Via email

23 September 2014

Dear Anna

Submission on Draft Determination for RIIO-ED1 slow-track companies

This submission was prepared by the Consumer Futures team within Citizens Advice and Citizens Advice Scotland (The Citizens Advice Service). It has statutory responsibilities to represent the interests of energy consumers in Great Britain and we welcome the opportunity to respond to this consultation. This response is not confidential and can be published on your website.

Summary

In our view, the Draft Determination represents a mixed outcome for consumers. While there are positive elements – networks have for example, taken real steps forward in the quality and extent of their engagement with stakeholders – we continue to be concerned that the DNOs will be over-remunerated under RIIO-ED1. This is in large part because the most recent set of pre-RIIO price controls for electricity and gas transmission and gas distribution show a pattern of financial 'outperformance' that does not appear to be justified by either the operational performance of the networks or as a reflection of the commercial risks they face. And when we look to the business plans that have been put forward by the networks for RIIO-ED1, we see elements that could contribute to this situation persisting into the period 2015-2023.

One of our key asks is therefore that Ofgem clarifies the assumptions that underpin the headline figures in the Draft Determination – particularly the £12 pound saving for the average duel fuel customer over the course of RIIO-ED1[1]. If this figure is based on 'base revenue' only i.e. does not include that which will be collected from consumers once the various incentives available to DNOs are taken into account, then this must be made clear to consumers so that they are in a position to make a more informed judgement about the merits of the Draft Determination.

[1] This is the average savings across the UK. The figures by network operator are as follows: Energy Northwest, £26; UKPN, £5; Scottish and Southern Energy, £20; SP Energy Networks, £12; Northern Power Grid, £13; and Western Power Distribution, £9. For more detail see https://www.ofgem.gov.uk//publications-and-updates/infographic-how-ofgems-network-price-control-proposals-riio-ed1-will-affect-you

An ongoing structural problem here, and this is a problem not just for the Citizens Advice service but all stakeholders, is that the complexity of the RIIO-ED1 framework and the business plans makes holistic judgements about value for money very difficult. The interplay of the various incentive, penalty and uncertainty mechanisms tend to obscure the overall picture for consumers. But although the process is nearing its completion, there remains an opportunity to design and implement a reporting regime that cuts through the detail to communicate performance and earnings in a clear and accessible way for stakeholders.

Our second ask therefore is that reporting arrangements meeting this description are implemented in time for the commencement of RIIO-ED1 in April 2015. We were pleased to receive a briefing at the Price Control Review Forum (PCRF) from Ofgem on the work it is currently undertaking to review and reform the monitoring and reporting arrangements for RIIO-ED1. This is a promising development and we look forward to contributing to this process.

We also take this opportunity to comment on some specific aspects of the Draft Determination that we have not addressed in detail in earlier submissions, including forecast savings from smart metering and grids, and losses.

Financial settings

Citizens Advice submitted detailed comments against the DNOs business plans for fast-track assessment in May 2014. Although some changes have been made to the business plans as they now appear (incorporating the changes in the Draft Determination), they are not significantly different from the earlier versions so our earlier comments remain relevant. These latest comments should therefore be read in conjunction with our May 2014 submission, contributions to the PCRF and the evidence that Richard Hall, Director of Strategic Infrastructure, Citizens Advice, gave to the Energy and Climate Change Committee in July 2014 as part of its inquiry into network costs.

The key change in the current plans as amended by the Draft Determination is the £2.1 billion reduction in total costs, £700 million having been offered up by the DNOs and a further £1.4 being found by Ofgem. This, according to the Draft Determination underpins a savings of £12 in real terms for the average consumer over the life of RIIO-ED1. If realised, this is a material saving for consumers which we welcome.

The other ‘new’ element in the Draft Determination that deserves comment is Ofgem’s decision to set the cost of equity at the bottom of the original 6.0-7.2 per cent range it specified in its March 2013 Strategy Decision. We supported Ofgem’s decision to revise the equity market return in light of the Competition Commission’s decision for Northern Ireland Electricity (NIE) to give greater weight to current market conditions in setting this metric.

But for a number of reasons, it is important not to overstate the extent to which 6.0 per cent represents a particularly tough target for DNOs. To start with, while we do recognise there are differences in circumstances between regulated sectors, 6.0 per cent is higher than the Competition Commission's 5.0 per cent for NIE[2] and the 5.65 per cent Ofwat selected in its recent Draft Determination for water and sewerage companies in England and Wales.[3] We also note that Ofgem has adjusted the methodology for setting the cost of debt allowance in the Draft Determination, a move that reduces the overall level of financing risk that the DNOs will face over the life of RIIO-ED1. There are also a number of 'uncertainty mechanisms' built into the price control – for instance in relation to load-related expenditure and major rail electrification projects – that insulate DNOs from risk and therefore increase the attractiveness of electricity distribution networks to investors. And finally, the pattern of financial outperformance by networks during the last round of price controls suggests that despite the focus on the cost of equity during the negotiation of price controls, the figure can be a something of a red herring, with some earning returns of more than 10 per cent and all more than their base allowance.[4]

Seen in this context, 6.0 per cent clearly represents a healthy rate of return for DNOs. The key implication is that earnings greater than 6.0 per cent should only be permitted where a DNO's performance is indeed 'exceptional'. In assessing the merits of the Draft Determination, a key question is therefore whether it will deliver returns that are linked to performance in this way. This will largely depend on whether the performance targets in the business plans are sufficiently ambitious. But given the length and complexity of the business plans, not to mention the fundamental information asymmetry that exists between regulators and regulated utilities let alone other external stakeholders, we find it very difficult to judge whether Ofgem has got this right in the Draft Determination. This is compounded by the fact that many of the outputs in the business plans are specified in ambiguous, open-ended terms i.e. in a manner that is not specific, measurable, assignable, realistic and time-bound or 'SMART'. We comment on this later in the submission in relation to losses. As we have argued in earlier submissions, this is bad for accountability difficult and may cloud the link between revenue and performance.

What should not be as difficult to understand, is how the range of possible revenues that the DNOs may earn relate to the headline figures in the Draft Determination, in particular the £12 pound saving. We ask this because we have difficulty reconciling a RIIO framework that has so much flexibility built into it with the fixed picture that is presented to consumers in the Draft Determination. This is why we request that Ofgem clarify the assumptions that underpin the projected savings for consumers. If it is that these savings are not 'locked in', then this must be communicated to consumers in a clear way in the Final Determination.

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[2] RIIO-ED1: Draft determinations for the slow-track electricity distribution companies Financial Issues, Ofgem p 7.

[3] http://www.ofwat.gov.uk/pricereview/pr14/det_pr1408draftappendixriskandreward.pdf

[4] In the transmission price control that ran April 2007-March 2013, the cost of equity was set at 7 per cent, actual returns ranged from 7.4 to 10.1 per cent. In the last gas distribution price control, the cost of equity was set at 7.25 per cent, actual returns ranged from 8.19 to 11.18 per cent. See p 16 of Ofgem's report 'Transmission networks: Report on the Performance of the Transmission Owners during the regulatory period TPCR4 and TPCR4RO' https://www.ofgem.gov.uk/publications-and-updates/transmission-networks-report-performance-transmission-owners-during-regulatory-periods-tpcr4-and-tpcr4ro-2007-08-2012-13

This lack of clarity about performance and revenue ex ante also points to the need for Ofgem to consider the calibration of the performance targets at the Mid-period review of outputs in 2018. If evidence does emerge during RIIO-ED1 that the targets are weak, then adjustments must be made to ensure consumers are not funding windfall gains by DNOs.

Accountability and transparency

What this general discussion about financial settings points to is the need for the DNO's performance, both in terms of delivering the commitments in their business plans and their resulting financial returns, to be communicated to the public in a clear and timely way throughout RIIO-ED1. While there has always been a two-way exchange of reporting and compliance information between the regulator and the DNOs during price controls, RIIO's focus on engagement and transparency means the game has changed and a new reporting model is required. As we outlined in our presentation to the PCRF in September, there are models in other regulated sectors that show how this might be achieved. The reporting arrangements Ofwat has in place for regulated water and sewerage are a notable example.

There are two core features of the Ofwat model that should be replicated for RIIO-ED1. The first is that in addition to the networks reporting on their performance on an annual basis, Ofwat also publishes consolidated reports. This provides the critical independent view that stakeholders need to assess the relative performance of the water utilities in England and Wales. Without this 'one-stop shop' stakeholders must resort to the almost impossible task of collating and comparing individual company reports. The second feature of the Ofwat model that we like is the portal on its website which lays out both summary and company produced information in an accessible way.

We understand that Ofgem has commenced work on new monitoring and reporting arrangements that include an Ofwat-style public portal and a new framework for regulatory accounts that present information in a way that is consistent with the RIIO-ED1 financial metrics. This is a positive development and we request that Ofgem consult on a draft design for this framework ahead of it going live for the commencement of RIIO-ED1. In the interests of ensuring that the DNOs publish reports that a comparable and transparent, Ofgem should also develop draft guidance for the DNOs new public reporting requirements under the new Licence Condition 50.

This process also presents an opportunity for Ofgem to address the longstanding issues with the reporting of projects and outcomes under the Low Carbon Networks Fund (LNCF). The LCNF has suffered from the absence of a single consolidated and accessible source of information on projects and outcomes and we are keen to see that this situation is not carried over into the new innovation regime for RIIO-ED1.

Other issues

There are two other issues on which we now comment: forecast savings from the smart meter rollout and the development of the 'smart grid' and losses. It is clear from the Draft Determination that it is in these areas that the greatest distance remains between Ofgem and the DNOs in the negotiation of RIIO-ED1.

Taking smart first, our view is that Ofgem was right to assume that the smart meter rollout and the development of a smart grid will deliver a greater level of savings (£400 million more) than that put forward by the DNOs in their business plans. We do not understand the basis for the DNO's forecasts given they appear to be inconsistent with those produced by their own Transform model. This contributes to a perception that the DNOs are only reluctantly embracing the opportunities of smart and could undermine consumer's confidence that the £11 billion smart meter program that they are funding through their bills will deliver the benefits they have been promised.

We are also disappointed with the DNOs apparent lack of commitment to minimising losses. It is important to note that we view the treatment of losses in the business plans and Draft Determination through the prism of the debates over data quality and the associated failure of losses incentive mechanism that was in place in DPCR4 and DPCR5 to deliver on its objectives. While we accept that data quality is an issue that has presented challenges for losses management, it is also clear that the electricity industry as a whole – suppliers included – have not attacked the issue in a proactive and coordinated way for the benefit of consumers.

Unfortunately the loss reduction strategies put forward by the DNOs tend to be little more than high level descriptions of work that is already underway, supported by loose commitments to 'explore' additional opportunities. Ofgem is therefore right to cast doubt on whether these plans will satisfy the relevant licence condition and call for their revision. DNOs must demonstrate that as an absolute minimum they have systems in place to identify and evaluate loss reduction opportunities, and evidence the decisions they take with robust cost benefit analysis. Foremost here is the need for DNOs to outline detailed plans that reflect, for example, the timetable for the smart meter rollout, to address the data quality issues that are a known and major barrier to forming a baseline and therefore, meaningful action on losses.

As a more general comment though, we are concerned that the DNOs mixed treatment of smart and losses suggest a failure to fully sign up to the RIIO innovation agenda. That Ofgem, based on the quality of the DNO's innovation strategies, proposes to award little more than half of the additional revenue that was available to the DNOs under the Network Innovation Allowance seems to support view that opportunities for innovation are not being fully explored.[5] The onus is now on the DNOs to demonstrate to their stakeholders that this is not the case.

[5] Assessment of the RIIO-ED1 resubmitted innovation strategies, Ofgem, p 3 https://www.ofgem.gov.uk/ofgem-publications/89066/assesmentoftheinnovationstrategies.pdf

Thank you for the opportunity to make this submission. Please do not hesitate to contact me if you would like to discuss it further.

Yours sincerely

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