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Dear Ms Rossington

Revised RIIO-ED1 business plans

This submission was prepared by the Consumer Futures team within Citizens Advice. It has statutory responsibilities to represent the interests of energy consumers in Great Britain. We welcome the opportunity to provide a submission on the revised RIIO-ED1 business plans. These comments complement those we made at the Price Control Review Forum (PCRF) on 23 April 2014.

Summary

The narrative for RIIO-ED1 being presented by the electricity distribution network operators (DNO) centres around an almost across the board reduction in real costs of electricity network services from the current price control, DPCR-5. Most DNO business plans have prices falling in 2015-16, with prices remaining flat or increasing gradually in the remaining seven years of RIIO-ED1. At the same time the DNOs assert that this favourable outcome in terms of costs will coincide with significant new investment in their assets, not only to maintain and replace components of it to deliver and improve on safety and reliability, but also to cater for load growth and the need to make networks 'smarter'. The DNOs also commit to improving customer service by meeting a tighter interruption standard, increasing the level of compensation payments for breaches of Guaranteed Standards and better supporting vulnerable customers by, for example, improving the accuracy and completeness of priority service registers (PSR).

This overall picture is exemplified by the package that United Kingdom Power Networks (UKPN) proposes in its revised plan. UKPN, states in its 'Business Plan Highlights Document' that it will cut prices on average by 3 per cent compared to DPCR-5, while improving reliability by more than 19 per cent in its Southern Power Network region. During the eight year term of RIIO-ED1 it will invest £6.6 billion pounds, delivering 'more investment volumes and lower operating costs'.[1]

At least on the face of it, this appears to be a good result for consumers. That the UK appears to enjoy comparatively low distribution costs by European standards would seem to contribute to the view that the business plans represent, at least on a relative basis, reasonable value for money for consumers.[2] The question is whether this is an accurate picture of the outcomes RIIO-ED1 will deliver.

Our view is that there are significant questions about the plans that must be answered before consumers can be comfortable that they are getting a good deal and accordingly, Ofgem is in a position to sign them off. The first question being, does this price profile appear as favourable for consumers when it is presented in nominal, rather than real terms? Consumers generally understand price movements over time in nominal terms and should not be expected to perform a conversion of real to nominal to reach a view on whether services represent value for money. Secondly, how was SP Networks (SPN) able to cut its costs by £450 million in its revised plan, without reducing the outputs they commit to deliver? This raises a host of questions about the SPN and other plans. Was SPN's first plan based on a financial model that would have seen it make a substantial financial windfall at the expense of consumers? If not, will the cost reductions it proposes come at the expense of reliability or other outputs? Or will SPN find these savings by pushing costs into the next price control period? These are the questions we expect Ofgem to explore as part of this phase of the RIIO-ED1 process.

In particular we think there needs to be more transparency on the real level of costs consumers are likely to face over the life of RIIO-ED1. That is, consumers need to understand the overall revenues DNOs will collect: not just base revenue but overall revenue including incentives. The extent to which it is changes in depreciation rules that will deliver cost savings compared to DPCR-5 rather than real efficiency gains must also be explained. The varying responses by DNOs to the decision by Ofgem – which we strongly support – to re-open the cost of equity in light of the Northern Ireland Competition Commission decision also raises questions about the real drivers behind these financial settings that should be examined. We also raise some issues specific to particular DNOs that are of concern.

Finally, it is important to emphasise that the issues we highlight in this submission do not represent an exhaustive list of specific questions we have on the content of the plans. Given their length and technical complexity, we use this submission to highlight areas or themes that we believe Ofgem should pursue with the DNOs as part of the negotiation of the final content of the plans.

Detailed comments

A key question we have is whether the high level narrative being presented by the DNOs, based largely around assumed base revenue, reflects the true costs consumers are likely to be exposed to over RIIO-ED1. We do not believe the revised plans do enough to explain how the various incentive schemes and uncertainty mechanisms could change what consumers

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[1] Source: 'Business Plan Highlights', UKPN. March 2014. http://library.ukpowernetworks.co.uk/library/en/RIIO/Main_Business_Plan_Documents_and_Annexes/UKPN_Overall_Executive_Summary.pdf
[2] Source: 'Energy Prices and Costs Report, 'European Commission, March 2014. http://tinyurl.com/nd32yku

see in their bills. For example, this lack of clarity can be seen in SPN's Business Plan where the chapter 'Our Revenues, Customer Bill Impacts & Value for Money', show a revenue profile from DCPR-5 to RIIO-ED1 comprising only of the base component. This is justified on the grounds that this is done to allow for comparability between price controls (which may be justified) but no attempt is made to explain the impact that adding other revenue streams might have on this picture.

Centrica has argued in earlier submissions on RIIO-ED1 that the DNOs have outperformed the return on equity measure set under DPCR-5 by a significant margin, with DNOs in five network regions achieving a real return on equity greater than 12 per cent for the first two years of the price control.[3] Although we understand the rationale for providing for out-performance, this is obviously well in excess of the allowed rate of 6.7 per cent and what could be considered an appropriate return on an investment as relatively risk free as an electricity distribution network. Importantly for this point about transparency, Centrica attributes this outperformance to the cumulative impact of incentive schemes, in particular the Information Quality Incentive (IQI). Although we are not in a position to assess the validity of these claims, they underline the need for DNOs to be upfront with their customers about the true costs that they will face.

We note that DNOs do discuss the extent to which returns may diverge from the base figure set by Ofgem taking into account upside and downside elements, including that linked to customer satisfaction. For example, Northern Powergrid (NPG) includes a chart in its business plan that shows potential returns on regulatory equity ranging between 0 per cent and almost 14 per cent centred on an 'expected return' of 6.3 per cent.[4] The supporting commentary describes this as being the range of 'plausible' returns. What would be more helpful would be for the DNO to go beyond this characterisation to provide a view of the probability distribution of this range of returns. This would help stakeholders understand, among other things, whether the likely returns concentrated at the upper end of this 0-14 per cent range.

We think it is critical that once it reaches a judgement about what is a fair financial settlement and signs off on the plans, Ofgem publicly reports on the actual financial performance of the DNOs against forecasts. This will allow it and stakeholders to understand the relative performance of the networks and whether the settlements are challenging or generous.

We are also disappointed that stakeholders' capacity to judge value for money continues to be hampered by the complexity and length of the business plans. Most plans are in excess of 1,000 pages – indeed we understand that a supplementary annex lodged by one DNO is itself more than 1,600 pages in length. But is not just the sheer volume of material, it is also the way it is presented, particularly how the various revenue streams available to the DNOs are quantified. An area where this complexity is particularly problematic is in relation to assessing the cumulative impact of the various incentive measures available to the DNOs under the RIIO-ED1 framework – an issue we have recently addressed as part of our

[3] Source: 'RIIO-ED1: Review of the DNOs Business Plans – Annex 4 Cost Efficiency and Expenditure', Centrica, August 2013. https://www.ofgem.gov.uk/ofgem-publications/82720/bgcepareport4costefficiencyriioed1businessplans01.07.13.pdf

[4] Source: Our Business Plan 2015-2023, Northern Powergrid, Ch. 3 'Financing' p 26. http://www.yourpowergridplan.com/som_download.cfm?t=media:documentmedia&i=1721&p=file

submission in response to the consultation on the Stakeholder Engagement Incentive Reward (SI).

Although the RIIO-ED1 Strategy Document states that the SI is an upside only reward, comprising a maximum 0.5 per cent of base revenue, it is not clear what this means in terms of pounds and pence – both at an aggregate level for the DNO and its impact on the average electricity bill. It is also difficult to understand how the SI interacts with other revenue streams. For example, consumers need to have confidence that a DNO that is performing poorly under the complaints element of the Broad Measure of Customer Satisfaction (BMCS) was not rewarded under the SI: logically the performance of these measures should be correlated.

We think there is merit in Ofgem producing a simple summary of the financial rewards available to each DNO, in either tabular or chart form, at an aggregate level and by revenue stream. In this way stakeholders could for example, identify the upper and lower bounds of reward available to DNOs under the Stakeholder Engagement Incentive element of the Broad Measure of Customer Satisfaction (BMCS). This should also be done as part of the annual reporting on the DNO's performance against their commitments throughout the RIIO-ED1 price control. We understand that Ofgem will review the specifics of what will be reported as part of a monitoring and evaluation piece. This should be completed ahead of the business plans being signed off so the 'rules of the road' are clear to the DNOs and other stakeholders.

The other factor that makes it difficult to make informed judgments about the plans is the lack of robust like-for-like data that would allow for comparison between UK and international network costs. This means we and other stakeholders have to rely, to a large extent, on a comparative assessment of the revised plans to make judgements about value for money. This lack of broader performance and costs benchmarks is a structural problem that limits scrutiny of the DNOs. There is an opportunity to go some way towards addressing this by assessing DNO's SI performance against broader benchmarks – an issue we discuss in more detail in our submission on the SI lodged on 7 May 2014.

While we welcome the reduction in the network component of bills that RIIO-ED1 appears to offer compared to the current price control DPCR-5, we think there needs to be a more transparent discussion of the extent to which this is a function of real efficiency gains, rather than merely a change in the accounting methodology to depreciate assets over a longer, 45 year, timescale. That is, today's consumers need to have a clear view of whether a fall in costs now is being secured by pushing costs to future consumers? To be clear we do not have an in-principle objection to aligning depreciation with the physical asset lives – this makes sense – but given the materiality of this accounting change for costs over RIIO-ED1, we think the DNOs should have highlighted it in the executive summaries of their plans. This omission is bad for transparency should be resolved ahead of RIIO-ED1 being finalised – preferably by making public the DNOs financial outputs normalised to disaggregate depreciation effects from underlying costs. Where relevant, DNOs should also make clear the justification for a phased approach to the adoption of the longer depreciation timescale, given the logic suggests consumers will benefit from one that better reflects the physical life of the asset.

Another aspect of the revised plans that seem to pose questions in terms of value for money for consumers is the significant gap that has opened up in the costs of equity being sought by the DNOs. We understand that there will be small differences in DNO's financial arrangements to reflect their particular circumstances, but how UKPN is able to live with a cost of equity of 6.0 per cent, while the position of NPG is that it requires 6.7 per cent, raises questions about the real drivers behind these settings. That most DNO's were able to cut their cost of equity from that they had proposed in their Fast-track submissions – without compromising on the delivery of outputs – suggests to us that there was significant fat in the plans and the appropriate number is closer to, if not lower than, the 6.0 per cent benchmark Ofgem set out in its Equity Market Returns Decision Letter. We understand that these differences can in part be explained by levels of ambition in cost and output targets. So while UKPN has proposed the lowest cost of equity, it has not responded to Ofgem's call in the Fast-track Assessment to cut totex by 14.3 per cent, proposing instead to do so by only 1.9 per cent.

Ofgem will presumably consider each plan as a package as part of its assessment, including whether DNOs balance between equity and costs is appropriate. What we request is that the rational for the decision is consistent, and communicated to stakeholders in an accessible way. As we move closer to RIIO-ED1 being finalised, we also think it is critical that attention turns to delivery and accountability. Given uncertainty is a defining feature of RIIO-ED1 in terms of the flexibility DNOs are being given to develop innovative responses to technological and social issues, Ofgem must ensure it is in a position to ensure DNOs deliver on the commitments in their plans. This means making sure that commitments are as specific, measurable, assignable, realistic and time-related – or 'SMART'– as possible and reasonable. It also means putting in place a robust monitoring and evaluation arrangements that can operate from day one of RIIO-ED1. This must include consolidated and accessible annual reporting of DNO performance against key performance metrics. These reports must detail comparative performance to the extent feasible to intensify the competitive tension between DNOs that has been stoked by the Fast-track process.

There is a risk that this accountability agenda could be undermined as a result of there being a number of reviews and policy processes either underway or planned that will inform the final shape of the RIIO-ED1 settlement. For example on:

- the governance regime for the Stakeholder Engagement Incentive;
- the Guaranteed Standards of Performance in relation to Severe Weather;
- the Priority Service Register (PSR); and
- DNO performance during the Christmas 2013 storms.

It is critical that Ofgem clarifies how the outcomes of these pieces of work will be drawn together and incorporated into RIIO-ED1. If for example, the Ofgem investigation into UKPN and Scottish and Southern Energy (SSE) finds systemic issues with their storm preparedness then it may be appropriate to re-examine aspects of their plans. At the very least we would expect to see an account of the lessons learned and the actions taken as a result of this experience in the revised business plans – particularly when unsuccessful call rates approached 30 per cent for some DNOs in relation to outages associated with the storms. It would also seem appropriate that the broader work that NPG and WPD are leading on to improve the information that DNOs hold on their customers, including in relation to vulnerability, is reflected in the business plans.

The revised plans also need to consider how the developments in Europe may affect the shape and implementation of their plans. It is particularly important that Ofgem ensures the plans will position the United Kingdom to comply with the terms of the EU Energy Efficiency Directive. This Directive, among other things, underscores the need for DNOs to pursue demand side measures (DSM), through for example district heating projects, to defer unnecessary investment in network reinforcement and support customers who may be at risk of fuel poverty.

Finally, we have seen DNOs improve the quality of their stakeholder engagement for the development of their business plans. We see the revised business plans that are now under consideration as a test of the strength of these processes. Where DNOs have adjusted their priorities, Ofgem should look for evidence that the DNOs sought feedback from their stakeholders as part of doing so. This should take the form of records of meaningful engagement with stakeholders on their willingness to pay and comparative priorities.

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

Yours sincerely

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