ofgem Making a positive difference for energy consumers

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Introduction to Low Carbon RAB regime

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21/10/2019

OFG1161

- Price Controls
- RIIO
- Potential Incentives for Low Carbon RAB

" Price Controls before 2010 "

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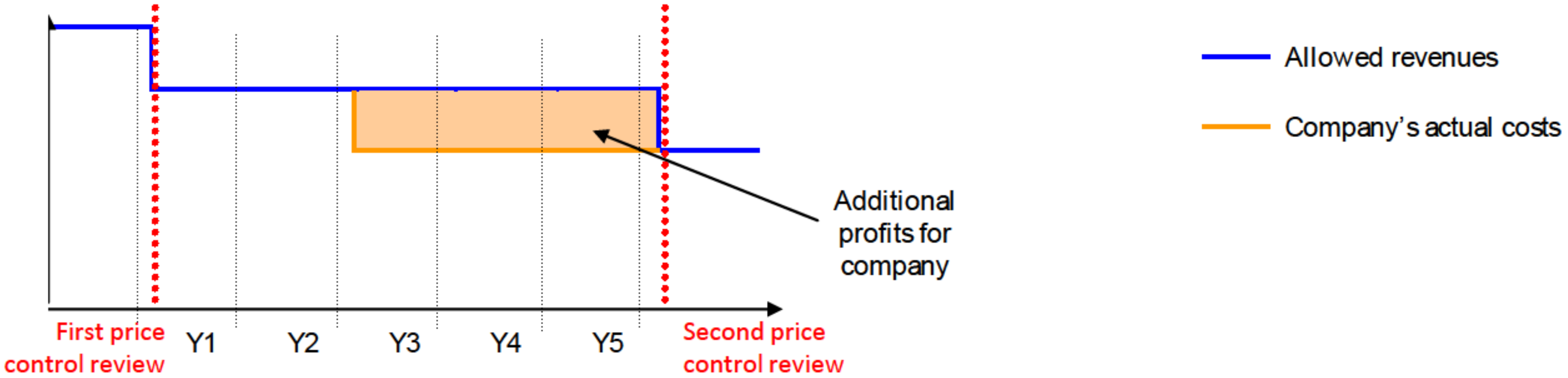
- GB networks were regulated in the past in a relatively blunt manner
- Price controls used to limit the amount of revenue that companies could recover
  - over the course of the price control period allowed revenues were adjusted by inflation (RPI) and a factor (X) that represents anticipated efficiency gains (or cost increases)
- Companies were incentivised to beat the regulators’ assumptions
  - If they do, they keep the benefit until the next price control
- At next control, consumers benefit
- Quality measures
- Sustainable delivery



"RIIO Model"

RIIO – a new model for network regulation

Revenue

Constraint set up front to ensure:

- Timely and efficient delivery
- Network companies are financeable
- Transparency and predictability
- Balance between costs faced by current and future consumers

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Incentives

Deliver outputs efficiently over time with:

- 5 yr control
- Rewards/penalties for delivery
- Upfront efficiency rate

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Innovation

Technical and commercial innovation encouraged through:

- Core price control incentives
- Option to give third parties a greater role in delivery
- Innovation stimulus package

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Outputs

Outputs set out in clear 'compact', reflecting expectations of current and future consumers

Incentives

Deliver outputs efficiently over time with:

5 yr control

Rewards/penalties for delivery

Upfront efficiency rate

- Strong efficiency incentives – sharing between company and consumers
- Long term perspective intended to encourage longer term business plans and the longer price control period – however we have since reverted to five years as it was felt eight years was too long

Comprehensive price control review
Drawing on longer term business plans

Focused review of output requirements

Comprehensive price control review

- Legislation, policy objectives, governance could change
- Opportunity to review package still appropriate
- Review not necessarily needed

Innovation

Technical and commercial innovation encouraged through:

Core price control incentives	Option to give third parties a greater role in delivery	Innovation stimulus package

- Regulation has been good at protecting against monopoly prices
- More difficult to challenge monopoly ‘quiet life’
- Why take risks, have new thinking, try new approaches?
- Of course different ways are not always right
- but companies in relatively competitive markets

have to keep on their toes for possible innovation

- RIIO supports innovation across business plan

but also extra stimulus

- Competition but with governance ensuring sharing

of benefits and company commitment

£60m/a available in electricity NIC

£20m/a available in electricity NIC

Outputs

Outputs set out in clear ‘compact’, reflecting expectations of current and future consumers

	Electricity transmission	Gas Transmission	Gas Distribution	Electricity distribution
Safety	Meet HSE requirements/ asset health measures	Meet HSE requirements/ asset health measures	40-60% reduction in safety risk, Meet HSE requirements/ Asset health measures	Meet HSE requirements/ asset health measures
Customer Service	Customer/stakeholder satisfaction survey, stakeholder engagement	Customer/stakeholder satisfaction survey, stakeholder engagement	Broad measure of customer satisfaction, complaints, stakeholder engagement	Broad measure of customer satisfaction, complaints, stakeholder engagement
Connections	Current licence requirements on timing of offers	Process established	Meet guaranteed standards	Meet guaranteed standards, new incentives on engagement (large connections)
Environment	Business Carbon Footprint and Sulphur hexaflouride targets	Business carbon footprint	Shrinkage, business carbon footprint, Biomethane capacity connected	Losses obligations and discretionary reward Business carbon footprint. undergrounding allowance -broad environmental impact (reputation).
Reliability and availability	Target for energy not supplied and boundary capacity levels	Sufficient to deliver 1 in 20 winter peak	Number and duration of interruptions	Interruptions incentive scheme Network resilience
Social	Not Applicable	Not applicable	Connection of up to 80,000 fuel poor, increased carbon monoxide awareness	Pro active in relation to vulnerable consumers

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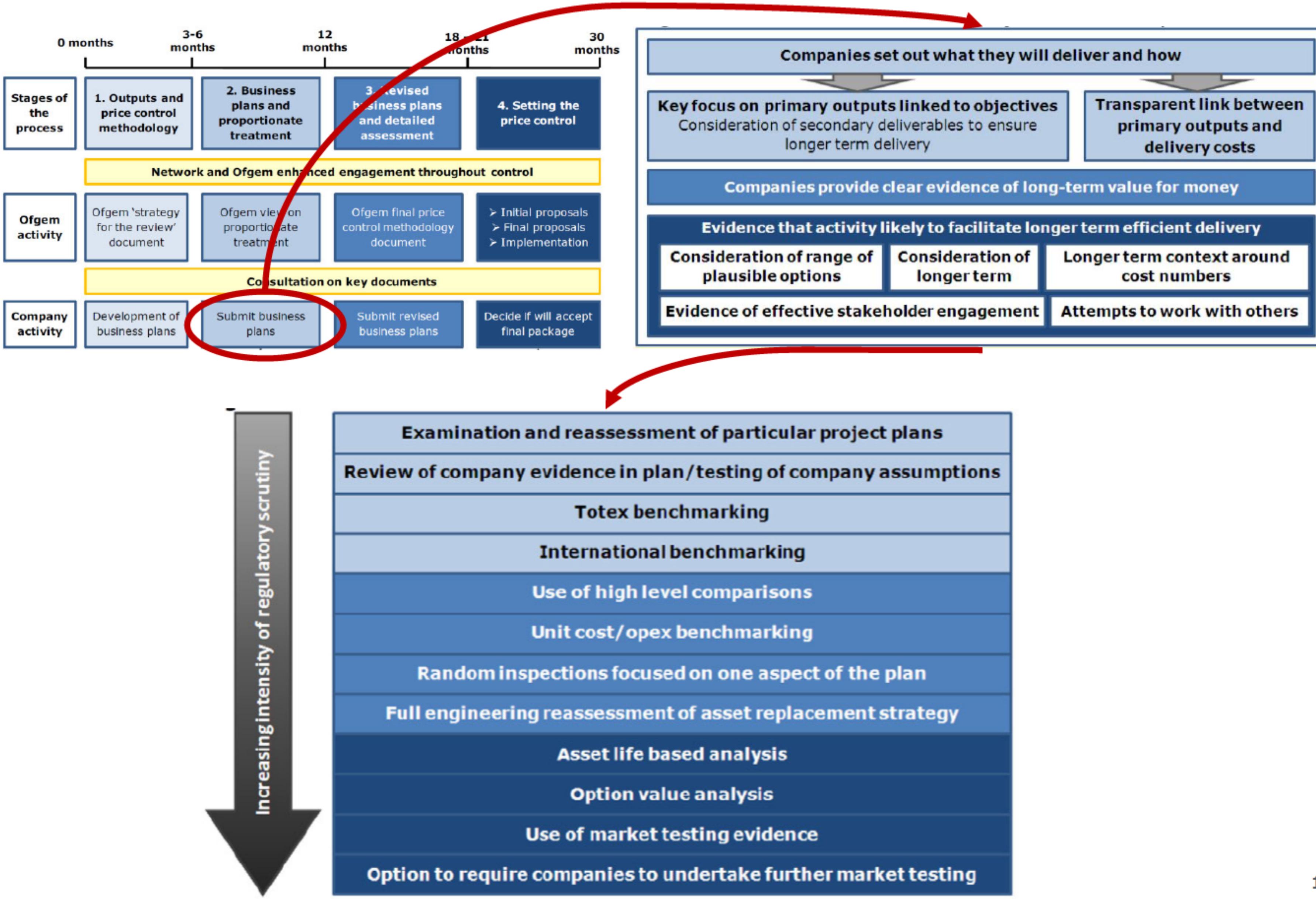
Business plans



- There are parts of the control where we do not have sufficient information to set revenues at the time of the review.

- Reopeners/ Uncertainty Mechanisms allow for the possibility to submit a case for further revenue when there is greater certainty.

- Examples of reopeners in RIIO-1 include:
  - Innovation Rollout Mechanism – allows companies to apply for additional revenues to roll out a proven innovation
  - Sub-sea cables – scope for SSE to apply for additional funding once there was certainty on the level of protection required for sub-sea cables to be determined by Marine Scotland
  - Load related – reopener if demand is significantly different from that envisaged in setting the control

Process for reopeners

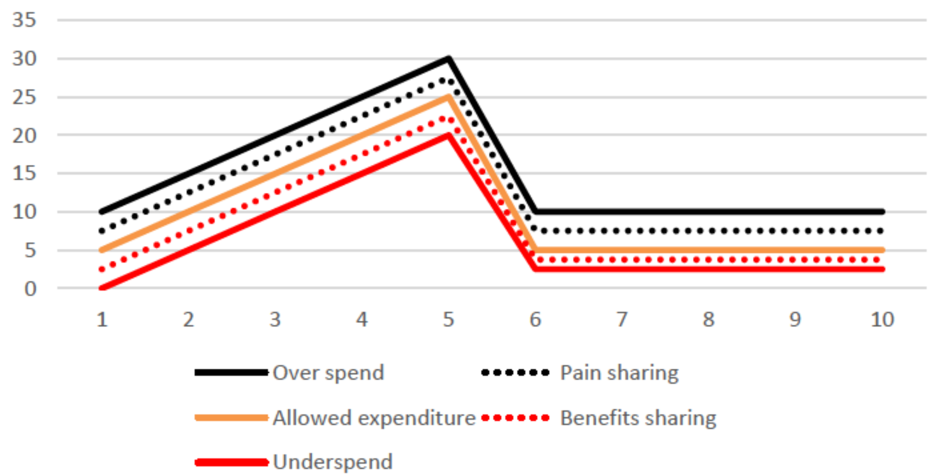
- Generally a time window is defined for submitting reopeners/ UMs to be triggered
- Submissions must be evidence based
- Discretion is retained by the regulator whether to grant additional revenues
- Company has recourse to legal challenge

Incentives during the control period: Risk Sharing

Table 1: Pre-tax Totex in 2015-16

£m 2015-16 Prices	NGET TO	NGET SO	SHE Transmission	SPT
Allowed Totex	1,805	137	781	354
Actual Totex	1,161	137	524	358
Overspend / underspend	-644	-1	-257	4
Sharing Factor[9]	53.11%	53.11%	50.00%	50.00%
Allowed Totex after sharing[10]	1,463	137	652	356

Risk Sharing Example



Risk Sharing - Totex Incentive Mechanism

Any over, or under spend is shared between consumers and companies. This is based on a sharing factor we set as part of assessing plans. Where a companies plans more closely reflects what we expect it receives a more generous benefits sharing factor.

However, the incentive is asymmetrical, if a company takes more of the gain on an underspend it also takes more of the pain on an over spend.

This is demonstrated below:

NGET's allowed Totex in 2015/16= £1,805m
Actual Totex= £1,161m
Underspend=£644
Sharing Factor=53.11%
Amount recoverable from consumers= £1,161+(0.4689*644)=£1463m

Incentives during the control period

Incentives can take a range of forms:

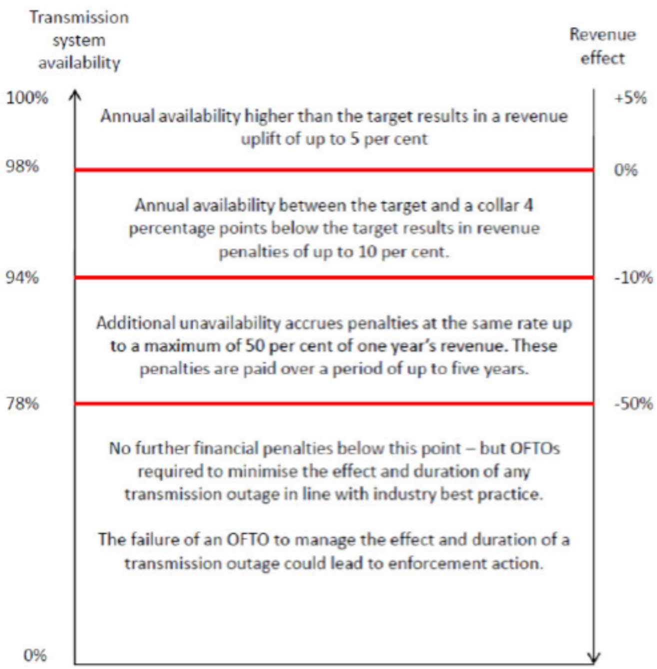
- Some are reputational only – we published 'league tables'
- Some are reward only – upside for exceptional performance
- Some are penalty only – downside for failing a KPI
- Some are strict licence requirements

Output Category	Incentive	Incentive Type
Environmental impact	Business Carbon Footprint	Reputational
Customer satisfaction	Stakeholder Engagement Incentive	Reward only
Connections	Incentive on Connections Engagement	Penalty only
Safety	Compliance with HSE	Licence requirement
Reliability and availability	Interruptions Incentive Scheme	Symmetric
Social obligations	Priority Services Register	Licence requirement

Availability Incentives

Table 7: ENS Three year performance – volume of unsupplied energy below annual target

	NGET	SHE Transmission	SPT
Target	**316 MWh**	**120 MWh**	**225 MWh**
2013-14	181 MWh	84 MWh	183 MWh
2014-15	307 MWh	14 MWh	222 MWh
2015-16	312 MWh	120 MWh	211 MWh



TOs are incentivised to maximise the amount of electricity that is transported through their assets from entry to exit.

These targets are static and set for the whole price control period.

They receive a reward for being under target and a penalty for being over target.

OFTOs are not protected per se.

They could be fined up to ten percent of their annual turn over if they fall below the 98% mark.

They could also have their licence revoked.

Our financeability duty

Ofgem's Principal objective: to protect the interests of existing and future consumers
Must also *"have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them"*

- In the interest of consumers that efficient network companies can secure finance in a timely way and at reasonable cost to facilitate their regulatory obligations
- No bail-out if financial distress is due to own behaviour
- No reward of inefficiency or unwarranted returns
- Capital structure remains the responsibility of network companies' management

Regulatory commitment provided through transparency and predictability
Transitional arrangements to avoid sudden impact on earnings and cash flows

"Low Carbon RAB Economic Regulatory Regime"

Redacted - s36 FoI Act 2000

"Parallels and divergences for Low Carbon RAB"

Redacted - s36 FoI Act 2000

Redacted - s36 FoI Act 2000

"Funded Decommisioning Programme"

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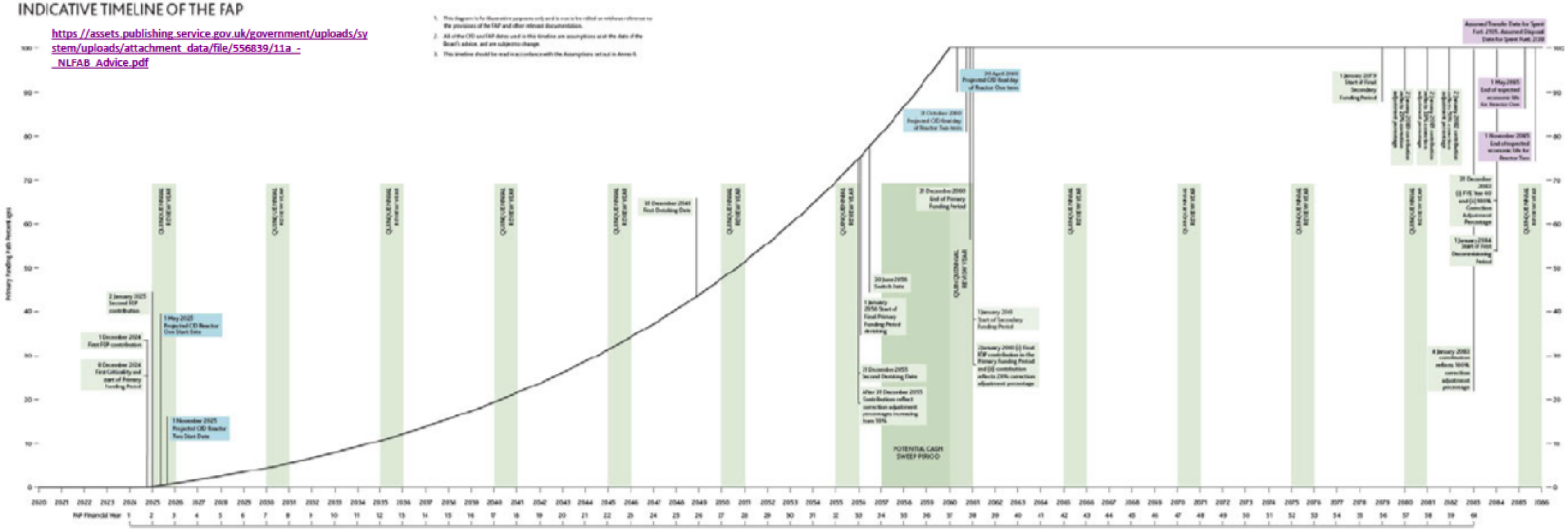
Hinkley Point C – FAP timeline

INDICATIVE TIMELINE OF THE FAP



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“Incentives”

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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 practical, 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.