

A Review of Recent UK Price Review Innovations

A report prepared for the CAA

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1. Introduction

This report contains a review of innovations that have appeared recently in price reviews carried out by Ofcom, Ofgem, Ofwat, ORR and the Competition Commission (CC) / Competition & Markets Authority (CMA).

Our terms of reference have been to look ahead to the forthcoming Q7 reviews, particularly the H7 review of Heathrow Airport's price cap, and to think about how the CAA's approach to price setting could evolve to embrace regulatory 'best practice' from other sectors. To this end, the reports seeks first and foremost to:

- provide an overview of the approaches that other regulators have been taking in recent reviews, focusing especially on the aspects of the other regulators' methodologies that have not previously been a feature of airport regulation; and
- give the CAA an objective assessment of the transferability of these ideas to an airport setting.

The paper is structured into four main parts as follows:

- section 2 looks at the importance that Ofgem and Ofwat have attached to 'well-justified' or 'high-quality' business plans and runs through some of the measures that the regulators have put in place to encourage companies to challenge themselves when they compile their cost and service quality forecasts;
- section 3 focuses on developments in the regulators' technical methodologies for price control calculation and incentive design;
- section 4 sifts through these ideas and make a first attempt to identify which innovations might be applicable and of benefit in an airport context; and
- section 5 concludes.

In producing this report, we have benefited from discussions with regulators and regulated companies from the relevant regulated sectors. The views contained herein are, however, our own.

2. Business Plans

A good deal of the thinking in the energy and water sectors in recent times has been directed at getting regulated companies to compile challenging business plans at the outset of the price review process. The perception has been that companies' plans have in the past sometimes been tactical in nature, in that they have been directed towards getting the best possible price review outcome for shareholders rather than at delivering the best possible outcomes for customers at lowest possible cost. Seeing this, Ofgem and Ofwat have sought to change companies' incentives and behaviours in the early stages of the price review, so that the regulators begin their work with much more realistic assumptions from companies about future revenue requirements.

There have been a number of complementary innovations, as follows.

2.1 Well-justified / high-quality business plans

As a starting point, Ofgem and Ofwat have been clear that company business plans are to be more than bidding documents. Ofgem has coined the term 'well-justified business plan' to capture the expectations that it has of companies:¹

Under the RIIO model our assessment of the outputs that network companies are required to deliver and the associated revenue to be earned from consumers will be informed, to a large degree, by the plans put forward by network companies. In the business plans a network company will set out what it intends to deliver for consumers of network services over time and what revenue it needs to earn from existing and future consumers to ensure delivery is financed. The onus is on network companies to justify their view of required expenditure.

A business plan will be considered well-justified where network companies demonstrate, amongst other things:

- focus on output delivery ...;
- a clear and well-evidenced case for their proposals ...;
- an open minded consideration of available options ...;
- link between costs and primary outputs ...;
- a consideration of the longer term ...;
- value for money ...;
- effective engagement with a range of stakeholders ...; and
- value for money

Ofwat has referred repeatedly to 'high-quality plans':²

We explained in our business planning consultation that we wanted to bring about a significant cultural change in the business planning process. We wanted to move away from companies being overly focused on meeting tightly specified regulatory guidelines, and instead place the emphasis on companies developing plans that deliver for consumers, including current and future customers and the environment, in the long term.

To deliver a proportionate price setting process, we will put an assessment of the quality of companies' business plans at the heart of the price setting process, using it to focus our scrutiny and challenge where it is most needed – and where we can deliver the greatest benefits for consumers (including current and future customers and the environment). We will complement this approach with a suite of powerful incentives for companies to deliver high-quality plans.

¹ Ofgem (2010), Handbook for implementing the RIIO model.

² Ofwat (2013), Setting price controls for 2015-20 – final methodology and expectations for companies' business plans.

...

A high-quality plan:

- is designed to deliver good outcomes for current and future customers and the environment;
has a coherent narrative based on sound reasoning and contains proportionate evidence;
- will ensure that a company meets its statutory obligations and enables the relevant regulators to confirm this ...;
- is based on good-quality engagement with customers and consumers, and the results of this engagement are reflected in the proposed outcome commitments, and the plan more generally;
- is cost efficient, containing accurate projections and estimates;
- proposes a reasonable balance of risk and reward between customers, investors, and other stakeholders, with efficient proposals to share 'pain and gain' with customers;
- is both affordable and financeable;
- comes with a high level of assurance – in the form of a statement from the company's whole Board that the plan is of a high quality, will ensure that it meets its statutory obligations, and that estimates and data have been arrived at appropriately, and independently of other companies and competitors; and
- does not seek to game the regulatory process in any way.

2.2 Business plan competitions, proportionate scrutiny and fast-tracking

Both regulators have put in place a range of incentives to reward companies that produce well-justified / high-quality plans. The idea has been that a change in mindset requires more than exhortation and that companies should see that it is in their own best interests to challenge themselves and self-regulate ahead of the formal price review process.

When Ofgem was devising its RIIO framework in 2009-10, it took the view that a promise to give proportionate scrutiny to companies' plans would help to change behaviours. At this time, it had the notion that it would sort plans into three categories:³

We will take a proportionate approach to assessing base revenue for the network companies. In particular, our approach to assessing network company plans will vary according to (a) the quality of the business plan submitted and (b) the network company's performance in delivering outputs and value for money in previous periods.

- companies in category A will be subject to relatively lower levels of scrutiny of their business plans, with an expectation that our assessment of primary outputs, secondary deliverables and expected efficient costs will be close to the proposals in their business plan ...;
- companies in category B will receive relatively higher levels of scrutiny of their business plans, with the level potentially similar to what companies experienced in price reviews in the past; and
- companies in category C will be subject to the most intensive assessment. For example, we might send in engineering experts to consider in detail the justifications that network companies have provided for the asset strategies proposed. Our questions will be likely to focus particularly on areas of failed past delivery and areas of their business plan highlighted as potentially inefficient compared with those of other network companies. This focus will help to highlight material inefficiencies and allow us to implement more significant reductions to the base revenues in such cases.

³ Ofgem, op. cit.

Ofgem also identified the scope for fast-tracking:

Where we are confident that the business plan of a company in category A is well-justified and provides value for money for consumers over the long term we may reach an early decision on the company's final proposal.

In its methodology paper for its most recent price control review, the 2014 RIIO-ED1 electricity distribution network operator (DNO) review, Ofgem explained what it saw as the benefits to companies of this approach:⁴

The scope for proportionate treatment and, to a greater degree fast-tracking, incentivises companies to submit realistic and well-justified business plans. This is because these approaches will allow DNOs to:

- get on with business as usual without focusing as much resource on the price control process;
- plan with greater certainty earlier in the process;
- be a significant driver of its own review outcome; and
- gain reputational advantage.

It also sought to strengthen incentives still further by announcing two further forms of reward for fast-track companies:

we will provide a fast-tracked company with upfront additional revenues of 2.5 per cent of totex

and

any DNO that is fast tracked will receive an efficiency incentive rate of 70 per cent.

(NB: the 'efficiency incentive rate' is the share that the company keeps of any out-/under-performance of its cost allowance. Ofgem's thinking is that a higher percentage acts as a form of reward.)

In November 2013, following the submission of the DNOs' business plans in July 2013, Ofgem announced it had found that that one company, Western Power Distribution (WPD), had produced a well-justified business plan and would be eligible for fast-tracking and the associated rewards. WPD was subsequently taken to a price control determination in February 2014,⁵ while the slow-track companies were asked to resubmit their plans and received their determinations nine months later in November 2014.⁶

Ofwat was meanwhile factoring a very similar approach into its PR14 review of water and sewerage companies. It spoke from an early stage of a 'risk-based review' in which it would:

... focus our challenge and scrutiny of companies' business plans where it is most needed – and where we can deliver the greatest benefit for consumers

It too considered it useful to sort plans into categories:

... our approach to implementing a risk-based review [contains] reputational, procedural and financial incentives for companies' Boards to produce high-quality business plans. Our risk-based review will ... assign each company to one of three categories – enhanced, standard or resubmission – which determines procedural, reputational and financial benefits.

⁴ Ofgem (2013), Strategy decision for the RIIO-ED1 electricity distribution price control.

⁵ Ofgem (2014), Decision to fast-track Western Power Distribution.

⁶ Ofgem (2014), RIIO-ED1 final determinations for the slow-track electricity distribution companies.

The incentives were described in the following terms:

... our package of incentives for high-quality business plans comprises:

- publishing our assessments of each company's overall business plan quality as early as is practical to do so creating reputational incentives – our proposals should give a clear signal to investors and other stakeholders to allow them to identify those companies that have – or do not have – high quality plans;
- tailoring our approach to scrutiny and challenge according to our assessment of the quality of the elements of companies' plans creating process incentives, focusing regulatory effort where it is needed and reducing costs;
- tailoring the process for setting price controls according to our assessment of overall business plan quality – including early draft determinations for enhanced companies and potentially the option of early final determinations to deliver procedural incentives; and
- financial incentives for enhanced category plans – enhanced category companies will have ... greater shares of cost outperformance, and will be better off overall than companies in the standard category.

Ofwat provisionally conferred enhanced status on two companies, Affinity Water and South West Water, in March 2014,⁷ following the submission of business plans in December 2013. The companies were subsequently given early draft determinations in April 2014,⁸ although Ofwat decided in the end not to proceed with early final determinations. For the other 16 companies, Ofwat dispensed with the idea of separate standard and resubmission categories and instead dealt with the rest of the industry as one group.

2.3 Customer engagement

Ofgem's criteria for a well-justified plan and Ofwat's criteria for a high-quality plan, reproduced in section 2.1 above, both spoke about the importance of customer and stakeholder engagement. This reflects a more general theme underpinning the two regulators' approach to price reviews in which end-consumers have been given more of a role than has been the case in the past.

Ofgem's RIIO documents coined the term 'enhanced engagement' to capture the change in mindset it was seeking to bring about:

Network companies should proactively engage with consumers of their network services ... It will be important that there is scope for this engagement to impact on the business plans developed by the network companies. Where effective engagement takes place this will provide opportunities for (a) stakeholders to drive changes to the regulatory regime, (b) network companies to explore and get stakeholder buy-in to proposed approaches for the delivery of primary outputs, and (c) network companies and stakeholders to identify delivery solutions that involve them working together.

Evidence that a company took such engagement seriously, and that it had an impact on the company's business plan, contributed one of the criteria that Ofgem used for fast-tracking purposes. Ofgem consciously stopped short, however, of spelling out to companies how they ought to interact with users, explaining:

we do not want to be prescriptive about how the DNOs engage with their stakeholders ... It is not a 'box-ticking' exercise but is about seeking to understand and, where appropriate, act on the information that is gathered.

⁷ Ofwat (2014), PR14: Ofwat announces results of pre-qualification tests.

⁸ Ofwat (2014), Setting price controls for 2015-20 – draft price control determination notice April 2014.

Ofwat possibly went further than Ofgem in its PR14 review. It mandated that each company should set up a Customer Challenge Group (CCG), comprising end customers, customer representatives and interest groups, to do three things:⁹

- review the company's engagement process and the evidence emerging from it. This is to ensure customers' views are considered as the company develops its business plan;
- challenge the phasing, scope and scale of work required to deliver outcomes, including legally prescribed standards and the requirements of other regulators; and
- advise [Ofwat] on the effectiveness of the company's engagement, and on the acceptability to customers or otherwise of its overall business plan and bill impacts.

Each CCG was to submit a report to Ofwat on the above things at the same time that the company submitted its business plan to Ofwat. The regulator was clear that:

Customer engagement will be an important factor in determining whether we will accept the companies' business plans. How much evidence of customer support we need, and how detailed our scrutiny of plans is, will be proportionate to the scale of changes to bills and services that an individual company is seeking. Customer acceptability is a key factor in our decisions.

2.4 Requirements for Board sign-off

The final strand in Ofwat's efforts to secure better plans was a focus on the role of a company's Board in the plan development and sign-off process. Ofwat wanted to ensure that the plans it were receiving were the companies' actual plans for the 2015-20 control period and not documents compiled for purely regulatory purposes. It sought assurance on this point from each company's Board, directing much of the discussion in its price control documents at these individuals. For example, the following statements appeared in Ofwat's price control methodology paper:

We stress the importance of the role of company Boards and the need for them to have good governance arrangements and ownership of their business plans.

... we expect companies' Boards – the whole Board, not just one or some executive member(s) – to take responsibility for signing off business plans. We also expect them to put in place any processes that they feel they need to be assured that they are submitting high-quality plans ...

Boards need to give us a statement, in their own words, of why they consider that all the elements (and supporting data) add up to a business plan that is high quality. For example, a Board might want to explain its assurance process (including any external assurance it used) to arrive at its conclusion that the plan is the best it can be, rather than simply asserting confidence in the plan.

In preparing their statement, Boards should also ... explain the governance processes of the Board and demonstrate how it provided strategic leadership, a transparent process and compliance with the relevant licence conditions and UK Corporate Governance Code.

It should be noted that Ofwat's efforts on this front were part of a wider push to entrench good corporate governance in the water sector, including a particular focus on strengthening the RegCo Board and the role of independent non-executive directors.¹⁰

⁹ Ofwat (2011), Involving customers in price setting – Ofwat's customer engagement policy statement.

¹⁰ In a September 2013 consultation document on Board leadership, Ofwat set out 'principles' which included the following statements:

2.5 Information quality incentive

The final part of Ofgem's toolkit has been an Information Quality Incentive (IQI), of the form set out in figure 1.

Figure 1: Ofgem's RIIO-ED1 IQI

DNO:Ofgem Ratio	90	95	100	105	110	115	120	125	130
Efficiency Incentive	65%	63%	60%	58%	55%	53%	50%	48%	45%
Additional income (£/100m)	3.1	2.4	1.7	0.9	0.1	-0.8	-1.8	-2.8	-3.9
Rewards & Penalties									
Allowed expenditure	97.50	98.75	100.00	101.25	102.50	103.75	105.00	106.25	107.50
Actual Exp									
90	7.95	7.9	7.7	7.4	7.0	6.4	5.7	4.9	4.0
95	4.7	4.76	4.7	4.5	4.2	3.8	3.2	2.5	1.7
100	1.5	1.6	1.7	1.6	1.5	1.1	0.7	0.1	-0.6
105	-1.8	-1.5	-1.3	-1.2	-1.3	-1.5	-1.8	-2.2	-2.8
110	-5.1	-4.6	-4.3	-4.1	-4.1	-4.1	-4.3	-4.6	-5.1
115	-8.3	-7.7	-7.3	-7.0	-6.8	-6.7	-6.8	-7.0	-7.3
120	-11.6	-10.9	-10.3	-9.9	-9.6	-9.4	-9.3	-9.4	-9.6
125	-14.8	-14.0	-13.3	-12.7	-12.3	-12.0	-11.8	-11.7	-11.8
130	-18.1	-17.1	-16.3	-15.6	-15.1	-14.6	-14.3	-14.1	-14.1
135	-21.3	-20.2	-19.3	-18.5	-17.8	-17.2	-16.8	-16.5	-16.3
140	-24.6	-23.4	-22.3	-21.4	-20.6	-19.9	-19.3	-18.9	-18.6
145	-27.8	-26.5	-25.3	-24.2	-23.3	-22.5	-21.8	-21.2	-20.8
150	-31.1	-29.6	-28.3	-27.1	-26.1	-25.1	-24.3	-23.6	-23.1

Source: Ofgem.

The IQI is a mechanism which compares the amount of expenditure in a company's business plan to the regulator's assessment of efficient expenditure (shown in row 1 of the matrix). This ratio then determines:

- the amount of expenditure that the regulator factors into its price control calculations, normally set at one quarter of the way between the parties' assessments (row 4);
- an amount of additional upfront revenue or a revenue deduction (row 3); and
- a sharing rule to be used in the event that the company under- or over-spends against its price control allowance (row 2).

As Ofgem puts it:

The aim of the tool is to encourage companies to submit more accurate expenditure forecasts to Ofgem.

Under the scheme, each company group is positioned in one of the columns of the IQI (NB: the matrix in figure 1 shows selected columns; there is, in fact, a continuum of columns for ratios that sit between the round numbers shown) and can read off the above three things. Crucially, a company will observe that if it expects to spend x (as represented in the row

We expect the Board of the regulated company (RegCo) to have full control of the business ... We expect a position where, by and large, a unitary Board operates and decisions are made at that level ... In practice, we recognise there may be decisions where, as an exception, the holding company (HoldCo) Board is involved ... These should be clearly articulated in the annual report. Useful guidance may be found in the matters reserved in a listed company for shareholder approval.

The contribution of independent non-executive directors is invaluable to Boards as they provide challenge and a different perspective to Board members who are more operationally involved with the business, or Board members who represent investors. We expect the independent non-executive directors to be the largest single group on the Board, compared to (i) executive directors and (ii) non-executive directors that are not independent.

Ofwat (2013), Board leadership, transparency and governance: principles.

headings on the left-hand side of the matrix) it is best off declaring that value x to the regulator in its plan and not some other value y . It is for this reason that IQI matrices contain shaded squares – i.e. the shaded squares show that if a company expects to spend, say, 115 and come out in the 115 row, it maximises its pay off by declaring 115 to the regulator and getting itself allocated to the 115 column.¹¹

IQIs of this form, with slightly different calibrations, have been deployed in all of the Ofgem's RIIO reviews. Companies have tended to come out, on average, around the 110 column.

¹¹ Compare the -6.7 pay-off that the company gets in Table 1 when it is in column 115 to the -7.0, -6.8, -6.8 and -7.0 pay-off that it would get if it were untruthfully declare expected spend of 105, 110, 120 and 125 respectively.