RIIO-2 SECTOR SPECIFIC METHODOLOGY CONSULTATIONS.

Economic Insight's Assessment

19th December 2018

OVERVIEW.

- This pack sets out Economic Insight's assessment of Ofgem's sector specific methodology consultation for RIIO-2, which was published on December 18th.

- Rather than simply summarising the main elements of Ofgem's proposals, we have instead reviewed each policy area - and here we present *our own evaluation of them* in three main dimensions:
  - **Scope for being able to influence Ofgem** (that is to say, for which policy areas is the detail less locked down, or is Ofgem's position more open, meaning that you might still be able to meaningfully influence the regulator?)
  - **Implications for investors** (our views on whether the policy position is likely to be positive, negative, or neutral, for industry investors).
  - **Consistency with expectations** (that is to say, for each policy area, does the method accord with previous signals sent by Ofgem – or are there any surprises?)

- The following pages contain a 1-side overview for each Ofgem policy area, consisting of a graphical "speedometer" for the above three criteria, which gives an 'easy to read' summary of our appraisal, alongside our views on the key issues. This is preceded by a short overarching summary page, in which we highlight what we consider to be some of the most important themes for companies and investors to consider at this time.

OFGEM RIIO-2 POLICY AREAS	
What customers want and value	Whole system solutions
Driving innovation and efficiency	Ensuring future resilience
Fair returns and financeability	Managing uncertainty
Striking a reasonable balance	

- Before setting out our appraisal of the policy areas, here we briefly highlight some key themes that we think emerge from Ofgem's methodology consultations.

The main elements of Ofgem's method accord with industry expectations. This is not surprising, given how widely trailed the direction of travel has been. Ofgem has now provided much of the cross-sector specification that could have been expected in its July RIIO-2 decision document.

Overall, **we rate the methodology as being negative for investors** – in particular: (i) mechanisms to mitigate uncertainty may be asymmetric in their application; (ii) the distinction between allowed and expected returns remains problematic and may also skew returns to the downside; and (iii) overall returns are likely to be significantly lower than at the RIIO-1 controls.

The discussion on risk and return continues to be driven by relatively simplistic observations regarding historical outturn returns and a need to mitigate uncertainty. There is little discussion as to the impact of the RIIO-2 framework on incentive power, nor how revisions to how uncertainty is addressed affect incentives – and, in turn, what this might imply for investor expectations for the WACC.

The proposals do little to simplify the framework, but provide opportunities for 'bespoke' regulatory settlements. Despite the rhetoric, the consultation proposes little that will simplify the RIIO framework – and in many cases complexity is increased. There are, however, opportunities for companies to receive tailored settlements, such as in relation to bespoke ODIs and cost assessment.

Many practical challenges lie ahead. The approach to RIIO-2 is highly ambitious and the details relating to financeability (including cash flow floors); real price effects; and ODIs, all require further stakeholder engagement.

REFLECTING WHAT CUSTOMERS WANT AND VALUE.

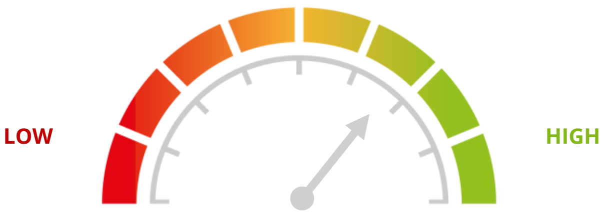
Features of Ofgem's approach

- Ofgem intends to consolidate outcomes into three categories: meeting the needs of consumers and network users; maintain a safe and resilient network; and deliver an environmentally sustainable network.
- Three types of output will be specified: licence obligations; price control deliverables (PCDs); and output delivery incentives (ODIs). Some outputs may be a combination of two or more of the outcome types e.g. a licence condition and ODI.
- Ofgem intends to use dynamic and relative targets and incentives where appropriate. For example, this may include targets that increase year-on-year, relative to the frontier.
- Companies will be allowed to propose bespoke PCDs and ODIs.

Key implications for companies

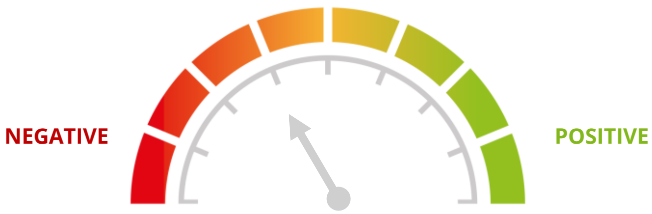
- Relative and dynamic targets and incentives may limit the upside available to companies. They may also reduce longer-term incentives for companies to improve (because the benefits of outperformance are not retained for as long a time period).
- Relatedly, it is not clear that Ofgem has fully understood the trade-offs between 'dynamic' and 'static' targets, nor the potential investor implications.
- A particular consideration with dynamic ODIs is the extent to which short-term variance is 'within company control'. This needs careful thought and has the potential to run contrary to the low risk environment Ofgem has in mind.
- In principle, the ability for companies to propose bespoke ODIs that they could then outperform on is an opportunity. However, experience in the water sector is that these can be highly complex.

Scope for influencing Ofgem



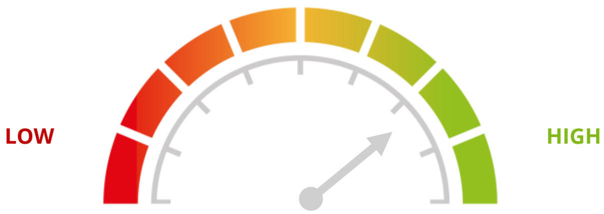
- There are numerous aspects of Ofgem's proposals that still need to be finalised, and scope for companies to influence the regulatory framework.
- Although Ofgem appear set on using dynamic and relative targets and incentives, they show little regard for the implications of long-term incentives that the companies will face. There is an opportunity for companies to influence Ofgem's thinking here.

Implications for investors



- Moderately negative.
- Relative and dynamic targets and incentives are likely to reduce potential upside.
- Relatedly, experience in the water sector is that the more complex this area becomes, the more 'arbitrary' its application. In practice this can give rise to both 'retrospectivity' and 'asymmetry' in regulatory decisions.
- However, bespoke ODIs present an opportunity.

Consistency with expectations



- Ofgem has previously signalled a move towards greater use of dynamic and relative mechanisms.

WHOLE SYSTEM SOLUTIONS.

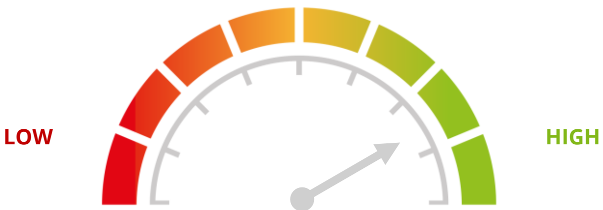
Features of Ofgem's approach

- Ofgem has provided further clarity on the term 'whole system' – it has chosen a 'narrow' definition that covers investment planning and operational delivery for electricity and gas networks.
- Companies are expected to set out in their business plans what their role in enabling whole system solutions will be. Ofgem will take into account the ambition and cost-effectiveness of companies' plans.
- Ofgem propose to use innovation funding to support schemes that provide value through whole system approaches.
- A number of other mechanisms are being consulted on, such as information sharing incentives; and approaches to balance incentives between licensees (e.g. transfer of outputs).

Key implications for companies

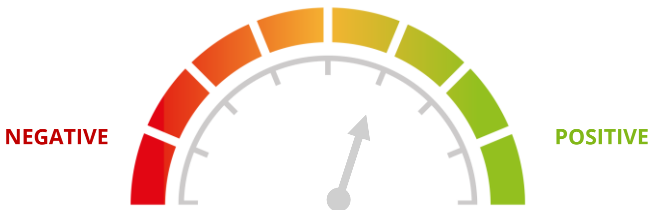
- Although some more clarity has been provided in terms of what is meant by 'whole system' solutions, there is still considerable uncertainty about how mechanisms will work in practice.
- It will be challenging to develop mechanisms that fully 'internalise' the benefits and drawbacks of company decisions from a whole system perspective, and Ofgem's options will add an additional layer of complexity to the framework.
- There is, however, an opportunity for companies to capitalise on potential additional revenue streams, although the absolute value at this stage appears to be limited.

Scope for influencing Ofgem



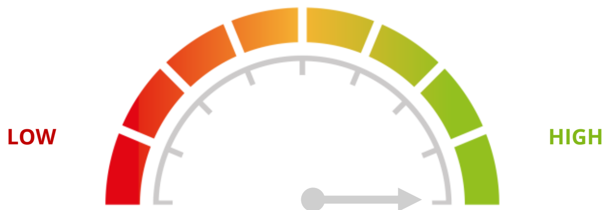
- Ofgem is rightfully keen to identify and exploit opportunities to improve the working of the 'whole system'. Its options for consultation are relatively high level, and therefore we think there is significant opportunity for companies to influence the direction of travel.
- However, the choice between any additional mechanisms will need a large degree of judgement, and the regulator may rely on its own preferences.

Implications for investors



- Moderately positive.
- There are opportunities to unlock potential within the whole system, and therefore for companies to share in part of this value.
- We expect the financial upsides for companies from whole system solutions, however, to be limited.

Consistency with expectations



- Ofgem has repeatedly discussed whole system solutions, and the consultation document provides further clarity on the direction of travel.

ENSURING FUTURE RESILIENCE.

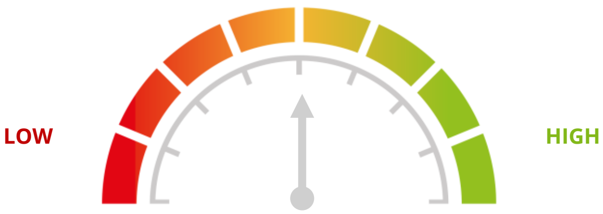
Features of Ofgem’s approach

- Monetised risk – now termed Network Asset Risk Metric (NARM) – will be used as the primary measure for defining the output targets and allowances for asset resilience.
- Outputs will be defined in terms of relative risk reduction, which better measures the effect of company plans compared to absolute risk. Relative risk measures will cover the longer-term, not just to the end of RIIO-2.
- Companies will face penalties if they don’t deliver against asset resilience targets.
- Ofgem is consulting on two options for funding work programmes that span price controls: only funding outputs delivered in the price control; and providing a fixed pot for outputs to be delivered in RIIO-3.
- Companies are expected to develop workforce resilience plans.

Key implications for companies

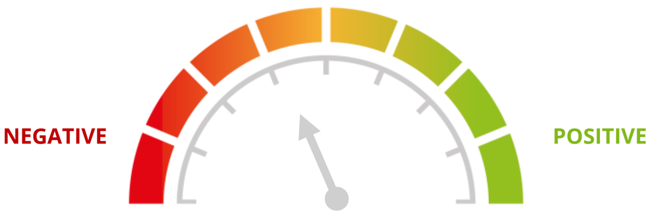
- Ofgem’s plans formalise the monetised risk measure that companies have been using; and therefore the broad approach will be familiar.
- There are a broad range of options in terms of precisely how long-term relative risk reductions are calculated – which will affect which programmes go ahead, and the ‘actual’ level of risk that customers face.
- Companies will face risk from failure to deliver output – both in terms of the loss of the associated cost allowance and, if failure is unjustified, a penalty equal to the reduction in monetised risk. Justification of under-delivery may be contentious.

Scope for influencing Ofgem



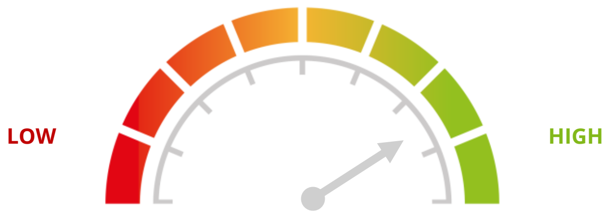
- There seems little scope to influence the overall approach that Ofgem has outlined.
- However, there is an opportunity to influence both: (i) how long-term relative risk reduction is calculated in practice; and (ii) a framework for assessing justifications of over or under delivery of outputs.

Implications for investors



- Moderately negative, due to penalties from under-delivery.
- However, there are opportunities for reward from over-delivery.

Consistency with expectations



- Broadly consistent with expectations.

MANAGING UNCERTAINTY.

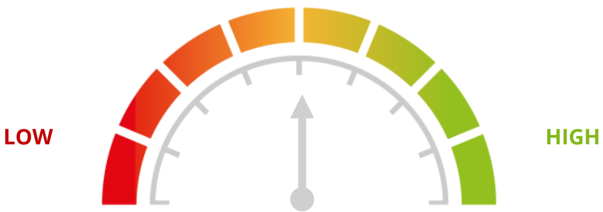
Features of Ofgem's approach

- Where the needs case or the scope of projects is unclear, Ofgem will use re-openers.
- Where there is uncertainty as to the evolution of quantities or demand, Ofgem will make use of volume drivers.
- Ofgem will move to an 'indexation' approach to address real price effects where possible (as opposed to using forecasts, as per RIIO-1).
- In cases where expenditure is entirely outside of a network company's control, Ofgem will continue to use pass-through costs (e.g. business rates).

Key implications for companies

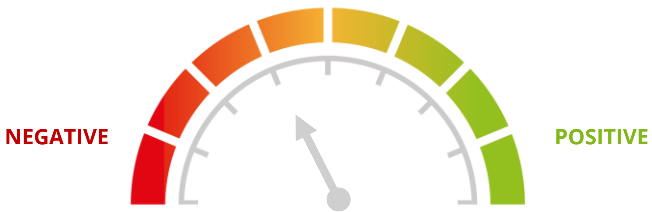
- Overall Ofgem is, as expected, recalibrating the balance of risk through its revised approach to uncertainty.
- In particular, the uncertainty mechanisms collectively: (i) further limit upside and downside risk exposure to companies; and (ii) allocate more risk to customers (e.g. indexing RPEs, rather than using fixed allowances).
- Network companies need to be mindful that, in practice, mechanisms that limit the impact of uncertainty can be 'asymmetric' in their application and so need to think carefully about the potential investor downsides in this area.
- In addition, there are clear implications for incentives over the longer term associated with explicitly 'de-risking' the RIIO framework.

Scope for influencing Ofgem



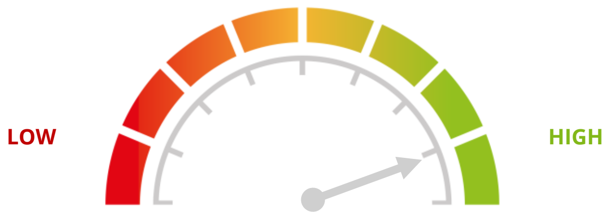
- It seems doubtful that network companies will be able to influence Ofgem's overall direction in this area.
- However, companies do have an opportunity to develop robust evidence to influence the 'detail' of how mechanisms (such as indexation for RPEs) will apply.

Implications for investors



- In theory, any recalibration of risk via uncertainty mechanisms should be value neutral. That is to say, a decrease in upside and downside risk exposure for companies can be reflected in a lower WACC, all else equal.
- However, recent regulatory experience (particularly in the water sector) indicates that the implementation of such mechanisms will be asymmetric and so investors may consider this to be an area with some downside.

Consistency with expectations



- No surprises.

DRIVING INNOVATION AND EFFICIENCY THROUGH COMPETITION.

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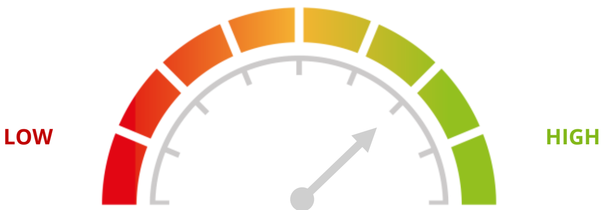
Features of Ofgem's approach

- Ofgem is moving the focus away from "business as usual" schemes that should be funded by totex allowances, to schemes that will address "strategic energy challenges".
- As part of this, companies will be expected to partner with third parties to identify and scope projects in order to secure funding.
- Ofgem will replace the NIC, remove the IRM reopener, and potentially also the NIA.
- Clear intention to increase the scope for competition in the early and late stages of project development, but the scale of this in £s is unclear.
- Signal of the potential for other parties other to run some or all stages of the competition, including Ofgem and ESO.

Key implications for companies

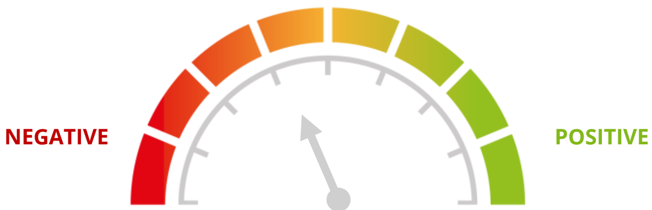
- There is a clear opportunity for engaging with Ofgem in this area – there is a long way to travel before this policy is pinned down.
- But we know now that companies will need to adapt to new ways of funding and innovating, with their ability to build relationships with third parties determining their success in this area.
- There will be increasing pressure on companies to show that they have considered and used competition for new, separable and high-value projects – with potentially significant impacts on finances and operation.
- Long term, there is the potential for an 'unlevel playing field', where 'new entrants' or partners face a better risk reward balance than incumbent networks (potentially creating 'moral hazard' risk: e.g. see PFI contracts beyond regulated sectors).

Scope for influencing Ofgem



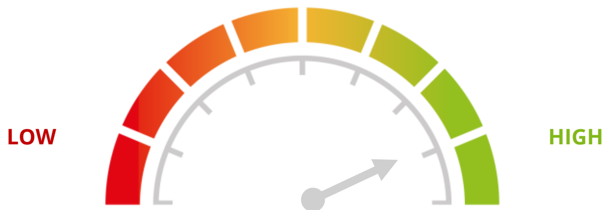
- There are several aspects of Ofgem's approach to innovation and competition that still need to be finalised – from both a macro-perspective (e.g. should we retain NIA?) and micro-perspective (e.g. how should we identify projects suitable for Ofgem-led competitions?).
- There is movement from the RIIO-2 Framework decisions, but still a long way to travel before this policy is pinned down.

Implications for investors



- Hard to say, though moderately negative.
- Likely to be winners and losers regarding innovation incentives.
- But the increased use of competition could be negative for companies, if the reforms result in more third parties carrying out activities that network companies would have undertaken and/or due to increase costs / loss of control associated with competition.

Consistency with expectations



- Broadly in line with expectations (though this is in part due to the very general formulation of the RIIO-2 Framework decision).
- Regarding innovation, the Framework decision signalled Ofgem's desire to better distinguish between BAU schemes and genuinely innovative schemes plus its hesitation concerning the future of the NIC.
- The Framework decision also signalled extending competition using the new, separable and high-value criteria.

FAIR RETURNS AND FINANCEABILITY.

Features of Ofgem's approach

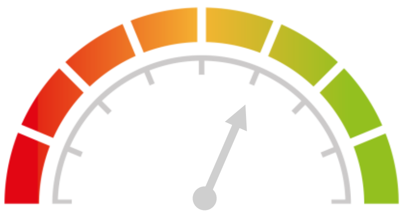
- In relation to the cost of debt, Ofgem proposes to retain a 'full indexation' approach. No 'within year' sharing mechanisms.
- Guideline cost of debt figure of 1.74% (real CPIH) given for RIIO-2.
- Cost of equity continued to be estimated using CAPM, with cross checks applied.
- Cost of equity will be indexed for the 'risk free rate' component.
- Guideline cost of equity range of 4.00% - 5.00% (real CPIH).
- Ofgem distinguishes between 'expected returns' and 'allowed returns' for equity returns. Ofgem considers that 'expected returns' will be positive, relative to allowed returns, and that this implies a reduction of 0.5% in allowed returns - and a central case cost of equity of 4.00% (in turn, implying a WACC of 2.64%).
- On financeability, a 'cashflow floor' remains on the table.

Key implications for companies

- The logic underpinning the distinction between 'allowed' and 'expected' returns remains highly questionable. In particular, it does not address the fundamental issues of 'why' historical returns may have deviated from allowed returns. As such, for companies this should remain an area of concern.
- Indeed, when seen in the context of other elements of the framework, which may now 'skew' risk asymmetrically to the downside for companies, this is particularly problematic (i.e. Ofgem seems to suppose that investor expectations are primarily a function only of the past, and also ignores more recent regulatory behaviour).
- More broadly, companies need to be mindful of whether Ofgem's approach to risk and returns (and other parameters) reflects an internally consistent view of the UK economy (e.g. inflation, RPEs, and productivity).

Scope for influencing Ofgem

LOW

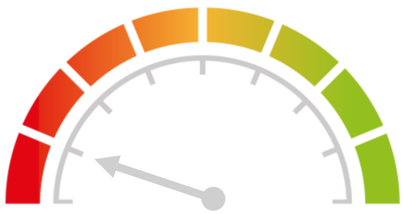


HIGH

- Ofgem's overall approach has been signalled for some time and so the scope to influence is limited.
- However, in relation to 'how' allowed returns are adjusted for investor expectations, we consider that companies do have scope to influence.
- In addition, as Ofgem's proposals for the 'variant 3' approach to the cashflow floor are new, there is scope to influence here.

Implications for investors

NEGATIVE

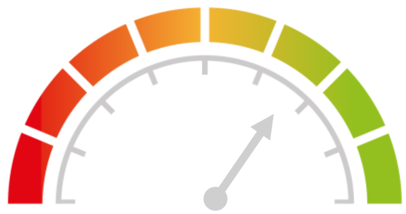


POSITIVE

- Highly negative. In particular, by drawing a distinction between allowed and expected returns: (i) it becomes less clear 'what' is being funded; and (ii) Ofgem is asserting that other elements of the framework provide investor upside that justifies a reduction in allowed returns – where in fact the opposite is likely to be true.
- In addition, returns at RIIO-2 will in any case be significantly reduced.

Consistency with expectations

LOW



HIGH

- As noted elsewhere, overall the package of proposals is in-line with Ofgem's previous positions on these matters. However, the 'variant 3' approach to the cash flow floor is new and so is somewhat unexpected.

ACHIEVING A REASONABLE BALANCE AT RIIO-2.

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Features of Ofgem's approach

- There are no specific proposals relating to 'achieving a reasonable balance'. Rather, here Ofgem is merely outlining the various factors it weighed up in making its policy decisions.
- Ofgem emphasises three high level trade-offs that have influenced its thinking:
  - **Achieving a reasonable balance between accuracy and simplicity.** Ofgem considers that, in weighing up new mechanisms such as the cash flow floor, it has struck a reasonable balance – but invites views.
  - **Balancing risk and return.** Ofgem is explicitly reducing the risks faced by companies. In addition, it believes that its new approach is more reflective of the 'fundamental' (low) risk nature of network businesses' activities.
  - **Efficiency vs fairness.** Ofgem recognises that, whilst it wishes to avoid significant cross-subsidy, it also thinks it is appropriate to support vulnerable customers in the interests of 'fairness'.

Key implications for companies

- **Collectively, the changes at RIIO-2 would seem to add complexity relative to the RIIO-1 approach** (e.g. the introduction of company specific ODIs; the partial indexation of the cost of equity; the distinction between 'allowed' and 'expected' returns). All else equal, this would seem to 'muddy' the purity of incentive based regulation. In addition, we do not agree with Ofgem's characterisation of the trade-off per se (i.e. the choice to use indexation for RPEs is not about 'accuracy' – rather, it is a choice about where risk is allocated to drive incentives).
- As noted elsewhere, we consider that there **is a risk that Ofgem is 'conflating' the balance of risk debate** (which is about incentive power) with observed outturn rates of return.
- **The 'fairness' debate is much broader than the energy sector** and is playing out not only in other regulated industries (water and telecoms) but also in unregulated sectors (see Citizens' Advise Super Complaint to the CMA). To date, regulators' thinking on fairness is relatively unsophisticated, and appears to reduce it to a trade-off between 'efficiency' and 'more equal prices and service levels'. There is, therefore, an opportunity to influence this debate by seeking to persuade regulators to take a more holistic approach.

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