Ofgem Future Insights:
The Future of Networks – RIIO-2

Breakout B:Ensuring fair returns

Marcia Poletti, Policy Director RIIO-2 Ofgem

#RIIO2
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Introduction

- RIIO-2 will allow companies to recover their costs, including the cost of raising finance from investors
- Debt and equity investors expect to receive a return. This should reflect what is reasonable for an efficiently run, regulated company
- A company's actual return can be higher or lower than the baseline allowed return, depending on how well the company performs against incentives to improve service and reduce costs.
- In our Framework Consultation, we describe our proposals for setting the **cost of equity and debt**. We also describe new mechanisms that could **ensure fair returns**.

Cost of debt - background

- In RIIO-1 we pioneered the use of an index to set debt allowances. When we set the allowances for RIIO-1, the markets were predicting increases in interest rates: these predictions turned out to be wrong.
- By using an index instead of an upfront allowance, we estimate savings to consumers of £2bn

Out-turn cost of debt/forecast cost of debt for RIIO-GD1/T1

Options for setting cost of debt

- In any year the cost of debt allowance is an average of historical market rates. There can be differences between the cost of debt actually incurred and the allowance

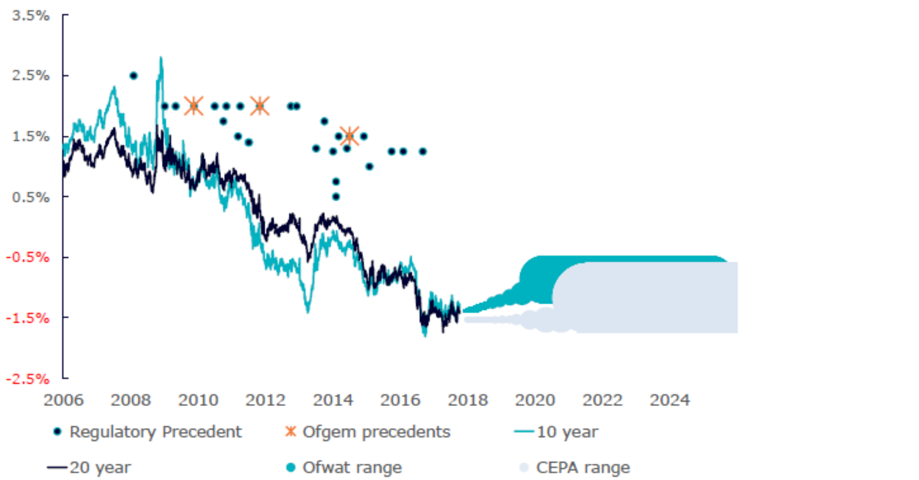
- We are considering different approaches for RIIO-2:
  - Re-calibrate the RIIO-1 indexation policies [we have a slightly different policy for G&T companies to that applying to ED]
  - Fixed allowance for existing debt plus indexation for new debt only
  - Pass-through allowance for debt

Cost of equity

- The cost of equity is more expensive than the cost of debt. Each % point is worth about £0.4bn for each year of RIIO-2
- 3 key components for estimating the cost of equity.
  We propose to:
  - Estimate the **risk free rate** using current yields on long-dated government debt
  - Estimate the **total market return** (TMR) by considering historical long-run averages and forward looking approaches
  - Estimate forward looking **betas** by looking at historical correlations of regulated utility share price

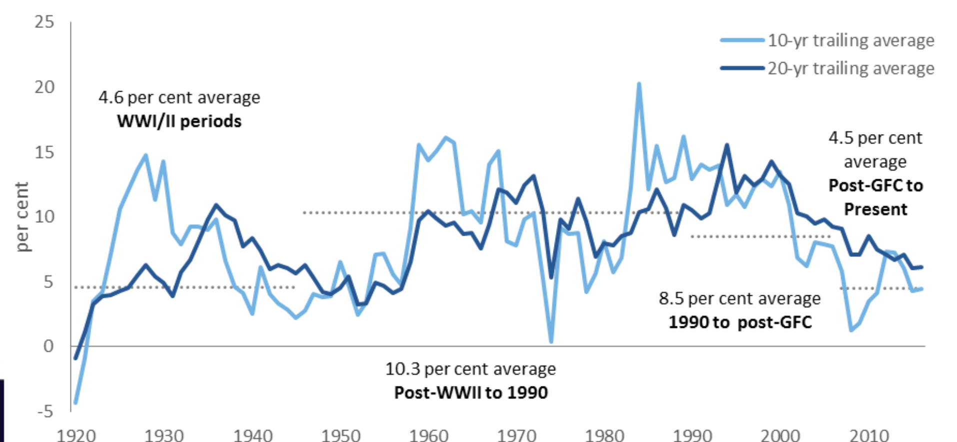
Cost of equity

Figure 5: Risk-free rates, regulatory precedents, Ofwat methodology and indicative CEPA recommendations



Raw equity betas for chosen comparators

Historical real equity market returns in the UK



Cost of equity

- **Our estimate is that the allowed equity return in RIIO-2 could be between 3% and 5%, should it be calculated based on today's conditions. This compares to RIIO-1 cost of equity of 6-7%**
- We believe market evidence offers further support to a lower cost of equity
- We are consulting on the methodology and also measures to address financeability issues arising from a lower cost of equity
- We are considering a move away from RPI as a measure of inflation. This may raise prices in the short term but lower them later on, it should also help in passing financeability tests

- In recent price controls, most companies have earned more than their baseline allowed return – due to incentives for underspending totex allowances, or beating output targets
- Higher returns are justified when companies find new, more efficient ways of operating their networks. But some outperformance is due to other factors. Companies also have an opportunity when we set the price control to seek cost allowances or performance targets they can easily beat
- We can mitigate against this but there may still remain a risk of higher returns than expected. We have identified 5 ‘failsafe’ options to ensure fair returns

Hard cap and floor

- Restricting returns from rising or falling above a pre-determined point.
- Curbs the risk of excessive returns, but diminishes incentives as company returns approach the margins.
- A company that overbids its plan may reach the cap without having to cut its real costs and would have lower incentive to improve

Discretionary adjustment

- Using more discretionary, wide-ranging claw-back mechanisms to make adjustments to returns
- Could be when unforeseen circumstances have worked in favour of a company.

Constraining totex and output incentives

A combination of measures to curb high returns from expenditure and output 'outperformance':

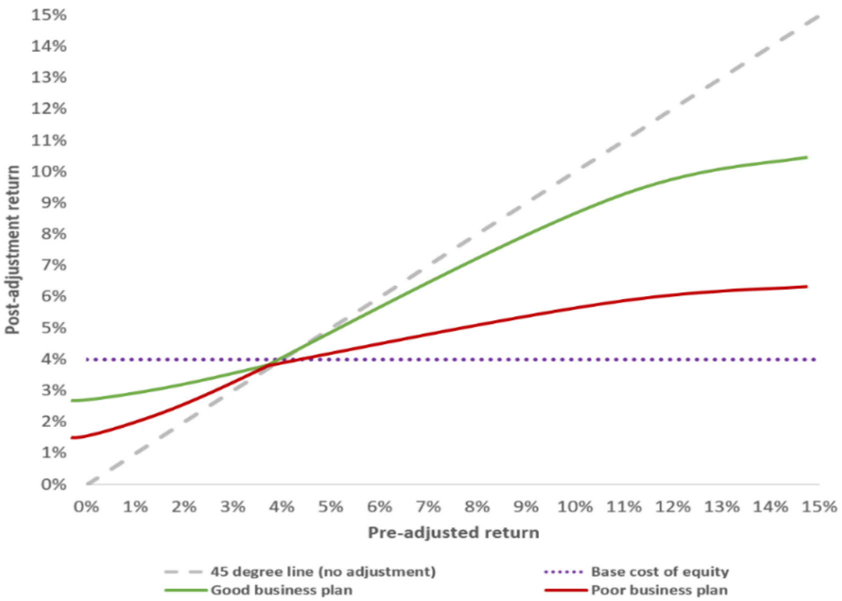
- In 'Sculpted' sharing factors consumers receive a greater share (%) of the benefits of lower totex spending spend, as a company's return increases.
- To mitigate against the risk of high returns through output incentives, we could set a fixed incentive pot for outputs that companies compete against each other for a share of (could be zero)

Options (continued) …

RoRE Sharing Factor

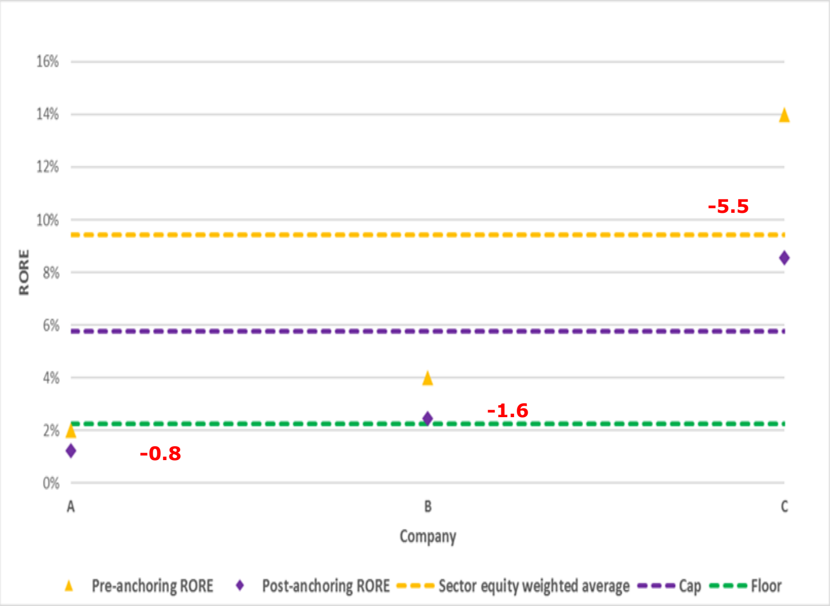
This would adjust individual companies' returns when they deviate from the baseline allowed return, based on a predetermined parameter – *essentially applying a sharing factor on returns*

Could be combined with incentives to reward good quality, low cost plans (companies get to keep a greater share of their additional return)



Anchoring

Anchoring would see us regulate revenues so that the average return for a sector is adjusted to a predetermined cap/floor when it drifts outside this range



Properties

- While the sector average remains within cap/floor no adjustment to individual company returns is required – even those performing outside the range
- If the sector exceeds the range however, we would make an adjustment so that the sector average aligns with the cap or the floor
- All companies’ returns would be adjusted, regardless of whether an individual company’s RORE falls within or outside the band

Questions/Discussion on Fair Returns

1. What behaviour could these arrangements drive?
   - in preparing business plans
   - in delivering during the period

2. What is a fair return for these companies/sectors?

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