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for energy consumers

RIIO-2 Business Plan content and incentive

RIIO-2 cross-sector workshop

RIIO cross-sector
5/11/2018

Goals for this session

- Describe our thinking on business plan content and incentive
- Seek feedback on our proposals

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Agenda

Time	Item
13:30 – 13:45	Introduction and ontext
13:45 – 14:30	Proposed approach to business plans Timescales for business plans submission
14:30 – 15:10	Breakout session
15:10 – 15:30	Characteristics of a good, poor and standard business plan Business plan incentive
15:30 – 16:00	Breakout session
16:00 – 16:30	Business plan incentive
16:30	Close

Context

In the framework stage we said:

- We are ruling out early settlement of business plans for GD, ET and GT
- We are developing alternative incentives for business plans
- We are still considering options for the totex incentive mechanism (TIM)

This means:

- Companies settlement and corresponding business plan reward will be based on a single submission
- Both the incentive on business plans and totex might differ across sectors depending on their characteristics

Our engagement on the topic so far

- We held three workshops so far on the two topics, one in March, one in May and another in September
- A number of companies reached to us with suggestion, we have considered these and taken them into account in developing a high level strawman on the business plans incentive

Indicative Timelines

- Consult on sector specific methodologies in December this year
- Issue a sector specific Methodology Decision – early Q2 2019
- Receive companies' business plans by the end of 2019

Approach to business plans

DRAFT

Proposed approach

- We want to standardize core elements of business plans to limit superfluous information and to facilitate benchmarking
- We want a clear line between past and future performance, and a complete contract between expenditure and what's being delivered
- We want to limit our reliance on forecast information – unless accompanied with tangible commitments
- We want to encourage companies to reveal useful information to us that we may not otherwise get
- We want to understand the risks and uncertainties
- We want the plan to reflect stakeholder requirements

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Proposed content of business plans

- Background
- Base scenario
- Forecast expenditure
- Managing uncertainty
- Outputs
- Innovation
- Whole system
- Competition
- Finance
- Workforce resilience
- Stakeholder engagement

Network business

(illustrative examples)

- Region
- Network length
- Peak demand
- Number of customers
- Customer type
- Number of employees
- Characteristics of region
- Shareholder profile
- Corporate structure

The RIIO-1 story

- What did you forecast in RIIO-1 and what did you spend?
- What were the reasons for the difference?
- What outputs did you deliver and how does your performance compare to other networks?
- Delivery against wider commitments
- Innovation and roll-out into business as usual
- Level of return earned
- Dividends paid out

Core scenario

- We intend to require all companies in a sector to use a core and common view of the future scenario
- Against this core scenario, companies should explain which elements are most susceptible to change, what factors could drive these changes and what these might mean for:
  - Volume/cost/scope/need of expenditure
  - Outputs
  - Indicators they will use to track changes
  - Uncertainty mechanisms (see later)
  - How these align/contrast with other scenarios used across industry
- Where a network's proposed expenditure plans differs from the core scenario, there should be sufficient and proportionate evidence to support that variation

Forecast expenditure

Historical spend	Forecast spend	
		Capex
		Opex
		By activity
		By output
		Load related
		Non-load related
?		One-off costs
		Totex per unit: per employee, mile of network, unit of energy etc

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- What are the key drivers of your expenditure for the RIIO-2 period?
  - Growth in demand
  - Condition of assets/utilisation
  - Legislative requirements

- What alternative options to new investment have you considered - scope/timing?
  - What is the cost benefit analysis underpinning the expenditure?

- What efficiencies have you factored into the forecast expenditure?
  - How will you achieve it? What innovation are you rolling-out into BAU?

- How does forecast expenditure compare with historical spend?

Managing uncertainty

Known unknowns

- Which costs/scope/volumes/need are uncertain & why?
- What is the scale/impact of this uncertainty?
- What control do you have for managing/mitigating upside/downside risks?
- What mechanisms do you propose to protect you and consumers against these risks?

Competition

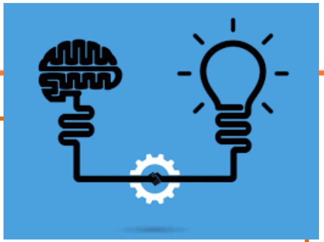
Native competition is competitive processes occurring within the price control, where the incentive is native to the totex incentive mechanism

- What are your plans for facilitating strong 'native' competition processes during the price control? How will you ensure appropriate and non-biased performance?

- What mechanisms do you recommend to ensure auditing can be undertaken?

- What mechanisms you propose to allow baseline revenues to flex for projects which were initially included in your business plan but are eventually delivered through competition
    - For example when an onshore electricity transmission project changes scope within period and becomes eligible for competition under our Competitively Appointed Transmission Owner (CATO) regime

- What bespoke outputs/targets for common outputs do you propose and why?
- What minimum standards will you commit to?
- How do these compare to historical levels?
- What value do you propose for over/under performance?
- Can you demonstrate that funding from base revenues will not contribute to performance improvements?



- What approach will you take to focus innovation on strategic energy issues?
- What type of benefits might arise from these activities?
- How will these be co-ordinated with innovation undertaken by other network firms across the sectors, or in other sectors?
- How will your approach align with other forms of public funding?
- What arrangements will you take to secure third party participation?
- Which steps are you taking to ensure that innovation is rolled-out into BAU? How is this reflected in your expenditure requirements?

- What arrangements have you put in place to share information and co-ordinate your activities with other network companies as part of BAU?
- Why is this different from what you are currently doing? What additional value would it create? What are the costs and benefits associated with your plans?
- How will you monitor how your plans are progressing and the realisation of any benefits?
- What specific re-openers for whole system outcomes would you recommend?

- Key data needed to calculate required revenues
  - Gearing
  - Tax
  - Fast/slow money split
  - Pensions
  - Dividend forecast assumptions
  - Equity issuance costs

Workforce resilience

- What are the key technical skills required by your network business that are particularly challenging to recruit for (e.g. protection specialists)? This should include identification of:
  - the specialist technology skills needed to support the energy system transition and for cyber security
  - market (pay) premium needed to attract people in these areas and how this is expected to evolve
- What is your long-term incremental resource requirement for these skills in your business (to include 10 years beyond the end of RIIO-2), taking account of churn, retirement etc?
- What are your plans to attract, develop, and retaining people into these roles?
- What are your incremental costs, if any, of delivering these plans compared to current expenditure in these areas?
- What are your proposals for measuring delivery of Workforce Resilience against which your network business can be held to account for delivery?

Enhanced engagement

- Have stakeholder been consulted in developing business plans?
  - Process, including access to information, resource and timescale to provide informed comment/challenge
  - What changed as a result
- What is your strategy and framework for engagement in RIIO-2? How does this embed best practice from across networks?
- Voluntary commitments and mechanisms to report performance against these (and consequence of non/under delivery)

Timescales for submitting business plans

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Timescales for business plans submission

July 2019
Initial submission of draft business plans to Challenge Group

October 2019
Second submission of draft business plans to Challenge Group

December 2019
Submission of final business plans to Ofgem

Breakout session

- Are we seeking the right information?
- What’s missing? What’s unnecessary?
- What’s impossible to provide?

What might distinguish between poor, good and standard plan?

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Characteristics that could lead to penalty – poor x

- Not meeting minimum criteria

Stage 1

- Information requested not provided/provided late/provided inaccurately
- Proposed uncertainty mechanisms overly biased on risks to companies
- Little/no consideration of non-network solutions
- Outputs proposed without credible justification, targets at too low a level, incentives requested where baseline funding already provided
- Proposed native competition approach poorly specified and difficult to monitor
- Innovation strategy with limited roll-out into BAU/overly focus on operation/maintenance
- Insufficient engagement in developing the plan – limited stakeholder access to information, resource, personnel, time to properly input to and challenge the plan

Stage 3

Characteristics that could lead to reward – good √

- Meeting minimum criteria

Stage 1

- Proposed uncertainty mechanisms highlight risks to consumers – that we may not be aware of
- Extensive consideration of non-network solutions and demonstrable benefits incorporated into plan. Mechanisms developed to ensure BAU approach
- Outputs proposed with more ambitious targets than we would otherwise set. Clear demonstration of additional risk company is taking on & value created
- Innovation strategy that addresses strategic energy issues, with tangible commitments, tracking, updating (and consequences for non-delivery)
- Engagement informing tangible commitments to deliver and report on additional consumer benefit and on performance against these (and consequences for non-delivery)
- Ambitious approach to implementing native competition processes and tangible metrics for monitoring

Stage 3

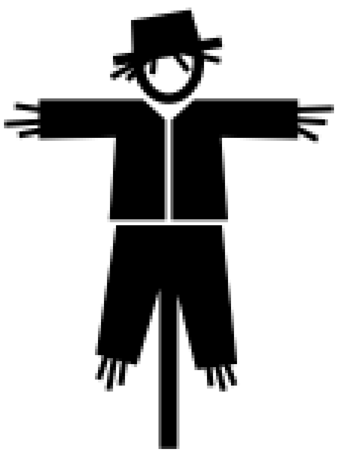
Breakout session

- Are we focusing on the right characteristics of a good/poor plan?
- What else should we take into account?

Business plan incentive

- Description of high level-indicative strawmen

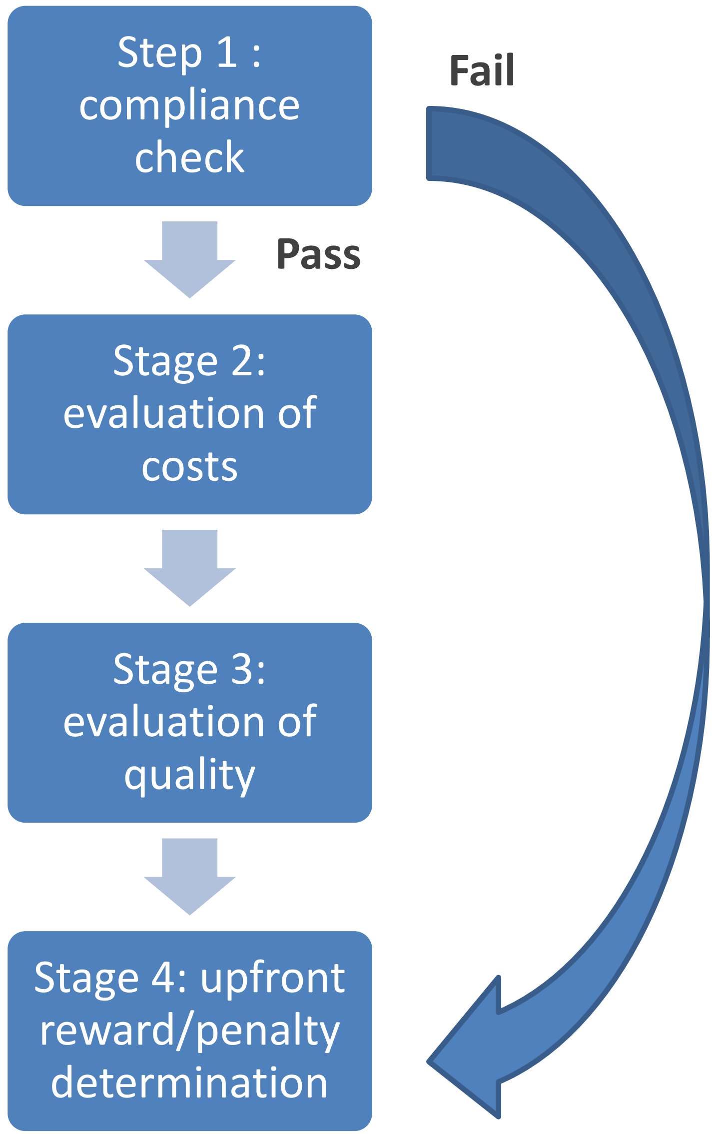
An indicative strawman on business plans



In brief:

- A four stage assessment process
- Upfront penalties are levied for low quality business plans
- Upfront payments are given when companies submit a high quality business plans in terms of both the qualitative and quantitative elements of the business plans
- Distinguishes between incentives on business plans and incentives on delivery
- Focus on rewarding information revelation and alignment of risk and reward
- Introduces a competitive dynamic on the reward side but individual penalties on the downside

Overview of process



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Overview: Business plan incentive strawman

1 Compliance check

Determines whether companies pass a minimum bar in terms of the process leading to the making of the business plan and its completeness

Yes – Pass company continues to the next stage of the assessment

No - Fail company is required to resubmit elements of it business plans and enters a penalty regime

2 Evaluation of costs

Looks at companies' forecasts vs our baseline and assigns a score depending on how lower/higher they are. This stage could build on the totex proposal on the totex incentive mechanism

3 Evaluation of quality

Assesses companies' overall business plans and grades it accordingly. This takes into account

- Output ambition and evidence of value for money
- Endorsement from stakeholders
- Tangible commitments to innovation & whole system thinking
- Identification of uncertainties and mitigation

We assign a score of 1-3 based on our assessment of quality

4 Upfront reward/penalty determination

Cost/Quality	3 Good	2 Average	1 Poor
3 Good	Good value	Value	Standard
2 Average	Value	Standard	Low value
1 Poor	Standard	Low value	Poor value

Discretionary Competed pot

No reward/penalty

Fixed penalties

Stage 1 proposal : Compliance check

This stage aims to ensure completeness of business plans and that companies' submissions meet the obligatory minimum requirements. Companies which do not meet the minimum standard would be required to do further work, their earning potential will be limited and they will also be exposed to an upfront penalty.

What could be considered as a minimum standard?

- Completeness of the business plan – companies submitted all the information required in a clear and understandable manner
- High level of quality assurance to prevent inaccuracies and mistakes
- Meeting Ofgem's requirements, such as obligatory cross-referencing and page/work limits
- Safety – companies' compliance with relevant regulations
- Meeting a minimum standard required on stakeholder engagement – this could be supplemented with feedback from the enhanced engagement groups

What could be the consequence of not meeting the above?

- Companies which fail to meet the above criteria enter into an alternative penalty regime and are not considered for the assessment of stages two to four. This <u>could</u> include:
  - Being granted a restrictive sharing factor
  - Restrictions to earning potential on incentives
  - Automatically assigned to the lowest category in <u>stage 4</u> (being exposed to an upfront penalty)

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Stage 2 proposal :
Evaluation of costs

2

- This stage is based on the choice of totex incentive mechanism. Currently we are considering a ‘blended’ sharing factor

- The aim is to provide companies with an upfront reward or penalty based on level of ambition

Ratio between a company and Ofgem’s view	<X	X to Y	y>
Category	Good	Average	Poor

- The outputs of this stage would feed into stage 4

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Stage 3 proposal : Evaluation of quality

3

This stage assigns a grade to companies based on companies' quality output delivery plan. The grade informs the level of upfront reward or penalty determined in stage 4

Possible criteria on output delivery plans:

- Companies' proposals on <u>discretionary outputs</u>, this *could* include:
  - Evidence that consumers value those outputs
  - Justification as to why a financial reward might be required (or in other words, why outputs should not be delivered even at the absence of a financial incentive). Failing to provide a justification for the need for a financial incentive can reduce a company's score
- Companies' proposals on <u>mandatory outputs</u>, this *could* include:
  - Companies' proposed target levels and their level of ambition
  - Quality of evidence of WTPs and also information on costs required to achieve improvement
- Quality of proposed uncertainty mechanisms and their ability to place the risk with the party best placed to control it
- Quality of long-term thinking: including innovation, whole-system and long-term investment plan
- Quality of stakeholder engagement: could use inputs from the enhanced engagement groups

Scoring

- The categorisation would be based on a qualitative assessment. We are not proposing weighting at this point but rather an assessment based on a good balance of the above

Business plan incentive Stage 4:
Overall evaluation score

- Only companies that reach a minimum standard in step 1 qualify for assessment under the matrix
- Companies would receive an upfront reward/penalty incentive only for combinations of quality and costs
- This would be based on inputs from stages 2 & 3
- A company that does not pass the minimum standard in stage 1 would be categorised as poor

Competed incentive

- Applies with respect to companies' individual size (eg % RORE or totex)
- Introduces a competitive dynamic– the more companies receive a positive rating (ie green in the matrix), the lower the incentive for each receives

Case 1: two companies in the Value category:

	Company 1	Company 2	Max per category
Value	0.125%	0.125%	0.25%

Case 2: one company in the Value category and another in the Good Value category:

	Company 1	Company 2	Max per category (incremental)
Good Value		0.25%	0.25%
Value	0.125%	0.125%	0.25%
Total reward	0.125%	0.375%	0.5%

Quality/cost	Good	Average	Poor
Good	Good Value Max 0.5% of RORE	Value Max 0.25% of RORE	Standard
Average	Value Max 0.25% of RORE	Standard	Low Value 0.25% of RORE (fixed)
Poor	Standard	Low Value 0.25% of RORE (fixed)	Poor Value 0.5% of RORE (fixed)

Absolute penalty: not relative

Draft – indicative values

Close

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Our core purpose is to ensure that all consumers can get good value and service from the energy market. In support of this we favour market solutions where pratical, incentive regulation for monopolies and an approach that seeks to enable innovation and beneficial change whilst protecting consumers.

We will ensure that Ofgem will operate as an efficient organisation, driven by skilled and empowered staff, that will act quickly, predictably and effectively in the consumer interest, based on independent and transparent insight into consumers' experiences and the operation of energy systems and markets.