Our approach to sharing risk during the RIIO-T1 period

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About sharing risk

During the RIIO-T1 period, SHETL expects to invest around £4 billion on our transmission network in the north of Scotland. While we bear much of the immediate risk in raising the necessary finance to deliver this investment, it is customers both today and tomorrow that will ultimately fund this investment through transmission charges.

It is essential to ensure that the risks faced by consumers and SHETL are appropriately balanced to ensure that the long-term interests of consumers are protected and SHETL is incentivised to invest in a timely and efficient manner. To that end, we propose the inclusion of the risk sharing mechanism described in this document.

It should be noted that this mechanism significantly informs our Financial Assumptions. The resultant view of shareholder risk allows us to create a financial package that we believe is adequate to allow efficient delivery of the forecast investment.

Cost risk

The price control regime that SHETL operates within sets upfront expenditure allowances for the relevant period on the basis of our planned activities. These allowances will almost always differ from actual expenditure, both in terms of actual costs incurred and the phasing of our expenditure. There are many reasons for this divergence, such as changes in demand for connections, retiming of works due to the weather or changes in investment priorities as we continually assess our assets. The majority of these changes are outside of our control, but it is essential that we are able to respond to them and act accordingly.

Through the regulatory regime, SHETL as a licensed transmission owner is incentivised to seek the best value possible for customers, who will ultimately bear the costs of our activities. In order to achieve this, it is essential that SHETL can finance its business and attract finance at appropriate rates to deliver its outputs.

To balance these objectives, the regulatory framework requires the sharing of any efficient over or under spend between transmission owners and customers. This sharing seeks to align licensees' and customers' interests. An important component is to encourage transmission owners to do everything possible to minimise their costs and act efficiently so that all benefit.

This sharing allows customers to benefit from cost efficiencies made by transmission licensees, but also protects licensees when there is a valid reason for

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over-spending. Hence, in the event that a transmission owner does efficiently over-spend, there is an automatic mechanism whereby a proportion of the over-spend can be recovered by the licensee, providing it has been efficiently incurred.

Traditionally, this sharing has been realised with separate approaches for capital expenditure (capex) and operational expenditure (opex). Under the current price control (TPCR4), for example, sharing of any over or under spend of capex allowance has operated on a 75:25 (customers:licensee) basis. So for a £1 million under-spend on a capital project, £750,000 has been returned to customers and the remainder retained by the licensee.

In 2010 for electricity distribution licensees, Ofgem introduced a new approach to sharing called **totex**. This concept removed the distinction between capex and opex, and applied the same approach to sharing to total expenditure or 'totex'. The intention of this change was to allow network companies to be able to trade-off different approaches to managing their network and to remove the perceived perverse incentives arising from different approaches to sharing.

For RIIO-T1, Ofgem has proposed to use this totex approach. This document sets out the implications of this approach and how SHETL intends to use it to balance the level of risk that both our customers and our shareholders are exposed to as a consequence of our activities. It therefore takes two main parts: firstly, our approach to capitalisation and the use of totex; and secondly how we propose to share risk with customers through the totex efficiency incentive mechanism.

Our approach to capitalisation

Capitalisation is the term used to describe how we categorise the costs incurred by SHETL as either capex or opex and, hence, their regulatory accounting treatment.[1]

In our **July Business Plan**, we adopted an 'actual' approach to capitalisation, whereby we envisaged treating costs incurred on capital schemes as capex – making these eligible for addition to our Regulated Asset Value (RAV) – and operating expenditure as opex – and expensed in the year in which they were incurred. This is the traditional approach and we developed our initial thinking on the basis of this approach.

[1] It should be noted that this is regulatory accounting differs from statutory accounting and is the rules under which we report our performance to Ofgem.

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We adopted this approach in light of the step change in SHETL's activities over the RIIO-T1 period and associated uncertainty. For the central case in our Business Plan, we anticipate expenditure in the early years being predominantly driven by capex, up to 98.2% in 2013/14. However, we then forecast a gradual increase in the proportion of opex as capex reduces to 89% in the last two years of RIIO-T1. This transition, combined with uncertainty around the timing of some of our large transmission projects (discussed further in section 5), suggested a traditional approach would be most applicable.

Since publishing our **July Business Plan**, we have reviewed this approach against the principles of RIIO[2] and a detailed reconsideration of the allocation of risk in our overall Business Plan proposal. In particular, we have taken into account the further detail on the Strategic Wider Works funding mechanism and the financial scenarios analysis.

In light of this work, we have revised our assumptions to reflect the totex approach, where a fixed capitalisation rate is set at the price control settlement to apply throughout the period. We are proposing that the capitalisation rate is set at 90% for the RIIO-T1 period. In other words, 10% of the efficient costs we incur will be borne by today's customers during this period through our transmission charges (fast money), and the remaining 90% of our efficient costs will be captured in our RAV and borne by tomorrow's customers (slow money).

[2] As set out in Ofgem, 'Handbook for implementing the RIIO model', October 2010

Sharing factor

As described above, the sharing factor – or totex efficiency incentive – is designed to incentivise SHETL to invest in the most efficient manner and consider the interests of today's and tomorrow's consumers. It builds on the principles of the incentives that have applied during TPCR4 (and previous price controls), whereby SHETL shared any capex under or over spend, where efficiently incurred, with consumers on a 75:25 (customers:SHETL) basis; and any opex under- or over-spend on a 0:100 (customers:SHETL) basis.

Our Update to our July Business Plan is based on a totex approach to capitalisation and, hence, a single sharing factor will apply.

In its March 2011 Strategy document, Ofgem reaffirmed its

"*commitment to a fixed and symmetric efficiency incentive rate for each company and a further commitment that will not make retrospective adjustments to revenue if costs are different to what*

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was assumed when the price control was set. We clarified that the efficiency incentive rate would be applicable to both opex and capex to reduce the risk of distorting decisions."

Ofgem set out an expected range for transmission owners' sharing factors, namely between 40 to 50%, and set out that any related adjustments would "*be implemented through annual revenue adjustments rather than an adjustment at the end of the price control.*"

In our **July Business Plan**, we proposed three different sharing factors to reflect the different risks associated with our base capex, opex and wider works capex. This approach was adopted in response to the uncertainty associated with our wider works investment plan, discussed further in section 5 of our **January Update** document.

Since July, a number of elements within our plan have evolved. Most notably, we have undertaken a significant level of further modelling (informed by greater detail on aspects of our proposals) that has resulted in a change to some of our financial assumptions. This has been underpinned by greater detail on the uncertainty mechanisms, especially the treatment of Strategic Wider Works. This development in our thinking around the treatment of these Strategic Wider Works projects, combined with an understanding of when penalties would be incurred and how they would be assessed, has further informed our understanding of the level of risk associated with our investment plans.

In light of this and the adoption of a totex approach to capitalisation, we propose to adopt a single sharing factor for base capex, opex and wider works capex; and to increase the share of the risk that SHETL is exposed to through this mechanism to 50%. This sharing factor then forms part of our overall financeability package.

This incentive will see SHETL returning 50% of any under-spend to consumers, and will reduce the proportion of any efficient over-spend borne by consumers to 50%.

Conclusion

We propose:

- A fixed capitalisation rate of 90% for the RIIO-T1 period, and
- A sharing factor of 50% applied to the totex incentive mechanism.

As part of overall financial package and treatment of risk, we firmly believe that our proposed package

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presents a strong incentive on us and offers good value for consumers.