

Protecting consumers, promoting value and safeguarding the future



PR09 incentives proposals

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PR09 incentives

- Summary of PR09 proposals
- Rationale
- Menu regulation
 - Quick reminder
 - Potential benefits
 - Issues – baseline and incentives
- Summary



Summary of PR09 proposals

- Opex
 - Retain broad approach to setting expenditure assumptions and incentives for opex outperformance in AMP5
- Capex
 - Menu regulation
 - Retain RCV rolling adjustments
- AMP5 service incentives ('son of OPA')
 - To be reviewed in context of overall incentive package
- Shortfalls for failure to deliver outputs
- Key change: menu regulation for capex



Why?

- Opex
 - Relatively predictable
 - Established methods appear to perform well
- Capex
 - Continuing need for sizeable programme and need to ensure value for consumers
 - More difficult to predict – importance of business plans
 - Case for improving the approach to incentives
- Delivery
 - Ensure outperformance is not at expense of delivery
 - Further thinking on customer service incentives



Operating expenditure and efficiency

- Our approach is highly transparent
- Clear incentives for each company to outperform by improving efficiency
- Base service opex based on outturn expenditure in the base year (2008-9)
- Enhancement opex based on specific assessments
- Company specific assumptions on catch-up efficiency assessed using econometric models
- Continuing efficiency assumptions for the whole industry



Menu – quick reminder

Company forecast	100	120	140
Allowance	100	105	110
Incentive	40%	30%	20%
Additional income	+2.5	0	-3.5
Actual			
↓			
80	+10.5	+7.5	+2.5
100	+2.5	+1.5	-1.5
120	-5.5	-4.5	-5.5
140	-13.5	-10.5	-9.5

☺ Incentive compatible (i.e. best option is to choose what you expect the outcome to be)

(Ofgem example)



Menu regulation: benefits for consumers

- Reduce risk of price limits being ‘too high’
- Reinforce company accountability and reduce company focus on regulator
- Stronger incentives for companies to ‘challenge themselves’



Menu regulation: benefits for companies

- Reduce risk of price limits being ‘too low’
- Choice of risk/reward balance
- Reinforce control and focus on delivery
- Rewards for leading companies and innovation
- Reduce regulatory burden



Menu regulation: benefits for regulator

- Address conservatism in capex forecasting
- Reduced emphasis on finding the 'right answer'
- Encourage company ownership / accountability
- Retain incentives for value and outperformance



Key areas: baseline setting

- Baseline should be reasonable ‘central estimate’
 - Balanced view of risk and scope of investment
 - Outputs package informed by customer preferences/CBA
- Base
 - Evidence from out-turn expenditure & cost base
 - Common framework based assessment of ‘future is different’
- Capital enhancement
 - Scope (cost benefit tests)
 - Price (cost base, capital estimating)
- Change
 - no continuing efficiency, capital maintenance econometrics
 - simplified common framework scoring



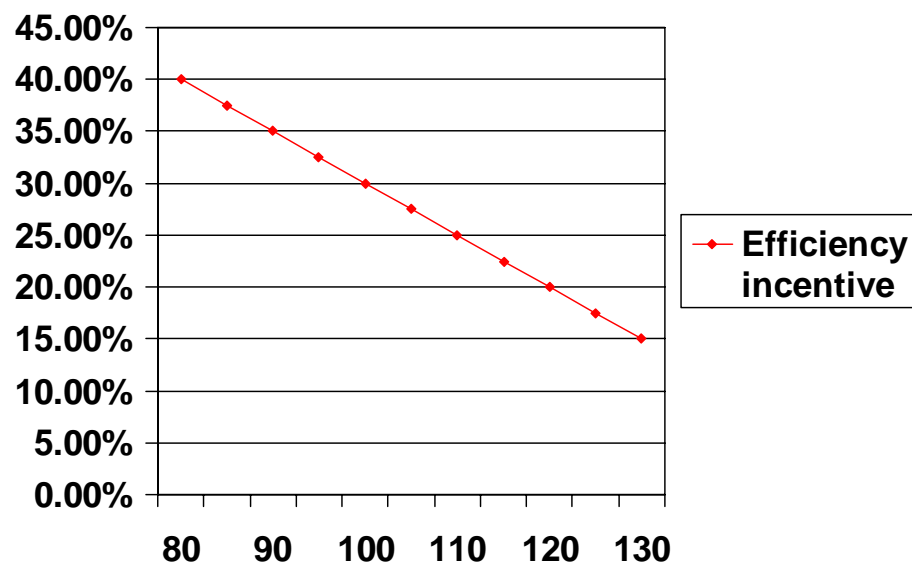
Key areas: breakeven point

- The point at which a company earns the cost of capital (ie no net penalty or reward through menu)
 - Can be varied to make it easier/harder for companies to achieve
 - Modelling suggests that customer bills may not be particularly sensitive to changes in the breakeven point
 - If baseline is central estimate, then logic suggests a company at this point should earn the cost of capital
- NB Baseline and breakeven point need to be considered together...



Key areas: efficiency incentives

- PR04 incentive rate for capex (roughly) 30%
- Stronger incentives for company choosing more challenging options
- Issues around 'slope of efficiency line'
- What about frontier companies?



Key areas: symmetry

- Symmetrical treatment of under and over spends
 - Potential concern that high cost companies might not have strong enough incentive to contain costs
 - Company may accept menu penalty if it can finance investment more cheaply than allowed return on RCV
 - Modelling suggests risks of this are low
 - Reduction in risk for companies
- Can we draw back from some detailed outputs regulation?



Summary

- Combination of evolution and new thinking
 - Genuine desire to break out of ever increasing detail
 - Begin to change the regulatory relationship
 - Initial reactions - overall positive, but range of implementation details need work
- Need to consider package as a whole
 - Setting expenditure assumptions
 - Outperformance rewards
 - Regulation of delivery / outputs / service

