Draft Determination Supporting Document NGET CORE Q38 - CVP Reporting and repayment

As a part of the NGET Draft Determination Response

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NGET suggestion for CVP reporting and repayments – March 2020

To implement Ofgem's consumer value proposition (CVP) we need:
1. an approach to reporting CVP benefits when they are achieved; and
2. an approach to repaying a proportionate part of a CVP reward for any benefits that are not achieved in full.

This note sets out our proposal for CVP reporting, repayments and additional payments. It is based on a review of Ofgem's guidance, other companies' business plans and our own CVP proposal.

This note is in three parts:
- Part 1 - CVP reporting
- Part 2 - Repaying CVP rewards
- Part 3 - The case for increased CVP rewards

Part 1 - CVP reporting

In this section we set out our proposal for an approach to CVP reporting. This draws on information included in our Annex NGET_ET.07_Consumer Value Proposition.

For each of our nine CVP proposals we have estimated the CVP benefits and when they occur (please see Table 1). The data is for net benefits for all but two of our CVPs. For two of our CVP proposals (CVP7 and CVP9) the gross benefits (shown in green) occur in the T3 period and the gross costs (shown in red) occur in the T2 period

Table 1 – the timing of when we estimate the net benefits of our CVP proposals will occur (in £m, present value, 2019-20 prices)

	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31
CVP1	3.76	3.76	3.76	3.76	3.76					
CVP2	3.68	3.68	3.68	3.68	3.68					
CVP3	2.10	2.10	2.10	2.10	2.10					
CVP4	0.59	0.59	0.59	0.59	0.59					
CVP5	2.93	2.93	2.93	2.93	2.93					
CVP6	4.52	4.52	4.52	4.52	4.52					
CVP7	-0.45	-0.45	-0.45	-0.45	-0.45	3.07	3.07	3.07	3.07	3.07
CVP8	16.98	16.98	16.98	16.98	16.98					
CVP9	-5.14	-5.14	-5.14	-5.14	-5.14	10.64	10.64	10.64	10.64	10.64

Blue = net benefit, red = gross cost, green = gross benefit.

The data in Table 1 provides the CVP benefit estimates in our RIIO-2 business plan that we will report against in the T2 period. For most of these CVP items, as we explain below, stakeholders will only be able to tell if we have fully delivered the benefits at the end of the T2 period because the benefits are not likely to be evenly spread across the years (although that was the best assumption for estimation).

We propose reporting our progress on delivering CVP benefits annually to our independent stakeholder group. We will do this for the CVP items that Ofgem provides CVP rewards for. We could publish our CVP update on our website to provide all our stakeholders with information on how we are progressing. The annual CVP updates will differ for our different CVP items as set out in Table 2 below.

Table 2: CVP annual and end-of-T2-period reporting by CVP item

<table>
<tr><th>CVP item</th><th>Nature of reporting</th></tr>
<tr><td>CVP1 – Optimisation of harmonic filtering</td><td rowspan="3">We will report our progress towards delivering benefits for consumers for these three CVPs annually.

It will not be until the summer 2026 report that we will be able to measure fully whether we have delivered the estimated cost saving benefits over the T2 period using alternatives to the standard approaches to harmonic filtering, reactor investments and low-voltage substation re-builds.</td></tr>
<tr><td>CVP2 – Whole-system alternatives to reactor investments</td></tr>
<tr><td>CVP3 – Whole system approach to low-voltage substation re-builds</td></tr>
<tr><td>CVP4 – Tougher energy not supplied (ENS) target</td><td>The CVP benefits of a tougher ENS target apply to consumers from the beginning of the T2 period when the target applies. As a result, the annual report will say that the CVP benefits have already been delivered.</td></tr>
<tr><td>CVP5 – Caring for the natural environment</td><td rowspan="2">We can report annually the natural capital value / social benefit improvements we have delivered for consumers.
In summer 2026 we can report on the total benefits delivered over the T2 period.</td></tr>
<tr><td>CVP6 – Supporting local urban communities</td></tr>
<tr><td>CVP7 – Developing alternatives to SF_6</td><td rowspan="2">During the T2 period we can report annually on the investments we are making on developing alternatives to SF_6 / the Deeside innovation centre and the outlook for delivering benefits in the T3 period.
In summer 2026 we can report on the costs we incurred in the T2 period and our best estimate of the benefits we now expect to deliver in the T3 period.</td></tr>
<tr><td>CVP9 – Deeside innovation centre</td></tr>
<tr><td>CVP8 – SO:TO optimisation</td><td>We will need the legally-independent ESO to report on the whole-system savings for consumers the flexibility services we have provided to the ESO have delivered each year.</td></tr>
</table>

Closing out CVP at the end of the T2 period

We have assumed that Ofgem will want to close out the RIIO-2 CVP scheme at the end of the T2 period. This is to avoid Ofgem, network companies and stakeholders being involved in reporting on CVP benefits up to 10 years after the CVPs were confirmed in final determinations. For our CVP7 and CVP9 this means that we would report in summer 2026 on our latest best estimate of the benefits these CVPs will deliver in the T3 period.

Other companies' approaches to reporting on CVP
We have been able to locate some other companies' approaches to CVP reporting in their business plans. We have picked out the following points of interest:

- SHE-T suggests reporting its CVP delivered in its business plan data tables as part of its Enhanced Reporting Framework for RIIO-T2. Please see pages 36-37 of SHE-T's annex on Regulatory Framework.

- NGGT explains that, after feedback from its independent stakeholder group, it should report directly to Ofgem rather than the group for CVP1: Resilience solution at Blackrod. See page 7 of NGGT annex A10.05 CVP.

- WWU says it will include its CVP in its performance reporting going forwards. See page 17 of WWU 200-page business plan

Part 2 - Repaying CVP rewards

In this part we set out our proposal for an approach to repaying CVP rewards in proportion to any benefits that we do not deliver. This draws on information included in our Annex NGET_ET.07_Consumer Value Proposition, where we set out the arrangement for non-delivery in row 7 of the table for each of our 9 CVP items.

The repayment of CVP rewards provides us with a strong incentive to incur the costs, make the changes to usual practices and take the risks needed to deliver the benefits to consumers from our CVP items.

In its RIIO-2 business plan guidance (31 October 2019) Ofgem said: "5.20. If the company receives a reward under this element of the BPI, Ofgem will consider whether it should include provision for the clawback of the reward in the event that the commitment(s) in question are not delivered." (page 52).

There are several steps to the repayment of any CVP rewards:

- Step 1 – For there to be any repayment Ofgem must provide a CVP reward for the CVP item in question as part of the business plan incentive in its RIIO-2 final determinations.

- Step 2 – We must report on the benefits we have delivered in line with the reporting approach we have set out in Part 1 of this note. We will do this for the CVP items that Ofgem has provided rewards for. This will enable our stakeholders to judge whether we have delivered the benefits for each of our CVP items. For the purpose of CVP reward repayment the relevant report will be in summer 2026 when we will be able to measure the benefits for the whole T2 period.

- Step 3 – If we have not delivered the benefits for a particular CVP item in the T2 period we should return a proportion of the CVP reward to consumers in proportion to the benefit we did not deliver. We cover this step in this part of our note.

The repayment process

In summer 2026 we will report the benefits we have delivered across the whole T2 period in relation to the CVP items we received rewards for.

Our typical approach to repayment will be:

- To compare the benefits we have delivered for each CVP item against the estimated benefits that underpinned the CVP reward.
- Where the delivered benefits are lower than the benefits underlying the CVP reward we will propose to return the CVP reward to consumers in proportion to the shortfall. We suggest making all CVP calculations in the 2019-20 price base for consistency.
- We will put our proposal for CVP repayment to our independent stakeholder group for checking. We will make any changes to our proposal following comments from the stakeholder group.
- We propose to implement the repayment through a reduction in the Transmission Network Use of System (TNUoS) charge to our customers in 2027-28. [This is on the assumption that Ofgem wants us to recover our original CVP rewards from our customers through TNUoS]. We will need to adjust the actual repayment into 2027-28 prices.

Illustration of a repayment calculation

An important factor to consider when calculating a repayment is that the original CVP reward is only a proportion of the CVP benefit. This reflects Ofgem's intention to calculate the size of the CVP reward by multiplying the net consumer value by a company's totex efficiency incentive rate (see paragraph 5.22 of its business plan guidance). This means that you must look at the proportionate shortfall in benefits delivered and apply this to the CVP reward. Table 3 below illustrates this effect for our CVP1.

Table 3 – calculating the CVP repayment for different shortfalls in the benefits delivered and different totex sharing factors (based on our CVP1: Optimisation of harmonic filtering)

<table>
<tr><td>(1)</td><td>(2)</td><td colspan="4">Benefits actually delivered:</td></tr>
<tr><td rowspan="2">(2) Totex sharing factor</td><td rowspan="2">CVP reward:</td><td>(3)
£18.82m</td><td>(4)
£10m</td><td>(5)
£5m</td><td>(6)
£0m</td></tr>
<tr><td colspan="4">Amount of CVP repayment:</td></tr>
<tr><td>(3) 50%</td><td>£9.41m</td><td>£0m</td><td>£4.41m</td><td>£6.91m</td><td>£9.41m</td></tr>
<tr><td>(4) 32.5%</td><td>£6.12m</td><td>£0m</td><td>£2.87m</td><td>£4.49m</td><td>£6.12m</td></tr>
<tr><td>(5) 15%</td><td>£2.82m</td><td>£0m</td><td>£1.32m</td><td>£2.07m</td><td>£2.82m</td></tr>
</table>

Table 3 illustrates the amount of CVP reward repayment we will need to make for different totex sharing factors and different amounts of benefits we actually deliver in the T2 period. We used the bottom and top of Ofgem's TIM range of 15 to 50% and the mid-point of 32.5%.

Table 3 uses our CVP1: optimisation of harmonic filtering, which we estimate has a monetised consumer benefit of £18.82m. Table 3 assumes Ofgem agrees with our monetised value, but the analysis in the table still holds if Ofgem chose a different value.

To help understand the table here is an example: if the totex sharing factor Ofgem uses to calculate our CVP rewards is 32.5%, we need to use row (4) in the table. This means the CVP reward would be £18.82m x 0.325% = £6.12m. We can then look at the columns:

- If we delivered all £18.82m of the benefits, we use column (3) which shows we have no CVP reward repayment to make because we have delivered all the benefits.
- If we delivered no benefits at all we use column (6) which shows we have to repay the whole CVP reward of £6.12m.
- Column (4) shows the case where we only deliver £10m of the £18.82m benefits. In this case we need to reduce the CVP reward proportionately for the benefits we have not delivered. We calculate this as the percentage of the benefits that have not been delivered: (£18.82m-£10m) / £18.82m = 46.865%. We then multiply it by the CVP reward to calculate the repayment: £6.12m x 46.865% = £2.87m.
- Column (5) shows the case where we only deliver £5m of the £18.82m benefits. We need to reduce the CVP reward proportionately for the benefits we have not delivered. We calculate this as the percentage of the benefits that have not been delivered: (£18.82m-£5m) / £18.82m = 73.433%. We then multiply this by the CVP reward to calculate the repayment: £6.12m x 73.433% = £4.49m.

Special cases

We have 9 CVP items and some of them require a different repayment approach as we explain below in Table 4.

Table 4 – Special cases of CVP repayment approaches for NGET's CVP items

CVP item(s)	Approach
CVP4 – Tougher energy not supplied (ENS) target	This CVP items involves us setting a tougher ENS target from the beginning of the T2 period. As Ofgem sets both our ENS target and the CVP rewards we would expect Ofgem either to award us the CVP reward with the tougher ENS target or not to award us the CVP reward. This means there cannot be a case where we would be given the CVP reward and would not deliver the benefits. As a result, there is no need for a CVP repayment for CVP4.
CVP7 – Developing alternatives to SF_6; and CVP9 – Deeside innovation centre	We can use the approach in Table 3 above, but we will use updated estimates of the benefits to be delivered rather than the benefits actually delivered. This is because for both of these CVP items we have conservatively estimated that the benefits will occur in the T3 period.

Part 3 - The case for increased CVP rewards

The repayment of CVP rewards provides us with a strong incentive to incur the costs, make the changes to our usual practices and to take the risks needed to deliver the benefits to consumers from our CVP items.

We could increase the power of the CVP incentive through increased CVP payments if a company can deliver more than the baseline benefits of its CVP items. This is particularly the case for our CVP items because we have intentionally taken a conservative approach to estimating the benefits to make sure consumers do not pay too much for CVP rewards upfront.

Implementing increased CVP rewards

We could implement increased CVP rewards using a similar mechanism to that set out in Part 2 for repaying CVP rewards:

- We compare the benefits we have delivered for each CVP item against the estimated benefits that underpinned the CVP reward.

- Where the delivered benefits are <u>higher</u> than the baseline benefits we will recover an additional CVP reward in proportion to the increase in benefits delivered. We suggest making all CVP calculations in the 2019-20 price base for consistency.

- We will put our proposal for additional CVP payments to our independent stakeholder group for checking. We will make any changes to our proposal following comments from the stakeholder group.

- For additional CVP payments we would expect Ofgem to have a role in approving them before we recovered the payments from our customers.

- We propose to recover the additional CVP repayments through an increase in the TNUoS charge to our customers in 2027-28. We would need to adjust the repayment into 2027-28 prices.

- Under our proposal we might need to make repayments for some CVP items, but recover additional payments for other CVP items. Therefore, the adjustment to TNUoS would be the overall net repayment / additional payment across all our CVP items.

Illustration of an additional CVP payment calculation

An important factor to consider when calculating additional CVP payments is that the baseline CVP reward is only a proportion of the baseline CVP benefits based on the TIM sharing factor. This means that you must look at the proportionate increase in benefits delivered compared to the baseline and apply this to the CVP reward. Table 5 below illustrates this for our CVP1.

Table 5 – Calculating the additional CVP payment for different increases in benefits delivered and different totex sharing factors (based on our CVP1: Optimisation of harmonic filtering)

(1)	(2)	Benefits actually delivered:			
(2) Totex sharing factor:	CVP reward:	(3) £18.82m	(4) £20m	(5) £25m	(6) £30m
		Amount of additional CVP payment:			
(3) 50%	£9.41m	£0.00m	£0.59m	£3.09m	£5.59m
(4) 32.5%	£6.12m	£0.00m	£0.38m	£2.01m	£3.63m
(5) 15%	£2.82m	£0.00m	£0.18m	£0.93m	£1.68m

Table 5 illustrates the amount of additional CVP reward payment for different totex sharing factors and different amounts of benefits we actually deliver in the T2 period. Table 5 uses our CVP1: optimisation of harmonic filtering, which we estimate has a monetised consumer benefit of £18.82m.

To help understand Table 5 we can look at an example: if the totex sharing factor Ofgem uses to calculate our CVP rewards is 32.5%, we need to use row (4) in the table. This means the CVP reward would be £18.82m x 0.325% = £6.12m. We can then look at the columns:

- If we delivered precisely the £18.82m of the benefits we use column (3), which shows we should not have any additional CVP reward payment because we have delivered all the estimated benefits, but no additional benefits.
- Column (4) shows the case where we deliver £20m of benefits, rather than £18.82m. In this case the additional CVP reward payment should be proportionate to the additional benefits we have delivered. We calculate this as the percentage additional benefits that we have delivered: (£20m - £18.82m) / £18.82m = 6.27%. We then multiply it by the CVP reward to calculate the additional payment: £6.12m x 6.27% = £0.38m.
- Columns (5) and (6) shows the additional payments of £2.01m and £3.63m resulting from us over delivering benefits by 32.8% and 59.4% respectively.

Protection for consumers

There is a benefit to consumers of network companies being incentivised to deliver additional CVP benefits for them. However, we recognise that consumers will want protection from additional CVP payments being too high. We propose the following protections could be considered:

- <u>Ofgem approval of any additional CVP rewards</u>. This would make sure that an independent, expert regulator has approved any additional payments. There would need to be Ofgem guidance on the approach it would take to approving additional CVP payments to avoid creating uncertainty that would undermine the incentive effects of the additional CVP payments.

- A cap on additional CVP payments. As part of the RIIO-2 final determination Ofgem could set a cap on any additional CVP payments.

  For example, using Table 5 with a 32.5% sharing factor (row 4), Ofgem could set the cap at additional CVP payment of £3.63m. This would mean we were incentivised to deliver CVP benefits for consumers of up to £30m rather £18.82m.

  When setting the cap Ofgem would need to take account of the balance between protecting consumers and retaining incentives for network companies to deliver additional benefits for consumers.

- A reduced marginal rate for additional CVP payments. Any additional CVP payments for extra benefits delivered could use a lower marginal rate than for CVP payments up to the baseline benefits.

  For example, for CVP1, with a 32.5% totex incentive, we effectively earn CVP rewards at a rate of £32.50 for every £100 of benefit delivered. For additional CVP payments that rate could be reduced to, for example, £25 for every £100 of additional benefit delivered.

  When lowering the marginal rate we would need to balance the benefits of protecting consumers with retaining the incentive for network companies to deliver further benefits for consumers.

National Grid Electricity Transmission
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