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Incentives on business plans and totex submissions

RIIO-2 cross-sector workshop

RIIO cross sector
26/9/2018

Goals and proposed agenda

Goals for this session

- Describe our thinking on the totex and business plans incentives
- Seek feedback on our proposals

Time	Item	Leading
12:45-12:55	Context & takeaways from RIIO-1	James Veaney
12:55-13:30	Description of options: totex incentive	Shai Hassid
13:30-14:15	Breakout session: totex incentive	James, Clothilde, Shai
14:15-14:25	Principles for the business plan incentive	James Veaney
14:25-14:45	Description of strawman	Shai Hassid
14:45-15:30	Breakout session: business plan incentives	James, Clothilde, Shai
15:30	Concluding remarks	James Veaney

Context and takeaways from RIIO-1

At the framework stage we said:
- We are ruling out early settlement of business plans for GD, ET and GT
- We are developing alternative incentives for business plans
- We are still considering options for the totex incentive mechanism (TIM)

This means:
- Companies' settlement and corresponding business plan reward will be based on a single submission
- The incentive for business plans is likely to take different shape from RIIO-1
- Both the incentive on business plans and totex might differ across sectors depending on their characteristics

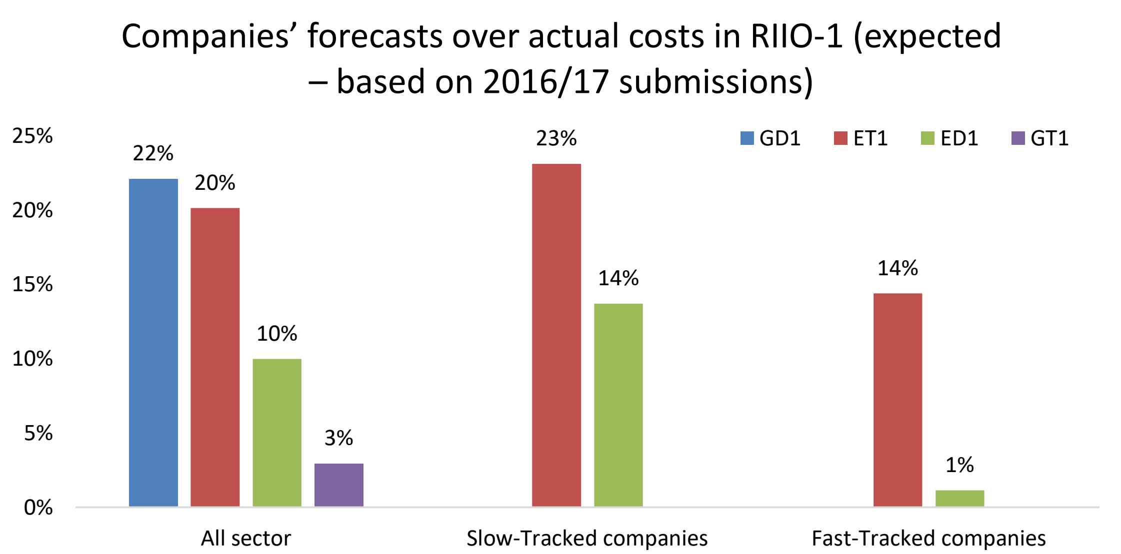
Our engagement on the topic so far
- We held two workshops so far on the two topics, one in March and another one in May
- A number of stakeholders reached out to us with suggestions; we have considered these in developing a high level strawman on the business plans incentive

Timelines
- Consult on sector specific methodologies in December this year
- Issue a sector specific Methodology Decision – early Q2 2019
- Receive companies' business plans by the end of 2019

Why are we focusing on totex and business plans incentive?

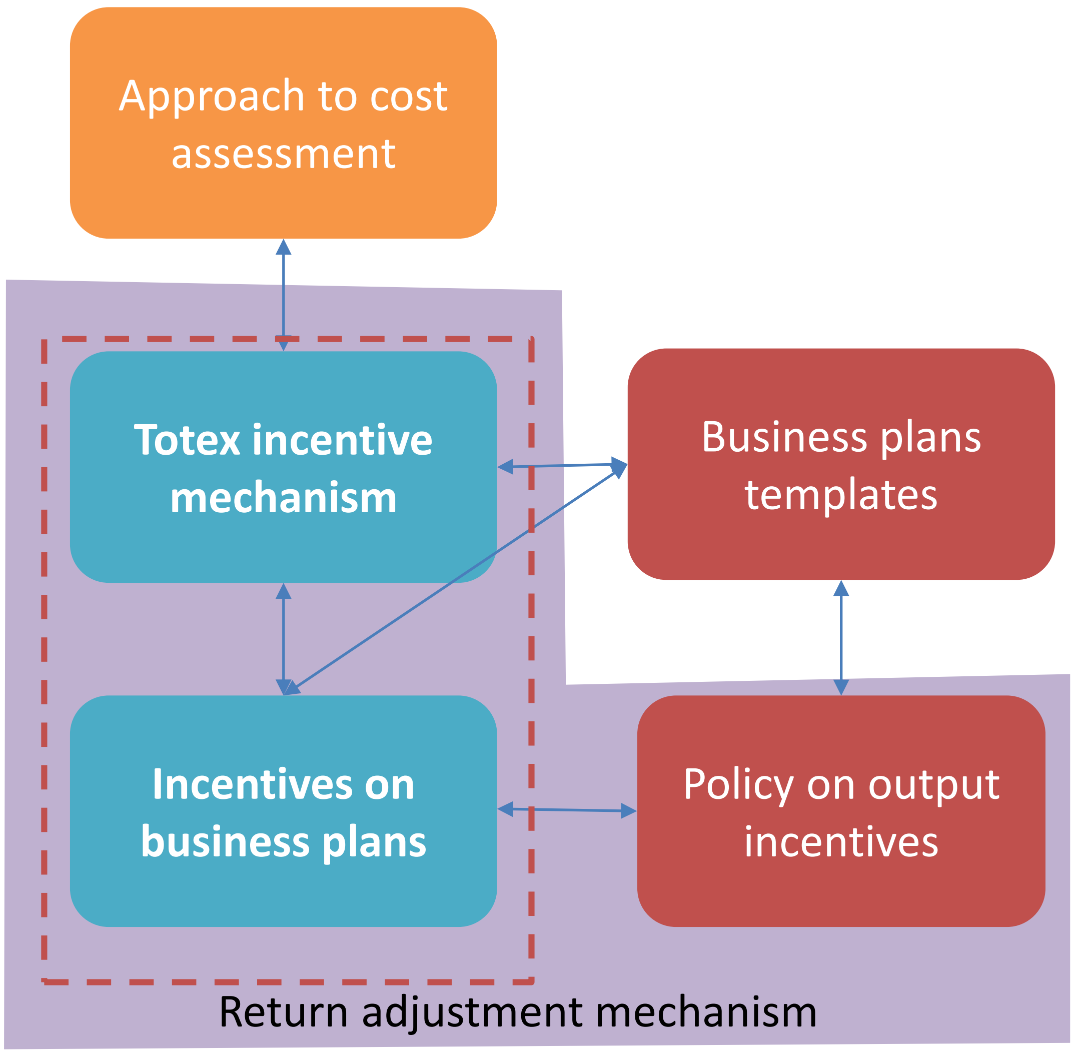
Takeaways from RIIO-1

- Companies' totex submissions to us, other than fast-tracked companies, were adjusted downwards based on our view of costs.
- Over half-way into RIIO-1 for 3 of the sectors we observed that companies' totex submission have been systematically higher than their expected cost by the end of RIIO-1
- While part of this outperformance could represent efficiencies and service improvement, it could also be due to companies submitting forecasts that are higher than their expected costs at the outset of the price controls.
- This led us to reassess the Fast-Tracking process and the Information Quality Incentive (IQI)
- We believe that alternative designs or implementation could be more effective in addressing incentives on companies to submit stretching business plans and also to mitigate adverse consequences on consumers where companies do not do so or the future is too uncertain.



- The aim is aim to encourage companies to give us high quality an information and are incentivised to achieve cost savings in delivering their plan
- We plan to do so through combination of an incentive and totex submissions alongside an incentive on business plans submissions
- We discuss both of those in today's session

Main Interlinkages between business plans and totex incentive and the rest of the framework



- Incentive on business plans and totex strongly link to other work areas
- Direct links include the totex incentive mechanism, policy on output incentives, business plan template requirements, and return adjustment mechanisms

Options for the totex incentive

- Intensified & simplified IQI
- Ofwat PR19 cost sharing mechanism
- Blended sharing factor
- Group discussion

The totex incentive mechanism: why and when we use it?

- The totex incentive mechanism has two roles:
  - Outset of price control: incentivise companies to submit forecasts which we can confidently use them for setting the level of allowed totex
  - During the price control: incentivise companies to spend below their allowed revenue by rewarding them with a share of the difference between the allowed revenue and their actual spending
- We note that it may not be desirable to rely solely on ex-ante allowances. This is particularly true where: i) past information is not a good predictor of the future and there is high uncertainty ii) costs are outside of companies' control and they are not best positioned to manage risks iii) we cannot verify cost independently from companies
- For this reason, we are looking to extend the use of tools such as:
  - Volume drivers, where quantity is uncertain
  - Indexes (where appropriate) where price is uncertain
  - SWW/Reopeners where requirements/timings are uncertain
  - Mechanism to reset cost allowances in-period
  - Ex post reviews/close-out where significant uncertainty surrounds allowances
- Nevertheless, we recognise the power of an ex-ante allowance based incentive. Therefore, we still envision setting an ex-ante allowance where we do not use the above options
- We are considering 3 options:
  - Intensified and simplified IQI
  - Ofwat cost sharing mechanism
  - Blended sharing factors

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Option 1: intensified and simplified IQI

This option introduces a number of changes to reduce the complexity of the IQI and reduce its sensitivity to potential influence of forecasts made by companies:

Simplify:

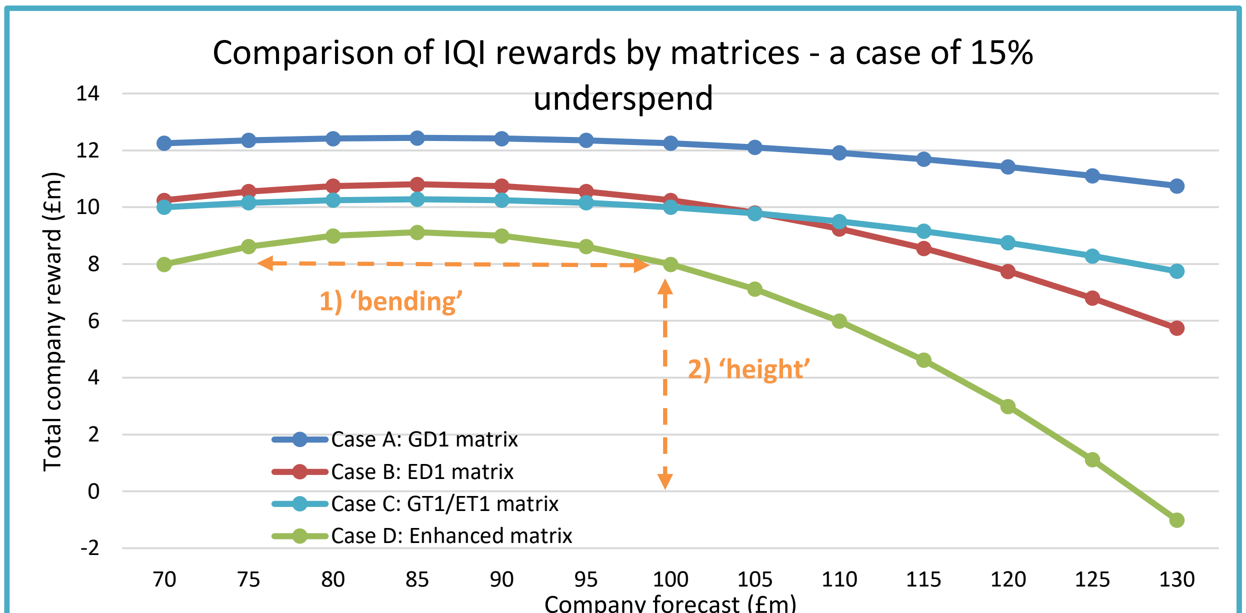
- ➢ scrap the 75/25 allowed totex interpolation rule (explained in the appendix)
- ➢ publish a matrix in advance

Amplify: give a stronger incentive to accuracy by changing the parameters of the IQI so that:

1) the differentiation in penalties and rewards is stronger the more companies move away from an accurate forecast (the ‘bending’ of the curve)
2) reducing the IQI ‘breakeven’ point (the ‘height’ of the curve)

Points to consider:

- Sensitivity to companies’ influence and risk and loss aversion
- Level of upfront penalty in the intensified version
- Compatibility with return adjustment mechanisms



For example, in the GD-1 matrix (dark blue) a company that submitted a forecast of £105m and spent £85 will only see a difference of £0.3m to its reward (£12.4m minus £12.1m). In the case of the enhanced matrix (green), a company that submitted a forecast of £105m and spend £85, will see a difference of £2m to its reward (£9.1m minus £7.1m).

Option 2: Ofwat cost sharing mechanism

The Ofwat matrix gives companies a higher sharing factor the lower their view of totex is in comparison to Ofwat's view. In doing so, it aims to incentivise companies to submit stretching cost forecasts

Features

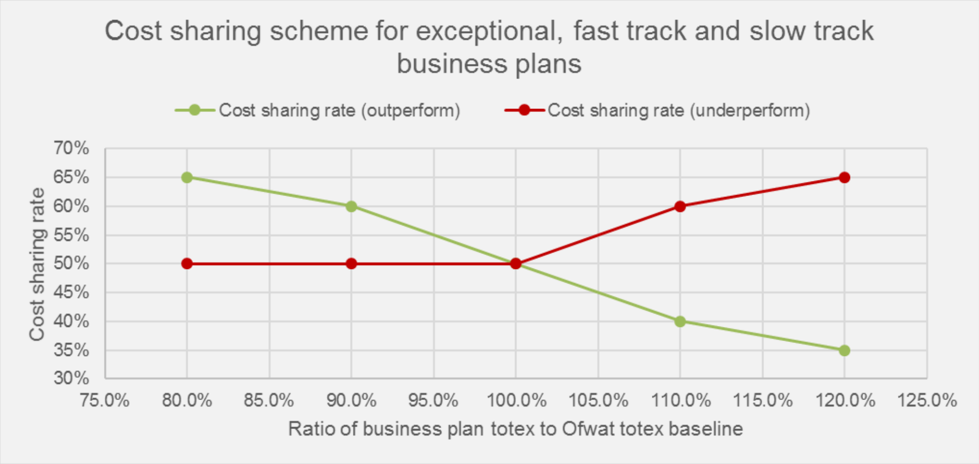
- Different sharing factors for outperformance and underperformance
- No upfront penalty or reward
- When a company's view of totex is below Ofwat's estimate of efficient totex, customers do not pay more than 50% of any underperformance

Points to consider:

- Companies' incentive to submit a challenging forecast if they believe the regulator might use it to set a lower cost allowance

Example:

Business plan totex %	80.0%	90.0%	100.0%	110.0%	120.0%
Ofwat totex baseline %	100.0%	100.0%	100.0%	100.0%	100.0%
Cost sharing rate (outperform)	65.0%	60.0%	50.0%	40.0%	35.0%
Cost sharing rate (underperform)	50.0%	50.0%	50.0%	60.0%	65.0%
Actual expenditure:baseline					
80.00%	13.0%	12.0%	10.0%	8.0%	7.0%
90.00%	6.5%	6.0%	5.0%	4.0%	3.5%
100.00%	0.0%	0.0%	0.0%	0.0%	0.0%
110.00%	-5.0%	-5.0%	-5.0%	-6.0%	-6.5%
120.00%	-10.0%	-10.0%	-10.0%	-12.0%	-13.0%



if a company submits a forecast that is higher by 10% in comparison to Ofwat's 100 baseline, it will receive an incentive rate of 40% if it underspends and 60% if it overspends. So if a company ends up spending 110 it will incur a loss of 6, and if it spends 90 it will keep a profit of 4. If companies go lower the Ofwat's baseline, they get a higher protection in a case where they overspend.

Option 3: Blended sharing factor

Rationale
Provide a higher earning potential to companies where we have better ability to set costs independently from companies' forecasts (baselined)

Description

- We determine a sharing factor based on the proportion of a company's expenditure that can be baselined
- The higher the share of costs that can be baselined, the higher the sharing factor companies will receive

What do we mean by baselined?
When determining whether cost can be baselined or not, we could consider levels of:

- **Predictability:** past expenditure as indicator of future expenditure
- **Comparability:** information from one company can be used in setting a baseline for another one
- **Justification:** whether the company has justified expenditure using external comparators
- **Uncertainty:** whether a suggested uncertainty mechanism sufficiently reduces the range of possible outcomes

Example

	Cost item A	Cost item B	Cost item C
Company view	500	100	400
Baselineable?	Yes	Yes	No
Sharing factor	50%	50%	0%
Weighted sharing factor	$\frac{500 * 50\% + 100 * 50\% \ + 400 * 0\%}{500 + 100 + 400} = 30\%$		

The example illustrates a case with three cost items two of them we consider as baselineable and one which is not. In the illustration, baselineable items are assigned a sharing factor of 50% in the weighted average and non-forecastable items are assigned a sharing factor of 0% in the weighted average. The calculation below on the three cost items yields a sharing factor of 30%.

Points to consider:

- Process for determining baseline costs
- Incentive on companies' behaviour

	Option 1: Intensified and simplified IQI	Option 2: Ofwat cost sharing mechanism	Option 3: Blended sharing factor
Main focus	Accuracy: incentivise companies to submit forecast which are close to Ofgem's forecast	Ambition: incentivise companies to submit stretching forecasts	Justification: incentivise companies to justify the costs in their forecasts
Form of incentive	Delivery based incentive rate + upfront incentive	Delivery based incentive rate	Delivery based incentive rate

- **Intensified and simplified IQI**
  - Relatively small differences between companies' and Ofgem forecast could lead to a severe upfront penalty, would that encourage different behavior in submitting a forecast?
- **Ofwat PR19 cost sharing:**
  - Would companies produce a more stretching forecast given the regulator might use their info to set their allowances?
- **Blended sharing factors:**
  - What type of incentive does it create among network companies (both on totex submission and delivery)?
  - Do you agree with our thoughts on baselineable costs (ie: predictable, comparable, justified, certain)?

45 minutes group discussions

Business plan incentive

- Aims
- Description of high level indicative strawmen
- Group discussion

Business plans incentive – why we are introducing one?

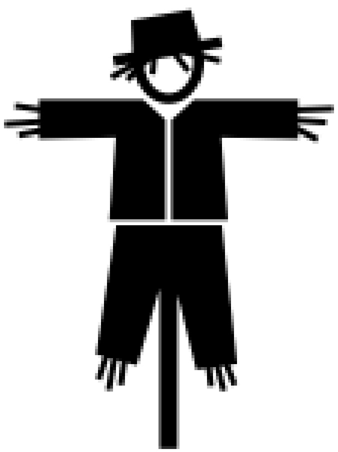
What we aim to achieve:

- We want companies to provide us with information that allows us to set a better price control, this might include:
  - ➢ Cost (incl. volume) forecasts that are lower than the baseline that we would otherwise set
  - ➢ Indication on areas where using historical information to set baselines is appropriate
  - ➢ Identification of uncertainties and mitigation measures
  - ➢ Demonstration of full commitment to the enhanced engagement process, and as a result:
    - propose outputs which are set at stretching levels
    - secure stakeholder support for their proposals
- Demonstration of long-term thinking in terms of whole system approach, innovation, and resilience Identification

How could we achieve this?

- We consider all companies should deliver the above. Nevertheless, we recognize that some companies may not, while some may do so better than others. We wish to incentivise accordingly
- We think the fast-tracking business plan assessment framework introduced in RIIO-1 can be improved
- We present a high level indicative strawman on the business plan assessment framework as a base for discussion
- The framework would evolve and change in the time leading to the sector consultation and there may be different applications across the different sectors

An indicative strawman on business plan incentive



In brief, the incentive could consist of the following:

- A four stage assessment process
- Upfront penalties levied for low quality business plans
- Upfront payments given when companies submit a high quality business plan in terms of both the qualitative and quantitative elements of the business plan
- Focused on rewarding information revelation and alignment of risk and reward
- Introduces a competitive dynamic on the reward side but individual penalties on the downside

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Overview: Business plan incentive strawman

1 Compliance check

Determines whether companies pass a minimum bar in terms of the process leading to the making of the business plan and its completeness

Yes – company continues to the next stage of the assessment

No - company is required to resubmit elements of its business plans and enters a penalty regime (i.e. it proceeds immediately to stage 4)

2 Evaluation of costs

Looks at companies' forecasts vs our baseline and assigns a score depending on how much lower/higher they are. (may not be needed under the IQI)

3 Evaluation of quality

Assesses companies' overall business plans and grades it accordingly. This takes into account

- Output ambition and value for money
- Endorsement from stakeholders
- Tangible commitments to innovation & whole system thinking
- Identification of uncertainties and mitigation

We assign a score of 1-3 based on our assessment of quality

4 Upfront reward/penalty determination

Cost/Quality	3 Good	2 Average	1 Poor
3 Good	Good value	Value	Standard
2 Average	Value	Standard	Low value
1 Poor	Standard	Low value	Poor value

Discretionary Competed pot

No reward/penalty

Fixed penalties

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Stage 1: Compliance check

1

This stage aims to ensure completeness of business plans and that companies' submissions meet the obligatory minimum requirements. Companies which do not meet the minimum standards could be required to do further work, their earning potential would be limited and they could also be exposed to an upfront penalty.

What could amount to a minimum standard?

- Completeness of the business plan – companies submitted all the information required in a clear and understandable manner
- High level of quality assurance processes to prevent inaccuracies and mistakes
- Meeting Ofgem's requirements, such as obligatory cross-referencing and page/word limits
- Safety – companies' compliance with relevant regulations
- Meeting a minimum standard required on stakeholder engagement – this could be supplemented with feedback from the enhanced engagement groups

What could be the consequence of not meeting the above?

- Companies which fail to meet the above criteria could enter into an alternative penalty regime and not be considered for the assessment of stages two to four. This could include:
  - Being granted a restrictive sharing factor (eg 10% on underspent and 90% on overspent)
  - Restrictions to earning potential on incentives
  - Automatically being assigned to the lowest category in stage 4 (being exposed to an upfront penalty)

Stage 2:
Evaluation of costs

- This stage is based on the choice of totex incentive mechanism
- The proposed aim is to provide companies with an upfront reward or penalty based on level of ambition (an upfront incentive only features in IQI but not in the other two options)
- Essentially the score in the case of an Ofwat cost sharing mechanism can be derived from a comparison between companies' and our view of totex. The same can be done if the blended sharing factor is used

Ratio between a company's and Ofgem's view	<X	X to Y	Y>
Category	Good	Average	Poor

- The outputs of this stage would feed into stage 4
- This complements the Ofwat cost sharing mechanism and the blended sharing factor approaches, whereby a company that submits a stretching forecast but is not able to underspend its allowance would still be able to earn a reward

Stage 3:
Evaluation of quality

It is proposed that this stage would assign a grade to companies based on companies' quality output delivery plan, including the levels of tangible commitments. The grade would inform the level of upfront reward or penalty determined in stage 4.

Possible criteria on output delivery plans (not exhaustive):

- Companies' proposals on outputs, this *could* include:
  - ➢ Evidence that consumers value of outputs and the additional risk that companies are exposing themselves to in delivering them
  - ➢ Justification as to why a financial reward might be required (or in other words, why an output should not be delivered even at the absence of a financial incentive). Failing to provide a justification for the need for a financial incentive can reduce a company's score in this stage
  - ➢ Companies' proposed target levels and their ambition (where applicable)
- Identification of risk (both down and up side) and the quality of proposed uncertainty mechanisms and their ability to place the risk with the party best placed to control it
- Quality of long-term thinking: including innovation, whole-system and long-term investment plan
- Quality of stakeholder engagement: could use inputs from the enhanced engagement groups

Scoring

- The categorisation could be based on a qualitative assessment. We are not proposing weighting at this point but rather an assessment based on a good balance of the above

Stage 4:
Overall evaluation score

- Only companies that reach a minimum standard in step 1 qualify for assessment under the matrix
- Companies would receive an upfront reward/penalty incentive only for combinations of quality and costs
- This would based on inputs from stages 2 & 3
- A company that does not pass the minimum standard in stage 1 would be categorised as poor

Competed pot – illustrative example

Case 1: at least one company is graded as exceptional

- Shared pot: 100:

Example:

Two companies achieve a score of value and one company a score of good value:

Value company (x2):$100 * \frac{1}{1+1+2} = 25$

Good value company (x2):$100 * \frac{2}{1+1+2} = 50$

Case 2: some companies are graded as value, no company is categorised as good value

- Shared pot: 50

Example:

Three companies achieve a score high value:

High value company (x3):$50 * \frac{1}{1+1+1} = 16.7$

Quality/cost	Good	Average	Poor
Good	Good value Points: 2	Value Points: 1	Standard
Average	Value Points: 1	Standard:	Low value
Poor	Standard	Low value	Poor value

Absolute penalty: not relative

- What are your views on the high-level strawman?
  - Does it capture the main elements you think we should incentivise in business plans (focus on qualitative elements and minimum requirements)?
  - Would it be suitable in all sectors? If not, which changes should be made?

- Should a business plan incentive only be upfront or should it also change companies' earning potential? (eg higher financial output incentives for a good output plan)

- What are your views on the competitive dynamic for the upside reward?

45 minutes group discussions

Concluding remarks

Appendix

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The 75-25 totex interpolation rule

Does it make any difference?

- The main characteristic of the IQI mechanism is that companies are always better off when their actual spending aligns with their forecasts.
- The 75-25 totex interpolation rule pulls in the opposite direction – companies get a higher totex allowance the higher forecast they submit.
- To maintain its properties, the IQI mechanism is calibrated in a way such that it counteracts the effect of the '25%' rule by offsetting any potential gain of over-forecasting by increasing the IQI penalty (or decreasing the reward).
- An identical reward and penalty IQI matrix can be constructed with or without the 75-25 rule:

Ratio of forecast to baseline	**100**	**105**	**110**	**115**	**120**	**130**	**140**
Incentive rate	0.50	0.49	0.48	0.46	0.45	0.43	0.40
Allowed expenditure	100.00	101.25	102.50	103.75	105.00	107.50	110.00
Additional income	2.50	1.86	1.19	0.48	-0.25	-1.81	-3.50
90	7.50	7.34	7.13	6.84	6.50	5.63	4.50
95	5.00	4.91	4.75	4.53	4.25	3.50	2.50
100	2.50	2.47	2.38	2.22	2.00	1.38	0.50
105	0.00	0.03	0.00	-0.09	-0.25	-0.75	-1.50
110	-2.50	-2.41	-2.38	-2.41	-2.50	-2.88	-3.50
115	-5.00	-4.84	-4.75	-4.72	-4.75	-5.00	-5.50
120	-7.50	-7.28	-7.13	-7.03	-7.00	-7.13	-7.50
130	-12.50	-12.16	-11.88	-11.66	-11.50	-11.38	-11.50
140	-17.50	-17.03	-16.63	-16.28	-16.00	-15.63	-15.50

The RIIO T1 IQI specification (with the interpolation rule)

...and now without the interpolation rule

Ratio of forecast to baseline	**100**	**105**	**110**	**115**	**120**	**130**	**140**
Incentive rate	0.50	0.49	0.48	0.46	0.45	0.43	0.40
Allowed expenditure	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Additional income	2.50	2.47	2.38	2.22	2.00	1.38	0.50
90	7.50	7.34	7.13	6.84	6.50	5.63	4.50
95	5.00	4.91	4.75	4.53	4.25	3.50	2.50
100	2.50	2.47	2.38	2.22	2.00	1.38	0.50
105	0.00	0.03	0.00	-0.09	-0.25	-0.75	-1.50
110	-2.50	-2.41	-2.38	-2.41	-2.50	-2.88	-3.50
115	-5.00	-4.84	-4.75	-4.72	-4.75	-5.00	-5.50
120	-7.50	-7.28	-7.13	-7.03	-7.00	-7.13	-7.50
130	-12.50	-12.16	-11.88	-11.66	-11.50	-11.38	-11.50
140	-17.50	-17.03	-16.63	-16.28	-16.00	-15.63	-15.50

We can achieve identical outcomes with less complexity and by avoiding misunderstandings and confusion

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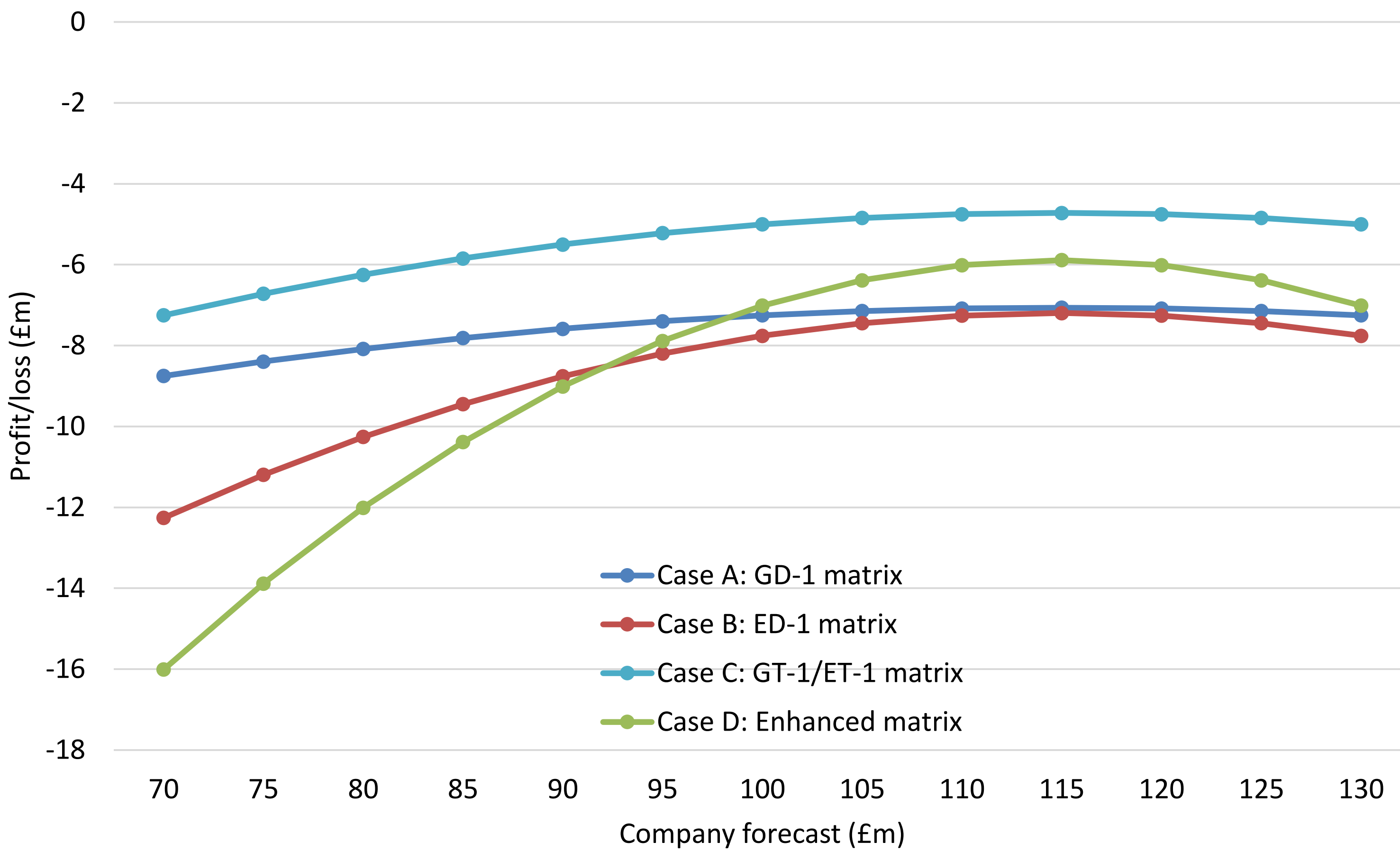
IQI case comparison:
Rewards by matrices - a case of 15% underspend



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IQI enhanced matrix

Illustrative

DNO:Ofgem Ratio	70	75	80	85	90	95	100	105	110	115	120	125	130
Efficiency Incentive	80%	75%	70%	65%	60%	55%	50%	45%	40%	35%	30%	25%	20%
Additional income (£/100m)	1.99	2.05	1.99	1.80	1.49	1.05	0.49	-0.20	-1.01	-1.95	-3.01	-4.20	-5.51
Rewards & Penalties													
Allowed expenditure	92.50	93.75	95.00	96.25	97.50	98.75	100.00	101.25	102.50	103.75	105.00	106.25	107.50
Actual Exp													
70	20.0	19.9	19.5	18.9	18.0	16.9	15.5	13.9	12.0	9.9	7.5	4.9	2.0
75	16.0	16.1	16.0	15.6	15.0	14.1	13.0	11.6	10.0	8.1	6.0	3.6	1.0
80	12.0	12.4	12.5	12.4	12.0	11.4	10.5	9.4	8.0	6.4	4.5	2.4	0.0
85	8.0	8.6	9.0	9.1	9.0	8.6	8.0	7.1	6.0	4.6	3.0	1.1	-1.0
90	4.0	4.9	5.5	5.9	6.0	5.9	5.5	4.9	4.0	2.9	1.5	-0.1	-2.0
95	0.0	1.1	2.0	2.6	3.0	3.1	3.0	2.6	2.0	1.1	0.0	-1.4	-3.0
100	-4.0	-2.6	-1.5	-0.6	0.0	0.4	0.5	0.4	0.0	-0.6	-1.5	-2.6	-4.0
105	-8.0	-6.4	-5.0	-3.9	-3.0	-2.4	-2.0	-1.9	-2.0	-2.4	-3.0	-3.9	-5.0
110	-12.0	-10.1	-8.5	-7.1	-6.0	-5.1	-4.5	-4.1	-4.0	-4.1	-4.5	-5.1	-6.0
115	-16.0	-13.9	-12.0	-10.4	-9.0	-7.9	-7.0	-6.4	-6.0	-5.9	-6.0	-6.4	-7.0
120	-20.0	-17.6	-15.5	-13.6	-12.0	-10.6	-9.5	-8.6	-8.0	-7.6	-7.5	-7.6	-8.0
125	-24.0	-21.4	-19.0	-16.9	-15.0	-13.4	-12.0	-10.9	-10.0	-9.4	-9.0	-8.9	-9.0
130	-28.0	-25.1	-22.5	-20.1	-18.0	-16.1	-14.5	-13.1	-12.0	-11.1	-10.5	-10.1	-10.0

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Our core purpose is to ensure that all consumers can get good value and service from the energy market. In support of this we favour market solutions where pratical, incentive regulation for monopolies and an approach that seeks to enable innovation and beneficial change whilst protecting consumers.

We will ensure that Ofgem will operate as an efficient organisation, driven by skilled and empowered staff, that will act quickly, predictably and effectively in the consumer interest, based on independent and transparent insight into consumers' experiences and the operation of energy systems and markets.

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