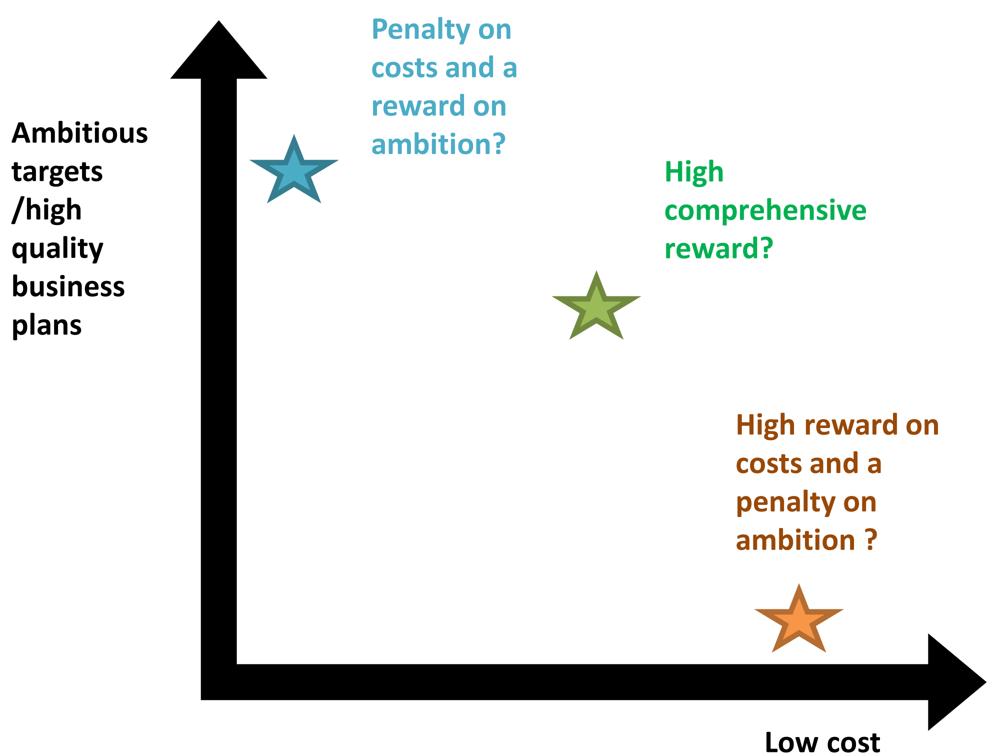
In this workshop we wish to:
- Introduce you to various aspects of potential approaches to BP assessments and hear your views
- Hear more about your thinking on our RAMs proposals
- Task work on BP assessment to interested parties

Why do we focus on BP assessment?
- IRDs aim to provide us with better information
- We've previously discussed IQI, but IQI (or other similar mechanisms) does not capture non-cost elements of BPs
- Additionally, one of our RAMs options builds upon our ability to assess business plans 'in the round'
- We (and you) have also identified that there is the potential for improvement in the BP assessment process, potentially improving elements of proportionate treatment
- We therefore want to engage with you on ways to improve our BP assessment process

Reminder of our timelines
- Schedule another workshop on BP assessment (June/July) - **optional**
- Publish a framework decision this summer
- Consult on sector specific methodologies by the end of this year (including IRDs and RAMs to be applied for each sector)
- Issue a sector specific Methodology Decision – early Q2 2019

We seek to understand the interplay between costs and outputs and how to reward and assess them in a way which will incentivise companies to find the right balance

- There are different tools for assessing and rewarding costs and outputs
- We can assess them all together or incentivise them individually
- So far we've mainly discussed IQI, but there are other things we also want to assess (eg output targets, uncertainty mechanism, engagement with stakeholders, innovation)
- Today we focus more on the (non-cost) elements of the business plan and how we could assess these alongside an IQI type of mechanism
- We will cover various elements of the assessment process:
  - Assessment methods
  - Rewards/penalty types
  - Submissions and reward sequencing



We will further develop our thinking on the above in the sectors' consultations

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A more proportional assessment scheme for business plans could improve the overall quality of BP submissions

- In RIIO-1 we only used 2 categories: fast-tracked and slow-tracked
- The reward for fast-tracked companies included additions to CoE, a higher sharing factor, and procedural benefits. We did not include penalties
- We used a traffic light system to produce a scorecard (see ED1 example on the right)
- An alternative could make use of weighting, so a final score could be aggregated to one number which would determine the category - see illustration in the bottom right
- Each category could grant a different reward (or penalty) – the weighting between categories could be determined by using inputs from stakeholder groups

Questions

- Do you agree with the idea of a more granular scoring process?
- Do you find the use of weighting plausible?
- Which other scoring alternatives could we use to score business plans more granularly?
- Should we set minimum standards in some criteria (eg process)?

Table 1: Summary of our assessment of DNOs' business plans

DNO Group	Licensee[7]	Process	Outputs	Resources – efficient costs	Resources – efficient finance	Uncertainty and risk
Electricity North West Ltd	ENWL					
Northern Powergrid (NPg)	NPgN					
	NPgY					
Western Power Distribution (WPD)	WMID					
	EMID					
	SWALES					
	SWEST					
UK Power Networks (UKPN)	LPN					
	SPN					
	EPN					
SP Energy Networks (SPEN)	SPD					
	SPMW					
SSE Power Distribution (SSEPD)	SSEH					
	SSES					

Weighted categorisation – illustration

Criterion	Score (1-5)	Weight
Process	5	25%
Outputs	3	25%
….	…	X%
Final score	**3.5**	

Category	Score	Reward
A	4<Score<=5	X
B	3<Score<=4	Y
….	…	…

The type and strength of reward is key for incentivising companies to submit BP upon which we can rely

- Fast-tracking was overarching – not only did it uplifted FT companies' CoE, it also granted the highest possible TIM reward (in ED) and a procedural benefit (3 types of reward in a single category)
- In doing so, it blended RAV-linked rewards (eg higher CoE & TIM sharing factors) with criteria which are not directly linked to RAV levels (eg process and outputs)

Q: Should we reward non-totex/RAV elements through RAV linked reward mechanisms ?

- There are a number of ways through which we could reward BP submissions

Return related reward	Lump sum payment	Adjusting totex sharing factors	Varying incentive earning potential
Adding or subtracting from RoRE or CoE	Providing a lump sum payment at the point of business plan submission (eg % of forecasted totex) – *could be contingent to delivery*	Adding or subtracting from sharing factors	Increasing/decreasing companies' earning potential from incentives based on the quality ambition of their incentive plans and output targets

Questions

- Which of the 4 options (or combinations of them) could be better in driving the desired behavioural changes?
- Is there a benefit in separating the <u>totex parts of business plans</u> (quantified) from other more <u>qualitative elements of business plans</u>?
- Should some categories of performance be associated with a penalty rather than a reward?

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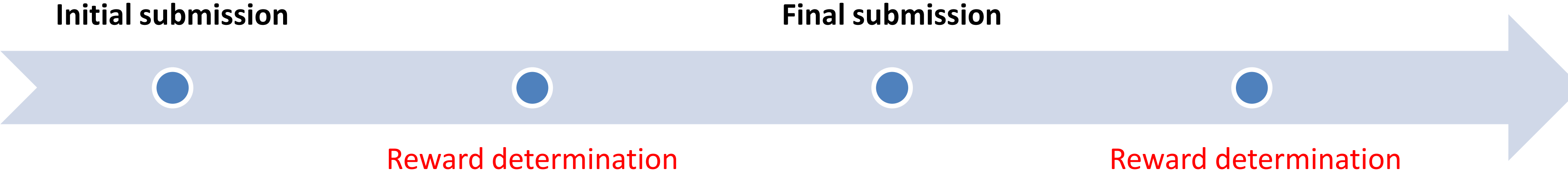
The sequence of BP submissions and the point at which they are assessed will determine the quality of information provided

- In RIIO-1, slow-tracked companies were required to submit two BPs (initial and final submission), TIM was based on the second submission.
- This might have reduced the incentive to submit an ambitious and high quality business plan and totex forecast in the initial submission for companies that did not aim to be fast-tracked

Initial submission

Final submission



Reward determination

- Full reward/penalty?
- 1st stage reward/penalty?

Reward determination

- Full reward/penalty?
- 2nd stage reward/penalty?

Questions

- Is there a need for 2 submissions or should the assessment of BPs be based on a single submission?
- Under which circumstances should the categorisation change in a single BP submission ?
- If we keep the process of initial and final BP submission:
    - how could we incentivise a high quality initial submission if the reward is based on the final submission?
    - how could we incentivise a high quality final submission if the reward is based on the initial submission?

Call for volunteers:

- Presentation on assessment categorisation and grading
- Presentation on types of rewards pros and cons

Companies presentations on RAMs

Ofgem Workshop
Revenue Adjustment Mechanism

9th May 2018

SGN

Your gas. Our network.

Overall Position

1. Regulatory Adjustment Mechanism / Failsafe is unnecessary with a correctly calibrated price control – the current toolbox is sufficient.
2. Introducing a Failsafe Mechanism adds to complexity and risk of unintended consequences.
3. Focusing on the design of the Failsafe Mechanism risks distracting from correctly calibrating the price control.
4. Good business plan submissions should be rewarded with equity uplift - shouldn't be linked to failsafe / RAM
5. A strong consumer voice and strong co-operation is key to legitimacy in RIIO-2 - both could be undermined by the failsafe mechanism.

SGN

Proposed Principles

Should not impede good price control operation

- It is a failsafe & therefore should not be anticipated to come into effect.

Should be reciprocal.

- Reciprocal protection of both consumers and investors so that neither group is inappropriately exposed to risk.

Should be calibrated.

- Calibrated to the level of incentives and output measures in place
- Agreed incentives should be able to operate unimpeded.
- If network companies adopt different incentives then these should be reflected in company specific calibrations.

Should not undermine financeability.

- Must not risk undermine the credit metrics the determine the companies financeability.

Must be forecastable

- Forecastable for network companies and their investors in terms of timing of application and impact.
- Information must be available to be released in a timely manner without retrospective adjustments.

Should not discriminate against good performers

- Difference in application between companies should be supported by evidence of a company specific error.

SGN

Overall Assessment

	Hard Cap/Floor	Discretionary Adjustments	Constrained Incentives	RoRE Sharing Factor	Anchoring Returns
Non-Impeding					
Reciprocal					
Calibrated					
Financeable					
Forecastable					
Non-discriminatory					

	Very difficult to design in a manner that enables this.
	Designed needs to be carefully considered to deliver this.
	Broadly intrinsic in the design.

Options 1 & 2

Options 1 & 2 we don’t believe can be made to work in a manner that does not undermine customer interests.

Hard Cap and Floor

- Distorts behaviour around the points of implementation.
- Reduces either the level of ambition (with the cap) or the level of effort (with the floor).
- Discriminatory design that impacts only the worst or best performers.

Discretionary Adjustments

- Very difficult to design a series of ex-post adjustments that provides forecastability.
- Lack of forecastability reduces financeability.
- Subjective nature and the lack of process will impede normal behaviour.
- Weakens incentives on companies to deliver and perform.

SGN

Constrained Outputs & Incentives

Very complex with a risk of unintended consequences that could undermine or be contrary to the consumer interest.

Sculpted Totex

- Encourages use of allowed expenditure regardless of efficiency at higher sharing factors.

Zero-Sum / Fixed Incentives

Consumer challenges of;

- Dampens the incentive mechanism reducing value per £ of incentive
- Delinks customers WTP and actual outcomes
- Barrier to co-operation

Practical challenges of;

- Comparable baseline
- Comparable effort
- Creating pseudo-competition

RORE Sharing Factors

Most applicable of all, but linking with Information Revealing Devices would create the misaligned drivers.

Sculpted Totex

- Challenge is to calibrate the bands / tranches correctly.
- Tranches need to be calibrated according to the level of incentives
- Assumption that only marginal increases are subject to the higher tranche level (to avoid perverse incentives).

Potential tranches

- Tranche 1: Deadband range of strong incentives with no sharing.
- Tranche 2: Anticipated range of incentives and sharing factors in line with RIIO-1.
- Tranche 3: Strong performance that exceeds anticipated range and equal sharing.
- Tranche 4: Unanticipated / unforecastable returns with a higher sharing factor for consumers.

SGN

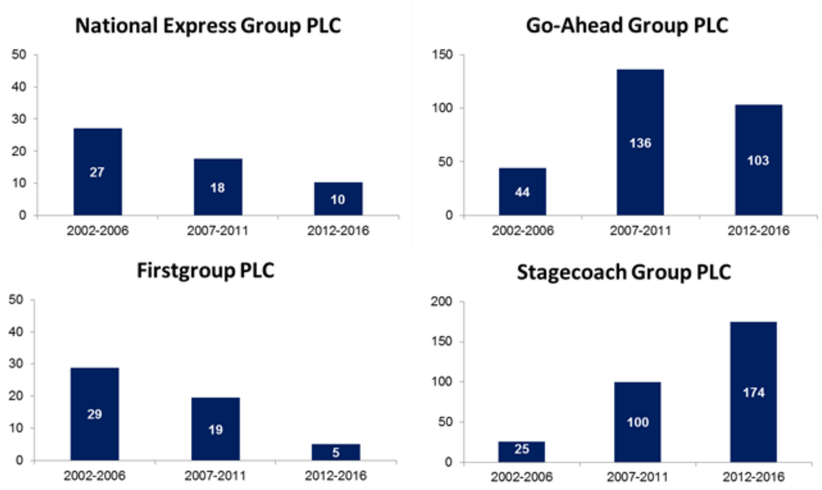
Anchoring Returns

Risks combining the challenges of ‘cap and floor’ with ‘constrained incentives’ unless the deadband wide enough to act as a true failsafe.

Deadband range

- Needs a relevant market benchmark to define an appropriate range.
- If range is too narrow then the problems of lack of financeability, inability to forecasts and impeding good price control behaviour come to the fore.
- NERA report proposed that Return on Book Equity is the nearest observable equivalent to RORE.

Return on Book Equity (5yr averages)



Source: NERA

Thank you …

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SP ENERGY NETWORKS

09 May 2018

Ofgem Information Revealing Devices and Return Adjustment Mechanisms Workshop

SPEN Views

Adjustment Mechanisms – SPEN's proposals

TOTEX is the only element of the price control which should be addressed to ensure "Fair Returns".

Source of outperformance	Is there a means for ensuring the levels set are fair?	Effectively dealt with in price controls?
Cost of Equity	This is dealt with via the re-setting of the price control following significant consultation and expert input. To date this has been evidenced based using financial markets and EU equivalents as cross checks.	✓
Incentives	Incentive rates are based at levels customers believe we should be rewarded/penalised for. These can also be based on past company performance.	✓
TOTEX	TOTEX can fluctuate significantly and currently not all investment is directly linked to outputs and governed by associated incentives or uncertainty mechanisms. It is our view that this is the ONLY element of variability within the price control which should be corrected by Ofgem (should it be found to be no longer required).	?
IQI Reward	This is set from the outset of the price control, so this is transparent and set upfront by Ofgem, so it is consistent throughout the price control.	✓

Adjustment Mechanisms – SPEN's views and proposals

As Ofgem notes, *"If we set the price control effectively and identify and manage all extraneous risks, we may not need to use any of these."* Therefore, this should be a <u>backstop mechanism only</u>.

Shift the weighting from predominantly ex-ante based allowances in RIIO-1, to greater use of re-openers/volume drivers. Focus on discrete areas for full correction as failsafe for customers (e.g. rail electrification). Retain sharing factor mechanism for totex.

In RIIO 2, focus on appropriately calibrating the revenue incentive mechanisms based on stakeholder feedback and past performance. Ofgem must have the conviction to set incentives for the price control with no adjustment mechanisms. Boards require certainty to invest.

RIIO has already evidenced significant benefits for consumers, so reinventing the wheel is not required. Important to retain the R = I + I + O regime. RIIO is regarded internationally as a benchmark regime.

Adjustment Mechanisms – SPEN's proposals

Companies take on a balance of **risk and reward** when submitting their business plans. A symmetric methodology needs to be retained.

SPEN supports the correction of material discrete unspent TOTEX allowances which are no longer required. TOTEX underspend that is due to genuine efficiencies should fall under the sharing factor mechanism.

What would a TOTEX Mechanism look like?

Such a mechanism would require industry input. Our initial view is that a new licence condition may be required to ensure that a clear scope is set from the outset of the price control to ensure that this does not become ex-post regulation.

- Our existing **Uncertainty Mechanism licence conditions** may form a basis for any correction mechanism.
- Transparent and **proportionate materiality thresholds** would be set from the price control outset and the definition of “unspent TOTEX allowances” would require significant scrutiny to ensure that this could not be used by Ofgem as an opportunity to correct genuine TOTEX efficiencies.
- **‘Materiality’** would require to be defined to provide further certainty to investors and to ensure that the mechanism is not abused.
- ‘unspent’ or ‘no longer required’ would require significant detailing and **scenario analysis.**
- The design of the mechanism needs to consider all credible scenarios and have a ‘fail-safe’ clause that protects both parties.

Such a correction mechanism **should not be considered as a substitute** for Ofgem performing due diligence on companies’ business plans

Session 1: Return adjustment mechanisms

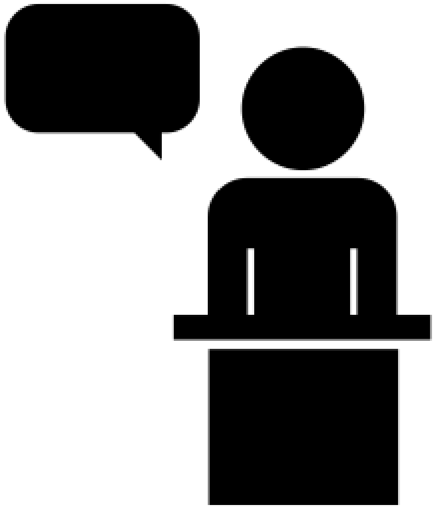
Sharing factors

- How would sculpted sharing factors (either on totex or RORE) affect companies' behaviour in terms of preparing and delivering a business plan?
- What is the link between sharing factor levels and the incentive to find cost efficiencies? Is there any evidence which suggests that below a certain level, lowering sharing factors leads to reduced performance and less innovation?
- Which method would you use the determine sharing factor ranges?

Metrics

- Which is the most suitable metric to base return adjustments to network companies?
  - RORE
  - RORE extended to include performance on debt
  - Under/overspent as % of totex
  - Return on invested capital/return on invested capital

Concluding remarks



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Ofwat

APPENDIX - OFWAT'S PR19 APPROACH TO REWARDING AND ASSESSMENT OF BUSINESS PLANS

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9 test areas determine the category, no weighting is being used

Figure 14.2 Summary of our approach to the initial assessment of business plans

Objectives

We want **companies to produce high quality, ambitious and innovative** business plans, pushing forward the performance of the industry as a whole and stretching the boundaries for delivery and efficiency.

Test areas

- Engaging customers
- Addressing affordability and vulnerability
- Delivering outcomes for customers
- Securing long-term resilience
- Targeted controls, markets and innovation
- Securing cost efficiencies
- Aligning risk and return
- Accounting for past delivery
- Securing confidence and assurance

Categories and characteristics

Significant scrutiny	Slow-track	Fast-track	Exceptional
Well short of required quality – material intervention required across the plan	Material interventions are required in some areas to protect the interests of customers	High quality, but not ambitious and innovative enough to attain exceptional status	High quality with significant ambition and innovation

Incentives

Disincentive → **Incentive**

Financial disincentive Procedural disincentive Reputational disincentive	No financial incentive Procedural disincentive Reputational disincentive	No financial incentive Procedural incentive Reputational incentive	Financial incentive Procedural incentive Reputational incentive

https://www.ofwat.gov.uk/wp-content/uploads/2017/07/Delivering-Water-2020-Consulting-on-our-PR19-draft-methodology-2.pdf

4 categories are introduced

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Table 3 – Summary of the main incentives originally proposed in our consultation for the initial assessment of business plans

Category	Reputational incentives	Procedural incentives	Financial incentives	
		Draft determination	Financial reward	Cost sharing rates
Exceptional	Published performance relative to peers + communication opportunities	Early (March or April 2019)	Allowance calculated as +0.2% return on regulatory equity (RoRE)	Standard
Fast track	Published performance relative to peers	Early (March or April 2019)	None	Standard
Slow track	Published performance relative to peers	July 2019	None	Standard
Significant scrutiny	Published performance relative to peers	July 2019	None. Potential cap on outcome delivery incentive (ODI) rewards	Reduced

The largest benefit – addition to RORE

Only procedural benefit for Fast tracking

https://www.ofwat.gov.uk/wp-content/uploads/2017/12/Appendix-13-IAP-FM.pdf

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Aspire towards BP submissions being a 'one shot' approach, but allow some flexibility

Categorisation

"the business plans submitted will be considered to be the final version for the purposes of the initial assessment of plans and the associated categorisation only"

Ofwat specifies that only the following circumstances will justify changes to submitted ODIs (outputs):

- errors (by Ofwat or the companies) including any misreporting to Ofwat;
- changes to legal obligations; or
- new information about the actions required to meet current legal obligations.

Totex

- Sharing factors are decided based on the first draft determination
- Companies can make adjustment claims afterwards on the grounds of:
    - company specific statutory requirements;
    - an atypically large investment by the company; or
    - regional operating circumstances that result in higher costs.
- Claims can result in an adjustment downwards as well as upwards
- Changes include a materiality threshold – for the network it stands at 1% of total totex for the period