

# RIIO-T1 and GD1 Mid-Period Review

Citizens Advice formal response

If you have any questions about this consultation response, please contact Morgan Wild on 03000 231295.



# Consultation Response

## General comments

Citizens Advice welcomes the opportunity to offer views on the desirability of mid-period reviews for the gas distribution, electricity transmission and gas transmission price controls. At £300 a year for the average consumer, network costs represent the second costliest component of the average consumer's bill (after wholesale costs). Interrogating networks' performance and justification for this level of charge, therefore, is a crucial part of our statutory role in representing energy consumers.

Distribution and transmission networks are fundamentally low-risk assets. The average return on investment for network companies in T1 and GD1 is forecast to be 9.4% over the course of the price control - well in excess of what appears appropriate for such low-risk investment as well as exceeding, for all companies, Ofgem's baseline rate of return. Ofgem forecasts that 4 out of 8 gas distribution networks' eight year return on regulatory equity (RORE) will exceed 10%, supposedly the level of return reserved only for "exceptional performance". For both transmission and distribution networks, the era of extraordinary returns for run-of-the-mill performance must come to an end. Our comments here are made through that prism.

The Mid Period Review (MPR) presents an opportunity to identify the root causes of outperformance, for both transmission and gas distribution. If outperformance has followed from real efforts by network companies to deliver outputs more efficiently, then that is one thing. However, if the level of outperformance follows from lax performance targets, or a failure to deliver the outputs promised in the settlements, then that is quite another.

We therefore welcome your intention to hold a mid-period review for electricity and gas transmission. However, gas distribution - at approximately £137 on average a year - forms the single largest part of consumers' network bill and consumers will be mystified as to why Ofgem are not taking this opportunity to investigate the gas distribution price control. We strongly encourage Ofgem to undertake a **mid-period review of RIIO-GD1** alongside the RIIO-T1 mid-period review. In the section '**Case for a mid period review of RIIO-GD1**' we lay out the case for such a review.

RIIO has been a significant step forward from the previous RPI-X price control model. However, RIIO is still maturing as a regulatory framework. Its approach will need to be built upon and improved for the next price control period. Alongside the mid-period reviews, we propose that Ofgem **conduct a bottom-up analysis of how RIIO-T1 and RIIO-GD1 has functioned to date and identify where there are opportunities to deliver better value for consumers**, both in the current

price control period as well as forming a key evidential base for the design of subsequent regulatory periods. In the section **'How RIIO has functioned: opportunities for learning'** we reiterate some of our suggested modifications from our recent report *'Many happy returns'*, where we believe specific changes to Ofgem's methodology would have delivered better value for consumers.

Our comments here are made in the spirit of constructive support and criticism. We recognise the very finely balanced judgements that Ofgem has had to make in designing RIIO. Given future conditions are always uncertain, it is inevitable that some of these judgements will need revisiting. We believe that the mid-period reviews offer an opportunity for Ofgem, the networks and stakeholders to reflect on what alterations can be made to achieve better outcomes for consumers, either through adjustments to the current price controls, or by highlighting areas for improvement in the second period of RIIO.

Finally, we appreciate the opportunity to offer early views on whether mid-period reviews should take place for RIIO-T1 and RIIO-GD1, in advance of Ofgem forming its position. However, it would have been useful to view the second set of annual reports for RIIO in advance of making these comments, particularly as the two year lag on incentive revenue makes it difficult to assess how they have complied with and been rewarded for output delivery.

### Case for a mid-period review for RIIO-GD1

In line with our reasoning above, we believe that a mid-period review for GD1 should comprehensively analyse if network companies are delivering outputs effectively and whether rewards are appropriate, rather than pick and choose specific outputs to consider. However, we also have specific comments to make.

As outlined above, we see the exceptional financial returns being enjoyed by gas distribution companies as a reason to conduct a mid-period review for RIIO-GD1. Your analysis presented in the [RIIO-GD1 Annual Report 2013-14](#) indicates that much of this return is not rewarding actions taken by the networks themselves. In section 5.9, Ofgem suggests that roughly £840 million of GDNs' outperformance relates to factors that the companies have no control over - namely, real prices being lower than those used in setting the price controls, the slower recovery of the economy leading to a reduced workload in connecting new consumers and (in the first year) a relatively mild winter reducing the adverse effects of cold weather on network assets.

We are mindful of your definition of a mid-period review as covering only 'material changes to outputs that can be justified by clear changes in government policy and the introduction of new outputs that are required to meet the needs of consumers and other network users'. You note (paragraph 1.12 of the consultation document) that there is no difference between introducing new outputs and altering existing ones. If outputs are not meeting 'the needs of consumers and other network users',

then we would argue that Ofgem is within its rights to alter the definition of those outputs.

As part of a mid-period review, we therefore recommend that Ofgem revisit the role that the specification or interpretation of the outputs might be playing in delivering what appears to be a major, and potentially unearned, financial windfall for the networks. This review should extend beyond the relatively brief assessment of the four primary outputs you report in the consultation document, to the in-depth and public study of all the relevant outputs stakeholders need to make an informed assessment about the settings in the price control and whether they should be adjusted. This seems to be a sensible 'no-regrets' piece of work.

Moreover, there is a paradox in the decision whether or not to proceed with a mid-term review. Without more detailed information than currently is in the public domain, it is not possible to judge whether the causes of companies' outperformance can be explained, in full or in part, by changes to government policy; nor whether the outputs are adequately meeting consumer need. Yet apparently, without a decision to proceed with a mid-period review, more detailed information will not be published.

A mid-period review for GD1 could have further value, as it will likely be the last major source of new information to be revealed before work begins devising the GD2 price control. Information flushed out during a GD1 MPR could be valuable - even if it does not lead to changes to the GD1 settlement - if it enables Ofgem to agree a more consumer-friendly settlement in GD2.

Finally, we welcome your analysis on asset health and risk and agree that - absent high quality, robust data from the gas distribution network companies - no additional spend should be allowed on maintaining operational performance in relation to the secondary deliverable of asset health and risk. Given the levels of outperformance that gas distribution networks have already achieved, we would be extremely sceptical that any additional expenditure would be in consumers' interests.

### Mid-period review for RIIO-T1

Our view for electricity and gas transmission is similar to our analysis of gas distribution - we are not convinced that the level of outperformance in RIIO-T1 is justified and we expect Ofgem to conduct a thorough analysis of output delivery and the appropriateness of rewards to network companies.

We agree that there are also specific issues in electricity and gas transmission that could be addressed by a mid-period review. There are several areas that you have identified where we welcome your proposals. In particular:

- Competitive tenders for new and high value onshore transmission assets would likely be in consumers' interests - though we suggest reviewing this initially to ensure that it is not adding unnecessary layers of bureaucracy.
- Extending the review of needs cases for Strategic Wider Works projects to align with the process for Incremental Wider Works is sensible.
- In principle, we support the introduction of an availability incentive for Scottish Islands to ensure reliable connections, subject to bill impact modelling and the evidence for need that you receive in response to this consultation.
- We support the aim of achieving the 1-in-20 obligation in Scotland and look forward to the results of your review regarding how NGGT is meeting this output.

We also welcome your investigation into whether there has been a material change in outputs due to changes in government policy relating to renewable subsidies. Some outputs - such as those related to making new connections - may well be addressed by revenue drivers. However, if we expect that the total proportion of our energy made up from renewables will decrease as a result of government policy, then it may have an impact on outputs not addressed by revenue drivers. This could include less need to manage intermittency and simpler strategies for balancing load and managing congestion. We would like reassurance from Ofgem that these impacts will also be looked at and monitored on an ongoing basis.

The jury is still out on whether stakeholder engagement incentives are driving real improvements in performance. In assessing stakeholder engagement performance, we believe that Ofgem should be looking not just at the level of stakeholder engagement but the extent to which stakeholders are *embedded* in the decision-making process. Stakeholder engagement should not be a tickbox exercise - it should be a way of involving stakeholders in all the major decisions that networks make.

### How RIIO has functioned: opportunities for learning

As outlined above, we believe that the mid-period reviews should be complemented by a wider analysis of how RIIO has functioned so far, identifying ways in which consumer value can be delivered for this and future price controls. RIIO GD2 and T2 will need to be designed before the full eight years of T1 and GD1 have been concluded. Any adaptations that come in the second round of RIIO controls will inevitably have to be decided on the basis of less than a full 8-year term's data. We have a number of initial observations and suggestions regarding how the RIIO framework could be improved.

Ofgem should avoid rewarding companies for positive outcomes that do not follow from industrious or innovative behaviour. We have identified specific examples of this above for consideration within the GD1 mid-period review. In general, our view is that wider use of benchmarking and automatic uncertainty mechanisms can be

crucial tools in avoiding this. Where possible, calculations of allowed revenue should be benchmarked to reflect actual market conditions rather than inevitably imperfect forecasts of these conditions. There are several opportunities where benchmarking would, in recent years, have reduced the costs to consumers.

As a regulator, Ofgem has been innovative in benchmarking the cost of debt to real world corollaries in its calculation of the Weighted Average Cost of Capital (WACC). This indexation should be extended to the risk-free rate. Now that network companies have had the opportunity to get used to indexation, Ofgem should also shorten the time encompassed by its cost of debt index to a period of around five years, to more accurately match market prices. Our analysis in *'Many happy returns'* demonstrates that these combined alterations to the calculation of WACC would have delivered better value for consumers without deleteriously affecting network companies' incentives.

Ofgem should also revisit indexing real price effects (RPE). We understand from your [most recent deliberations](#) on the issue that Ofgem did not see a strong case for introducing RPE indexation at the late stage of the design of the ED1. We appreciate the difficulties in designing an adequate RPE indexation, particularly if network companies can influence the price for certain goods. However, we believe this judgment must be revisited, particularly in light of the *ex ante* forecast for GD1 being wrong to the tune of £600 million in network companies' favour.

In other consultation responses, and in our report *'Beginning to see the light'*, we showed why there needs to be greater transparency in reporting on networks' performance. We welcome Ofgem's recent decision to require electricity distribution networks to publish meaningful summaries of key performance data as part of their RIIO reporting obligations, and look forward to working with Ofgem to extend this requirement to electricity transmission, gas transmission and gas distribution.