

TECHNICAL PROFILE

APPLICATION OF THE TOTEX APPROACH IN THE ELECTRICITY SECTOR

Initial guidelines for the introduction of incentivising regulation schemes based on the overall control of expenditure

683/2017/R/EEL (*)

In Consultation Document 683/2017/R/EEL, the Italian Regulatory Authority for Electricity Gas and Water (AEEGSI) has set forth the initial guidelines for defining an activity plan aimed at the introduction of a new incentivising regulation approach based on the overall control of expenditure and the assessment of network operator business plans with reference to the expected demand, system development needs and expected outputs (hereinafter referred to as the *totex approach*) for regulated infrastructure services in the electricity sector.

The rapid changes underway and the significant investments connected to these (technological change and the increasing importance of digitalisation in network management) require revision of the RAB-based tariff regulation models (i.e. models based on costs for infrastructure construction), as well as an approach that is more oriented to the value of the service provided.

Document 683/2017/R/EEL contains considerations on the development of regulatory models based on the *totex approach*, focussing on the objectives of introducing such models. In this regard, to identify regulatory mechanisms the following elements are key:

- ✓ information and the information asymmetry issue;
- ✓ risk allocation;
- ✓ the degree of discretion in regulatory choices;
- ✓ the degree of delegation of regulatory decisions;
- ✓ the time horizon of the 'contract' between regulator and regulated.

The regulatory mechanisms developed in different contexts differ in the way these elements were considered when designing the various models.

The *totex approach* increasingly integrates tariff regulation, regulation of continuity and quality of service and support for innovation with output based logic. It has the following features:

- ✓ focus on total expenditure, going beyond the current regime that considers operating costs and investments separately. It is based on total expenditure being the sum of operating costs and investment costs;
- ✓ forward-looking orientation which requires an increased ability to critically evaluate the expenditure forecasts of the various companies, as summarised in their business plans (cost assessment). In particular, the regulator must identify its own scenario for the future evolution not only of operating costs but also of total expenditure (i.e. total expenditure baseline or baseline), including capital expenditure assessments;

- ✓ application of regulatory menus (IQI matrix, which combines efficiency incentives with incentives to formulate truthful forecasts) to address the issue of information asymmetry.

In addition to the ability to estimate service costs ex-ante and to calibrate the IQI matrix incentives, developing an effective *totex* based regulatory scheme also requires an adequate reporting scheme to be defined that enables monitoring and verification of actual expenditure, output, technical and quality performance of the system.

With the *totex approach*, the regulator aims at combining the need to allow companies to achieve levels of return on invested capital that are consistent with the riskiness of the regulated sectors, with the need to favour efficiency and cost-effectiveness of the service for the benefit of customers. According to this perspective, the regulator establishes a development path for the output levels and costs of the service that it deems cost-effective and efficient, based on weighted assessments of the service performance conditions that companies must achieve.

The Regulatory Authority, in implementing the *totex approach*, intends to ensure gradual implementation to the greatest extent possible, saving and using individual elements of the previous regulation, through their streamlining, homogenisation and completion.

To develop the *totex approach*, the Regulatory Authority, with a view to making tariff regulation incentives coherent with the objectives of greater investment selectivity and following international regulatory best practices, decided to define an activity plan to be developed over a multi-year horizon, providing for specific phases of recognition, consultation and creation of ad hoc working groups.

So, the document identifies the main themes to be studied in detail before developing a *totex approach*, with particular attention to the tools that characterise this approach and including in particular, a brief analysis of these tools according to the following four thematic areas:

- ✓ business plan: companies submit their business plans to the regulators (with a medium-term horizon of 5-10 years). In these they must explain to the regulator their assessments of the demand for the service they provide (not only in terms of quantity but also of expected quality) which underpin their investment choices. They must specify their objectives and show that they will adopt the most efficient solutions to achieve them. These activities are complemented by public discussion sessions, where companies hear stakeholder points of view;
- ✓ cost assessment: includes issues related to expected expenditure estimated by the regulator (baseline), and issues related to acquisition and organisation of data for managing the *totex approach*, both in forecasting as well as the final accounting and control phases;
- ✓ incentives: the intention is to continue the current regulation incentive scheme;
- ✓ management of uncertainties and progress checking: this means starting an interactive process with companies to provide the regulator with a defined quality for the information required; and at the same time developing an enforcement mechanism to limit and deter possible opportunistic conducts by companies.

Finally, in document 683/2017/R/EEL the first elements and timing for the activity plan are identified, indicating the objectives, tools and main outputs for each stage of the plan.

The **first phase of plan development** aims to align the expectations and knowledge of operators and stakeholders concerning the contents of the reform. This is followed by a **data gap analysis phase** that directly involves the Regulatory Authority and operators to identify the information needed to develop the *totex approach*. The **regulatory criteria definition phase** follows, aimed at identifying the regulatory criteria to be adopted when the *totex approach* becomes effective. Then comes the **phase of business plan presentation, analysis and approval**, aimed at preparing business plans that actually reflect the need for efficient development of the regulated services. **In the final phase, suitable reporting is developed for the control and monitoring of business plan implementation**, which is particularly relevant for enforcing the regulation.

For the scope of application, the document intends to evaluate the possibility of applying, in the fifth regulatory period, the *totex approach* to the national Transmission System Operator and, for the distribution service, to guarantee broad coverage of the national territory while limiting the number of stakeholders.

In the Annex a summary report from Pöyry (the company consulted by the Regulatory Authority) is available, concerning the identification and analysis of thematic areas to establish a strategic plan for the application of a *totex approach*.

Interested parties are invited to submit their observations to the Authority by 26th January 2018.

(*) This sheet is for disclosure purposes only; it is not a measure.