ofgem Making a positive difference for energy consumers

RIIO-2 Costs & Outputs Working Group

Electricity Transmission

Paul O'Donovan, Anthony Mungall & Neill Guha

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Agenda (1 of 2)

Introductions

Purpose of working group

- Objectives
- Terms of reference
- Timelines for activities & deliverables

Interactions with User group/Challenge Group

Take-aways from Framework Decision

- Highlights
- Implications for setting outputs & incentives

Review of RIIO1

- What's worked well
- What needs improvement

Agenda (2 of 2)

Scenario planning
- What does Ofgem need?
- Key considerations

Cost Benefit Analysis

Future Work

Next steps

Stakeholder presentations (integrated with relevant sections)
- SP/Citizen's Advice/NGET/SHETL

Purpose of Working Group

Objectives

- **Inform ETO business plan submissions**

  - ✓ **Content**
  - ✓ **Form**
  - ✓ **Evidential base required**

- **Inform development of analytical techniques for assessment of business plan**

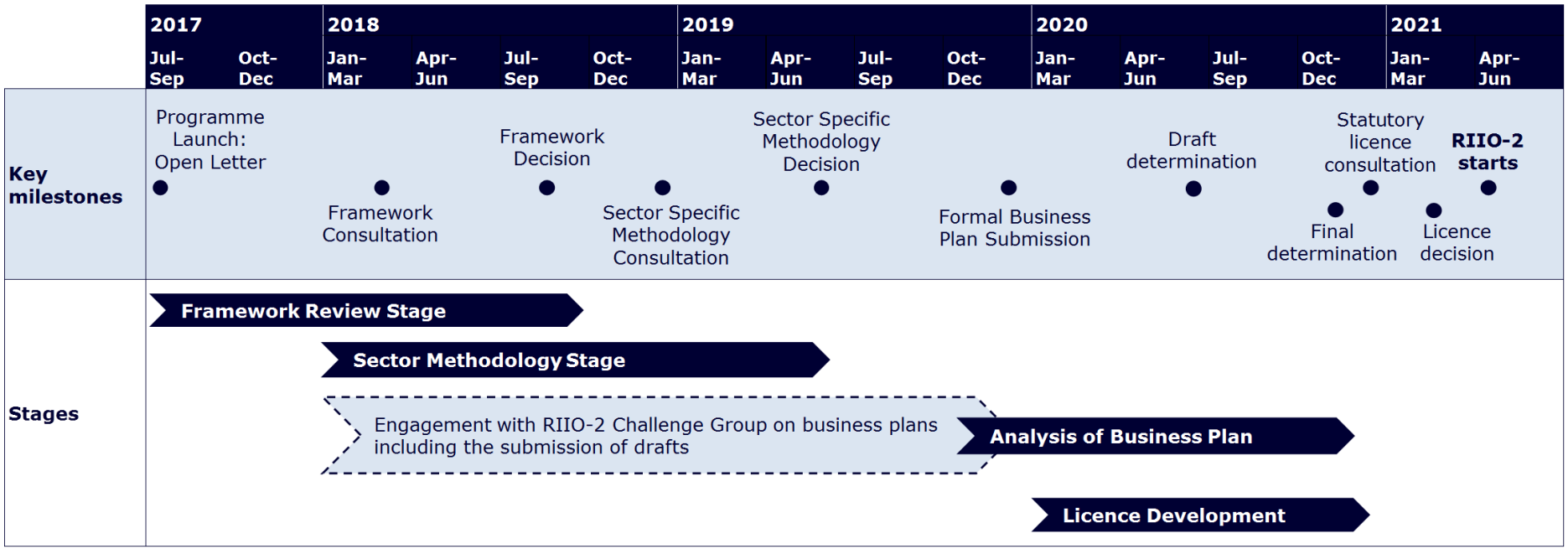
- **Forum for working out the practical implementation of performance monitoring through course of RIIO-ET2**

Terms of reference

- **Not a decision making group**
- **Membership comprises Ofgem, ETO & ESO representatives and other interested parties**
  - ✓ **Expectation that members will be active participants**
  - ✓ **Chatham House Rules apply**
  - ✓ **Discussions not binding on GEMA**
- **Meet at ~ 5 week intervals**
- **Run through to business plan submission (late 2019)**
- **Publish brief, non-attributable minutes**

Timeline for activities and deliverables (1 of 2)

Indicative High-Level RIIO-2 Plan for ET, GT, GD and ESO Sectors



Scope of workgroup activities

- Review RIIO-ET1 cost analysis work program
  - ✓ Determine what is still suitable, what needs to be changed
- Develop and refine assessment methods for
  - ✓ Totex
  - ✓ Capex
  - ✓ Opex
- Establish the approach to and treatment of:
  - ✓ Business support costs
  - ✓ Contractor modelling
  - ✓ Whole life costs
  - ✓ Innovative solutions
  - ✓ Investment avoidance
  - ✓ Associated investment costs
- Cross Sector WG to discuss specific common areas

What will we need to determine allowances?

Unit costs

Benchmarking approach

- **Bottom up**
- **Top down**

View on future work requirements

- **Volumes**
- **Scope/nature of work**
- **Compatibility with whole system view**

Interactions with User Groups/ RIIO Challenge Group

Role of different groups

Ofgem - decision-maker

Sector-specific Working Groups

Core role: support development of common outputs and incentives, and approach to cost assessment

Input to Ofgem policy development

Independent RIIO2 Challenge Group

Core role:

Support Ofgem's Business Plans assessment

Output: independent report

Network Operators

Independent User Groups/ Company Groups

Core role: provide challenge to company Business Plans + support development of bespoke outputs

Output: independent report

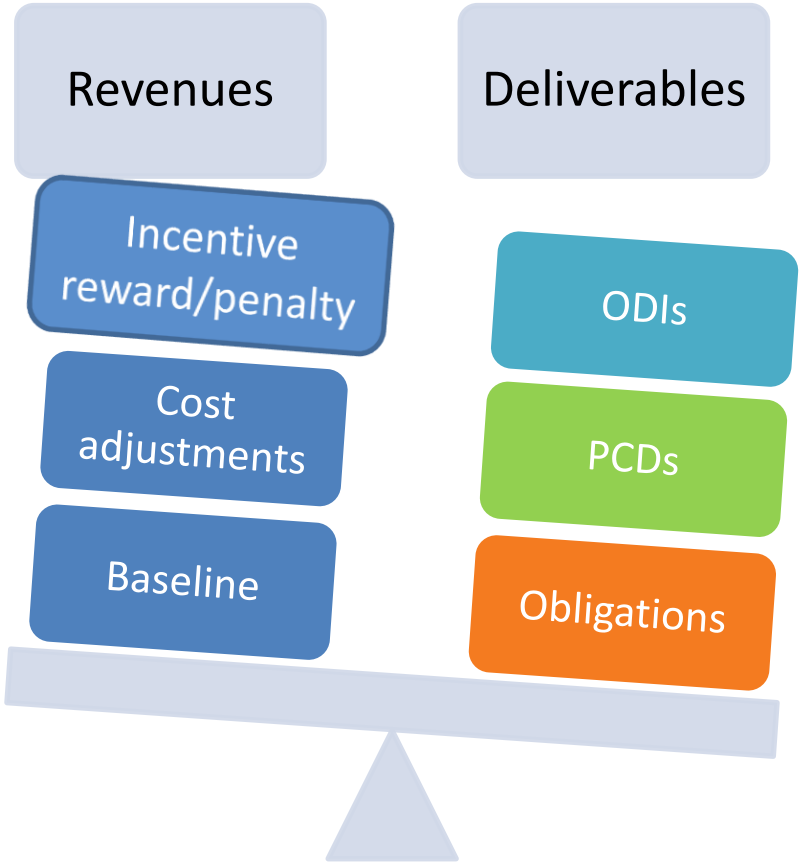
Network Operator stakeholder engagement

Framework decision document

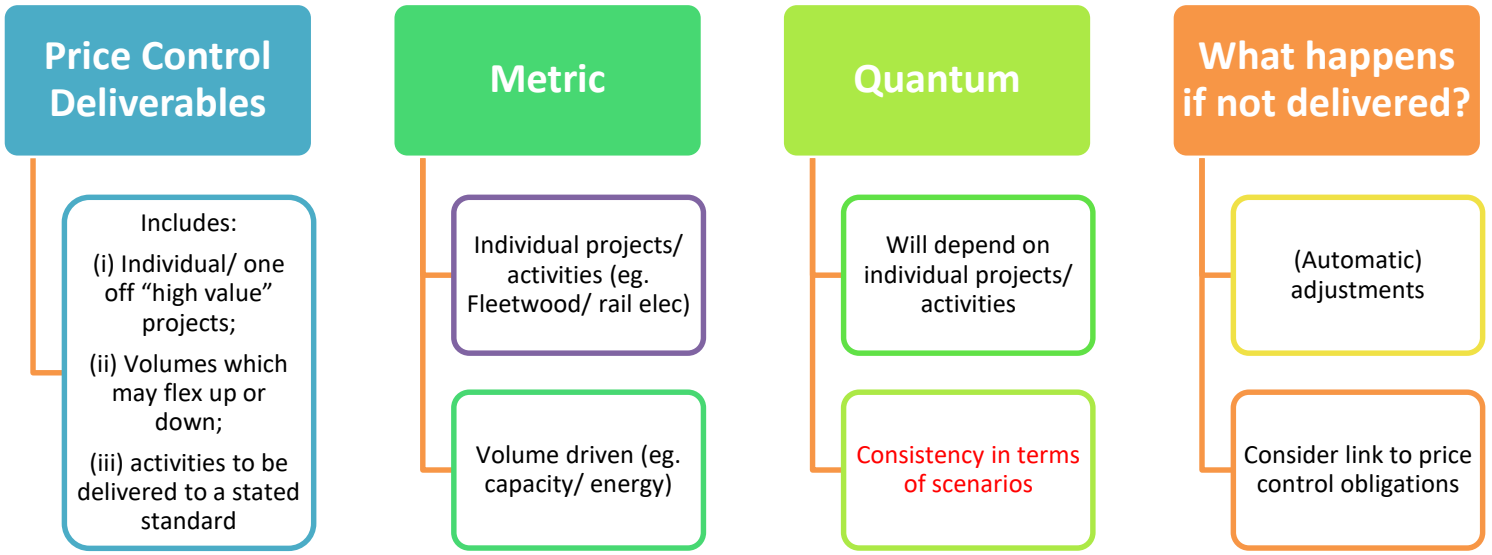
Types of outputs for RIIO2

- Output Delivery Incentives (ODIs)
- Price Control Deliverables (PCDs)
- Licence Obligations

Balance of price control



Characteristics of PCDs



Key take-aways – 1 of 3

- We will specify outputs as a set of consumer-facing outcomes that we expect network companies to deliver.
- We will set minimum standards and these will be imposed as a condition of the licence. We will use the enhanced engagement framework to inform network companies' licence obligations.
- We will establish price control deliverables where appropriate. For these, we will provide a revenue allowance to enable delivery. In addition, the framework will set out a clear methodology of what happens if an output or input activity is not delivered, is delivered late, or is delivered to a lower or different specification.
- Where deliverables are no longer needed due to a change in circumstances, we will put in place mechanisms for consumers to be automatically refunded.

Key take-aways – 2 of 3

For costs, these are the measures we will take to protect consumers against from forecasting risk:

- ✓ Where appropriate, we will use competition to set prices for new, separable and high value investment projects
- ✓ We will improve and simplify incentives to improve the quality of company forecasts
- ✓ We will index uncertain costs where possible, including for labour and construction cost inflation (to the extent evidence suggests this is different from general consumer price inflation)
- ✓ We will use volume drivers where unit costs are stable but quantities difficult to predict
- ✓ Where there is uncertainty over the scope of work and the potential costs are significant for consumers, we will not set upfront allowances. We will instead use either revenue drivers or within-period mechanisms.

Key take-aways – 3 of 3

- Where we continue to set upfront baseline allowances, we will incentivise companies to drive down costs, where:
  - ✓ The costs are within the control of the company
  - ✓ We are able to benchmark allowances against historical performance and relevant industry comparators
  - ✓ We are able to use outperformance to set lower allowances or return benefits to consumers.

- Where the cost profile of work spans multiple price, we will consider taking a long-term view of costs in setting allowances.

- We will also consider resetting certain cost allowances automatically during the price control period.

Review of RIIO1

Composition of RIIO1 cost allowance

1

- **Baseline allowance**
- We set their ex-ante allowances on the basis of the business plan (BP) to reflect areas of work where there was an established customer-driven need for the delivery of pre-agreed outputs (or works not linked to specific outputs because of their unique nature). Allowances included the company view of real price effects (RPEs).

2

- **Volume drivers**
- The BP position was not fully funded with ex-ante allowances as part of the RIIO-ET1 settlement. Instead, we included a combination of ex-ante allowances and allowances that would be released through "uncertainty mechanisms" (UMs).

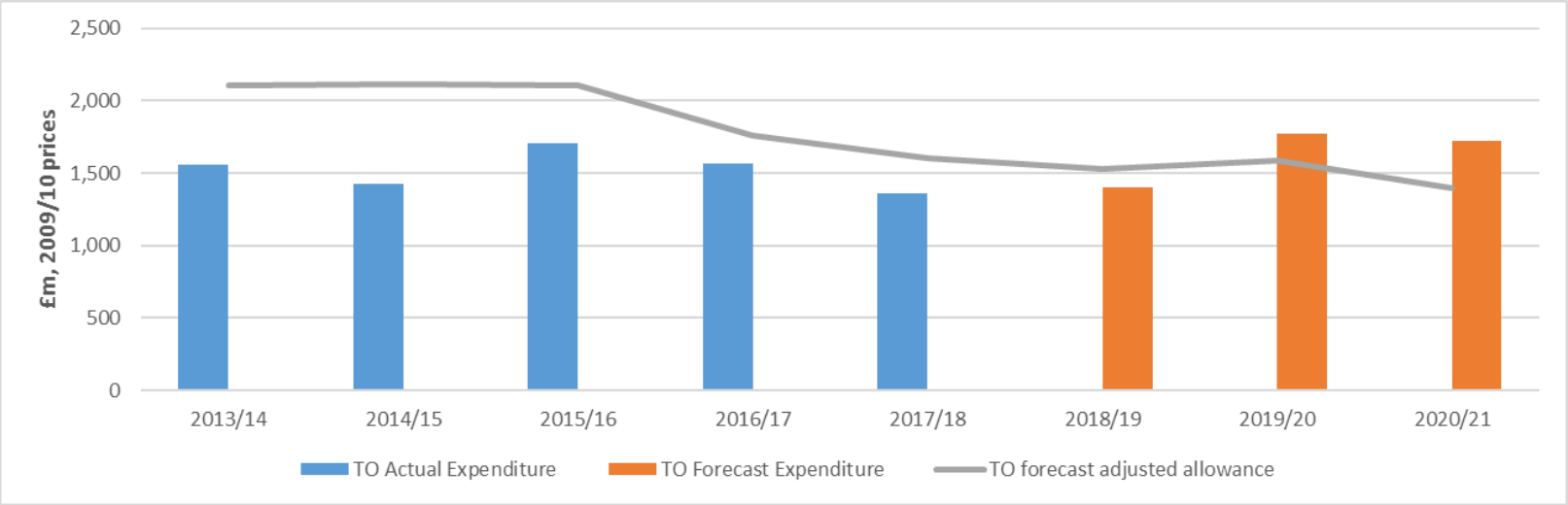
3

- **Other mechanisms / Reopeners**
- The 'automatic' UM approach was not suitable to all aspects of the BP; there was significant uncertainty associated with some large-scale investment projects. To deal with these in RIIO-ET1, we put in place the Strategic Wider Works (SWW) process, the Mid Period Review and two specific reopeners windows (2015 and 2018).

TO performance summary

All TOs

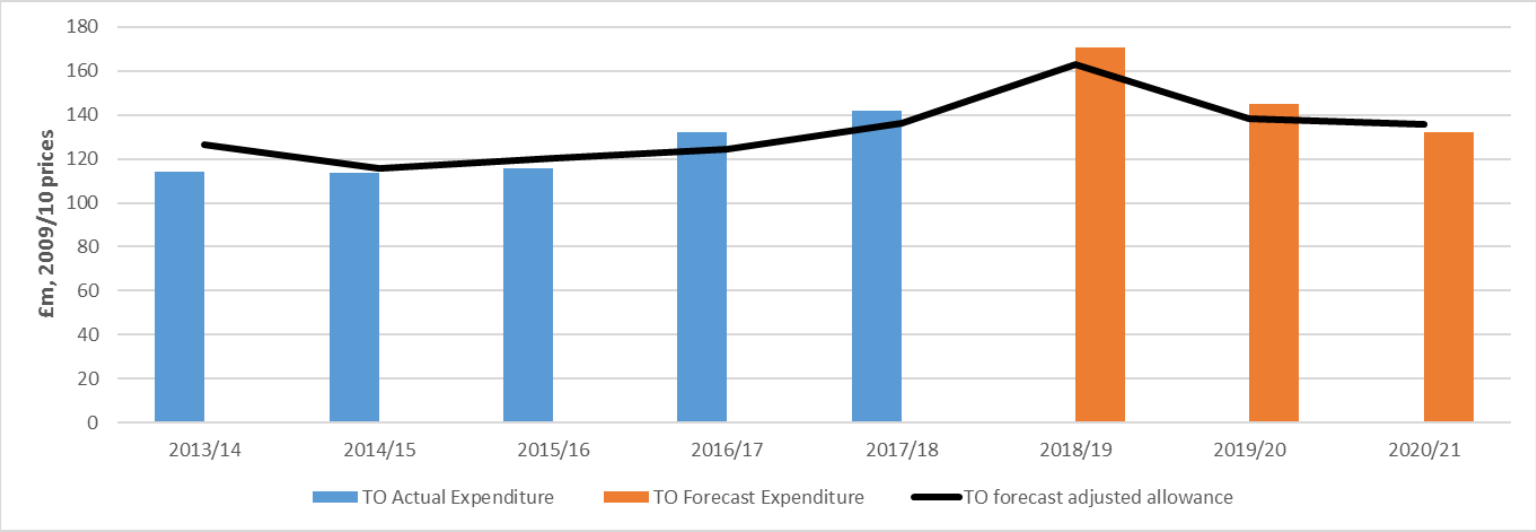
- Overall total expenditure forecast for the RIIO T1 period is £12.52bn set against forecast allowances of £14.20bn which is a £1.68bn reduction of costs below allowances (12%).



- The forecast underspend is comprised of:
  - Load related expenditure £0.78bn (12%) less than allowances.
  - Non Load expenditure £1.18bn (21%) less than allowances.
  - Overspend in non-operational capex (£123 million) and controllable opex (£152 million).

NGET SO performance summary

- Overall total expenditure forecast for the RIIO T1 period is £1.066bn set against forecast allowances of £1.060bn which is a £6 million increase of costs above allowances.



- The forecast overspend is comprised of:
  - Non-operational expenditure £10 million more than allowances.
  - Controllable opex £4 million less than allowances.

What's worked well

- Volume drivers are operating as intended, automatically flexing allowances to reflect the level of outputs required.
- Uncertainty mechanisms (SWW and reopener) have provided additional flexibility to address significant uncertainty with some investment projects.
- Stakeholder engagement has improved.
- Companies are performing well against the agreed output targets.
- ETOs sufficiently funded to deliver resilient networks.

What needs improvement (1 of 2)

- **Expenditure not linked to PCDs / uncertainty around targets not considered**
  - ✓ Load related:
    - ❑ volume drivers parameters based on inappropriate scenario
    - ❑ Projects being delivered very different from those originally envisaged and are funded through the operation of the UMs.
  - ✓ Non-load:
    - ❑ Non lead assets/activities are seen to be driving large underspends.
    - ❑ Lack of clarity on the impact of lead assets for delivery in RIIO-T2.
- **Poorly defined PCDs**. Examples include:
  - ✓ "non-variant" category where there was a lack of clarity over actions that should contribute to output delivery (and penalties for non-delivery).
  - ✓ The inability of connection volume driver to react to external change and appropriately reward genuine efforts to provide efficient network services.

What needs improvement (2 of 2)

- **Insufficient linkages to related cost categories**
  - ✓ (e.g. maintenance), and lack of flexibility in allowances to appropriately reward innovation and whole system solutions.

- Fixed ex-ante allowance based on the companies' **Real Price Effects (RPEs)** forecast.
  - ✓ TOs have benefitted from slower than expected growth in input prices.

- Ensuring that allowances appropriately reflect latest technologies and business practices
  - ✓ (for example, the practice of tower painting).

Scenario planning

What does Ofgem need?

What are we looking for?

- Realistic baseline
- Measurable
- Independently verifiable
- Additions to reflect possible/likely outcomes

Coordinated/holistic view

- Agree common scenarios
- Whole system perspective
- Identify correlations between scenarios
- Confidence intervals

What are best parameters to quantify?

- ✓ RIIO1 used connections
- ✓ Identify scenario drivers

Exogenous/Endogenous drivers

- ✓ Exogenous – flexibility mechanisms
- ✓ Endogenous - incentives

Cost Benefit Analysis

Why do we need CBAs?

- **CBAs are needed to:**
  - ✓ Demonstrate the range of options considered for a given issue
  - ✓ Demonstrate how the key parameters for each option have been quantified
  - ✓ Evidence the decision making process that led to the preferred choice being made
  - ✓ Give confidence that the proposition represents value for money to consumers

- **CBAs have evolved over the years. We expect:**
  - ✓ all major investment proposals to be underpinned with a CBA
  - ✓ best practice to be adopted for all CBAs
  - ✓ Uncertainty estimates to be incorporated as appropriate

Future work

Business Plan / Annual Reporting templates

- The Business plan data template will be a natural evolution of current RIGs with further modifications to cater for RIIO-2 policy decisions.

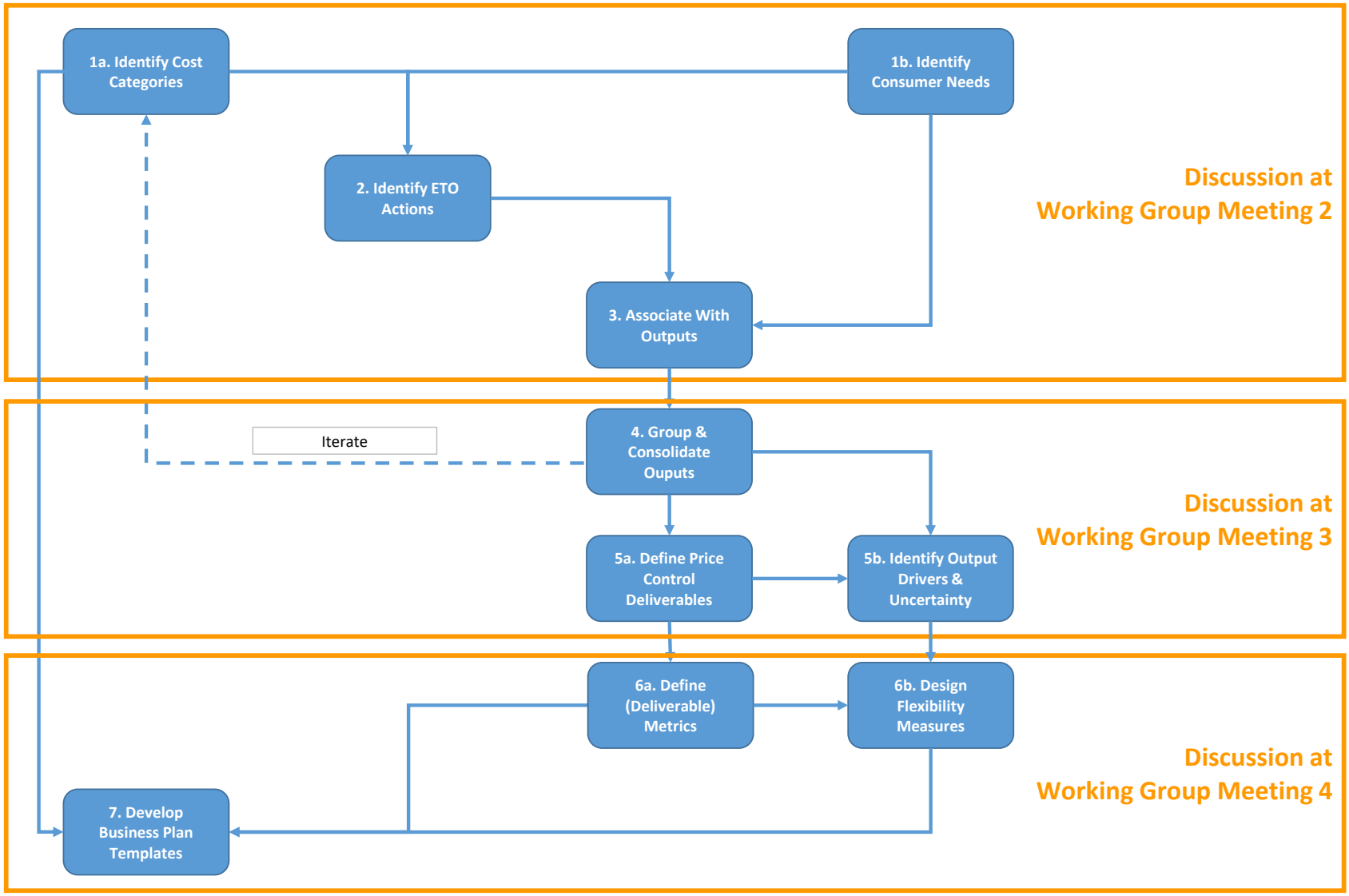
- We need to attempt greater level of standardisation between ED and ET, both in terms of general language and structure of information.

- Every 'thing' that a licensee intends to deliver must be allocated a unique reference. The schemes that comprise the project that ultimately delivers this 'thing' will map to the reference. Any changes to the delivery can be tracked, and any new 'thing' post-BP will be similarly identified.

- Recognition that price controls are artificial boundaries. Requirement for greater transparency on investment cycle beyond RIIO-2. The multi-period approach better reflects companies' natural corporate cycle for investment.

- Requirement for greater transparency on companies' non-lead asset intervention strategy. Greater level of disaggregated reporting across all non-lead asset categories - further discussions required around definitions and categorisations - and the treatment of high value non-lead assets (e.g reactive compensation).

Steps for determining PCDs



Next steps

List of actions arising

[To be picked up during course of meeting]

ofgem Making a positive difference for energy consumers

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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