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RIIO-2 Managing uncertainty & ensuring fair returns

11 December 2017

RIIO-2

- The current suite of network price controls allow the recovery of £bns of revenue to ensure gas and electricity can be transported from point of generation to end user. 25% of the supply bill funds this investment

- Our approach to controlling the prices the network companies charges follows the RIIO model – where **R**evenue = **I**ncentives + **I**nnovation + **O**utputs

- The first round of RIIO price controls – gas distribution and gas/electricity transmission – end in 2021. Work on the price controls for these sectors will start next year.

- Before we launch into sectoral reviews, we want to understand whether any elements of the RIIO framework need to change

- In July we issued an Open Letter on the context for the development of RIIO-2. In February we plan to publish a consultation on the framework for the next round of controlsb

Introduction – Striking the right balance

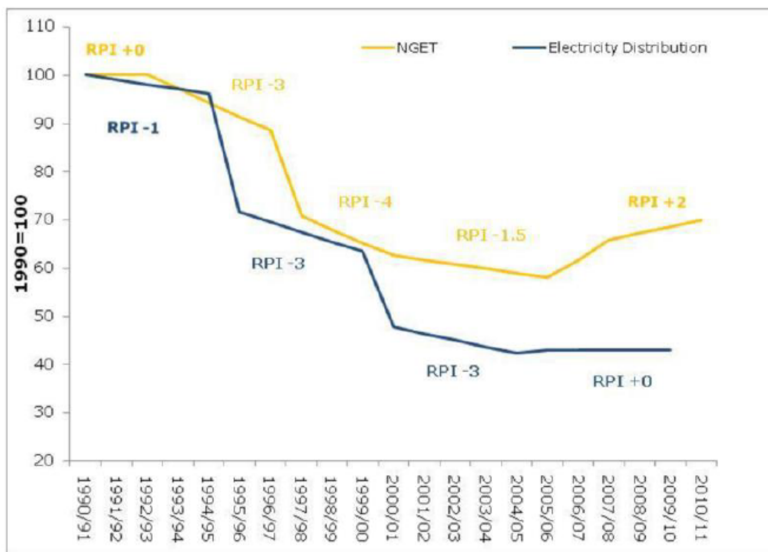
- The pace of the energy transition will quicken in RIIO-2 but there remains uncertainty around the direction and scale – shifts in the way all parts of the energy sector currently operate, introduction of new players, technologies, opportunities and risk – including for network companies
- In setting the next price control we therefore need to balance and manage two core issues:
    1. Setting the right framework to respond to the energy transition and associated uncertainty
    2. Ensuring company returns are fair and legitimate
- Our decision-making for setting the framework needs to reflect this balance

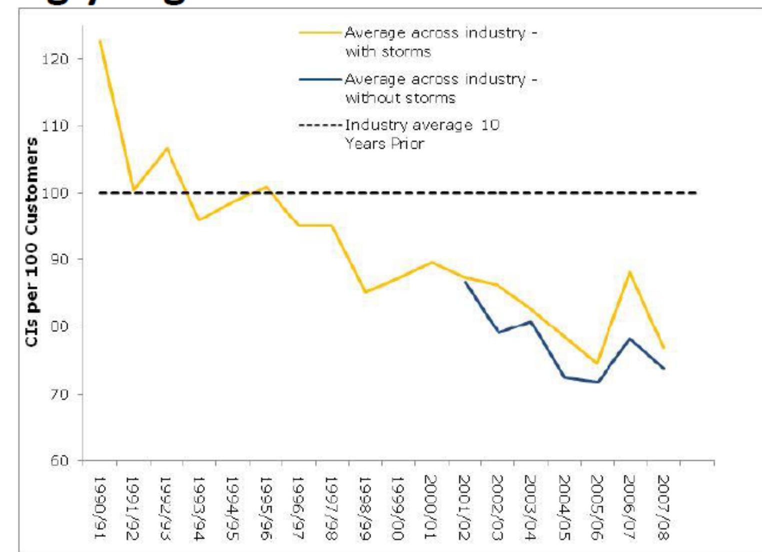
Introduction – Purpose of the workshop

- **This session is to provide you with an update on how our thinking has evolved since the session we held in October on ‘ensuring fair returns’**
- **We want to hear your views on the different measures we are considering for RIIO-2. In particular on the benefits and impacts these might have**
- **We also want you to engage with underlying issues we are trying to address – if there are other options out there, now is the time to bring them to our attention**
- **Structure of session:**
  - Presentation on the issues and the options (45 mins)
  - Presentation from Cadent (15 mins)
  - Breakout groups to discuss specific aspects of these proposals (1 hour)
  - Report back (30 mins)

Public perceptions of legitimacy

- **Historically explaining the benefits of network regulation was relatively straightforward - costs were reducing and service quality was increasing.**
- **Investor and consumer interests were seemingly aligned**

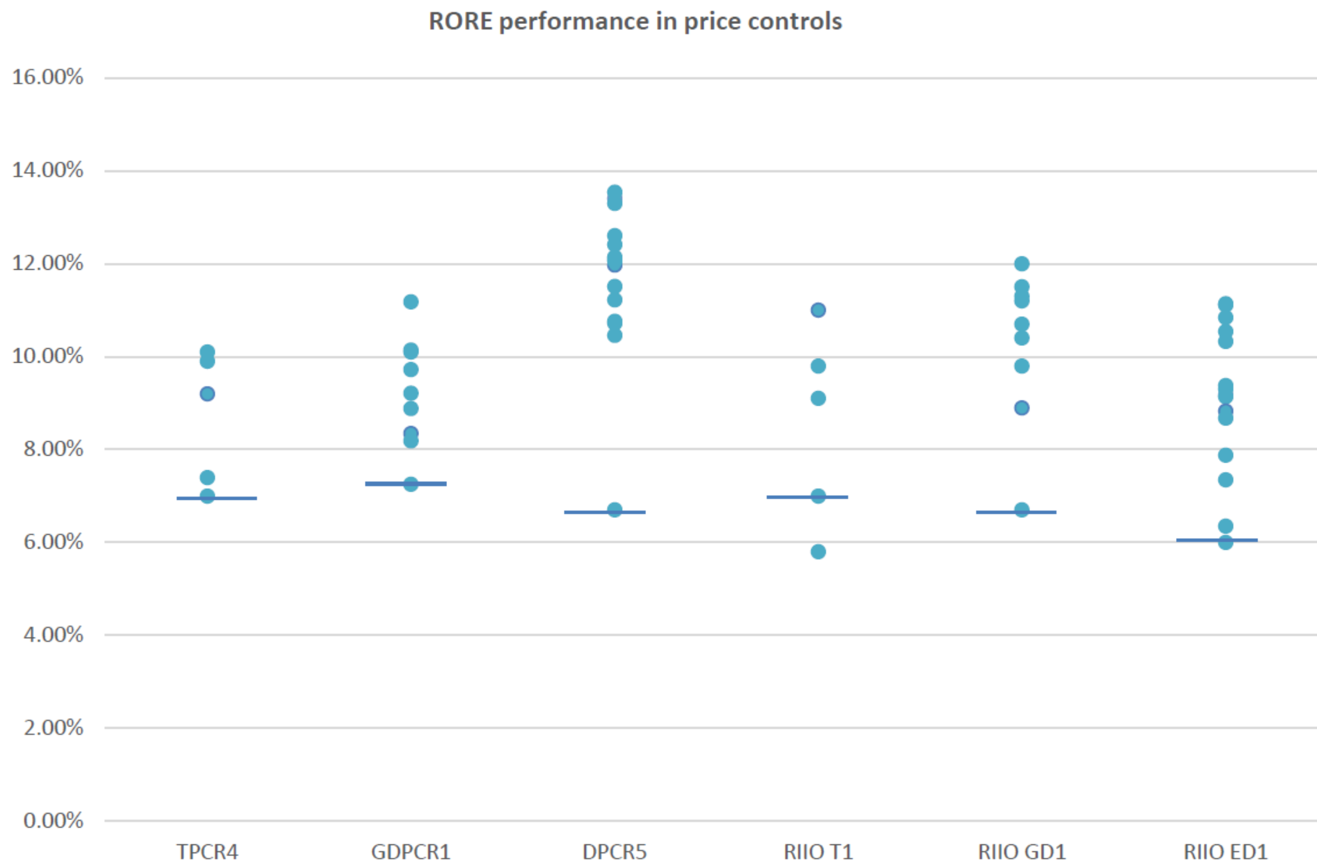




Source: Ofgem and Offer, various sources[28].

- **RIIO was introduced in anticipation of a changing world and one in which significant new network investment would be required and the function of the network operators would be more complex**
- **Now, revenue requirements are increasing and while service quality continues to improve, these additional revenues need to be justified**

- **This brings into the spotlight the returns earned by the companies, with growing concern that the framework is too far tilted in the companies' favour**



With networks and our approach to regulating them coming under scrutiny

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THE LABOUR PARTY MANIFESTO 2017

"Regaining control of energy supply networks through the alteration of the National and Regional Network Operator license conditions"

Energy Consumers' Missing Billions

citizens advice

The profits gifted to energy networks

"If network companies fail to act, the government must act to make sure consumers get their money back"

"Why the periodic reviews should be abandoned in the long run"

Cost of Energy Review

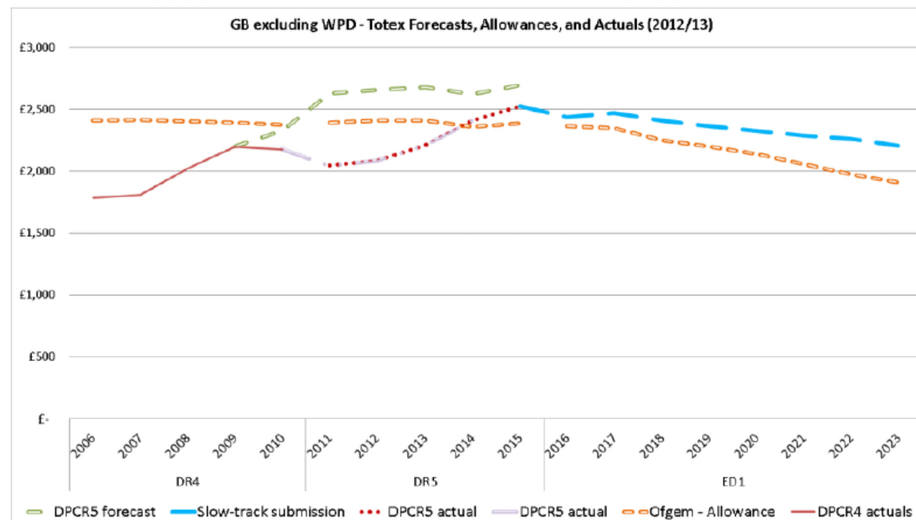
Dieter Helm

25th October 2017

Ex ante regulation

- **The ex ante, incentive-led framework is intended to drive companies to find efficiencies - and it works**

- **But companies have an information advantage when a control is set and can forecast a need for allowances above their actual costs. There are also activities where no-one knows what will be required in the future – we can speculate what might be required but the reality may be very different**



- **In a repeat-game this is less critical if we share savings with consumers and capture them fully in future control periods. Forecasting errors provide no benefit - consumers have simply paid for work that was not required (or pay twice)**

What's happened in RIIO-1

- **Cost of capital & £4.8bn underspend against totex are driving outperformance (also output delivery, particularly in electricity distribution)**
- **Some of the underspend has been driven by efficiencies/ innovation but other factors are relevant:**
  - **Input price inflation running lower than forecast**
  - **Economic conditions/milder winters leading to lower demand and work avoided**
  - **Expenditure being reprofiled and lower value work being carried out earlier**
  - **Assumptions on scope higher than actual requirements**

Hard to establish corresponding benefit to consumers when outperformance is due to these factors

Managing uncertainty and unfair returns

- Information asymmetry & trying to ‘guess the future’ expose weaknesses in ex ante regulation.
- Uncertainty mechanisms allow us to adjust allowances in line with changes from forecast
- We also use yardstick (comparative benchmarking), menus (IQI), fast tracking and are considering a move towards constructive engagement
- Even so, returns continue to be high. Our challenge is how to:
  - Minimise forecast errors
  - Manage information asymmetry
  - Ensure fair returns

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Minimising forecast errors & their impact

- **To minimise forecasting error, we are looking to:**
  - Maximise use of indexation rather than forecasting, in particular for RPEs;
  - Where appropriate link allowances clearly to outputs and activities and use uncertainty mechanisms to adjust for changes in forecast volumes
  - Where no good indices exist or where uncertainty mechanisms cannot adjust for changes, we will have to balance the ability to contain forecast errors in a shorter control period vs. the benefits of a longer period.
  - There are 3 broad options for the length of the price control:

5 year price control	Long term evolving	5 year+
We reset allowances every 5 years and use totex & output incentives and innovation stimulus to drive efficiencies	**We maintain 8 year price control with more all-encompassing mid period review, with renegotiation of variable/ volume driven capex and evolving outputs.**	**As with 5 year price control, we reset allowances every five years, but:** • Allow companies to bid for longer allowances against defined value proposition (X% saving relative to 5 year baseline because of ability to do Z).

In all options we should take longer term view of costs that can be shifted between price controls

Managing information asymmetry

- **Getting the right time horizon will minimise impact of forecast error but doesn't on its own deal directly with information asymmetry. To address this :**
  - Cost assessment to isolate repeatable costs (opex, repex, some capex) through time and drive these down through resets
  - Apply early competition on higher value load-related expenditure, where possible and where alternative viable options may be feasible
  - Take cost elements out of the main price control where scope is uncertain (and prices and quantities difficult to fix), and use an uncertainty mechanism such as Strategic Wider Works (SWW), and have these priced using competition wherever possible
  - Use incentive mechanisms and constructive engagement so that companies benefit from revealing true information, where these are likely to be most effective
- **This will help to contain the problem but there remains a residual risk of undeserved returns**

Ensuring fair returns

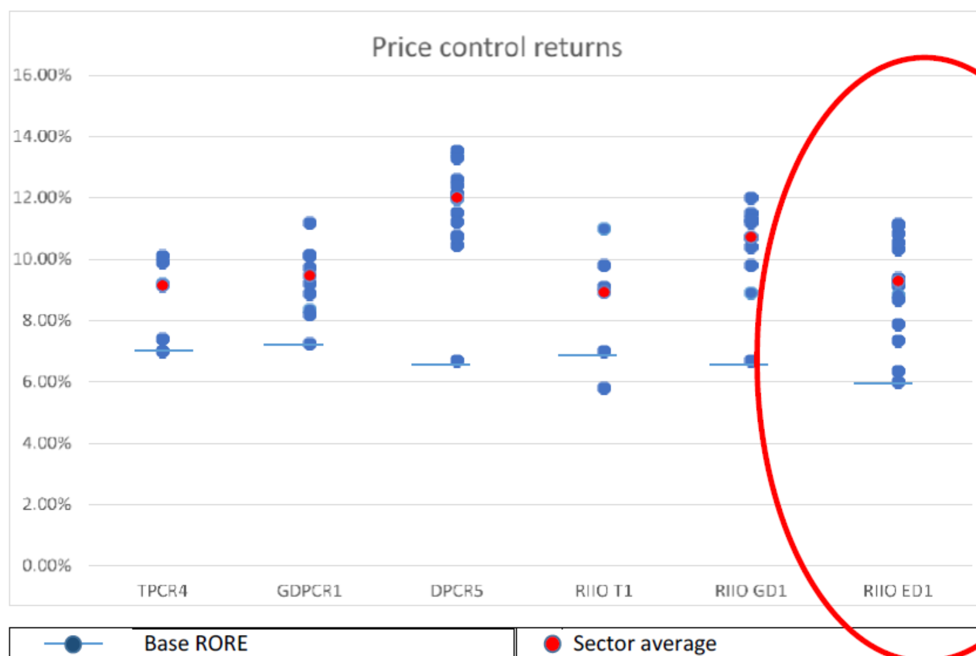
- **To ensure fair returns, we will firstly set an appropriate cost of capital**

- **To address the residual risk of undeserved returns we will explore one or more of the following options;**
  - 'Sculpting' incentives - Moderating the power of incentives so consumers keep a greater share of the gain as company returns increase
  - Incorporating investor expectations of outperformance into cost of capital assessment
  - Discretionary reopeners/ex post claw backs (wide-ranging MPRs)
  - Zero sum incentives on outputs

- **These further reduce prospect of excess returns, but to guarantee sectoral returns remain in line with expectations, we will also explore**
  - Anchoring returns

Anchoring

- **Anchoring employs existing tools to set low costs and manage uncertainty, but provides protection at a sector wide level that returns won't rise above the ex ante cost of equity**



RIIO ED1		
Realised return	Anchored adjustment	Anchored return
8.83%	-3.13%	5.70%
7.88%	-2.79%	5.09%
8.68%	-3.07%	5.61%
9.38%	-3.32%	6.06%
10.33%	-3.66%	6.67%
10.54%	-3.73%	6.81%
9.30%	-3.29%	6.01%
10.84%	-3.84%	7.00%
11.11%	-3.93%	7.18%
11.14%	-3.94%	7.20%
7.35%	-2.60%	4.75%
6.35%	-2.25%	4.10%
9.17%	-3.25%	5.92%
9.14%	-3.24%	5.90%

- **Could work in any number of ways – assume annual adjustments and company size is accounted for**

Impact of options

- **None of these solutions are silver bullets and all have the potential to impact on company behaviour**

- **We want to understand what these impacts could be and how we could mitigate any downsides**

- **We also want to hear of other ways we can tackle these issues.**

Questions?