

Key questions for RIIO-T2 and GD2

MENU REGULATION AND LESSONS FROM RORE



This is part of a series of discussion notes that are relevant for the next RIIO price controls.

The 'IQI' menu is a core element of Ofgem's incentive-based approach to regulation. But network companies have outperformed their totex allowances – is this because the IQI is not causing them to reveal their true efficient costs as expected? If so why and what can be done to improve the incentives to reveal efficient costs?

CONTEXT

One of the biggest challenges in regulation is how to overcome the information asymmetry between the regulated companies and the regulator so that consumers only pay for efficient costs. Over the past decade, menu regulation has emerged as Ofgem's (and Ofwat's) preferred approach to address the information asymmetry with regard to companies' expenditure plans.

Ofgem's menu is called the Information Quality Incentive (IQI). It was first introduced for the electricity distribution price control of 2005-10 (DPCR4) when it was known as the 'sliding scale incentive' and only applied to capex. In subsequent price controls the mechanism has been refined and its application has extended, first to include opex and later to apply to totex.

"The IQI is used to set the strength of the upfront efficiency incentives each company faces according to differences between its forecast and [Ofgem's] assessment of its (efficient) expenditure requirements. [...] The IQI will provide:

- an additional financial motivation for companies to spend the time and resources necessary to produce high-quality and well-justified business plans; and
- a financial deterrent against the submission of inflated expenditure forecasts."

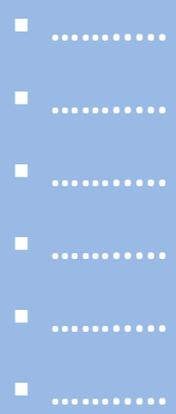
Ofgem, RIIO handbook (2010)

The IQI is conceptually simple but mathematically complex and requires careful calibration, including how Ofgem's view of efficient costs is set, in order to achieve the desired outcome. It consists of three interlinked elements:

- a ratio of the company's proposed expenditure to Ofgem's view of efficient costs;
- a sharing factor for over/under-spend that is a function of the above ratio; and
- a financial reward or penalty that is a function of the above ratio.

The combination of the above factors results in a matrix of expected outcomes for the company. When the IQI is calibrated appropriately, and companies respond in an economically "rational" (i.e. profit-maximising) way, the best outcome for the company is always to propose efficient expenditure and not to inflate its proposal.

Ofgem's use of the IQI in RIIO-ED1 had lower expected outcomes for the companies across most of the menu compared to the RIIO-GD1 menu. This was coupled with stronger incentives for companies to propose efficient expenditure (or greater penalties for inflating their proposals).





WHAT DOES IT MEAN FOR RIIO-T2 AND GD2?

One of the consequences of having a tougher baseline and reward structure in the IQI menu in RIIO-ED1 is that slow-track companies would have been identified as inefficient and penalised accordingly. Between its draft and final decisions, Ofgem decided to adjust the IQI so that some slow-track companies would earn a reward. British Gas appealed that change to the Competition and Markets Authority (CMA), arguing that it would result in consumers paying more. But the CMA rejected the appeal, arguing that Ofgem acted in line with its overall strategy.

The CMA’s decision seems to undermine the purpose of the IQI as a “one shot opportunity” for the companies to reveal their efficient costs. If network companies assume that Ofgem will retrospectively adjust the IQI in their favour if all of them were to propose costs judged to be inefficient, what is the incentive for them to bid truthfully in the first place?

At the same time, Ofgem’s return on regulatory equity (RoRE) metric shows that, after the first three years of RIIO-T1 and GD1, all network companies are forecasting returns above Ofgem’s baseline. The main source of outperformance is underspend on totex. While outperformance can be in consumers’ interest, the IQI aims to reduce underspend by incentivising companies to reveal efficient costs in their forecasts.

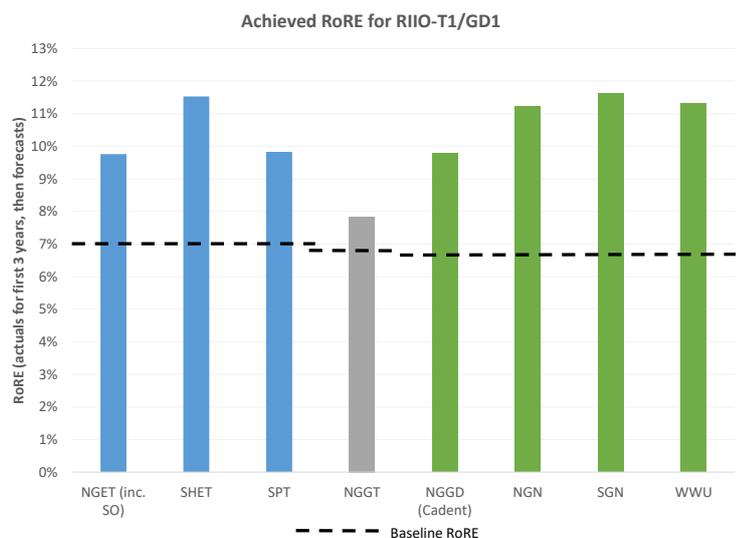
WHAT ROLE FOR BEHAVIOURAL ECONOMICS?

We tend to think of behavioural economics as mainly applying to the way individuals make decisions, but it can be similarly applied to companies. Menu regulation is based on the assumptions that regulated companies:

- seek to maximise profits (or returns), rather than achieve a satisfactory level;
- weigh upside and downside risks equally; and
- use a knowable discount rate to consider trade-offs between the short- and long-term.

Ofgem is likely to clamp down on allowed costs in RIIO-T2 and GD2, but what should be the role of the IQI in getting there? It is difficult to say what the companies would have proposed, and Ofgem allowed, in the absence of the IQI. At the same time, it is reasonable to question whether menu regulation has achieved its aim after a decade of use. If it has not, are there changes that can be made to improve the IQI or does an entirely different approach need to be developed?

Perhaps a bigger game-changer is fast-track. Network companies and investors (as well as politicians!) have taken note of the favourable deals earned by the fast-tracked companies in the first set of RIIO controls. The competition to be fast-tracked at RIIO-T2 and GD2 is likely to be fierce, and with it the incentive to propose lower costs than others.



These assumptions may not hold true for some, or even all, regulated companies. *Loss aversion* can lead a company to respond to regulatory incentives in a way that favours minimising the downside risk over maximising returns. Similarly, *present bias* can exacerbate preferences for short-term wins over longer-term optimisation.

A prudent regulator should reconsider its approach to incentives, and primarily to menu regulation, in light of these perspectives.



EFFECT ON DIFFERENT INDUSTRY PLAYERS

Network companies
<ul style="list-style-type: none"> • Direct impact on network companies’ allowed revenue and on their ability to recover operating and capital costs • Calibration of the menu can determine the reward (and risk) of being fast-tracked
Suppliers
<ul style="list-style-type: none"> • Potential impact on energy prices and, consequently, public pressure on suppliers
Ofgem
<ul style="list-style-type: none"> • Interactions with the RoRE range and with the financeability implications of companies overspending • Potential impact on energy prices and, consequently, public/political pressure on Ofgem

Consumers
<ul style="list-style-type: none"> • Consumers will need to have confidence that above-baseline returns by network companies reflect service improvements, and that they are not overpaying for network services

KEY QUESTIONS

1. Should Ofgem continue to use the IQI and, if so, how should Ofgem calibrate its parameters for RIIO-T2 and GD2?
2. How should companies approach their business plans in light of changes to the IQI?
3. How can insights from behavioural economics be used to inform menu regulation?

CONTACT US

		<p>Ian is a regulatory economist with over 25 years’ experience of supporting regulators and companies in price control reviews. He is an expert in designing regulatory regimes and incentives, having worked extensively on these matters in the UK and internationally.</p> <p style="text-align: right;">Ian.Alexander@cepa.co.uk</p>
 <p>Ian Alexander Director</p>	 <p>Ben Shafran Managing Consultant</p>	<p>Ben is an experienced regulatory economist and manager. He has played a key role in the development and implementation of regulatory approaches, including the RIIO framework, that set the benchmark for innovation and transparency while balancing the interests of consumers and investors.</p> <p style="text-align: right;">Ben.Shafran@cepa.co.uk</p>

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