Response to Ofgem RIIO-ED2 Sector Specific Methodology Consultation, dated 30 July 2020

On behalf of 4D Economics Ltd[1]

1 October 2020

Dear RIIO-ED2 team,

I am not responding to all of the detail in the SSMC but wanted to follow up on a question I raised in one of your webinars, to recognise the challenges you face in setting the methodology for RIIO-ED2, to pick out some unfortunate (and presumably unintended) consequences of your approach and to suggest some amendments to the methodology that would still meet your aims but mitigate the adverse consequences.

These are set out overleaf.

I would be happy to discuss any of this if it would be useful.

Kind regards,

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[1] Martin Crouch is a member of the Customer Engagement Group for WPD but this response is not on behalf of the WPD CEG.

Among the Challenges that Ofgem face in RIIO-ED2…

Ofgem characterises RIIO-1 as having led to too high profits (and hence bills higher than they needed to be) due to companies getting too high allowances and not spending them and/or too easy targets. Ofgem is concerned not to repeat this in RIIO-2. This leads Ofgem not to trust the network companies and it is fair to say the distrust is mutual.

Ofgem also recognises the importance of the RIIO-ED2 period both for making progress towards net zero and for delivering fair value for consumers.

Ofgem notes that the activities and cost levels that are appropriate in the RIIO-ED2 period are uncertain and that it is hard to know now for sure whether many of the projects that DNOs may put forward in their business plans will be needed in this period. Ofgem considers that policy decisions to be taken by government may reduce this uncertainty substantially during the ED2 period.

If this is a fair characterisation of some of Ofgem's concerns, are they valid? In the main, I think they are. I would only note that government policy decisions may not be clear cut and – importantly for what follows – are influenced by industry activity (including DNO actions – not just lobbying but also evidence provision and innovation, such as the constructive actions of GDNs on hydrogen).

So if the concerns are valid, how are they to be addressed?

Ofgem's response

A large part of Ofgem's response to these challenges is to limit cost allowances to those which they are sure will be needed (and by implication are expected to be insufficient in aggregate) and then provide "uncertainty mechanisms" to enable them to increase allowances in future. The uncertainty mechanisms are (at least in some cases) uncapped and Ofgem say they expect them to lead to large allowances (possibly £10bn although other times they say they could be almost as much as baseline expenditure which is much higher).

Ofgem has also reduced the rewards for underspending allowances slightly, and in the case of some types of expenditure (NARM categories of asset replacement) quite dramatically.

Ofgem has also taken a cautious approach to other allowances, for example excluding most CVP proposals and novel proposals that have stakeholder support. Having removed fast track, Ofgem has also sought introduced business plan incentives which appear (bearing in mind GD and T experience), skewed to the downside and to discourage more ambitious proposals that do not have a strong track record (ie are not just incremental builds on current practice).

I won't comment on other parts of Ofgem's proposals such as cost of capital as I suspect this needs further thought in light of the recent CMA provisional findings.

Three obvious concerns with Ofgem's approach

A. The uncertainty mechanism process may delay necessary investment. Attention has focussed on the time that may be taken for Ofgem to approve any proposals from the DNOs. But this is only part of the issue: the DNOs will struggle to provide proposals quickly as they will worry about the justification Ofgem will require, and once approvals are given, fitting additional work into annual workplans will also lead to delays, perhaps more so for DNOs with programmes of work than for transmission companies with more chunky project work.

B. Having pushed DNOs to engage more with their customers and stakeholders and build regionally appropriate and justified plans, Ofgem's centralised approach is likely to (drawing again on experience in GD and T) disappoint and disenfranchise those customers and stakeholders, including through the Customer Engagement Groups.

C. Ofgem's approach is discouraging ambition and innovation in developing business plans. Comments at the recent Infrastructure Forum annual conference (under the Chatham House rule, so not attributable) suggest this is already having an effect in the innovation supply chain.

I don't believe Ofgem intends any of these effects. Ofgem was clearly alive to the risk of delay but appeared to think this was mainly an issue of the time Ofgem took to make decisions (and the network companies also focus on this issue, as one might expect), whereas other parts of the process are also problematic and will likely lead to greater delays in practice.

From my experience and understanding, I think all three concerns are valid and Ofgem should look for variants to its approach which avoid these problems. But before coming to that, there are two other concerns which may be less obvious but are at least as problematic and arguably more fundamental.

Less obvious, but perhaps even more serious concerns

D. Ofgem's reliance on ad hoc uncertainty mechanisms (not meaning volume drivers, but reacting to network company proposals for additional allowances) risk worsening system efficiency and increasing costs to consumers. This can happen in multiple ways. One is that in Ofgem's desire to be agile and prompt in responding to applications, there is less time and comparative information to assess efficiency. Another is that it changes the incentive on DNOs to focus their management effort on arguing for additional allowances on an ongoing basis, not just at price reviews – that becomes a key driver of their profits. A third is that it changes their incentives in interacting with government and informing government policy setting.

    Case study: in 2013/14, once the RIIO-ED1 control was set, some DNOs experienced a big increase in PV connection applications and gave very high quotes for connection charges, effectively saying that their network was shut for new connections. Potential connectees complained, leading to the affected DNOs asking Ofgem to give them large additional allowances to reinforce their network and ease connections. Ofgem refused and made clear that the DNOs had to resolve the issue, which it then did without incurring substantial costs. Under the RIIO-2 approach, the DNOs would have triggered the uncertainty mechanism and Ofgem would have presumably granted the large additional allowances, which the DNOs would then likely have spent or, if not, pocketed. In either case, this would have been a worse outcome.

E. Underlying these concerns, Ofgem's approach marks a fundament shift aware from the type of incentive regulation that has served consumers well over the past 30 years. A central tenet of incentive regulation is that the regulator sets the framework every few years to try to align the incentives that the company faces with those that give the best outcomes for consumers. The companies then take investment and operational decisions. This has at times been blurred in practice – for example, more intervention by the regulator can be justified for "lumpy" decisions such as with Strategic Wider Works. But Ofgem's new approach marks a break – more decisions will sit with Ofgem on an ongoing basis. I don't see how the challenges of asymmetric information will be any less than they are in a price review. It moves the focus of company management more onto lobbying the regulator and less on owning the problem and finding creative solutions.

One of the main motivations for the introduction of RIIO was to move network companies away from focus on interactions the regulator and more to focus on the needs of their customers and stakeholders. While that was arguably never really achieved by RIIO, it seems that RIIO-2 is a sizeable step in the opposite direction. However much expertise sits within Ofgem, it must surely be a given that companies should have greater expertise to make operational and investment decisions and hence the preferred approach should be to leave as many decisions with them as possible, provided their interests can be aligned with those of their customers.

So what could be done?

I am not arguing that Ofgem is wrong in its characterisation of the problem: so something must be done.

And I agree that it would not be sensible for Ofgem to "take a punt" on giving additional upfront allowances without justification and then offer large profits to companies that don't spend the allowances.

But that is not the best alternative to Ofgem's proposals in the SSMC.

A package

As a basis for discussion and development, I think there are four key components to a better solution, that mitigate all five of the concerns listed above and still address Ofgem's objectives if I have understood them.

A. Strengthen the allocation of responsibility, so that it is clear DNOs are responsible for meeting all of the needs of their customers and stakeholders with the allowances they are given and using the processes set up (see point B). Recognise the importance of company purpose and governance (eg building on work Ofwat has been doing), encouraging clarity of social responsibility (eg giving shares to customers, even for privately held companies) and more effective sufficiently independent NEDs.

B. Instead of a "centralised reactive" uncertainty mechanism (Ofgem decisions responding to "bids" from companies) move to a semi-decentralised, proactive mechanism. Utilise a panel (per DNO) that interacts with local stakeholders to update allowances several months ahead of time (eg in summer 2023, update the 2024/25 allowances in time for this to be built into company workplans and budgets) based not just on company "bids" but also stakeholder views of what is required. Ultimate decisions may need to be reserved to GEMA but the panel's views can be given due weight. Establishment of this framework could build on and be informed by the CEG and CCG models. This approach is more "adaptive" and "agile" than the ad hoc and one-off adjustments currently proposed, building in learning and iteration over time, as well as rebuilding the local interaction that the current approach misses. If necessary, there could be an emergency ad hoc process in parallel, although this would likely delay rather than accelerate the process so may be better avoided.

C. Recognise that Ofgem cannot necessarily identify the full merit of ambitious business plans and innovative proposals in advance. Instead of (or as well as) the business plan incentive and other price control incentives, hold back sizeable rewards for excellence to be judged on an ongoing basis and paid out with a significant delay to company actions that really add value for customers but don't get sufficient reward from ex ante incentives. This would build on the ideas behind the ESO incentive mechanisms but would need to recognise that the ESO mechanism has not achieved its potential. Deferring payment of the rewards would allow them to be adjusted if what seems at the time to be a great idea turns out not to be so, mitigating the risk that the best presented case (or most effort on lobbying) wins rather than the best substance, which should be easier to see in the fullness of time, with hindsight if necessary. This builds on mechanisms used elsewhere in the economy where long-term success is hard to see in advance, such as LTIP schemes. To work well, this needs trust to be rebuilt between network companies and Ofgem, so it is contingent on proposal A above and a process something like proposal B, as well as mitigating the features that damage trust now (eg through proposal D).

D. Consistent reduction in rewards for not spending allowances. Ofgem proposes to retain high company shares (albeit lower than RIIO-1) for most types of expenditure but very low for some (95% clawback) which creates perverse incentives to focus on some cost reductions and reallocate costs. RIIO-1 allowed DNOs to keep up to 70% of underspend on capex, plus compensated them for additional tax on the additional profits, so customers only got about 20% of the value. This contrasts with RPI-X where customers got about 70% of capex underspend returned to them – consistency at this level would maintain reasonable and balanced incentives without excess profits from "windfall" underspend, while still maintaining a Totex approach. It would also allow the removal of the complexity of sculpted returns which give the greatest rewards for unearned windfall gains and lower marginal rewards for genuine efficiency. Consistent with the CMA provisional findings (the sharing factors are not directly comparable – I understand the tax treatment is different), companies could bear a larger share of overspend.

What will this achieve?

The package set out above will produce a better deal for customers as well as enabling more effective facilitation of net zero. It includes a stronger role for local stakeholders and customer views[2] and, done well, could revitalise ambition and innovation. It reasserts company responsibility for solutions and allows Ofgem to step back to a more regulatory role.

I recognise that the details will need further work and I would be happy to discuss.

[2] Encouraging companies to conduct customer research independently has substantially undermined the usefulness of the research but it may be too late to correct this now for business plan submission – otherwise a different approach would provide proposal E.