

## Key questions for RIIO-T2 and GD2

### OUTPUTS AND PERFORMANCE INCENTIVES FOR RIIO-GD2



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

Outputs are a central part of Ofgem’s regulatory framework for the gas distribution sector under RIIO. At RIIO-GD1, Ofgem implemented incentives that aim to encourage efficient delivery of a range of outputs. Some incentives include rewards or penalties beyond gas distribution networks’ (GDNs) base revenue allowance. We expect Ofgem to retain an outputs delivery framework at RIIO-GD2, with the potential for outstanding performance to achieve double-digit investor returns. However, as at any price review, we also expect Ofgem to: (i) review the performance of the current RIIO-GD1 outputs framework; (ii) consider whether new outputs or incentives are needed; and (iii) re-assess the level of performance expected from GDNs in RIIO-GD2 and the rewards/penalties attached to output delivery.

#### CONTEXT

The introduction of the RIIO framework saw Ofgem place greater emphasis on company outputs in setting the regulatory package for energy networks:

*“by defining the outputs companies need to deliver (eg risk-removed), instead of prescribing a set of inputs (eg length of mains abandoned), the framework provides incentives for companies to innovate and deliver services that customers require at least cost. An outputs based framework also provides greater transparency for customers (as well as companies) in relation to the services companies need to deliver.”*

- Ofgem, RIIO-GD1 Final Proposals

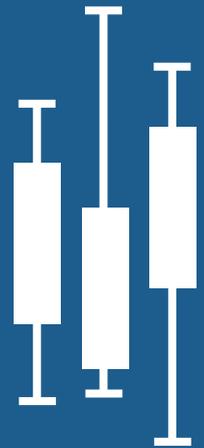
Ofgem defined six output categories for RIIO-GD1: **safety, reliability, customer service, environment, social obligations** and **connections**. Each of these categories has primary outputs and secondary deliverables for each GDN. Financial and/or reputational incentive mechanisms are in place to support the delivery of these outputs over the eight-year price control. For example:

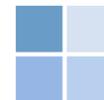
- GDNs are expected to improve gas transport losses from the network and reduce their business carbon footprint. This has been incentivised in RIIO-GD1 through a shrinkage allowance incentive and environmental emissions incentive.
- The national transmission system (NTS) exit capacity incentive encourages GDNs to minimise the cost of NTS exit capacity bookings, whilst still providing sufficient capacity for each GDN to meet its 1-in-20 peak demand output.
- The GDNs are financially incentivised to improve customer service with penalties and rewards linked to company performance on customer surveys and compliant metrics.

The table on the next page summarises the principal outputs and associated incentive mechanisms in RIIO-GD1. The impact on GDNs of some of the financial incentives will depend on the conclusions of Ofgem’s outputs performance review at the end of RIIO-GD1.

All GDNs are forecasting that they will outperform baseline targets on several key incentive schemes over the eight years of RIIO-GD1, with a resulting increase in returns earned.

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### Principal outputs and incentive mechanisms in RIIO-GD1

Policy area	Principal outputs and secondary deliverables	Incentive mechanism
Environment (broad)	Report on percentage of biomethane capacity connected. New connection standards and information on biomethane connections. Separate process to consider connection boundary and charging arrangements for biomethane.	Reputational incentive related to biomethane connections. Discretionary reward scheme (DRS) of up to £12 million for companies that deliver environmental outputs not funded at the price control review.
Environment (narrow)	15-20% reduction in gas transport losses. Reductions in business carbon footprint, and other emissions and resource use.	Strengthened shrinkage allowance incentive and environmental emissions incentive, including rolling incentive mechanism.
Customer service	Broad measure of customer service, comprising customer satisfaction survey, complaints metric, and discretionary reward for stakeholder engagement.	Financial incentive of +/-1% of allowed revenue.
Social obligations	Connecting up to 80,000 fuel-poor households. Increased carbon monoxide (CO) public awareness.	Fuel poor connections reviewed at the end of period; penalty for under-delivery. Comparative assessment of CO awareness; reward through stakeholder engagement. DRS for companies delivering outputs in relation to social objectives not funded at review.
Customer connections	Maintain current guaranteed standards. New connection standards of service for distributed gas entry customers during RIIO-GD1.	Penalty payments through guaranteed standards of performance.
Safety	40-60% reduction in safety risk. Compliance with statutory health and safety requirements.	Safety risk: review of output performance at end of RIIO-GD1, and requirement to carry-over under-delivery to RIIO-GD2. Statutory enforcement.
Reliability	Expected number and duration of interruptions. Asset health/risk scores. Achieving 1-in-20 capacity obligation – asset load/capacity utilisation. Maintaining operational performance.	Asset health/risk/load: review of output performance at end of RIIO-GD1, and requirement to carry-over under-delivery to RIIO-GD2. NTS exit capacity incentive.

Source: CEPA adapted from Ofgem

## KEY ISSUES FOR RIIO-GD2

The current output categories are central to the good performance of a gas distribution business, so we expect Ofgem to retain them for RIIO-GD2. However, the framework will need to evolve in light of the changing business and stakeholder environment in the gas sector. In doing so, Ofgem, GDNs and other stakeholders will need to consider the following key issues:

- Whether to introduce new schemes to deal with new industry/business challenges?
- What financial value should be attached to both existing and new output schemes? How will this decision be taken in the overall context of setting the RIIO-GD2 price controls?
- What is the role of Ofgem, GDNs and other

stakeholders in identifying and developing existing and/or new outputs and incentive schemes for RIIO-GD2?

More specifically, we consider that the key focus areas for RIIO-GD2 should be:

- Can GDNs be encouraged to play a greater role in supporting a low carbon economy – e.g. connection of renewable gas and Compressed Natural Gas (CNG) infrastructure for transport? The regulatory treatment and roll-out of CNG infrastructure is an issue in a number of other jurisdictions.
- Could new and innovative uses and planning approaches of the gas network be incentivised through a future outputs framework e.g.



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development of hydrogen networks, ‘multi-vector’ interactions between gas and electricity, and greater integration of planning at the transmission and distribution levels?

- What are the future expectations from GDNs in terms of customer service improvements, stakeholder engagement, connections and social obligations? Are there new initiatives GDNs should be incentivised to focus on during the next control period?

Ofgem and the GDNs have been developing a Network Output Measures (NOMs) scheme. The scheme will allow monetisation of risk removed from the network, and provide GDNs with greater flexibility to balance asset health and risk between asset classes. The NOMs scheme builds on the scheme that applies to electricity distribution. As such, it will need to be calibrated to address the specific challenges, investment programmes and context of the gas distribution sector. It will also need to build on the experience from electricity distribution, particularly the difficulties of the DPCR5 close-out.

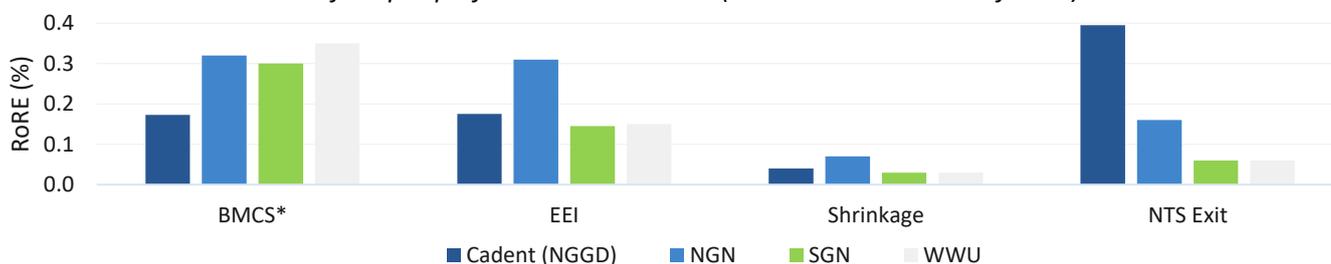
### ACHIEVING THE RIGHT BALANCE OF RISK AND REWARD

A key issue for all stakeholders will be the financial value that is attached to the outputs and incentives adopted at RIIO-GD2. Ofgem will be acutely aware that all four GDN groups are forecasting to achieve returns on regulatory equity (RoRE) above its baseline.

Positive GDN returns should, in principle, be perceived by Ofgem, customers and other stakeholders as positive, provided that the improvements in performance against targets are valued by customers

at similar levels to the financial rewards on offer. But the experience of RIIO-GD1, public and political pressure on utility bills, and several possible pathways for the gas sector, place the onus on Ofgem and the GDNs to demonstrate the value of service improvements proposed for RIIO-GD2. This could be through cost-benefit assessments, customer willingness to pay surveys, and earlier engagement with consumers to inform incentive design.

Forecast RoRE under subset of output performance incentives (above baseline RoRE of 6.7%)



Source: CEPA adapted from Ofgem RIIO-GD1 Annual Report 2014-15. Average company RoRE is presented for groups with multiple GDNs.

\* Broad measure of customer satisfaction

Ofgem has, in the past, considered the incentive framework and RoRE ranges “in the round”, and has stated that double-digit returns should potentially be available to good or outstanding performing network companies. So the calibration of rewards and penalties on outputs incentives will need to be cognizant of expectations of the scope for under/out-performance in other elements of the controls (e.g. totex).

For example, if network utilisation is expected to decline over the medium/long-term there will be less opportunity for GDNs to achieve additional returns by outperforming totex allowances. Instead, emphasis would need to shift to GDNs facilitating the efficient use of existing gas network infrastructure, with greater financial value attached to delivery of the outputs framework of future controls.

### STAKEHOLDER INVOLVEMENT IN THE EVOLUTION OF THE OUTPUTS FRAMEWORK

A successful price review should involve a debate amongst a range of stakeholders within the industry rather than being a purely bilateral engagement between the regulator and the regulated company.

This has been another key principle of the RIIO framework. In the specific context of the outputs framework, there is a question of how the forthcoming price review can best facilitate the development of the

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existing regime. Should the emphasis be on Ofgem (as part of its initial strategy consultations) to identify themes and priorities for new output categories and incentives, or should it be on the GDNs to identify opportunities (informed by stakeholder views) as part of their business plans?

Clearly all stakeholders will need to be involved in the process in some form or other, but it may be sensible for Ofgem to emphasise the benefits of the GDNs and

other stakeholders within the industry working together to identify opportunities to enhance the RIIO-GD2 outputs framework. An innovation that Ofwat introduced at PR14 was the opportunity for companies to submit their own incentive proposals, tailored to the needs and feedback from their individual customer base. We note that this approach introduces its own set of challenges in terms of comparability across companies and the resourced required from the regulator to assess each output target/incentive.

## EFFECT ON DIFFERENT INDUSTRY PLAYERS

<b>Network companies</b>
<ul style="list-style-type: none"><li>• Impact on the balance of risk and reward in the price control</li><li>• Business emphasis and focus during RIIO-GD2</li><li>• Management of industry change and new pathways</li></ul>
<b>Suppliers</b>
<ul style="list-style-type: none"><li>• Willingness to pay, value of output delivery and performance improvement</li><li>• Role in establishing new industry outputs</li></ul>
<b>Ofgem</b>
<ul style="list-style-type: none"><li>• Role of existing and new outputs in the evolving gas sector</li><li>• Calibration of the price control incentive framework</li><li>• Customer willingness to pay, value from ongoing output delivery and performance improvement</li></ul>

<b>Consumers</b>
<ul style="list-style-type: none"><li>• Important for consumers (or their representatives) to engage in the regulatory process from the outset so that the outputs/incentives framework reflects what they value</li></ul>

## KEY QUESTIONS

1. How should the outputs and incentive framework evolve in the next price control? What new outputs should the GDNs be encouraged to deliver?
2. What financial value should be attached to individual incentives and the overall outputs framework in RIIO-GD2?
3. Should GDNs (and other stakeholders) be able to propose new incentives, similar to the approach Ofwat took at PR14?

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