ACM's framework proposal for REG2027

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Recommendations for a robust cost-plus framework

Prepared for ACM Klankbordgroep meeting

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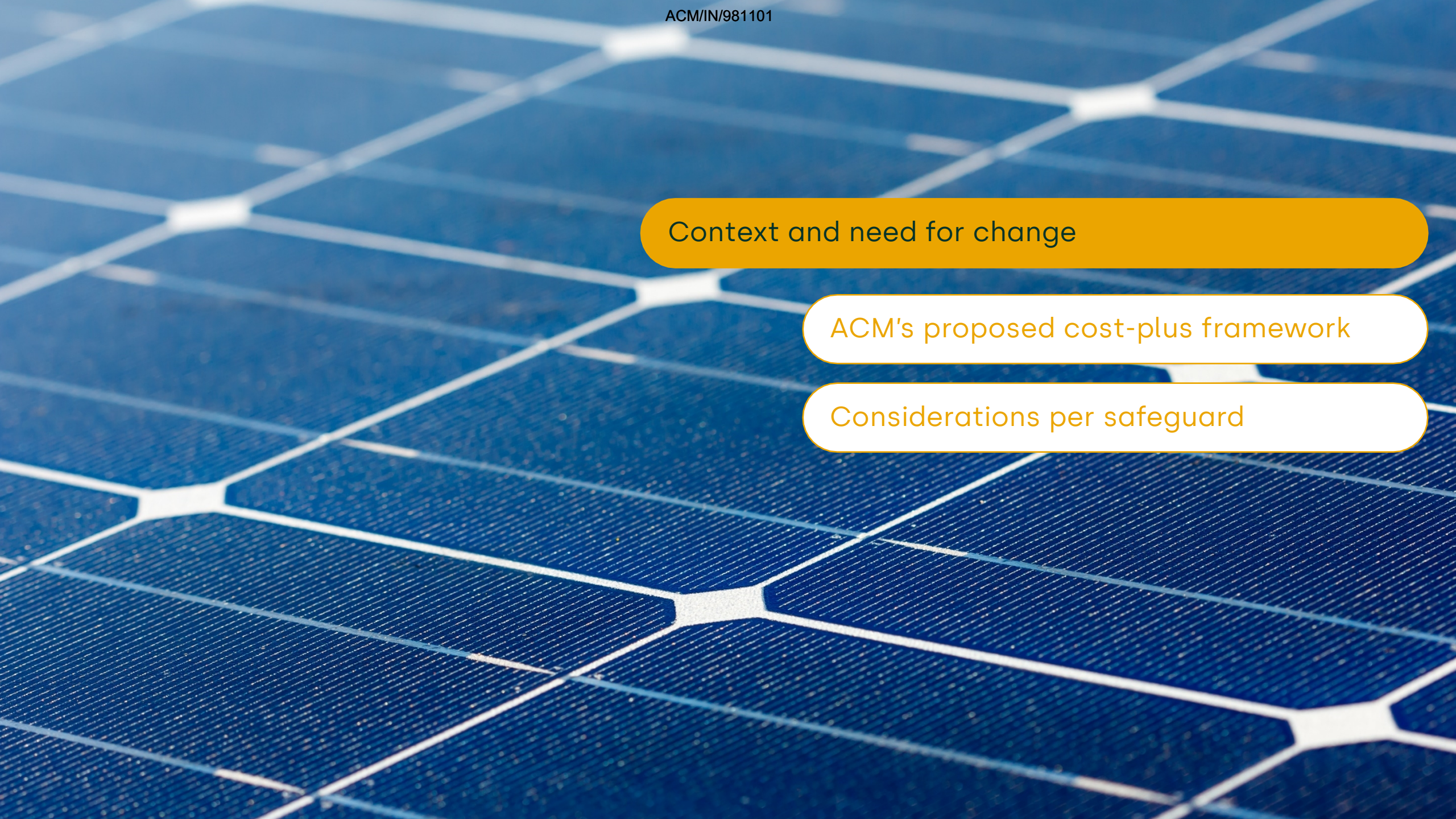
oxera



Context and need for change

ACM's proposed cost-plus framework

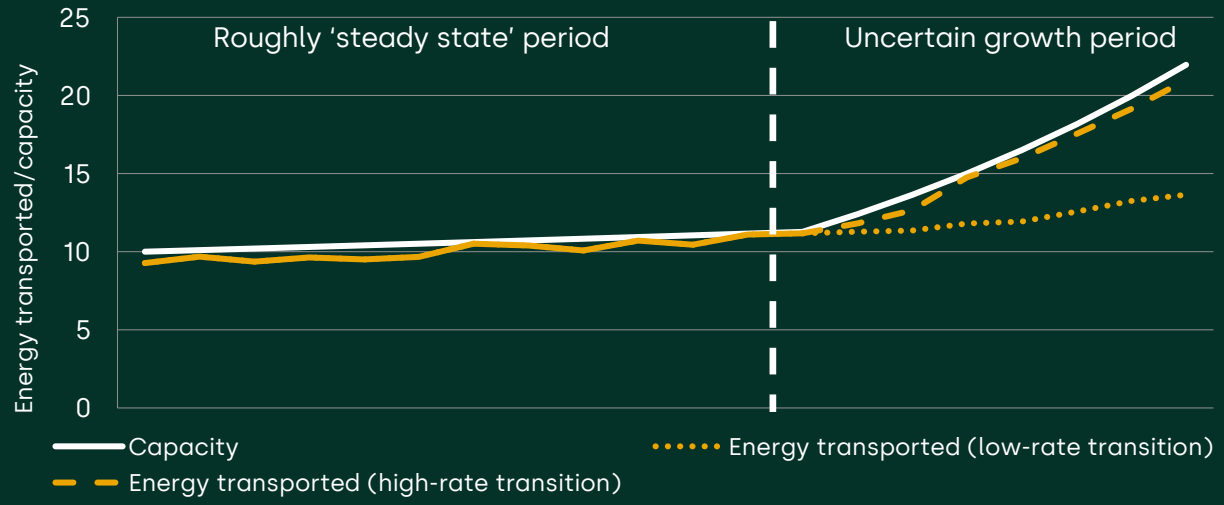
Considerations per safeguard

Context and need for change

Energy transition challenges

Major energy regulators across Europe are reconsidering their regulatory frameworks to deal with energy transition challenges, especially on funding new investments, given:

- grid congestion and capacity shortages
- increasing demand from electrification
- new cost drivers (e.g. smart grids, renewables)
- uncertainty around declining gas demand and clean alternatives



Current framework shortcomings (DSOs)

The yardstick benchmark is not appropriate as a comparative benchmarking tool. The main shortcomings of the approach are:

- input–output disconnect (especially for CAPEX)
- relies solely on backward-looking data
- does not adequately account for regional/operational differences
- lack of mechanisms to deal with risk and uncertainty

'Los van het versnellen is deze transitie op zichzelf ook al een grote opgave voor de netbeheerders. Zo hebben de netbeheerders ook te maken met grote veranderende omstandigheden en uitdagingen, waaronder de krappe arbeidsmarkt en materiaal tekorten.

Deze aspecten vragen om een passende reguleringsmethodiek. Een methodiek die ruimte biedt voor de benodigde investeringen voor elektriciteit en ook flexibel is om in te kunnen spelen op de nog steeds veranderende marktdynamiek.' — ACM[1]

[1] Source: ACM (2024), 'Update REG2027: Methode op hoofdlijnen elektriciteit', June.

Context and need for change

ACM's proposed cost-plus framework

Considerations per safeguard

ACM's proposed cost-plus framework

Key features (aims)

- Proactive assessment with ongoing monitoring, as opposed to backward-looking yardstick
- Transparency and accountability (e.g. public reporting)
- Simplicity, with reduced admin. costs/regulatory burden
- Collaboration, sharing best practices and ensuring system-wide efficiency

No application of the current DSO yardstick (or TCB for TSOs)

Efficiency safeguards

- Testing processes, including investment plans, procurement strategy and risk management
- Ongoing KPI monitoring of key cost and service metrics, to identify potential inefficiencies
- Explain-and-improve process, based on targeted reviews of strategic or outlier areas
- Transparency, such as regulator and/or company published annual performance reports

Escalation ladder where inefficiency is identified and not addressed

Cost categories

CAPEX

- investment planning, procurement & risk strategy, implementation tracking

OPEX—general

- cost control for maintenance, personnel and choices around IT costs

OPEX—energy & power

- procurement & risk management strategy around grid losses and congestion management services

Context and need for change

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Considerations per safeguard

Safeguard 1—testing processes

ACM's stated aim is to ensure robust (and transparent) decision-making and that broader business processes align with industry best practices. Simply put, expectation is that robust processes will result in good decisions, which in turn ensure efficient costs and high levels of service performance.

CAPEX

- upfront investment plan (IP) review
- ongoing implementation tracking

OPEX—general

- ongoing cost control processes

OPEX—energy & power

- procurement strategy (diligence, efficiency)
- risk management processes (e.g. IT costs)

Considerations

1 Alignment with the IP process

- leverage existing IPs (avoiding duplication, ad hoc requirements)
- pre-define assessment criteria and evidential bars per criteria (e.g. need, optioneering, cost efficiency, risk management)

2 Standardise/streamline reporting

- common investment KPIs (e.g. capacity delivery, renewable connections), templates and guidance can improve data quality and comparability
- specify a baseline future demand planning scenario

3 Targeted ongoing process tests

- focus on high-value, strategic procurement areas (e.g. grid loss, congestion)
- constructive engagement approach, learning from best practices
- assess other cost control processes based on ability to explain outcomes

Safeguard 2—monitoring cost and performance KPIs

ACM's stated aim is to identify trends and outliers (i.e. potential inefficiencies for the explain-and-improve process).

CAPEX

- cost efficiency (e.g. CAPEX per km of cable)
- service performance (e.g. reinforcements per technician)

OPEX—general

- cost efficiency (e.g. staff costs per FTE)
- service performance (e.g. connection completion times)

Considerations

1 Focus KPIs on priority areas

- limit to areas with clear basis for monitoring (cognisant of necessary normalisations, data availability and operational trade-offs)
- bar cost efficiency, potential priorities include investment effectiveness , network reliability and performance, and energy transition progress

2 Common KPI definition & reporting

- differences in capitalisation rates and cost allocation rules are common hurdles to like-for-like assessments across jurisdictions
- requires common reporting templates and guidance on cost allocation

3 Acceptable performance ranges

- preferring simpler KPIs (e.g. unit cost ratios) over robust benchmarking necessitates wider uncertainty ranges for 'acceptable' performance
- need to account for relevant regional and network-specific heterogeneity

Safeguard 3—explain and improve (+ escalation ladder)

ACM's stated aim is to keep networks accountable, requiring them to explain potentially inefficient decisions and suboptimal outcomes. It also forms the starting point for potential escalation ladder measures.

CAPEX

- tracking IP implementation progress
- thematic and/or risk-based audits

OPEX—general

- thematic and/or risk-based audits (e.g. based on outlier staff costs per FTE)

OPEX—energy & power

- thematic and/or risk-based audits (e.g. congestion management strategies)

Considerations

We note that ACM has since provided more detail on the escalation stages envisioned, but stated that the details will be developed 'throughout the period'

1 Define triggers (evidential bar)

- providing clarity on targets and thresholds, for both individual KPIs and the assessment of performances 'in the round'
- defining the burden of proof and relevant factors considered

2 Updating targets/thresholds

- to ensure targets do not become more relaxed or stringent over time
- option 1: pre-defined uncertainty mechanisms for 'known-unknowns' (e.g. input price inflation, demand growth)
- option 2: annual updates based on networks' outturn performance

3 Proportionate escalation

- sequentially, from reputational (e.g. 'league tables'), to procedural (e.g. improvement plans, enhanced scrutiny), to potential financial measures
- escalation should be preceded by sufficient time for improvement

Safeguard 4—transparency requirements

ACM's stated aim: to increase accountability to customers (increasing the transparency of network decision-making) and act as a reputational incentive for efficient operations.

CAPEX

OPEX—general

OPEX—energy & power

Publications from ACM and networks on performance (KPIs) and key decisions (e.g. ACM performance reports, network regulatory reports)

Considerations

1 Leverage existing processes

- IPs already contain much of the relevant information (e.g. explaining investment decisions, progress reports, identifying bottlenecks & solutions)
- ACM already collects service performance data which could be packaged in performance reports or league tables (e.g. Ofgem/Ofwat-style)

2 Business-sensitive information

- regulators may seek more clarity on, and to share learnings from, companies' strategic internal processes (e.g. procurement practices)
- however, should be balanced against the need to treat business-sensitive information confidentially between the regulator and networks

Summary of recommendations

Testing processes

- Constructive engagement focus for priority procurement areas only
- Streamline and integrate the IP with the new methodology and ensure consistency
- Assess cost control and implementation processes on outcomes

Monitoring cost and performance

- Identify key KPIs for priority areas only
- Accepted performance ranges should be linked to the robustness of the assessment
- Standardise KPI definitions and reporting (templates)
- Account for regional factors and network-specific heterogeneity

Explain-and-improve process

- Pre-define triggers and evidential bars for controls
- Pre-define mechanisms to update targets and thresholds during a period
- Ensure escalation measures are reasonable and proportionate

Openness and transparency

- Leverage existing processes (e.g. IP) and standardised reporting
- Consideration of business-sensitive and confidential information

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Appendix: setting KPIs

Setting KPIs

Smart metering costs: stylised example

After engagement with stakeholders, the ACM considers setting a cost efficiency KPI in relation to smart meter installation costs, and collects historical unit cost information

DSO	2022	2023	2024	Average
DSO 1	121	118	118	119
DSO 2	104	104	112	106
DSO 3	109	108	103	107
DSO 4	118	120	126	121
DSO 5	113	119	110	114
DSO 6	128	126	125	126
Average	**115**	**116**	**116**	**116**

Source: Oxera analysis of simulated data.

- There is volatility in unit costs between DSOs and over time
  - The ACM investigates whether this variation can be explained by operational factors (e.g. economies of scale, existing penetration, population density) but finds no strong evidence that these factors explain differences in unit costs
- As a central case, the ACM considers that **the KPI should be in line with the industry average unit cost of €116 per meter**
  - given the volatility, the ACM defines a **tolerance threshold of +/- €8 per meter**, in line with the standard deviation in unit cost performance i.e. a company meets the target if its unit costs are €108–€124 per meter
- Two DSOs would have missed the target based on historical data
  - as a proportionate approach, the ACM **only requires improvement** (and ultimately investigates if there is no improvement) **for DSOs that miss the tolerance range by a further €8 per meter**

Appendix: assessing performance overall

Assessing overall performance

In-the-round assessment

Keys:

- **Green**: the company has exceeded the target for the individual KPI
- **Blue**: the company has met the target
- **Amber**: the company has missed the target, but not by an amount that would normally trigger an investigation
- **Red**: the company has materially missed the target, which would normally trigger an investigation

Regulators often assess performance in-the-round, in addition to (or instead of) focusing only on individual areas—due to operational trade-offs, difference in operating environments, one-off shocks, etc. In the stylised example above, this could look as follows:

- DSOs 1 and 2 have generally met targets (no action required)
- DSOs 3 materially fails only one cost efficiency KPI, outperforms on others and generally performs well on service quality KPIs. This may be explained by operational trade-offs (e.g. CAPEX/OPEX solutions), in which case it may not require further improvement or investigation.
- DSO 4 has prioritised cost efficiency (lower bills) while DSO 5 has prioritised service performance. This may be due to different customer priorities, management focus or operational challenges. The appropriate trade-off would depend on customer and policy priorities at the time.
- DSO 6 has missed several targets (requiring investigation, improvement and later escalation if no improvement)