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RIIO-T2: Real Price Effects

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Scottish Hydro Electric Transmission plc

RIIO-2 Policy Paper

Real Price Effects

Purpose

This paper summarises our policy position for Real Price Effects (RPEs) policy for RIIO-2. It has been prepared following research and analysis of the RPE policy options and their respective merits. We have also undertaken a review of RPEs for our Business Plan with Oxera who have reviewed input prices and our cost structures considering historical and forecasted indices and expenditure[1].

Executive Summary

RPEs is a regulatory mechanism that has been utilised in previous price controls to provide additional totex allowances to cover expenditure that is expected to escalate by more than inflation (RPI for RIIO-1 and previous price controls). This was based on analysis of certain labour, plant and material indices for input prices based on historical analysis and forecasts. These indices then created a ratio for escalating costs for each cost category based on the mixture of costs between labour, plant and materials. In RIIO-T1 RPE totex allowances were included as ex-ante (up-front) fixed allowances as well as for specific uncertainty mechanisms[2]. For RIIO-ED1, Ofgem consulted on changing to an indexation approach for RPEs based on a basket of indices. Ofgem concluded[3] for several reasons that this was not appropriate for RIIO-ED1 but has been considering this as a policy for RIIO-2 as part of its Framework Decision[4] and Sector Specific Decision Methodology (SSDM)[5].

Our assessment of RPE policy options is based on considering the merits of ex-ante funding versus indexation mechanisms for RPEs and also the application of indices on the future outlook for RIIO-T2. In doing so we have considered different factors in determine what is the most appropriate mechanism including:

1. Impact on incentives including cost reflectivity
2. Volatility to network allowances
3. Impact on current and future customers
4. Regulatory complexity

In considering these elements, as set out in this policy paper, and external analysis undertaken on input indices for labour, plant and materials, we believe RPEs should only be considered for labour costs[6]. This is based on the underlying cost base and incentive properties while also reflecting wider macroeconomic impacts. We have considered the merits of ex-ante funding compared to indexation

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[1] Oxera, November 2019, *SHE Transmission's Cost Assessment*

[2] An RPE allowance was also derived and allowed for Generation Connections Volume Driver related allowances as set out in our Licence for RIIO-T1.

[3] Ofgem, *Reasons for our decision on the treatment of real price effects for RIIO-ED1 slow track electricity distribution network operators,* sets out the factors considered before concluding that there is significant risk of unintended consequences due to the challenges of designing and index, and the impact on incentives and costs for network operators and consumers.

[4] Ofgem, July 2018, Framework Decision

[5] Ofgem, May 2019, RIIO-2 SSMD – Electricity Transmission, Para 5.13, Page 106

[6] Oxera, November 2019, *SHE Transmission's Cost Assessment*

of labour RPE allowances and believe it creates uncertainty and a moving target for Networks. We do not therefore believe this is appropriate similar to Ofgem assessment in RIIO-ED1.

We have set out why we believe RPEs should be zero for certain cost categories in conjunction with our assessment of labour RPE allowances set on an ex-ante basis.

Background

RPEs exist where network operators incur costs which may not rise in line with the inflation metric set for the price control period. Examples of such costs are labour, plant, material and construction costs.

Ofgem have previously allowed for expenditure for *expected* differences between the price control inflation (RPI for RIIO-1 and previous price controls) and specific input prices based on a range of indices. For RIIO-2, the Consumer Price Index (CPIH) is the Ofgem proposed inflation index for the period. Where network operator costs are expected to move inconsistently with CPIH, an RPE allowance can be proposed and may be justified if costs are more closely linked to RPI or greater than RPI given the *historical and expected wedge* between RPI and CPIH inflation measures. Such an allowance aims to protect operators against deviations in cost inflation compared to CPIH.

RPE Options

Ofgem's Sector Specific Methodology Decision (SSMD) set out the current options for RPEs as follows:

- Option 1 – forecast RPEs as zero, effectively assuming that input price inflation is the same as general inflation
- Option 2 – fix a forecast of RPEs for the duration of the price control, using the same broad approach as for RIIO-1
- Option 3 – annually update RPE forecasts with the latest available input price data, assuming an annual mechanism for the updating of RPE allowances

We have considered these options in turn and will be proposing appropriate funding allowances or treatment of costs for RPEs in our Business Plan.

With regards to RPE indexation, Ofgem has proposed the following methodology:

- Include a forecast of RPEs in upfront allowances
- Annually true up the difference between RPE forecasts and upfront allowances for RPEs
- Set RPEs on a notional cost structure basis

The intent is to consult further on RPEs before making a final decision and we anticipate that this will be undertaken as part of the review of RPEs from final business plan submissions.

Our Preferred Option

<u>Factors to consider</u>

When setting RPEs, justifying the need for such allowances is important. There should be consideration given to whether the underlying cost base will move in a materially different way to the inflation metric agreed for the price control period.

There are two differing options on index selection:

A. Indices which closely reflect the underlying cost base

B. Indices which do not closely reflect the underlying cost base

For Option A, closely reflecting indices represent the characteristics of a pass-through mechanism and therefore may dampen the totex incentive mechanism for operators. For Option B, the nature is more uncontrollable and therefore, in the short to medium term, there would be a risk of material gains or losses for operators and customers. In the long term, operators would need to implement a change in their underlying cost base to mirror the indices selected in order to help control the risk. This would carry transaction costs and would likely take several years to transition to while in the meantime exposing operators and customers to uncontrollable risks.

Use of Indexation

We do not believe that indexation of RPEs is appropriate for RIIO-2. The increase in the volatility of input price indices implies annual indexation would lead to uncertainty in network charges. Indexation is not appropriate due to the following factors:

- risk exposure – due to volatility of underlying indices
- impact on incentives - indexation of RPEs may undermine cost-efficiency incentives
- predictability of network charges - indexation could lead to volatility in charges for customers in line with volatility in indices
- complexity – the annual mechanism does not appear simple to understand

When reviewing forecast and outturn indices, and considering averages and indexation lengths, it would be highly speculative to implement indexation of RPEs. It is difficult to see that indexation would be in the best interest of consumers and allocates risk appropriately.

In relation to materials and plant specifically, due to the uncertainty of input prices in terms of import tariffs, duty and supply chain costs resulting from the UK's exit from the EU, an uncertainty mechanism to would be more appropriate in this area.

When considering the factors and appropriateness outlined above, we do not believe that indexation of RPEs should be implemented in RIIO-2. The selection and volatility of indices will be a determining factor in managing in year changes. We also believe that indexation of RPEs would be distortionary on incentives, misallocate the risk between company and consumers and are likely to lead to cost increases.

We note that a similar approach to that taken by Ofwat in PR19 would be appropriate, whereby Ofwat did not allow for any RPEs upfront but instead asked companies to provide evidence on input price inflation. We would welcome a similar approach, allowing companies to submit proposals for RPE allowances for individual cost categories.

External Review of policy and proposals

We have undertaken an assessment of the options for RPEs with Oxera[7] and have set out where we believe the high threshold for justifying an ex-ante RPE allowance is merited in our Business Plan. The process has allowed us to conclude that RPEs would most likely impact on labour costs. There is likely to be some form of impact but this is both less predictable and controllable and likely to lead to unintended consequences similar to an indexation approach of RPEs.

We therefore believe that the cost certainty on RPEs for labour costs should be included in our RIIO-T2 allowances[8]. Oxera note that labour costs comprise 38% of our overall cost structure and when considering a range of input prices as well as the tightening labour market. They identify that on this basis there is likely to be real wage increase of 1.1-1.3% per annum above CPIH compared to OBR raising its estimate for average earnings growth from 2018 to 3%. This translates to an overall RPE impact of 0.46% of additional costs on our total Business Plan totex.

Oxera note that when evaluating the volatility of other indices for materials and plant and equipment, the volatility for materials is too significant to be relied upon for forecast or introduce indexation. They also note that for plant and equipment there is no obvious trend or factors that provide sufficient insight to forecasting RPEs. This would introduce an unknown risk and therefore create unintended consequences that could adversely affect our Business Plan, our stakeholders and also the supply chain arrangements.

Policy Position

In summary, we are not supportive of RPE indexation and believe it is more appropriate to have limited RPE allowances for clear and simple cost areas that are likely to exceed CPIH. We believe that RPEs are more appropriately managed by the network operator by way of a fixed allowance, which may be zero in some categories. We have therefore proposed an ex-ante allowance for RPEs in relation to labour costs only as noted in our Business Plan.

We have not proposed to include an ex-ante allowance for RPEs in relation to materials and plant as this would be too volatile and it does not appear merited considering the risks and complexity of implementation.

[7] We undertook a separate review of RPEs in April 2019 with Oxera and the other Transmission Operators to assess the options for RPEs and what is the most appropriate. Additionally, we have undertaken a separate study with Oxera, (November 2019, *SHE Transmission's Cost Assessment*), to evaluate the cost impact of RPEs on different cost categories and drivers.

[8] In our Business Plan we have evaluated ongoing efficiency or productivity as well as other factors and note that where appropriate how RPEs have been factored into each cost category of our Business Plan.

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