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Presentation

Operator

Hello and welcome to the Ofgem Networks Call. Throughout the call, all participants will be in a listen-only mode and afterwards there will be a question and answer session. Just to remind you, this conference call is being recorded. Today, I'm pleased to present Akshay Kaul and Marcia Poletti. Please go ahead with your meeting.

Akshay Kaul

Good morning and welcome everybody to the call. Thank you for taking the time out this morning. We published this morning a consultation document on the framework for RIIO-2, the next generation of price controls for the gas and electricity networks. I wanted to go through the key points in the document with you on this call and then give stakeholders a chance to ask questions, any immediate questions that you have. So, I'm going to speak for about 15 minutes. And then we will open up the call for questions.

So, first of all, the RIIO model that we have operated since 2013, we think has worked well. And we think it is the most appropriate way of meeting consumers' needs in the future. And that we have been clear in the document that we will continue to incentivise companies to deliver the outputs that consumers value at the most efficient cost. In our thinking on the RIIO framework consultation we have identified ways that we think we can enhance the model and we have set these out for consultation in the document. These ideas build upon the learnings from the first round of RIIO price controls and they aim to address the challenges that lie ahead for the network.

The proposals we have set up will ensure that companies work with customers and stakeholders to deliver the networks that will support our future energy needs at a fair cost to the consumer. And our proposals will also set returns for companies that reflect the low levels of risks that these companies face, alongside a more general reduction in the overall riskiness of the price control. As a result, the expected return in RIIO-2 would be lower than they are in RIIO-1, but still very attractive to investors.

In terms of next steps, our framework consultation closes on 2nd May on 2018 and we expect to publish our decision in the summer of 2018. We will then start to develop the sector-specific methodologies and we expect to publish the consultation on sector-specific methodologies issues by the end of this year. And we will finalise those sector-specific methodologies by the spring of 2019. And we expect business plans then to come back to Ofgem in autumn of 2019 for the distribution and transmission sectors. You will see from the timetable that there's a slightly staggered timeline for the distribution sector because it is slightly different approach that we're planning to undertake on business planning in that sector.

I'm going to talk through very quickly now the key highlights of our proposals in the consultation document. These are essentially organised into five chapters reflecting the five key objectives of RIIO-2. And these five objectives are, firstly, to give consumers a stronger voice in the determination of the price controls. Secondly, to respond to how networks might be used in the future. Thirdly, to use the regulatory framework to drive innovation and efficiency. Fourthly, to simplify the price controls where possible. And finally, to ensure fair returns and financeable investment.

So, taking each of these blocks in turn, the chapter on giving consumers a stronger voice talks about how in RIIO-1 we saw companies putting significant resource into engaging with the wide range of stakeholders to get inputs into their business plans. We thought this was a big advance on what had happened before. But this is not always clear how companies and indeed the regulators used the outputs of the stakeholder engagement in the actual determination of the price control. So, we're therefore setting out that we want to implement a new stakeholder engagement approach in RIIO-2.

In distribution, companies will be required to establish an independently chaired customer engagement group. This group will report to us on how the company has reflected the needs and preferences of local users and customers, including on outputs, service quality standards and willingness to pay in their plans.

In the transmission sector, we will require companies to establish a user group to co-create and challenge the Transmission Company's business plans. These user groups will consist of large, well-informed users such as generators, suppliers and DNOs. They will scrutinise transmission network outputs as well as costs.
And finally, we will also set up an independently chaired RIIO-2 challenge group that will assess the business plan proposals in both the sectors from an end consumer perspective. This group will report to us on their findings and we will provide this challenge group with any secretariat support and access to technical and financial assistance that they may require.

The outputs from both these groups will inform our final determination and the eventual license conditions for the companies. Obviously, as a matter of public law, the final decision on the price controls will remain with GEMA, underpinned by our own analysis.

Once we are in receipts of business plans, we are proposing to hold open hearings where any stakeholder can participate. These hearings will focus on the specific topics of contention raised by either of these two stakeholder groups. They will enable us to get very transparent inputs from – and dialogue with - a very wide range of interested parties prior to making our decision in 2020.

We expect companies to put these models in place as early as possible and we propose to publish more guidance on how the new approach might work towards the end of this month.

Secondly, moving on to the objective of how networks might be used in the future. We think the price control needs to be adaptable to this change. And the first area we talked about is the length of the price control. We continue to be of the view that network companies should take a long-term view of their business, rather than looking to operate within some artificial price control period. However, we need to balance this against the uncertainty that companies and consumers face in the RIIO-2 period and the difficulty of setting outputs and allowances with any degree of confidence over a long period of time.

So, as a result, we're consulting on the option to revert to a five-year price control as a default across the four sectors, but with the flexibility to set certain allowances for particular activities, projects or programmes [to a longer or shorter period] where there is a clear and compelling case on innovation or efficiency grounds for consumers. We're also asking for views on an alternative option of an eight-year price control with a significantly enhanced MPR.

The second area in this space that the document deals with is the whole systems outcomes. We think the energy transition will drive major changes and increase complexity in the landscape. And it creates more opportunities for the system as a whole to be better coordinated to deliver value of consumers. We think that we need to review those areas of the price control that might have a material impact, either on enabling or becoming barriers to whole system coordination, as part of our setting of sector-specific strategies. We've considered the specific points about whether we should align the electricity transmission and distribution price controls, but we have concluded and we're consulting on not doing so in the document because we think that the cost associated with such a realignment probably outweigh the benefits to consumers.

Moving on then to the ESO price control, we have been doing quite a lot of work to develop the role of institutional framework for the electricity system operator. And as a result, the system operator will now be a separate legal entity from National Grid transmission operation[1]. We are therefore proposing in RIIO-2 to have a separate price control for the electricity ESO. We are consulting on whether the current RAV-based remuneration model remains the most appropriate model for regulating a separate ESO or whether indeed we should consider non-RAV-based models as well. At this stage, we're not proposing any change to gas SO arrangements, but we are seeking views from stakeholders whether any of the changes that we're proposing for electricity ESOs ought to be applied to the gas SO as well.

Moving on then to network utilisation and investment risk, we think that with the changes in the energy system and the changes in how networks might be used, there is both an opportunity to create more accessible and flexible networks, but also a risk that consumers end up paying for costly new network infrastructure that could become stranded in the future. We therefore intend to put in place some mechanisms to ensure that consumers are properly protected from this risk. This could include setting some tests that companies consider alternative arrangements to building new assets before we commit that sort of investment in RIIO-2; to considering whether there are particular types of investment where we might apply different risk allocation arrangements

[1] To note, the Electricity System Operator will become a separate legal entity from 1 April 2019

where, for instance, companies can take on greater exposure to the utilisation of the asset. We're consulting fairly openly on what options should be explored to effectively manage this risk.

And finally, in terms of demand reduction and heat decarbonisation, we are asking a question in the consultation document on whether network companies should have a role to play in end-use demand reduction, and specifically in the context of heat decarbonisation to reduce future investment needs in the networks.

So, that was the block of issues related to the second objective on how networks might be used in the future. The third objective is around driving innovation and efficiency through the regulatory framework. And here, our main proposals on innovation are to move a lot more innovation spending to business as usual, using the normal TOTEX incentives in the price control. However, given the scale of the energy transition, we think we should retain dedicated innovation funding in some limited circumstances where there are market failures and the price control will not deliver innovation projects. We are consulting on three broad areas of reforms for the innovation funding that we provide. Firstly, an increased alignment of funding with government support for innovation in the energy transition space; secondly, increasing targeting the funding of the major R&D challenges in the energy transition environment; and thirdly, the potential to open up increased access to third-party, non-network companies, third parties who could bring disruption or innovation into the sector.

On competition policy, we propose in RIIO-2 to expand the scope of competition across all four sectors. Currently, it's restricted only to transmission. And we are consulting on both the application of criteria, the new, high value, separable criteria, for late stage competitions to expand that across the four sectors, as well as ideas for developing earlier stage competition models for ideas or solutions to network constraints. And again, we will consult fairly widely on these early models and develop thinking [on competition] in time for the summer document in the summer and then for the sector methodology documents that follow later in the year.

Moving on to the third objective which is – sorry, moving on to the fourth objective which is to simplify the price controls, we have set out in the consultation document some options to simplify the way and clarify the way that we set outputs, particularly in distinguishing between outputs that are license obligations; things that are price control deliverables which have funding attached to them; and incentives which are not license obligations, where we rely on incentives to deliver improvements in service quality. We hope that this will clarify the framework for a wide variety of stakeholders.

We're also proposing in the document to simplify our approach to the setting of cost allowances. We will build on our ideas in RIIO-1 to protect consumers and companies from inadvertent forecasting errors. And therefore we plan to increase the use of indexation where we cannot be sure of the evolution of particular types of costs, particularly in the context of real price effects, the cost of labour and materials and so on.

But in general, our approach to cost allowances will be to use competition to reduce cost, to reveal information wherever possible; to index cost that we're not certain of the ex ante cost estimates, in particular to consider indexing RPEs[2] where there is uncertainty as for this scope of work, and the potential costs [are] significant, we will not in general set an ex ante cost allowance. Instead, we will consider whether we can take an approach similar to the strategic wider works mechanism in RIIO-1. We would use uncertainty mechanisms such as volume drivers to manage uncertainty around load or volume. And we will limit the instances where we set allowances based purely on forecasts with no adjustment mechanisms whatsoever.

And thirdly, in terms of simplification, we are looking at what we call information revealing devices, which essentially are the information quality incentive and the fast-tracking process in our price controls. We are consulting on three options for these mechanisms, the first of which is to retain and modify the IQI[3] in all the sectors, simplify the IQI in all the sectors. The second one is to remove fast-tracking from transmission, but retain it in the distribution sector. And the third one is to remove fast-tracking from transmission, but in the distribution sector to bring together the IQI and fast-tracking into a single business plan incentive, which includes an explicit financial reward as well as differential sharing factors, but not a procedural reward in the form of early settlement. So, our initial thinking overall is that we will remove fast-tracking from transmission, but we consider retaining it in distribution or combining it with the IQI into a simpler, unified business plan incentive.

[2] Real Price Effects
[3] Information Quality Incentive

And finally, the last set of objectives was about ensuring fair returns and financeability in RIIO-2. On the cost of debt, we are proposing some options to refine the way that we calculate the cost of debt. We think our approach to indexation has broadly worked well and it has delivered savings for consumers. But we think that there's always scope for improving the index. We're therefore consulting on whether we could make refinements to the index in the sense of how it's constructed; whether we could move to a hybrid of a fixed allowance for embedded debt and index the new debt along the lines that Ofwat has proposed; or indeed whether we should consider a pass-through allowance for debt for company-specific cost of debt.

On the cost of equity, we are consulting on our proposed methodology to set the cost of equity in RIIO-2, based on the advice and guidance that we've had from the team of academics through the UK Regulators Network. We've asked CEPA[4] to apply this methodology on the basis of current evidence [to] propose what an indicated range of the cost of equity might be for RIIO-2. And CEPA proposed an indicative range of between 3% to 5% where the price control is to be set under today's market conditions.

We're also consulting on the appropriate merits of indexing the cost of equity. We have indicated three potential ways forward in terms of indexing: [indexing] the risk-free rate only; indexing the risk-free rate with an offsetting adjustment to the equity risk premium; or to index the risk-free rate and the total market return. However, we do propose a specific indexation mechanism which we think is simpler and simplest potentially. And that is to treat the cost of equity as a weighted average between the risk-free rate and the total market return, assume that the betas and the total market return remain stable over the lives of the price control, and therefore index simply the risk-free rate times one minus beta.

Finally on financeability, we are consulting on a range of options to address any financeability issues that might arise as a result of an overall reduction in the cost of equity. And the options that we're consulting on include moving to a nominal return regime rather than a real return regime, in other words to remove the indexation of the RAV and pay returns in nominal terms. Secondly, to put the onus on the companies to resolve any actual and notional financeability constraints by using levers that they already have in the price control. And thirdly, to protect company's ability to make debt payments by introducing a license-backed revenue floor.

We also talk about tax allowances in the consultation document. We are proposing to review our tax arrangements in the price controls to ensure that the tax allowances that we set broadly reflect the tax that is paid by companies to Her Majesty's Revenue and Customs. We think that we already have clawback mechanisms to adjust for things like changes in gearing or changes in tax rates. But we think it is important that we review the tax arrangements overall to ensure that they're broadly aligned with the tax that the companies are paying to HMRC. We've set out some options that we might consider later on, depending on our review. And if there are any material deviations between tax allowances and tax paid, the sorts of things that we might consider making changes to.

In terms of other finance issues, the consultation document highlights in particular a proposal to move away from the retail price index as a way of indexing the RAV, if we keep the indexation of the RAV, to either the consumer price index or the consumer price index including housing or CPIH. And we're seeking views from stakeholders on which of the two are the alternative indices [sic] we should adopt. And whether or not we should consider a transition to the new index or move immediately and directly.

And finally, the consultation document talks about the need to introduce backstop mechanisms into the price controls to prevent systematically higher returns than we expect when we set the price controls ex ante. We obviously welcome outperformance in the price controls where this is generating efficiency or innovation that consumers benefit from. But given that there are inherent limitations in terms of information and setting ex ante mechanisms, we think it is important that there is a backstop mechanism to give consumers, and the public, trust that there will not be excessive returns coming out of the price controls.

So, we're proposing a range of options. We haven't got a preferred option here, but we're proposing quite a wide range of options for what these backstop mechanisms could look like. These include hard caps and floors, discretionary adjustments, constraining the overall TOTEX or incentive packages, aRoRE sharing factor or RoRE's sculpting factor and the idea of anchoring returns, which is essentially to set a cap on the average sectorial return in the price control. We will seek views in these before reaching a decision in the summer as to which of these should be taken forward for further development in RIIO-2.

That's it from me and I'd like to open out for questions or comments from our audience.

[4] Cambridge Economic Policy Associates

Q&A

Operator

Thank you. If you do wish to ask a question, please press 01 on your telephone keypad now. If you wish to restore your question at any time, you might do so by pressing 02 to cancel. So, once again if you wish to ask a question please press 01 on your telephone keypad now. And there will be a brief pause whilst any questions are being registered.

And our first question comes from the line of Steve Edwards from Wales & West. Please go ahead, your line is now open.

Steve Edwards

Akshay and Marcia, thanks for that brief. One question, on your first theme, voice of the consumer, you mentioned submission of business plan, back end of 2019. I thought that had moved to early 2020. Would you be able to clarify the timing please?

Akshay Kaul

Thanks, Steve. So, I think as far as indicating for the distribution sector, we're proposing a slightly different approach in the sense that we'll have a two stage submission, a preliminary submission and then a revised submission, whereas in the transmission sector, we will have only a single submission. So, we're proposing for the distribution sector that the business plans will come in, in the autumn of 2019 as a preliminary submission. And then they will come in, in Quarter One 2020 as a final submission, whereas for the transmission sector, business plans will need to come in Quarter Four 2019 as a final submission.

Steve Edward

Thanks, Akshay.

Operator

Thank you. And once again, ladies and gentleman to ask a question please press 01 on your telephone keypad. And our next question comes from the line of David Handley from SGN. Please go ahead David. Your line is open.

David Handley

Thank you. Thank you for that Akshay. Quick question in terms of the CEPA report. I think that's supposed to be released alongside the document. I just wanted to check if that was coming out because there's quite a lot of questions in terms of notional gearing surrounding the WACC and sort of what notional gearing rates are used and things like that. So, I wondered how we're going to get clarity on that.

Akshay Kaul

Thanks David. So, the CEPA report will be published this afternoon alongside the documents on the website.

Marcia Poletti

And the UKRN cost of capital study is live now.

David Handley

Great, thank you.

Operator

Thank you. And once again, ladies and gentleman, if you do wish to ask a question or have any comments for the speakers, please press 01 on your telephone keypad now. And there will be a further brief pause whilst any questions are being registered. And our next question comes from line of Stephen Hassall from Cadent .Please go ahead your line is open. Steven, your line is open to ask a question.

Dave

Hi, Akshay, it's Dave from Cadent. Sorry, I was on mute there. Classic. Just a couple question; so, firstly, the bit on outcomes and outputs, I wonder if you could expand a bit on that. I'm just trying to understand that part, sort of what it means and perhaps some examples to how that would – how you'd apply that from the current framework for that, how it all fits together?

Akshay Kaul

Yeah, sure. So, I think in terms of the outputs and outcomes, we considered moving back to a simpler outcomes based framework, but concluded against that because we think that the price control is more complex than a simple outcome-based framework would allow for. And so, what we've tried to do in the consultation document is say that we will have clarity in terms of how we treat outputs that are license obligations, outputs that essentially have minimal standard of service associated within the companies have to deliver as a condition of their license. And if they don't deliver, we take enforcement action against companies for not delivering those license obligations.

Second would be called price-controlled deliverables which [are] essentially things that we have given funding for – the consumer is paying for. It could be big capital projects for instance, like rail electrification scheme in distribution, where there is a [clear project] – they're not outputs in the sense of consumer-facing outputs, but they are deliverables that contribute to a consumer-facing output. And if those outputs are not then delivered, they're non-license obligations, in the sense we won't take enforcement action because, for instance, government policy might have changed or in need for the activity might have - disappeared. But we will want to have mechanisms in place to return the funding back to consumers.

And thirdly, we want to distinguish both of these things from incentive mechanisms where there isn't a license obligation, there's sort of a target to improve the quality of service, say, cut the incidents of power cuts. But it is an incentive mechanism. So, companies can choose how far they want to improve that particular service and how far they want to benefit from the incentive mechanism. But if they don't, then it is not a license obligation; we're not going to take enforcement action in those areas.

Dave

Okay, that's great. That's really helpful, thank you. And then I have a second question. So, - a lot of references to fair returns. Obviously it's been a hot topic over the last six months or so. Do you have a view on what fair return looks like, so in terms of kind of – it's kind of early to go into a RoRE range but have we got any kind of feel as to where we're getting to with that?

Akshay Kaul

So, I think our main thinking around fair returns is in the context of how we set or how investors expect returns out of the price controls. We've taken on board quite seriously the recommendation from the UKRN team that we should be more deliberate about distinguishing between the allowed returns that we've set and the returns we expect investors to achieve, taking account of our incentive mechanisms. We sort of tried to do a bit of that in RIIO-1 where we tried to set out the baseline return. We set out what we expected high-performing companies to be able to earn. And we will definitely do a similar exercise in RIIO-2. But our experience in RIIO-1 has been the systematic nature of the outperformance raises the question about whether the underlying allowances were set too generously or the targets were set too low.

And so, I think what we're looking at in terms of fair returns is having some kind of measure that the consumer population of the public would understand is protecting their interests and is not generating artificially high returns for investors that don't reflect the risk that they actually face. And we've set out a number of ways of doing this. I mean, obviously, if you [want to] directly address the question of systematic sectoral outperformance, the proposal of anchoring does that directly by setting a sector level cap on the RoRE that the sector can earn. Individual companies under that system can earn whatever return that they can generate through outperformance, but the sector as a whole is constrained. But we've also proposed alternative mechanisms which are perhaps less direct.

For instance, to sculpt the sharing of the RoRE returns, so as companies outperform more and more and more, you return more and more of the savings to consumers. And obviously, the third option is that at a company-specific level is to set a cap at some level that everybody would agree – beyond that would be an excessive return.

So, those are sort of alternative mechanisms. We're not being very prescriptive at this stage. I think we want to have a quite open conversation with consumer advocates, as well as industry, on which of these to take forward.

Dave

Thanks, Akshay. I don't suppose I could have one more if I'm allowed [one more question]. And in terms of – I guess, my reading of it was , in all this, was kind of looking to kind of strengthen the power of incentives, that kind of strengthening versus kind of current opportunity. Do you think that's right or is that to be decided?

Akshay Kaul

So, I think the strengthening [of the] incentive regime, we will settle in the sector methodologies later in the year. I think it's probably fair to say our overall assessment of the price control package is that we want to move it from the current situation, which is sort of low risk/high return back to a low risk/low return. And we are taking some steps, in fact, to deliberately reduce the overall riskiness of the price control package to investors, for instance, by indexing RPEs, by potentially indexing the cost of equity, by having a slightly more accurate mechanism for the cost of debt.

Dave

Okay, thank you.

Operator

Thank you. And as there are no more questions registered, I'll now hand back to you, speakers.

Akshay Kaul

Okay. So, I hope that was a helpful briefing. And we look forward to engaging with all of you over the next couple of months, which will help us immeasurably in arriving at a final decision on the framework for RIIO-2 in the summer. I'd just like to reiterate again the next steps in the timetable. So, we hope to publish the final framework decision in July. And we will then move on to the sector-specific methodologies issues. And we hope to consult in these towards the end of 2018 with a view to taking a final decision on sector-specific methodologies in the spring of 2019. We will then move into the business plan submission phase. And then just again to confirm, we expect that for the transmission sector, business plans will come back to us in Quarter Four of 2019. For the distribution sector, we're expecting an initial submission of business plans in Quarter Three, and then a final revised submission in Quarter One of 2020. And we look forward to working with you to achieving a great result for consumers in RIIO-2. Thank you.

Operator

This now concludes our conference call. Thank you all for attending and you may now disconnect your lines.