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Statutory Consultation to modify price control financial models to account for the London medium pressure refund and the National Grid voluntary allowance deferral

Consultation

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Response deadline: 01 August 2017

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Overview:

Changes are required to price control financial models to account for two recent decisions. The first is our decision to accept voluntary allowance deferrals by National Grid. The second is our decision to accept Cadent's offer to refund consumers £53.9 million for work to replace medium pressure iron mains in central London, which Cadent has partly delayed to future price controls. This consultation proposes how the consequential licence changes are to be implemented.

Context

The RIIO Price Control Financial Models (PCFMs) determine adjustments to the annual revenue allowances for the companies that own and operate the transmission and distribution networks. As they are a part of the network licences, changes to PCFMs are subject to normal processes for making licence revisions. This includes changing previously agreed allowances, as is the case for this consultation. There are exceptions that allow for changes to PCFMs that do not require consultation, these situations are included in the Special Conditions of the licences and can be broadly described as either being when a change will not result in material change to licensee allowances and when conducting the RIIO Annual Iteration Processes. In both of these cases, notification of changes are given with a 14-day window for representations to be made. On this occasion, the allowance changes proposed are material and therefore require this consultation to be issued.

Associated documents

Open letter: National Grid Electricity Transmission's deferral of £480m of RIIO-T1 allowances
https://www.ofgem.gov.uk/publications-and-updates/open-letter-national-grid-electricity-transmission-s-deferral-480m-riio-t1-allowances

Mid-period review parallel work consultation
https://www.ofgem.gov.uk/publications-and-updates/consultation-mid-period-review-parallel-work

Mid-period review parallel work decision
https://www.ofgem.gov.uk/publications-and-updates/mpr-parallel-work-decision

The RIIO-GD1 Price Control Financial Model (PCFM) prior to proposed revisions
RIIO-GD1 Financial Model following the Annual Iteration Process 2016

The RIIO-ET1 Price Control Financial Model (PCFM) prior to proposed revisions
RIIO-ET1 Financial Model following mid-period review

Contents

Executive Summary

We are consulting on the implementation of two of our recent decisions to modify allowances within the RIIO-ET1 and RIIO-GD1 network price controls made as part of separate processes. These two decisions were:

1) Our acceptance of the National Grid offer to defer voluntarily a total of £480m of their allowances with respect to non-variant load and asset replacement expenditures.

2) Our decision, made in our mid-period review parallel work process, to accept Cadent's offer to refund consumers £53.9 million for work to replace medium pressure iron mains in central London, which Cadent has partly delayed to future price controls.

We propose to revise our PCFMs to reflect the refund and deferral in the companies' allowances. We intend for these PCFM revisions to be decided on in time for their inclusion in the next price control Annual Iteration Process, due to conclude 30 November 2017.

The revenue reductions associated with these PCFM modifications will be realised over many years into the future. In the nearer-term, we estimate that these changes will reduce revenue by £101m and £13m for RIIO-ET1 (2019/20 to 2020/21) and RIIO-GD1 (2018/19 to 2020/21) price controls, respectively.

1. National Grid, Allowances Deferral

Chapter Summary

We wrote an open letter welcoming the National Grid proposal volunteering to defer £480m of its RIIO-ET1 allowances. Here we report a response to that open letter and propose specifically how we plan to implement the deferral of allowances.

Question 1: Do you agree that the proposed PCFM changes correctly implement the voluntary deferral of the specified £130m plus £350m of non-variant allowances for Load and Asset related investments, respectively?

Background to Allowance Deferral

1.1. During the review that set the RIIO-ET1 price control, National Grid submitted its eight-year business plan setting out forecast expenditure throughout the RIIO period. National Grid was assigned Totex allowances based on this plan and Ofgem's cost assessment process, these were incorporated into their Opening Base Revenue Allowance (the PU_t term as defined in Special Condition 3A).

1.2. As part of its ongoing monitoring of investment plans, National Grid has identified certain investments are no longer required during the RIIO-ET1 period. This expenditure allowance falls outside of the scope of the Variant Totex Allowances, meaning Totex Allowances would not be adjusted during the regular course of the Annual Iteration Process (AIP) in relation to this matter.

1.3. National Grid has therefore voluntarily decided to defer £480m (2009/10 prices)[1] of Totex Allowances for its electricity transmission owner business (NGET TO). This was announced to the stock market on the Regulatory News Service (RNS) on 28th March 2017[2].

[1] All monetary values in this document are reported in 2009/10 prices unless stated otherwise.
[2] RNS Number: 6797A, available at; http://otp.investis.com/clients/uk/national_grid/rns/regulatory-story.aspx?cid=374&newsid=858383

Our Open Letter regarding the offer of deferral

1.4. Ofgem published an Open Letter welcoming National Grid's announcement on 13th June 2017[3].

1.5. We received one response to our open letter, from British Gas. They also welcome the voluntary deferral. In their response they asked for further details: the specific investments that have been deferred; the impact on NGET TO revenue allowances and matters of process regarding how this decision relates to our Mid Period Review and the wider RIIO framework. We have addressed these below.

1.6. In our Open Letter, we set out that the deferral relates to £130m of load related investment and £350m of asset refurbishment and replacement investment. We understand from National Grid that the £130m of load related investment relates to the deferral of two projects previously planned for this price control period: the Walpole substation and Humber. We understand that the majority of the £350m of asset refurbishment and replacement investment relates to the London Power Tunnel 2 project and tunnels at Birmingham and Sheffield.

1.7. This deferral has not formed part of the RIIO-T1 mid period review or the MPR parallel work. We consider National Grid's voluntary deferral is in the interest of consumers and therefore intend that it is given effect in the way set out in this consultation.

Treatment of deferred allowances

1.8. We set out in the Open Letter that we intend for NGET's £480m reduction in allowances to be spread over the regulatory years 2019/20 and 2020/21 to minimise volatility in network charges.

1.9. The deferral will not change any of NGET's agreed RIIO-T1 targets or outputs. We, therefore, do not intend to change the Outputs as defined in Table 1 of Special Conditions 2M.

Proposed modifications to the RIIO-ET1 PCFM

1.10. We propose to modify the Non-variant Totex allowances reported in the PCFM for the NGET TO as a means of incorporating the deferral into our allowance calculations.

[3] https://www.ofgem.gov.uk/publications-and-updates/open-letter-national-grid-electricity-transmission-s-deferral-480m-riio-t1-allowances

1.11. Specifically[4], we propose to reduce:

a) the Non-variant Allowed Load-related Expenditure by £65m for both 2019/20 and 2020/21 (NGET TO, AN84 and AO84); and

b) the Non-variant Allowed Asset Replacement Capex Expenditure by £175m for both 2019/20 and 2020/21 (NGET TO, AN85 and AO85).

1.12. A breakdown of the specifics of these revisions is in Appendix 3.

1.13. No further modifications are required to the PCFM to implement the deferral. The reduction in revenue will flow through automatically as part of the MOD_t terms for 2019/20 and 2020/21.

Allowed revenue impact of the expenditure allowance changes

1.14. This deferral will reduce consumer revenues in the near term and in future years. Allowed revenue reductions will first be delivered in 2019/20; the reduction is estimated to be approximately £45m in that year and £56m[5] in 2020/21. The reductions will be greater in these two years than in future years because approximately £72m of the reduction for these two years is due to the two one-off decreases in Fast Money.

[4] The PCFM (appended to this consultation) is change control version reference CC23. The current official version is CC19. CC23 also includes other minor modifications not discussed presently. These are already agreed with the PCFM working group and do not require consultation. They do not change the PCFM functionality and will be reported at the time that we notify stakeholders of our intention to direct the PCFM revision to this version of the model.
[5] These values are indicative as they are subject to tax adjustments whose exact values are dependent on the overall performance of the company, which is not known at this time.

2. Cadent, London Medium Pressure

Chapter Summary

We propose how we will implement our decision to accept Cadent's offer to refund consumers £53.9 million for work to replace medium pressure iron mains in central London, which Cadent has partly delayed to future price controls. This chapter describes how we propose to implement the adjustment in the RIIO-GD1 PCFM.

Question 1: Do you agree that that the proposed PCFM changes are an accurate implementation of the decision that has been made to accept the Cadent (London) expenditure allowance refund?

Background to the London Medium Pressure refund

2.1. Cadent (formerly National Grid Gas Distribution) is funded to remove or abandon medium pressure iron mains in London. Removing these iron mains will make the gas network more safe and reliable.

2.2. Cadent now reports that the majority of planned medium pressure work cannot go ahead due to a combination of engineering and stakeholder challenges. Cadent intends to undertake the remaining work in future price controls.

2.3. Cadent has offered to return £53.9 million in funding for the work that will no longer be undertaken in RIIO-GD1.

2.4. We considered this offer as part of our mid-period review parallel work process and decided to accept Cadent's proposal.

Allowance refund details

2.5. The allowance refund is for works that are categorised as a Non-Variant Repex Allowance. The profile of the refund is set out in Appendix 2.

2.6. The refund first affects the expenditure allowance of the regulatory year 2016/17. The design of the RIIO framework means that revenue allowances for that year and for the year after have already been determined. However, the price control has processes for the revision of expenditure allowances that are made after revenue allowances have been determined.

2.7. RIIO takes account of expenditure allowance revisions through the price control Annual Iteration Process (AIP)[6]. Each year the AIP adjusts company allowed revenue with consideration of a multitude of factors, including the reconciliation of revisions to past periods. The price control conducts these allowance reconciliations on a net present value neutral basis.

2.8. The AIP process can only take account of this if the PCFM is revised. This consultation seeks to modify the PCFM in time for the next AIP, which is to conclude by 30 November 2017. This will mean that Cadent's London gas distribution network (the London GDN) allowed revenue for regulatory year 2018/19 and future years will include an adjustment for the refund. The 2018/19 year will also include the adjustments that would have been applicable to the two years prior, as these allowed revenues have already been determined.

Proposed modifications to the RIIO-GD1 PCFM

2.9. We propose to modify the Non-Variant Repex Allowances reported in the PCFM for the London GDN as a means of incorporating the refund into our allowance calculations.

2.10. Specifically, we propose[7]:

a) on sheet "London" to reduce the Totex, Non-Variant Allowance "Non-variant allowed Repex" by £53.9m over the years 2016/17 to 2020/21, and the distribution of the refund over these years is given in Appendix 2. (cells AK86:AO86); and

b) on each of the eight sheets (each licensee): "East", "London", "North West", "West Midlands", "Northern", "Scotland", "Southern", "Wales & West" two rows have been added (289 and 290). These report the Original Allowed Totex each year of the price control and the total of these values for the whole price control, respectively. In addition to these two new rows, other new rows have been added for labelling purposes.

c) on sheet "Input" corresponding updates have been made to rows 289, 290 and associated labelling rows, as per the normal function of this sheet,

[6] See here for details about the Annual Iteration Process: https://www.ofgem.gov.uk/network-regulation-riio-model/price-controls-financial-model-pcfm

[7] The PCFM (appended to this consultation) is change control version reference CC17. Currently the official version is CC16. CC17 also includes other minor modifications not discussed presently. These are already agreed with the PCFM working group and do not require consultation. They do not change the PCFM functionality and will be reported at the time that we notify stakeholders of our intention to direct the PCFM revision to this version of the model.

these new rows report the values for the licensee that the user has currently selected.

d) On sheet "TIM" the formulae of cells AH106:AO106 have been revised. Previously they reported the sum of the current Allowed Totex; they now report the original Allowed Totex, which now differs from the current value for the London GDN following the refund.

2.11. The changes made to the sheets of all other licensees are for consistency and simpler operation of the PCFM. No changes are being made to the allowances of other licensees.

2.12. The information about Original Allowed Totex has been added for two purposes. One is to provide an audit trail of allowance changes. The second is to ensure that the relative profiling of the Additional Income allowance continues to equal the relative profile of the Original Allowed Totex; the refund revises the Allowed Totex profile. This approach to treating Additional Income was adopted because the scope of the MPR parallel work decision did not include changes to the Additional Income allowances. For context, Additional Income is a small contributor to the overall allowance; the potential profiling adjustment of having it match the updated Allowed Totex would be immaterial.

Allowed revenue impact of the expenditure allowance refund

2.13. The refunded expenditure allowance contributes to the calculation of the Totex Incentive Mechanism (TIM). TIM performance translates into revenue allowances in two ways known as "Fast Money" and "Slow Money"; details about these terms and other factors that govern revenue allowances calculations are explained in Appendix 1 of our 2015/16 Annual Performance Report[8]. A network licensee's revenue allowances is a key variable for determining its network connection and usage charges to energy suppliers and therefore to consumers through their bills.

2.14. TIM performance is divided between being treated as Fast Money and Slow Money. Fast Money contributes directly to allowed revenue in the year it is allowed. Slow Money is added to the company Regulatory Asset Value (RAV) and contributes to revenue over decades through depreciation of assets and a return on the remaining RAV.

2.15. This refund will therefore reduce consumer revenues in the near term and in future years. Allowed revenue reductions will first be delivered in 2018/19 and

[8] https://www.ofgem.gov.uk/publications-and-updates/riio-electricity-transmission-annual-report-2015-16

this will reflect all expenditure allowance adjustments for the years 2016/17 to 2018/19.

2.16. For The RIIO-GD1 price control the division of money between Fast Money and Slow Money changes year-on-year for Repex expenditure. It is an equal split for the year 2013/14 and changes linearly year-on-year to be entirely allocated to Slow Money by the last year, 2020/21. This combined with the profile of the refund (see Appendix 2) means that the majority of this refund will reduce revenue allowances in the long term.

2.17. During the RIIO-GD1 price control the London revenue allowance will be reduced by approximately £13m[9] because of this refund.

[9] These values are indicative as they are subject to tax adjustments whose exact values are dependent on the overall performance of the company, which is not known at this time.

Appendices

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Appendix 1 – Consultation response

We would like to hear from interested parties about whether they agree that these licence modifications correctly implement the policy position.

Please include any reasoning and evidence in your answers.

Unless you mark your response confidential, we will publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we will respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

We prefer to receive responses in electronic form so we can more easily place them on our website.

Responses should be received by 5pm on 01 August 2017.

Responses should be sent to:

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London SW1P 3GE
Email: RIIOFinance@ofgem.gov.uk

General feedback

We believe that consultation is at the heart of good policy development. We are keen to hear your comments about how we've conducted this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send your comments to stakeholders@ofgem.gov.uk

Appendix 2 – RIIO-GD1 PCFM revisions

The revisions to the PCFM[10] for the London GDN are shown in Table 1, the sheet and rows that these changes are applied to are detailed in the table caption. The revised PCFM is as per Appendix 5.

Table 1: Revision to PCFM to account for the refund of Non-Variant Repex Allowance expenditure; these changes affect sheet "London", Row 86

£m 09/10 prices	Year ending	31 Mar 2014	31 Mar 2015	31 Mar 2016	31 Mar 2017	31 Mar 2018	31 Mar 2019	31 Mar 2020	31 Mar 2021	Total
Previous[11]		122.7	123.0	128.0	124.1	133.1	129.5	133.6	136.3	1,030.2
Deferral		-	-	-	(1.1)	(12.9)	(12.1)	(13.3)	(14.5)	(53.9)
Revised		122.7	123.0	128.0	123.0	120.2	117.4	120.3	121.8	976.3

[10] PCFM before these changes: https://www.ofgem.gov.uk/publications-and-updates/riio-gd1-financial-model-following-annual-iteration-process-2016

[11] This is inclusive of a previous correction (not a policy change) to these allowances: https://www.ofgem.gov.uk/publications-and-updates/modifications-special-licence-condition-3e-gas-transporter-licence

Appendix 3 – RIIO-ET1 PCFM revisions

The revisions to the PCFM[12] for the NGET TO licence are shown in Table 2 and Table 3, the sheet and rows that these changes are applied to are detailed in the table captions. The revised PCFM is as per Appendix 6.

Table 2: Revision to PCFM to account for the deferral of Non-variant allowed load related capex expenditure; these changes affect sheet "NGET TO", Row 84

£m 09/10 prices	Year ending	31 Mar 2014	31 Mar 2015	31 Mar 2016	31 Mar 2017	31 Mar 2018	31 Mar 2019	31 Mar 2020	31 Mar 2021	Total
Previous		226.5	189.8	179.4	186.9	142.3	123.5	43.9	28.4	1,120.7
Deferral		-	-	-	-	-	-	(65.0)	(65.0)	(130.0)
Revised		226.5	189.8	179.4	186.9	142.3	123.5	(21.1)	(36.6)	990.7

Table 3: Revision to PCFM to account for the deferral of Non-variant allowed asset replacement capex expenditure; these changes affect sheet "NGET TO", Row 85

£m 09/10 prices	Year ending	31 Mar 2014	31 Mar 2015	31 Mar 2016	31 Mar 2017	31 Mar 2018	31 Mar 2019	31 Mar 2020	31 Mar 2021	Total
Previous		468.8	464.1	459.0	462.2	597.4	695.0	760.5	680.4	4,587.2
Deferral		-	-	-	-	-	-	(175.0)	(175.0)	(350.0)
Revised		468.8	464.1	459.0	462.2	597.4	695.0	585.5	505.4	4,237.2

[12] PCFM before these changes: https://www.ofgem.gov.uk/publications-and-updates/riio-et1-financial-model-following-mid-period-review

Appendix 4 - Glossary

Allowed Revenue

The amount of money that a network company can earn on its regulated business.

Annual Iteration Process

The annual iteration process is the process of annually updating the variable (blue box) values in the Price Control Financial Model (PCFM) and running its calculation functions in order to provide updated MOD and SOMOD values.

Opening Base Revenue

The best estimate at the start of a price control on the amount of money that a network company can earn on its regulated business.

MOD Term (MOD_t)

The term of that name included in the formula for Base Transmission Revenue (System Operator Internal Revenue) set out in Special Condition 3A (or Special Condition 4A for SO) of the Electricity Transmission licence. It represents the incremental change to be applied to the licensee's Opening Base Revenue Allowance for the Relevant Year concerned. The value of the MOD term is calculated through the Annual Iteration Process for the ET1 Price Control Financial Model (see Chapter 1 of the Price Control Financial Handbook) and is specified in a direction given by the Authority by 30 November in each Relevant Year.

Regulatory Asset Value (RAV)

A financial balance representing expenditure by the licensee which has been capitalised under regulatory rules. The licensee receives a return and depreciation on its RAV in its price control allowed revenues.

Total expenditure (Totex)

Totex consists of all the expenditure relating to a licensee's regulated activities with some specified exceptions. See the Reporting Instructions and Guidance[13] for a list of these exceptions.[14]

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[13] Latest versions for RIIO-GD1 and RIIO-ET1, respectively:
https://www.ofgem.gov.uk/publications-and-updates/direction-modify-regulatory-instructions-and-guidance-rigs-riio-et1
https://www.ofgem.gov.uk/publications-and-updates/direction-modification-riio-gd1-price-control-regulatory-instructions-and-guidance-version-40

[14] https://www.ofgem.gov.uk/publications-and-updates/notice-modification-relation-riio-t1-electricity-transmission-price-control-regulatory-instructions-and-guidance-version-3-0-0