Promoting choice and value
for all gas and electricity customers

Strategy decision for the RIIO-ED1 electricity distribution price control

Business plans and proportionate treatment

Supplementary annex to RIIO-ED1 overview paper

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Contact: Anna Rossington

Team: RIIO-ED1

Tel: 020 7901 7401

Email: RIIO.ED1@ofgem.gov.uk

Overview:

RIIO-ED1 is the first price control review in electricity distribution to reflect the new RIIO model. RIIO is designed to drive real benefits for consumers by providing network companies with strong incentives to step up and meet the challenges of delivering a low carbon, sustainable energy sector at a lower cost than would have been the case under our previous approach. RIIO puts sustainability – alongside consumers – at the heart of what network companies do. It also provides a transparent and predictable framework, with appropriate rewards to promote timely delivery.

The business plans that each Distribution Network Operator (DNO) will produce are an important part of the RIIO process. They are where we expect the DNOs to demonstrate that they have responded to the key RIIO objectives.

This document sets out our decisions on the stages and timing of the process we will use to assess the business plans. It also explains the criteria against which we assess the plans and provides high level guidance to DNOs on how their plans should be justified, presented and structured.

This document is aimed at those who want an in-depth understanding of our decisions. Stakeholders wanting a more accessible overview should refer to the main overview document.

Associated documents

Strategy decision for RIIO-ED1 - Overview
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1DecOverview.pdf

Links to supplementary annexes

- Strategy decision for RIIO-ED1 - Outputs, incentives and innovation
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1DecOutputsIncentives.pdf
- Strategy decision for RIIO-ED1 - Business plans and proportionate treatment
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1DecBusinessPlans.pdf
- Strategy decision for RIIO-ED1 - Uncertainty mechanisms
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1DecUncertaintyMechanisms.pdf
- Strategy decision for RIIO-ED1 - Financial issues
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1DecFinancialIssues.pdf
- Strategy decision for RIIO-ED1 - Tools for cost assessment
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1DecCostAssessment.pdf
- Strategy decision for RIIO-ED1 – Reliability and safety
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1DecReliabilitySafety.pdf
- RIIO-ED1 Glossary of terms
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1SConGlossary.pdf

Links to other associated documents

- Strategy consultation for RIIO-ED1 - Overview
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1SConOverview.pdf
- Open letter consultation on the way forward for RIIO-ED1
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/consultations/Documents1/RIIOED1LaunchOpenLetter.pdf
- Handbook for implementing the RIIO model
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf
- Electricity Distribution Price Control Review 5 (DPCR5) Final Proposals
http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/FP_1_Core%20document%20SS%20FINAL.pdf

Contents

1. Introduction

Chapter Summary

This chapter sets out the importance of network companies' business plans in the RIIO process and gives an introduction as to what is covered in this document. We set out how the document is structured and detail how we have come to each decision.

Importance of business plans

1.1. This document sets out the important role that DNOs' business plans will play in the RIIO-ED1 process and explains our decision to apply the RIIO principle of proportionate treatment in assessing these plans. Under the RIIO approach, the business plan each DNO will submit in July 2013 is hugely important. It is an opportunity for DNOs to set out what they intend to deliver for consumers over the RIIO-ED1 period as well as the associated costs; and to show how they have responded to the key objectives of RIIO and the specific challenges faced by their businesses.

1.2. The quality of the plan, the robustness of the data within it, and how well it is justified, will influence the degree of regulatory scrutiny we apply during the review ('proportionate treatment').

1.3. If a DNO produces a business plan of a high quality, we propose to subject their business plans to a lower level of scrutiny and focus our attention on the areas that merit further analysis. In some cases, where a DNO produces a very high quality business plan, we will consider whether it is appropriate to conclude their price control process early ('fast-tracking'), thereby significantly reducing the level of scrutiny the DNO is to undergo.

1.4. In addition to their regulatory role, business plans should be public-facing documents for the DNOs and their stakeholders to refer to throughout the price control period. These documents should be more than a submission to the regulator. The RIIO framework seeks to encourage DNOs to develop business plans informed by, and used by, each DNO and its stakeholders.

1.5. In the September strategy consultation we set out and consulted on:

- what we would expect to see in a well-justified business plan and how we would like it to be presented and structured
- the process we would follow in assessing the plans, including our assessment of the plans for the purposes of proportionate treatment.

1.6. We have included guidance on business plan presentation and structure as a separate appendix (Appendix 2). This is the final guidance that DNOs should use when writing their business plans.

1.7. Each chapter sets out our decision upfront and then provides our reasons and the full details of our requirements.

Structure of this document

1.8. Figure 1.1 below sets out a map of the documents published as part of this decision.

1.9. The remainder of this document is structured as follows:

- In Chapter 2 we explain the process we will use when assessing the business plans including our approach to applying proportionate treatment (including fast-tracking). Through proportionate treatment, we intend to reward those DNOs who produce a well-justified business plan and focus the heaviest scrutiny on those who produce less well-justified plans.

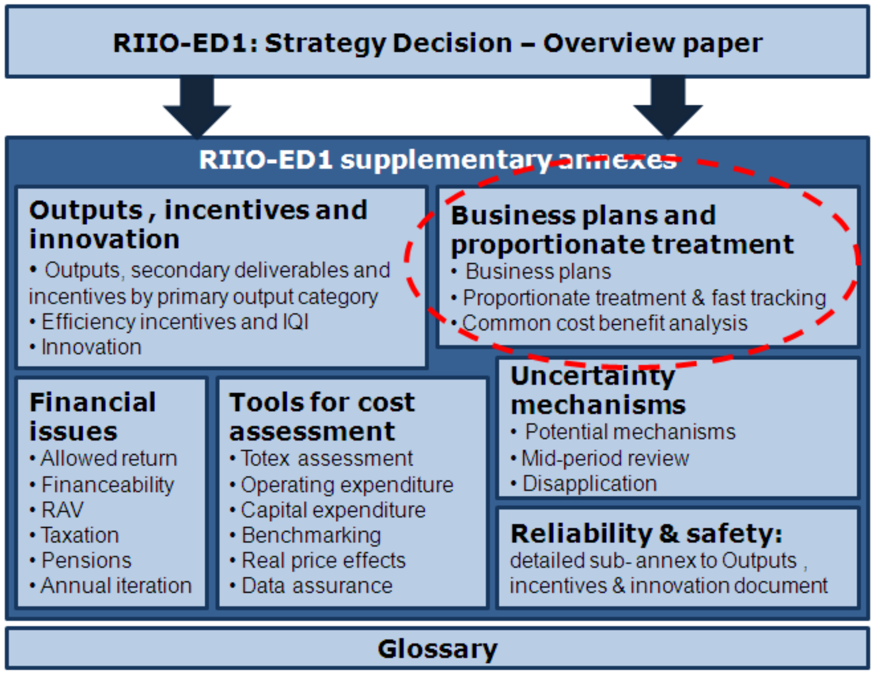
- In Chapter 3 we set out our core assessment criteria and provide detailed guidance on what Ofgem will be considering in each of these areas when assessing business plans.

- In Chapter 4 we set out our guidance on how the DNOs' business plans should be presented and structured to ensure the plans are more accessible and comparable. In addition to our proposals in the September document, this chapter also details our decision to require the DNOs to produce a one page factsheet of the key information in their plan. This factsheet will have a standard format to be used by all DNOs.

- In Chapter 5 we explain our decision on cost benefit analysis (CBA) following consideration of the responses received. We set out the parameters that may need to be specified in order to ensure consistency in how DNOs undertake this critical input to their business plan submissions. We also set out areas where further work is required ahead of us reaching a decision.

1.10. In the September strategy consultation we also had a chapter on 'Building on our experiences of RIIO-T1 and GD1'. We have not repeated this chapter here but have included the learning from this in our decisions.

Figure 1.1: RIIO-ED1 Supplementary annex document map



Links to these documents can be found in the 'Associated documents' section of this document

2. Business plan assessment process

Chapter Summary

This chapter explains the process we will use when assessing the business plans. It outlines our proportionate approach, whereby the intensity and timescale of the assessment will reflect the quality of a DNO's business plan and the DNO's record of efficient output delivery. We have not made significant changes to the proposed process set out in the September strategy consultation.

Proportionate treatment and fast-tracking

Our decision

2.1. Proportionate treatment and, to a greater degree, fast-tracking provides the DNOs with incentives to step up to the challenge of submitting realistic and well-justified business plans.

2.2. If a DNO produces a high quality business plan, we will subject their business plans to a lower level of scrutiny and focus regulatory attention on the areas that deserve further analysis. Where a DNO produces a very high quality business plan, we will consider whether it is appropriate to conclude their price control process early (ie the DNO would be fast-tracked). It is essential that a DNO performs well in each and every section of the core assessment criteria. It is therefore possible that no DNO will be fast-tracked if our assessment is that none have met the required standard. Conversely, DNOs whose business plans are not of a high enough quality will receive a higher degree of regulatory scrutiny and are likely to be required to make substantial improvements to their plans following our initial assessment.

2.3. We believe being fast-tracked offers DNOs a number of advantages as set out later in this chapter. We are also providing fast-tracked DNOs with upfront additional revenues of 2.5 per cent of totex in lieu of their IQI settlement. There were some concerns that those who are fast-tracked could be disadvantaged in the overall process, if they would have obtained a better deal by being slow-tracked. We will ensure that fast-tracked DNOs are no worse off than if they had continued in the assessment process (ie been slow-tracked).

Summary of consultation proposals

2.4. In our September strategy consultation we said that proportionate treatment and, to a greater degree, fast-tracking, gives DNOs a range of advantages such as being able to plan with greater certainty earlier in the process, being able to refocus resources on business as usual activities earlier in the process and gaining positive reputational advantages.

2.5. We said that proportionate treatment may also provide incentives for DNOs to reveal information that would not otherwise be available (or only become available late in the price control review process).

2.6. If a DNO produces a well-justified business plan we proposed not just to focus less regulatory resource on them, but also to undertake an investigation to decide whether it is appropriate to reach an early, fast-tracked, settlement. This early settlement does not change the price control implementation date of 1 April 2015. However, it means all reviews of a fast-tracked business plan would be complete by February 2014.

Summary of consultation responses

2.7. The majority of respondents agreed with our proposed process and supported the principle of proportionate treatment.

2.8. However, whilst some DNO and supplier respondents felt being fast-tracked offered enough rewards without the need for additional incentives, other DNOs were concerned that a DNO whose settlement is concluded later may get a better deal than one that was fast-tracked. They believed this could occur either as a result of new information arising in the interim period, or because we change a decision on an element of the settlement which could result in the DNO having a better outcome if they had not been fast-tracked.

2.9. One DNO thought additional revenues similar to those received by fast-track companies from RIIO-T1 were appropriate. Another DNO thought at this stage a range of between two and four per cent of totex would be more appropriate.

2.10. One supplier said they had yet to see any quantified benefits to consumers of fast tracking. They added that with the longer price control period and uncertainty of key investment decisions, consumers will bear the risk of higher prices and/or lower outputs. Another supplier was concerned that fast-tracking may result in inequality in the retail supply market, as a major supplier in a DNO area that is fast-tracked will have more certainty over its cost base than a major supplier in an area where the DNO has not been fast-tracked. They thought this could result in consumers in non-fast-tracked areas paying more for their energy due to the risk margin having to be applied by suppliers.

Reasons for our decision

2.11. We have considered the responses and believe we already have in place mechanisms to guard against the concerns. We outline these below.

Mitigating the perceived risk of being fast-tracked

2.12. In our strategy consultation we said we thought it unlikely a DNO would have an inferior outcome under a fast-track settlement. We have put in place a number of important mechanisms, including the cost of debt index, which will automatically adjust for changes occurring between concluding the fast-track settlement and the beginning of the price control.

2.13. When presented with final determinations in February 2014, any fast-tracked DNO will be able to reject a fast-track settlement. For these reasons, the agreed settlement for the fast-tracked DNO will be their view of the revenue it needs to run its network and contain sufficient consideration for the risk the DNO believes it is facing (including in the period up to the start of the price control period).

2.14. We will provide fast-tracked DNOs with upfront additional revenues of 2.5 per cent of totex (in lieu of their IQI settlement). For the control as a whole we will ensure that fast-tracked DNOs are no worse off than if they had continued in the assessment process. That is to say, if a fast-tracked DNO would have had a better result on the IQI matrix by presenting their package at slow-track, we will trade them up to the better package. In addition, there is no risk of being traded down for a fast-tracked DNO.

Assessment process

Our decision

2.15. The high level steps in our process can be summarised as follows:

- Step 1: Initial assessment for each DNO
- Step 2: Consultation and decisions on any proportionate treatment
- Step 3: Assessment of non-fast tracked DNOs or areas of a DNO's plan that is not subject to proportionate treatment.

2.16. These stages and the assessment process are described in more detail from paragraph 2.20 onwards.

Summary of consultation proposals

2.17. We proposed a three-stage assessment process in our September strategy consultation. This differed from the four-stage process we used in RIIO-T1 and GD1 which included an 'initial sweep stage' plus a further stage of analysis before a decision was made on proportionate treatment (including fast-tracking). This additional stage was included because it was the first time the network companies had been required to produce business plans under the RIIO framework. We stated that we did not intend to do this for RIIO-ED1 as DNOs have now had the chance to learn from RIIO-T1 and GD1.

Summary of consultation responses

2.18. Most DNOs agreed with our proposed assessment process. However, one DNO did not agree with the streamlined process, fearing it reduced the level of regulatory scrutiny and could possibly reduce the number of fast tracked companies. There were also concerns from some stakeholders that the timetable was too ambitious and they would not have adequate time to respond.

Reasons for our decision

2.19. We have decided to maintain the three stage assessment process as set out in our September strategy consultation and have not made any changes to our original proposals. As DNOs have had an opportunity to learn from the RIIO-T1 and GD1 processes, we believe that a three stage assessment process is sufficient and there is therefore no need for an additional 'initial sweep' stage.

Assessment process

Initial assessment

2.20. In July 2013, the DNOs will submit well-justified business plans informed by stakeholder engagement. We will then undertake our first assessment of the plans and other relevant information.

2.21. The initial assessment will be informed by three different evidence sources:

- an assessment of the business plan, including accompanying data and the completed Price Control Financial Model (PCFM) and business plan narrative (we discuss the assessment criteria in Chapter 4)
- use of any available comparative evidence (eg benchmarking)
- assessment of past performance.

2.22. During this process we may seek clarity from the DNOs on aspects of their plans. To ensure we can complete the assessment in a timely manner, we will require the DNOs to respond to requests within a short timescale. We will clearly define the specific timescale at the time as this will depend on the nature of the query. DNOs will need to be prepared for this process.

2.23. All DNOs will have the opportunity to make representations to Ofgem's RIIO-ED1 Committee of the Authority on the contents of their business plans during this stage in the process.

Consultation and decision on any proportionate treatment

2.24. Following our initial assessment, we will publish a consultation on the extent to which each of the DNOs' business plans has met our criteria; and therefore the level of regulatory scrutiny each DNO will be subject to in reaching a settlement. We expect to publish this document in October 2013. This will also set out our proposals on which DNOs, if any, will be offered a fast-track settlement. For each DNO, there are three broad options the Authority could adopt. These are explained below.

- ***Fast-tracking*** - we may decide a DNO, or DNOs, have provided business plans of sufficiently high quality for them to be fast-tracked.
- ***Other proportionate treatment*** - we may decide a DNO, or DNOs, have provided business plans that are well-justified in certain areas, but have issues to be addressed in others. Where this is the case, the business plans will be subject to proportionate treatment. Such DNOs will benefit from proportionately lower scrutiny of the well-justified sections of their business plans throughout the remainder of the price control process.
- ***Full scrutiny*** - DNOs who are neither fast-tracked nor subject to proportionate treatment will be subject to full scrutiny of their plans.

2.25. Where we propose to fast-track a DNO we will publish a Draft Determination. The Draft Determination will be subject to an eight week public consultation.

2.26. At this stage of the assessment process we will also provide feedback to those DNOs that have not been selected for fast-tracking on the quality of their business plans. This would include setting out any areas of proportionate treatment.

2.27. If, following responses to our consultation, we decide to fast-track the DNO(s) identified in the consultation for fast-track, we will publish a decision and their Final Determination. This is currently scheduled for February 2014.

2.28. If for any reason a DNO identified in the consultation for fast-track is then not fast-tracked, it would return to the non-fast-tracked process with the other slow-track DNOs. However we assume that, having been considered for fast-tracking, elements of the DNO's plan would be subject to proportionate treatment. We would set this out in our decision.

2.29. The settlement set out in the Final Determination of any fast-tracked DNO, will subsequently be updated in a number of respects before it comes into effect in April 2015.

- The cost of debt assumption in the business plan is set at 2.92 per cent. This will be updated to reflect the end of October 2014 value (and initially updated to the end of October 2013) in accordance with our policy for annual updates to the cost of debt assumption.

- Funding for the established pension deficit for all network operators is updated on a triennial basis. The next review and update is due for completion in the autumn of 2014 with changes to allowed revenues taking effect from April 2015. If the review is completed in time we will update the funding in the fast-track settlements as appropriate.
- Once each DNO's actual financial results for 2013-14 are reported during the summer of 2014 we will update their opening RAV value, opening tax pools and true-up amounts and adjust allowed revenues accordingly.

2.30. Our approach to the allocation of expenditure to tax pools is to use generic attributions applicable to all DNOs. Companies will use their DNO specific attributions in their business plans. We will set the final generic attributions after a review of all the business plans and updated requested tax allowance accordingly. This will happen before the Draft Determination for any fast-tracked DNO.

2.31. Further details on these financial adjustments can be found in the 'Supplementary annex – Finance'.

Non-fast-track process

2.32. Following publication of our initial assessment decision, DNOs not identified for fast-track will follow a year long process for finalising their settlement. This process will be dependent on the level of regulatory scrutiny that we deem appropriate.

2.33. Non-fast-tracked DNOs will need to submit revised business plans. The date of resubmission will be set out in our decision on any proportionate treatment in the initial assessment decision.

2.34. Those DNOs subject to proportionate treatment may only be required to focus their revisions on limited aspects of their plan. However, a whole new business plan should be submitted and published by all non-fast-tracked DNOs, accompanied by a paper summarising the changes made from their first submission.

2.35. Following resubmission, we will undertake further analysis of these business plans. This analysis will inform our Draft Determination. The quality of the original plans and how DNOs have responded to external challenge with their final plans, will determine the degree of regulatory intervention they face in the publication of our Draft Determination. We may accept a DNO's revised proposals for consultation or make alternate proposals if we do not consider the revised proposals to be sufficiently well-justified.

2.36. We will publish Draft Determinations for slow-tracked DNOs in July 2014. These Draft Determinations will be subject to an eight week consultation.

2.37. In November 2014, the Final Determinations will be made by the Authority. The Final Determinations will be informed by feedback from the Draft Determination consultation and any further analysis or material information received from the DNOs.

Licence conditions

2.38. Prior to the business plan submission we will set up a licence-drafting working group with the DNOs to work (with policy working groups) on the licence conditions required to implement this strategy decision.

2.39. In parallel we will develop the Price Control Financial Instruments; that is the Price Control Financial Model (PCFM) and the Financial handbook. The financial instruments will be incorporated into a new 'Governance of Price Control Financial Instruments' condition of each licence and will be subject to a formal modification process set out in that condition.

2.40. A first draft of the PCFM was issued to the DNOs in October 2012. It has been reviewed and further developed by the finance working group. The final version of the model will be issued in March 2013 and DNOs will be required to return this alongside their business plans, populated with data consistent with their business plans.

2.41. Subsidiary documents to the licence (known as 'associated documents' for RIIO-T1 and GD1), such as the Regulatory Instructions and Guidance (RIGs), the Financial Handbook and the Innovation Stimulus Governance Documents, will be developed in a parallel process to the licence drafting, and may involve separate working groups.

2.42. The new licence will come into force and the RIIO-ED1 price controls for both fast-tracked and non-fast-tracked DNOs will commence from 1 April 2015.

2.43. The licensee, other electricity licensees who may be affected, and certain other specified bodies representing licensees or consumers then have the right to appeal the licence modification decision to the Competition Commission if they are dissatisfied.

3. Assessment criteria

Chapter Summary

This chapter sets out our decision on the criteria we will use to assess whether we consider a business plan to be well-justified. This will inform our decision on closing the settlement with each DNO and any use of proportionate treatment. This chapter outlines our decision, summarises our consultation proposals and the responses we received. We then repeat the detail of the assessment criteria (with minor changes).

Our decision

3.1. We have decided to retain the five core business plan assessment criteria which we consulted on in September. All respondents to our consultation agreed with the criteria we set out although there were some small changes suggested to the criteria questions; however we feel that the categorisation remains appropriate.

3.2. We have repeated the detail from the consultation in paragraph 3.9 onwards of this chapter.

3.3. Our assessment will be based on the quality of the business plan against the criteria set out in this chapter. We recognise that in providing these criteria we may not have foreseen all eventualities that may contribute to a well-justified plan. In such cases, we will consider the quality of justification made and set out clearly how we have dealt with the proposal overall.

Summary of consultation proposals

3.4. In the September consultation document we set out our proposed criteria building on the nine core principles[1] of a well-justified plan.[2] This was explained in the RIIO handbook and aligns with the criteria we used for RIIO-T1 and GD1. We simplified the criteria to reflect stakeholder feedback and lessons learnt from RIIO-T1 and GD1. For RIIO-ED1 we proposed five core criteria with further questions under these, as opposed to the fifteen criteria we originally proposed for RIIO-T1 and GD1.

[1] Page 48-49 of the RIIO handbook.

[2] These are: focus on output delivery; consider secondary deliverables; contain an open minded consideration of available options; present a clear and well evidenced case for proposals; link costs and primary outputs; consider the longer term; provide value for money; and demonstrate effective engagement with a range of stakeholders and working with others.

Consultation responses and reasons for our decision

3.5. All respondents who commented broadly agreed with our proposed criteria. Three DNOs had specific comments as outlined below.

3.6. One DNO had concerns regarding the criterion for assessing secondary deliverables. They did not believe a DNO should be rigidly held accountable for movements in these metrics. We feel that as secondary deliverables are an important part of the DNOs' business plan they should form part of the assessment criteria.

3.7. One DNO wanted a commitment to safety to be a key requirement of a well-justified plan. As safety is one of the six output areas DNOs are required to deliver upon, we do not consider that we need to alter the criteria to make safety a key requirement.

3.8. One DNO wanted more detail on some of the criteria. In particular, they wanted the criterion on outputs to split the question on resource implications for the delivery of each output into two criteria; one specifically for assessment of resources and another assessing the adequacy of the forecasting of secondary deliverables. We want to keep the criteria as clear and simple as possible therefore we do not feel it necessary to split this question or provide further information.

Final assessment guidance

Overview of criteria

3.9. Table 3.1 below sets out the five core criteria against which we will assess the business plans. It includes the key questions we will consider in assessing each DNO's business plan against the criteria. In order to be fast-tracked, DNOs must demonstrate that their plan sufficiently meets the criteria in all of the sections listed below.

Table 3.1: Assessment criteria

Process: Has the DNO followed a robust process?
Is the business plan clearly presented, with all key content included?
Has the DNO engaged with stakeholders, and explained how this has influenced its business plan?
Has the DNO submitted, and justified, all data tables and the PCFM?
Does the business plan provide a strategy for long-term delivery?
Outputs: Does the plan deliver the required outputs?
Has the business plan covered the outputs specified in our strategy decision or provided clear and compelling justification for any departures from the strategy decision?
Has the DNO explained the resource implications for delivery of each output

identified?
Has the DNO explained how it will deliver outputs, and justified output baseline/forecast?
Has the DNO explained the quality of its existing outputs and secondary deliverable information (including information on asset health, criticality and asset risk) and how it plans to improve this information in future?
Resources (efficient expenditure): Are the costs of delivering the outputs efficient?
Has the DNO demonstrated that cost projections are efficient?
How does the plan compare with others/does it reflect wider best-practice?
Has the DNO demonstrated that their financial costs are efficient (eg through market-testing)?
Has the DNO explained cost projections in context of historical performance?
Has the DNO demonstrated a consideration of alternative approaches to achieving value for money in the delivery of its outputs?
Has the DNO clearly linked its expenditure to relevant outputs and secondary deliverables?
Resources (efficient financing): Are the proposed financing arrangements efficient?
Does the business plan conform with the financial policies specified in the strategy, are any departures well-justified?
Has the DNO provided evidence that financial costs are efficient?
Is the data in the plan consistent and has the DNO explained cost projections in context of historical performance?
Uncertainty & risk: How well does the plan deal with uncertainty and risk?
Has the DNO clearly articulated the key uncertainties it faces and considered how it will address them (eg including uncertainty mechanisms)?
Has the DNO considered risk and how to mitigate those risks?

Explanation of criteria

Criterion 1 - Process

3.10. DNOs need to demonstrate through their well-justified business plan that a strong and robust development process has been followed in planning for the RIIO-ED1 period. This process should include the engagement of the business and its stakeholders and ensure proposals are clearly communicated and evidenced. This process needs to be evidenced throughout the plan so that readers can clearly see how the DNO has arrived at its conclusions.

Is the business plan clearly presented with all key content included?

3.11. Plans should be clearly and simply written. Technical language should be kept to minimum and clearly explained where it is used. Plans should include all the main elements of a well-justified plan, as set out in the RIIO handbook and all elements of our strategy decision. Chapter 4 of this document has further guidance on how business plans should be presented.

Has the DNO engaged with stakeholders, and explained how this has influenced its business plan?

3.12. The DNOs should develop business plans reflecting their engagement with their stakeholders. As highlighted in Chapter 2, it will not be sufficient for DNOs to just set out the stakeholder engagement activities they have carried out. We expect the DNOs to demonstrate what they have learned from their engagement, how they have reflected it in business plans, or why they have decided not to respond to stakeholder views if this is the case, eg mapping the impact. We also expect DNOs to demonstrate they have effectively engaged with a wide range of stakeholders when formulating their plans.

Has the DNO submitted, and justified, all data tables and the PCFM?

3.13. The DNO must ensure all data tables submitted are well-justified in the text and there is clear linkage between the data tables and the text where needed. It is important the DNOs maintain consistent terminology between their business plan narrative and the data tables. The PCFM should be correctly completed. To ensure this we urge all DNOs to spend time familiarising themselves with the PCFM.

Does the business plan provide a strategy for long-term delivery?

3.14. A well-justified plan should detail information on the DNO's long term strategy for developing their networks and delivering long term value for money. We will expect DNOs to link this to their strategy for contributing to meeting the government's carbon and renewable targets.

3.15. This will require the DNOs to show they have not only considered the expenditure they need for the duration of the price control, but also the implications this will have on required investment and associated efficiency beyond the price control period (ie in the RIIO-ED2 period). They will need to justify expenditure in the eight-year period in the context of their long term strategy.

3.16. DNOs will need to explain how their plans can achieve a range of demand and generation scenarios at efficient cost as set out in the outputs, incentives and innovation section of this document.

Criterion 2 - Outputs

3.17. The DNOs' explanation of how they will deliver their outputs over the full price control period and beyond (ie DNO's consideration of RIIO-ED2) is a key part of the business plan. To be considered 'well-justified' a DNO's plan needs to clearly describe its outputs and secondary deliverables and explain how it will deliver these.

Has the business plan covered the outputs specified in our strategy decision or provided clear and compelling justification for any departures from the strategy decision?

3.18. The 'Supplementary annex - Outputs, incentives and innovation' sets outputs and secondary deliverables against the primary output categories (eg customer service, environment, safety, connections, reliability, etc). We expect DNOs to comply with the final policies we have set or provide clear and compelling justification for departure from them. Ultimately it will be for us to decide whether or not to accept a DNO's proposals for new or revised outputs.

Has the DNO explained the resource implications for delivery of each output identified?

3.19. A well-justified business plan would demonstrate how the DNO will achieve successful output delivery. This means identifying planning and resourcing requirements, especially where the level of activity looks to increase significantly from historical levels. The DNOs will be required to demonstrate their resourcing requirements are efficient.

3.20. As part of their business plans the DNOs are required to set out their views on asset health, criticality and replacement priorities at:

- the start of the price control period, effectively reflecting their view on the current condition, risk and replacement priorities of the network
- the middle of the price control period with no intervention, effectively reflecting their view on asset degradation over the period
- the middle of the price control period with intervention as proposed in their well-justified business plan
- the end of the price control period with no intervention, effectively reflecting their view on asset degradation over the period
- at the end of the price control period with intervention as proposed in their well-justified business plan.

Has the DNO explained how it will deliver outputs, and justified output baseline/forecast?

3.21. The plan should clearly identify how a DNO intends to deliver the outputs. Except where we prescribe specific outputs levels, we will expect DNOs in their business plans to propose a target level delivery for each output and to justify this with reference to stakeholder feedback, network performance and a consideration of efficiency. The plan should clearly identify the impact of these outputs on the required expenditure for the price control period. Where we outline output levels in outputs and incentives, we will expect DNOs to provide justification where they consider an alternative level of outputs to be appropriate.

Has the DNO explained the quality of its existing outputs and secondary deliverable information (including information on asset health, criticality and asset risk) and how it plans to improve this information in future?

3.22. Good quality information on outputs, secondary deliverables and expenditure is a key part of the regulatory process. This information is essential for DNOs to manage their networks and prepare their forecasts, for customers to understand what will be delivered in return for price control allowances, and for us to assess business plans, set revenue allowance, output targets and incentives and monitor compliance with the price control settlements. As such, DNOs should explain the current quality of their existing output and secondary deliverable information (including information on asset health and deterioration, criticality and asset risk) and how they intend to improve this information in the future to support the objectives discussed above.

Criterion 3 - Expenditure

3.23. The DNO must clearly set out and explain the costs of delivering its outputs. A well-justified business plan will demonstrate, through clear evidence, that a DNO's costs are efficient.

Has the DNO demonstrated that cost projections are efficient?

3.24. The costs set out in the business plan should be efficient over the longer-term. DNOs will need to provide evidence that they need to do the work, that they have considered alternative options (eg operating expenditure and capital expenditure alternatives; network and non-network solutions) and that the costs of delivery are appropriate. This will include taking into account the longer-term development of their networks. We expect DNOs to use a range of tools in demonstrating the efficiency of their costs including internal and external benchmarking evidence and market testing. We would expect the DNOs to take a proportionate approach to providing evidence with greater information for more material areas of costs.

3.25. We will consider efficiency through our toolkit approach to cost assessment. This will include both higher level and more disaggregated analysis. It will also include comparisons of both forecasts and historical data across DNOs. If the costs a DNO identifies are higher relative to other DNOs and past performance, then it will be for that DNO to demonstrate efficiency in the long term. More detail of this approach is set out in the 'Supplementary annex – Tools for cost assessment'.

How does the plan compare with others/does it reflect best-practice?

3.26. A key element in judging business plans will be the comparison of each DNOs plan with best practice. In assessing whether a plan is well-justified, we will consider the quality of that plan in comparison with other plans in areas such as cost efficiency. We will also consider the extent to which a DNO has looked to other sectors in their approach to the delivery of outputs and secondary deliverables.

Has the DNO provided evidence that costs are efficient (eg through market-testing)?

3.27. The plans should provide sufficient evidence to support the DNO's proposals. The evidence should demonstrate that the forecast outputs are justified and the costs to deliver these outputs are efficient. A well-justified business plan will demonstrate that efficient volumes are being proposed as well as appropriate unit costs for undertaking that work.

3.28. As set out in our RIIO recommendations, a key component of this evidence is market-testing evidence.

3.29. The key test for Ofgem will be the level of scrutiny we consider we are required to undertake of a DNO's plan. DNOs should ensure they learn from the process undertaken by RIIO-T1 and GD1 companies.

Has the DNO explained cost projections in context of historical performance?

3.30. We expect DNOs to demonstrate in their plan how their forecasts relate to their performance under the current controls. For example, if a DNO recognises it is likely to have inefficiently high costs relative to its peers for a particular activity, it will need to demonstrate how it plans to address this inefficiency. If there is an under-spend in the current period, then they will be expected to justify this and put their forecasts in the context of previous performance.

Has the DNO demonstrated a consideration of alternative approaches to achieving value for money in the delivery of its outputs?

3.31. We expect DNOs to clearly demonstrate throughout their business plans that they have considered the use of alternative techniques (such as innovative technical, operational, commercial and contractual arrangements) in all areas of their business to deliver their outputs more efficiently and reduce costs.

3.32. We also expect that some of the projects funded under the Innovation Funding Incentive (IFI) and Low Carbon Networks (LCN) Fund will have delivered valuable learning DNOs can use within their businesses. Therefore, we expect to see evidence of this learning (both from their own innovation projects and those of other DNOs) in the development of DNOs' business plans.

Has the DNO clearly linked its expenditure to relevant outputs and secondary deliverables?

3.33. The DNOs should demonstrate how their expenditure forecasts map onto relevant outputs and secondary deliverables. In some cases there will be a direct link, in others some of the expenditure will have an enabling role in supporting the delivery of other work. For example, certain business support expenditure.

Criterion 4 - Financing

3.34. The DNO needs to clearly set out in its business plan how it plans to finance its activities over the price control period. To be considered well-justified a plan must demonstrate, through clear evidence, that the DNO's financing projections are efficient.

Does the business plan conform to the financial policies specified in the strategy, are any departures well-justified?

3.35. This strategy decision sets out guidance on financial policies. These include cost of debt index, asset lives, tax, pensions and capitalisation as well as a methodology for arriving at the cost of equity. We expect a well-justified plan will reflect these or provide robust analysis to support any departures from our policy.

Has the DNO demonstrated that their financial costs are efficient?

3.36. We expect DNOs to use a range of tools in demonstrating the efficiency of their financing costs, including: established economic models, evidence from market data and relevant comparators and precedents. We would expect the DNOs to take a proportionate approach to providing evidence with greater information for more material areas.

3.37. We would expect robust analysis to support any view on the value of parameters, especially where a DNO's proposal departs from our policies, is outside the ranges set out in this strategy decision, or are out of step with precedent.

3.38. The DNO's plan should provide sufficient evidence to support its proposals. The evidence should demonstrate that the estimated financial costs are efficient. The evidence would include key elements of the financial arrangements including an assessment of risk, notional gearing, the cost of equity, financeability analysis and, if needed, any transitional arrangements.

Is the data in the plan consistent and has the DNO explained cost projections in context of historical performance?

3.39. An important element of the business plan is consistency. We expect the data within the written business plan to be consistent with the data in the business plan data tables, the submitted financial model and reported historical performance. Any inconsistencies will make understanding the plan more difficult and adversely affect the analysis of the plan. Data inconsistencies undermine confidence in the quality and reliability of the plan.

Criterion 5 - Uncertainty and Risk

Has the DNO clearly articulated the key uncertainties it faces and how it will address them (eg including uncertainty mechanisms)?

3.40. There will always be uncertainty about whether the outputs and expenditure requirements will be appropriate over the duration of the price control. A well-justified business plan will need to articulate the key uncertainties the DNO faces and how the DNO has taken account of these in developing its long-term business strategy. We have set out our thinking on potential uncertainty mechanisms in this decision. The DNOs have the opportunity in their business plans to say which of these mechanisms they think are required and to propose and justify additional mechanisms that meet our principles. Ultimately it will be for us to decide whether or not to accept a DNO's proposals for new or revised uncertainty mechanisms.

Has the DNO considered risk and how to mitigate those risks?

3.41. An important part of any price control settlement involves considering what type and what level of risk it is efficient for DNOs to bear and what risks if any should be borne by customers. A well-justified plan should demonstrate an assessment of risk during the price control period and say what the DNO intends to do in the light of that risk.

3.42. DNOs should outline how they plan to strike an appropriate risk balance by identifying what they will include in their ex ante allowance and what they will include in uncertainty mechanisms. The consequences of these risks should be clearly modelled and linked to the justification of forecast financing costs.

4. Guidance on presentation and structure

Chapter Summary

This chapter sets out our decision on how the business plans should be presented and structured. This includes a template for a one-page factsheet which will be required for each of the DNO's licence areas. The chapter outlines our final decision and summarises consultation proposals and responses to the questions posed. Our final guidance on presentation is set out in full in Appendix 2 of this document.

Our decision

Business plan presentation and structure

4.1. Each DNO will submit a well-justified business plan to reflect the strategy for their business. The plan will be owned by the network company and we are keen that each DNO develops a real business plan for use by their employees and stakeholders, rather than just a regulatory submission. We have therefore not been too prescriptive in our requirements for the common presentation and structure that should be used.

4.2. We received feedback from a variety of stakeholders that RIIO-T1 and GD1 business plans were not easy to read and it was difficult to find information and compare companies. We have therefore decided to issue high-level guidance on presentation and structure which DNOs should follow when they are drafting their business plans. The guidance covers three areas:

- Presentation: the written style and look of the plans
- Structure: how the information in the plans should be grouped to allow for a level of consistency and comparability across the plans
- Navigation: how to make it easier for readers to find the information they require easily.

4.3. We presented this proposed guidance in our September strategy decision document. All stakeholders agreed with this guidance and the final guidance is set out in full in Appendix 2 of this document.

4.4. As well as submitting plans to Ofgem, DNOs will be expected to publish their business plans in full on their websites. DNOs should aim for their published plans and the plans they submit to us to be as similar as possible. DNOs should keep any redactions to published versions to a minimum and must fully justify to us why any redactions are necessary.

4.5. In addition, we require all DNOs to set out their key information in a one page factsheet. The format of the factsheet will be common across all DNOs and they will be required to fill in a factsheet for each of their licence areas. This factsheet is intended to assist stakeholders such as consumers, consumer groups, media and small suppliers, who have an interest in some of the high-level information in business plans but may not have the time, resources or expertise to scrutinise the plans and extract the information they require.

Summary of consultation proposals

4.6. As part of RIIO-T1 and GD1 processes Ofgem provided limited presentation and structural guidance. Feedback from stakeholders suggested that these business plans were difficult to navigate. As a result, in the strategy consultation we said we would provide guidance on how business plans should be presented and structured. We said the aim of this guidance was to ensure that:

- plans are coherent and consistent so as to allow for effective comparison and assessment across DNOs
- it is easy for Ofgem and other stakeholders to find the information they require
- DNOs have sufficient guidance on what they need to produce in order to focus their efforts most appropriately.

Consultation responses and reasons for our decisions

4.7. Responses to our proposals were positive with both DNOs and other stakeholders welcoming the extra clarity guidance brings. DNOs thought the guidance was helpful without being too prescriptive.

4.8. In the consultation we asked whether we should set a word limit for the executive summary. Most respondents were against this idea as it would be too restrictive. We agree with this and have decided not to set word limits but we do expect DNOs to be as succinct as they can in their executive summaries.

4.9. Some DNOs said they would not like any significant changes to this guidance in the Strategy Decision as they will already be well into the planning stage by this point. This is one reason why we have not made any significant changes.

4.10. In the consultation we also asked how DNOs should present the impact of their plans on consumers' bills. We had a range of suggestions with most agreeing that consumers should be able to clearly see the effects on their bills in pounds per year. There was agreement for a common method that DNOs should use to calculate and present figures which consumers can easily compare. Appendix 4 provides instructions on how DNOs should do this.

4.11. It was clear from the responses and from further discussions and feedback that there are groups of stakeholders such as consumers, consumer groups, media and small suppliers who have an interest in high-level information.

These stakeholders may not have the time, resources or expertise to scrutinise the business plans and extract the information they require. However, it was felt that even the executive summary would not allow stakeholders access to the information as quickly and easily as they required.

4.12. A common structure as set out in Appendix 2 will go some way towards helping stakeholders locate information within the plans. However as not all stakeholders would be able to read through the plans we have decided to require all DNOs to include their key information in a one page factsheet.

4.13. We created a draft template of a one page factsheet and discussed it with DNOs, consumer groups and suppliers through stakeholder groups and bi-lateral meetings.

One page factsheet

4.14. The format of the factsheet would be common across all DNOs and they would be required to fill in a page for each of their licence areas. This page will contain only the key information and data these stakeholders would want/need to know including:

- a brief description of the network, number of customers, number of staff, length of cables etc as well as brief background detail on the company that owns the network
- how the plan will be financed, the cost of equity and notional gearing
- the impact of the plan on customer bills
- how the money received will be spent, either as network investment or operating costs
- a brief description of the DNO's strategy for the network over the eight years of the price control and the challenges faced by the network.

4.15. If a stakeholder should require further information they will be directed to the relevant part of the main plan. The factsheet is intended to be high level and is therefore limited in detail. Stakeholders requiring in depth information will need to find it in the full business plans.

4.16. DNOs must publish these factsheets alongside their business plans and they should be clearly signposted to ensure consumers can easily access them. Links to all the factsheets will also be published on the Ofgem website.

4.17. A template of the factsheet which DNOs are required to fill in is included in Appendix 3 of this document.

4.18. It is important to note this factsheet should not replace any part of the DNO's business plan and DNOs should continue to write their business plan as per the guidance in Appendix 2.

4.19. We will not use the content of the one page factsheet in our assessment of the business plans other than to confirm accuracy and consistency.

4.20. Using the factsheet does not preclude DNOs from producing any additional communication material for their stakeholders if they wish to do so.

4.21. We have also produced instructions on how to complete the factsheet, which are found in Appendix 4.

Calculating impact on consumer bills

4.22. The factsheet includes a table where DNOs will set out the distribution charges for the average customer bill. The table requires DNOs to forecast for each year of the eight year price control:

- the percentage change in distribution charges
- annual change, in pounds and pence, in distribution charges
- the total distribution charge.

4.23. Using the charging statements from each of their licence areas DNOs will multiply the domestic unit rate by the average level of consumption plus the standing charge for that licence area. The average level of consumption is the national average used by Ofgem.

4.24. DNOs will then forecast the changes in charges over the course of the price control by applying their proposed change in revenue, using their best view scenario.

4.25. It is important to note these figures show the distribution charges that form part of a customer's overall bill, not the customer's overall bill.

4.26. Appendix 4 explains in more detail how DNOs should calculate these figures.

Scenarios

Our decision

4.27. In their business plans, DNOs must provide details of forecast expenditure and volumes over the RIIO-ED1 price control periods for all four scenarios of future low carbon technology penetration developed by the Department of Energy and Climate Change (DECC), alongside their best view scenario.

4.28. In developing expenditure forecasts based on these scenarios we expect DNOs to utilise the Transform model[3] or other comparable modelling tools along with other evidence (including cost benefit analysis)[4] to demonstrate that they have fully considered smart grid solutions.

4.29. A DNO's best view scenario is the core forecast they put forward in their business plan reflecting the expenditure and volumes they expect over the RIIO-ED1 period. It should be developed in consultation with stakeholders and should reflect their view on the likely impact of accommodating low carbon technologies on their network. The best view is the scenario upon which the business plan should be based and it can be one of the DECC scenarios or a scenario the DNO has constructed.

4.30. We believe that a reference case scenario is required in order to compare DNOs' costs. This reference case will be the DECC medium (high heat pump, central electric vehicle) scenario (Scenario 1 under DECC's naming convention), corresponding to the high abatement in low carbon heat scenario in the Transform model.

4.31. For the reference case, the Transform model must be used with the "incremental" investment approach as this will provide comparability of both smart and conventional solutions.

4.32. We acknowledge that each DNO's best view may not be the scenario that materialises during the RIIO-ED1 period. Therefore, DNOs must present a narrative on how their investment strategy can flex to meet demands associated with any of the DECC scenarios. This will form part of the core narrative section of DNOs' business plans. This should cover how the DNO will monitor the scenario that materialises, including use of notification processes for installation of low carbon technologies. We also expect explanations of how unit costs of managing problems on the network may change across scenarios. DNOs are able to choose how best to construct and present this narrative.

4.33. We wish to understand each DNO's forecast long term trend of expenditure and volumes beyond the RIIO-ED1 period. Different forecast scenarios and investment strategies will see different expenditure profiles to the end of the RIIO-ED2 period. Therefore expenditure that in some DNOs' forecasts falls during the RIIO-ED2 period, may be expected for RIIO-ED1 in other DNOs' forecasts. In order to overcome this potential problem for assessing business plans, we require a narrative on longer term forecasts and strategy. We expect DNOs to explain how their best view for RIIO-ED1 fits into their long term strategy for RIIO-ED2.

[3] The Transform model is a spreadsheet model commissioned by the DNOs under Work Stream 3 of the Smart Grid Forum. Further information can be found at: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=47&refer=Networks/SGF/Publications
[4] For further information on our guidance on cost benefit analysis see Chapter 5.

Scenarios data required

4.34. In order to assess DNOs' best view scenarios we will require detailed information on forecast volumes and costs in the business plan data templates. This will include details of the volumes of low carbon technologies assumed.

4.35. To enable us to adequately compare DNOs' costs, we will also require all tables to be submitted for the reference case.

4.36. In order to provide an indication of the range of expenditures across the scenarios, we will require partially aggregated details of costs for all four DECC scenarios.

Summary of consultation proposals

4.37. In the September strategy consultation we proposed that DNOs provide detail on all four DECC scenarios and their own best view scenario, with the level of detail to be determined and set out in the strategy decision. We proposed that one of the scenarios should act as a reference case, allowing us to compare costs across DNOs. We were minded for this to be the DECC low scenario.

4.38. We also proposed that DNOs provide a narrative explaining how their investment strategy would flex in order to allow them to meet all DECC scenarios.

Consultation responses and reasons for our decision

4.39. The majority of respondents broadly agreed with our proposals.

4.40. There was wide support from respondents for our proposal to allow DNOs to put forward their own best view scenario. We believe that a DNO's best view scenario is required as this will form part of their forecast for expenditure over the RIIO-ED1 period. While any of the DECC scenarios may occur during the period, we expect DNOs to develop a justified forecast as part of their business plan.

4.41. One respondent suggested that the DECC low scenario is not appropriate as a reference case and proposed that one of the medium scenarios would be preferable. Current evidence from the DNO submissions indicates that to enhance comparability between best view scenarios, the medium (high heat pump, central electric vehicle) DECC scenario should be used as the reference case. This is more appropriate than the DECC low scenario as it is more likely to demonstrate costs associated with implementing smart solutions.

4.42. One respondent proposed that each DNO should determine the level of detail required to be submitted. We do not support this proposal as we require consistent information in order to compare DNOs. Another respondent proposed that more detail than initially suggested should be provided in order to aid comparison. We have considered this response in determining the appropriate level of detail required on each of the scenarios.

5. Cost benefit analysis

Chapter Summary

This chapter sets out our latest thinking on cost benefit analysis (CBA). It sets out our thinking on the parameters that need to be specified to ensure DNOs adopt a consistent approach to CBA, which will be a critical input to their business plan submissions.

Our updated thinking

Introduction

5.1. In order for us to be able to assess and compare the companies' business plans properly we need DNOs to adopt a common approach to cost justification. The following chapter sets out our updated thinking on CBA guidance the for RIIO-ED1 business plans. This guidance has evolved, and is a simpler, though consistent, approach to the CBA guidance we provided for RIIO-GD1.

5.2. The purpose of the CBA models is to enable the DNOs to demonstrate the proposals included in their business plan provide the optimum solution which demonstrates best value for consumers.

5.3. DNOs should submit their CBA models as part of their July 2013 business plan submissions. DNOs must confirm that their analysis is consistent with the framework set out here or, alternatively, identify the areas where it is not and the reasons for departing from it. We have developed a CBA spreadsheet model, as was done in RIIO-GD1. We intend to issue this spreadsheet model following ongoing discussions with DNOs.

5.4. In addition to employing CBAs, our latest thinking is that DNOs must use the Transform model[5] or other equivalent tools[6] to justify certain costs and narratives in their business plans. Guidance on the use of this model is in the 'Transform model' section at the end of this chapter.

5.5. Our updated thinking on the following specific areas is set out in the remainder of chapter:

[5] The Transform model is a spreadsheet model commissioned by the DNOs under Work Stream 3 of the Smart Grid Forum. Further information can be found at: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=47&refer=Networks/SGF/Publications
[6] For the remainder of this chapter references to the "Transform model" relate to either the Transform model or other equivalent tools.

- identification of options
- identification and quantification of costs and benefits
- time period for discounting costs and benefits
- sensitivity analysis
- decision rule
- affordability
- link to business plans.

Identification of options

5.6. Consistent with the HM Treasury Green Book[7], DNOs should clearly identify the range of options that were considered to meet the stated aim. This list should include an option that takes the minimum action necessary (the "do minimum option") against which other options are compared. We intend to include a section in the CBA spreadsheet model for DNOs to identify clearly the options they have considered for each investment decision.

5.7. The list of options should include those that have been considered and rejected before full costing, and the short list of those that have been considered and costed, with a clear rationale for including/excluding them.

Identification and quantification of costs and benefits

5.8. For the short list of options that have been considered and costed, the DNO should identify the costs and benefits of options relative to the do minimum option. We set out below our guidance in relation to discounting costs and benefits, valuation of marketed and non-marketed goods, and other assumptions.

Discounting and the cost of capital

5.9. We are minded to adopt a simple discounted cashflow approach for CBAs. The approach involves discounting all costs (including financing costs as calculated using the weighted average cost of capital (WACC)) and benefits (with the exception of safety benefits discussed in paragraph 5.14) at the social time preference discount rate (STPR). This involves the following two steps:

1. Convert capital costs into annual costs using the DNO's cost of capital

2. Use the STPR of 3.5 per cent in discounting all costs and benefits, as recommended by the HM Treasury Green Book.[7]

[7] http://www.hm-treasury.gov.uk/d/green_book_complete.pdf

5.10. The capital costs should be converted into the equivalent annual costs that are recovered through customers' bills. We expect DNOs to convert the capital cost into the annual cost using the sum-of-the-years' digits (SOYD) depreciation method in line with our regulatory depreciation policies. The annual capital costs should also be calculated over the assumed economic life of the asset (as discuss in paragraph 5.24).

5.11. To convert capital costs into the annual cost recovered through customers' bills, we envisage requiring DNOs to use the same pre-tax WACC using the latest modelling assumption in the RIIO-ED1 financial model.

Financial costs and benefits

5.12. The financial[8] costs and benefits should correspond to the financial/market values set out in the DNO's business plan (where applicable). For example, the expected reduction in any cost of repairs and maintenance (a financial benefit) arising from an investment should be consistent with the assumptions on unit repair and maintenance costs set out in the plan.

5.13. The financial costs and benefits should also include real price effects (RPEs) net of expected productivity improvements. However, we expect DNOs to present the analysis of alternative assumptions on these issues. We intend to include functionality within the CBA spreadsheet model for DNOs to present the analysis of alternative RPE assumptions.

5.14. Where expenditures are justified using the reduction of electricity lost, our updated thinking is that DNOs should use the wholesale price of electricity less the EU Emissions Trading Scheme (ETS) cost of carbon (which is factored into the wholesale price) plus the carbon abatement value described below. We recognise that both the wholesale price of electricity and the EU ETS cost of carbon will fluctuate over the price control period. To ensure consistency between DNOs' CBA models, we intend to set a standard £/MWh value for DNOs to use in order to estimate the reduction of electricity lost. We intend to base this on average wholesale and carbon prices over 2011-12.

Treatment of non-marketed goods

5.15. CBA should include those non-marketed goods that can be monetised. We will continue to work with licensees to discuss and agree the principal monetised non-marketed goods for inclusion in the CBA. This may include for example the loss of supply, the value of carbon abatement, restoration costs, environmental damage and the value of preventing fatalities and injuries.

[8] Financial costs here, and in the rest of this chapter, refer to monetary costs and benefits rather than non-marketed goods.

5.16. Our updated thinking is that assumptions for certain non-marketed parameters should be standardised. In relation to carbon abatement values, DNOs should use the DECC non-traded carbon values.[9] Our decision is that DNOs should use the STPR for discounting carbon values. This approach is consistent with DECC and Green Book guidance.

5.17. Where benefits associated with preventing fatalities and injuries are identified, DNOs should draw on guidance set out in the HM Treasury Green Book[10] and the CEPA April 2011 report[11] which state that health and safety benefits should be discounted at the "pure time preference rate" or PTPR[12] for marginal utility. The HM Treasury Green Book estimates the PTPR at 1.5 per cent.

5.18. As part of our on-going discussions with DNOs we will look to see whether further non-monetised parameters require fixed assumptions to allow for cross-DNO comparisons and whether this functionality can be included within the CBA spreadsheet model.

5.19. DNOs should also set out any non-marketed impacts or factors that cannot be monetised within the wider investment appraisal and carry out a qualitative assessment of them. This should be factored into the overall CBA decision and the CBA model spreadsheet will include a section where DNOs can outline those benefits which have not been monetised.

Other assumptions regarding discounting

5.20. Our latest thinking is that DNOs should use a common base-year of 2015-16, ie the start of the price control period. The price base for costs and benefits should be 2011-12, consistent with DNO business plan submissions.

5.21. In line with the guidance issued for RIIO-GD1, our latest view is that DNOs should assume that 50 per cent of the benefits calculated for year one of investment (ie six months' worth of benefits) are realised in the first year of the project.

Period for discounting costs and benefits

5.22. Our latest thinking is that the period for the CBA should be a maximum of 45 years which represents the useful economic life of the asset.

[9] https://www.gov.uk/carbon-valuation
[10] http://www.hm-treasury.gov.uk/d/green_book_complete.pdf
[11] http://www.hse.gov.uk/research/rrpdf/rr888.pdf
[12] NERA (9 August 2007) Discount Rates for the Office of Rail Regulation, p.3

5.23. DNOs will need to consider the uncertainty over the future use of low carbon technology as part of their modelling and consider this in their CBA modelling.

Assessing risks and uncertainties, and sensitivity analysis

5.24. DNOs should set out sensitivity analysis for the key risks and uncertainties. The main uncertainties and risks relate to:

- the economic life of the asset (ie consider scenarios over different time periods, less than 45 years)
- the current assumed performance of the asset (for example in terms of repairs and maintenance, losses, customer interruptions, fault rates etc), and the expected deterioration in the performance of the asset over time. We expect DNOs to submit robust information to support assumptions on deterioration rates.

5.25. To accommodate uncertainty over the economic life DNOs should use the functionality within the CBA spreadsheet model to analyse the net present value (NPV) for different pay-back periods. We intend to work with DNOs to establish a number of consistent pay-back periods which will allow for comparability between DNO CBA submissions. We propose that DNOs should also set out the switching value for the economic life of the asset.[13]

Decision rule

5.26. We do not expect DNOs to submit CBAs for every asset. Our updated thinking is that the CBA guidance should be applied at a scheme level and asset class level. It applies to areas of expenditure where the DNO has discretion over the choices it makes (for example, in terms of decisions on whether or not to refurbish or replace an asset) and where the costs forecast to be incurred over the life of the asset or activity are material.

5.27. We expect DNOs to submit CBA models where a materiality threshold is met. As part of the ongoing CBA work, we will be discussing suitable materiality thresholds with DNOs and will issue guidance on this along with the CBA spreadsheet model.

5.28. Where projects within expenditure categories are homogenous in terms of the costs and benefits involved, we expect these projects to be considered as part of one CBA decision. Schemes where costs and benefits are specific to the

[13] The HMT Green Book states: *The calculation of switching values shows by how much a variable would have to fall (if it is a benefit) or rise (if it is a cost) to make it not worth undertaking an option. This should be considered a crucial input into the decision as to whether a proposal should proceed. It therefore needs to be a prominent part of an appraisal. Source:* HM Treasury Green Book (2003) paragraph 5.79.

scheme or project being proposed may require consideration under a separate CBA model.

5.29. Given the importance of ensuring that information requirements are proportionate, in combination with the application of a materiality threshold (see paragraph 5.27) we are also minded to set a limit on the total number of CBAs[14] DNOs are required to submit as part of their business plan. Again, this will be determined following ongoing work with DNOs and issued as guidance along with the CBA spreadsheet model.

5.30. In addition we would expect DNOs to present CBAs regarding the adoption of smart grid solutions and use of lower loss equipment.

Overall rule

5.31. We recognise that CBA analysis may need to be undertaken at a project level or at an asset class/activity level where the same or similar characteristics are displayed (eg HV transformers that are Health Index (HI) 5 and Criticality Index (CI) 4 might be presented together under one CBA). In any case (subject to any significant factors that are not monetised) the overall investment plan should constitute all projects which have positive (or strictly non-negative) NPVs. In other words, at a strategic level, our latest thinking is that the DNO should invest up to the point that the marginal project has an NPV greater or equal to zero.

5.32. Where the project has a marginally positive or negative NPV the DNOs should consider the inclusion/exclusion of such a scheme drawing on identification of any non-monetised benefits or costs. As an example, such non-monetised costs/benefits might include (non-monetised) engineering judgement on what constitutes an efficient project. We envisage that DNOs would clearly set out such judgements as part of their submission.

Project components

5.33. Our latest thinking is that there may be instances where DNOs propose the replacement of an entire population of an asset class on the basis that at the population level the NPV is positive. We expect there will be separable projects which have a negative NPV and should be excluded. Consistent with the above decision rule, each individual project within the population should have a positive NPV.

5.34. A project can also comprise a number of different components. For example, a DNO might propose a project with the principal aim of replacing a specific

[14] We expect one CBA may include multiple options/scenarios related to one investment decision. This would represent one CBA submission.

faulty cable, but also propose the replacement of a contiguous cable within the same project on the basis that the marginal cost of replacing the contiguous cable is low. In such a case, there are two clear components: the faulty cable, and the contiguous cable. In this instance we would expect the DNO to demonstrate that the separable components have a positive NPV. If the NPV of the contiguous cable component has a negative NPV this should be excluded even where the overall NPV of the components taken together is positive.

5.35. We accept that in some instances the rationale for the replacement of the contiguous cable might be based on engineering judgement rather than explicit cost benefit analysis. In such cases, the engineering judgement supporting the contiguous cable inclusion (in this example) needs to be set out.

Benefit cost ratios (BCRs)

5.36. Our latest thinking is that DNOs should present benefit cost ratios (BCR) for the proposed schemes. The BCR is the ratio of discounted benefits to discounted costs and will be greater than one for projects with a positive NPV. The BCR should be used to help prioritise projects where there is a funding or delivery constraint.

Affordability

5.37. We propose that the DNO should present CBA analysis in terms of cost to customer rather than cost to business.

Links to business plan

5.38. DNOs should clearly show the links between their CBA and the business plan and business plan data tables. For example, the DNOs should state in their business plan data tables commentary where forecast expenditures have been justified by CBA and make reference to the CBA model number submitted.

Summary of consultation proposals

Identification of options

5.39. We proposed that consistent with the HM Treasury Green Book[15], DNOs should clearly identify the range of options that were considered to meet an investment decision. This list of options should include an option that takes

[15] http://www.hm-treasury.gov.uk/d/green_book_complete.pdf

the minimum action necessary (the "do minimum option") against which other options are compared.

Quantification of costs and benefits

Discounting and the cost of capital

5.40. Our proposals used the Joint Regulators Group (JRG)[16] guidance, described as the Spackman approach. We proposed discounting all costs (including financing costs as calculated using the weighted average cost of capital (WACC)) and benefits, with the exception of safety benefits, at the STPR of 3.5 per cent as recommended by the Green Book. We proposed that Health and Safety benefits should be discounted using PTPR for marginal utility of 1.5 per cent as outlined in the HM Treasury Green Book.[15]

Period for discounting costs and benefits

5.41. We proposed that the period for the CBA should be the useful economic life of the asset and stated that we would specify a maximum value.

5.42. We proposed to require DNOs to consider the uncertainty over the future use of electricity networks in modelling the prospective benefits and in making the assumption relating to the economic life of the investment.

Sensitivity analysis

5.43. We proposed that DNOs should set out sensitivity analysis for key risks and uncertainties and NPV for different pay-back periods. We also proposed that DNOs should set out the switching value for the economic life of the asset.[17]

Decision rule

5.44. We recognised that the CBA analysis may need to be undertaken at a project level or at an asset class/activity level. We proposed that the overall investment plan should constitute all projects which have positive (or strictly non-negative) NPVs. Consistent with this approach, at the project component level, we proposed that each individual project within the population should

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[16] Joint Regulators Group (4 October 2011) Discounting for CBAs involving private investment but public benefit.
http://stakeholders.ofcom.org.uk/consultations/discounting-for-cbas/summary

[17] The HMT Green Book states: *The calculation of switching values shows by how much a variable would have to fall (if it is a benefit) or rise (if it is a cost) to make it not worth undertaking an option. This should be considered a crucial input into the decision as to whether a proposal should proceed. It therefore needs to be a prominent part of an appraisal. Source:* HM Treasury Green Book (2003) paragraph 5.79.

have a positive NPV. We also proposed that DNOs should present benefit cost ratios (BCR) for proposed schemes.

Affordability

5.45. We proposed that DNOs should show the actual customer bill impacts of proposed investments for each individual asset class as well as the overall investment plan for the period RIIO-ED1 and RIIO-ED2.

Summary of consultation responses

5.46. Overall respondents agreed with our proposed approach to CBA assessment. There were a number of areas suggested by respondents which required further guidance.

5.47. One respondent suggested that our proposal for applying CBA was not necessarily consistent with the economic realities DNOs would price into an investment decision. The respondent suggested that the broad application of the STPR discount rate cannot fully account for individual DNO risk profiles.

5.48. In general respondents supported the introduction of a materiality test as this is aligned to a core RIIO principle of proportionality. Two respondents suggested a purely financial metric may not always be appropriate. However one respondent suggested an appropriate threshold could be set against percentage of category spend. One respondent agreed that there should be a *de minimis* threshold below which CBA is not expected, but felt companies should be allowed to undertake the analysis below this threshold where it would be helpful.

5.49. One respondent stated that a threshold level would be useful as a guide but suggested that this might exclude areas where CBAs might provide significant stakeholder value. They suggested it would be helpful to specify categories of expenditure that CBAs should be provided for as well as a threshold value.

5.50. Overall respondents agreed that we identified all the relevant CBA parameters to ensure consistency in methodologies used between DNOs. Respondents agreed with using the STPR discount rate of 3.5 per cent, health and safety benefits derived from the Treasury Green Book and carbon abatement calculations based on DECC non-traded carbon values.

5.51. Two respondents who commented on the base year for discounting agreed that 2015-16 is appropriate. One respondent commented that a positive NPV should be achieved over a 30 year life which takes account of uncertainties over future network use.

5.52. One respondent agreed that DNOs should assume only a specified percentage of year one benefits to be realised in the first year of the project. Another respondent did not agree that a set proportion of benefits should be realised in the first year.

Reason for our updated thinking

5.53. In order for us to properly assess and compare the different business plans we require the DNOs to adopt a common CBA framework to facilitate cross-DNO comparisons of asset investment plans. The CBA framework we have set out is consistent with the latest thinking on how to conduct CBA in a regulated context.

5.54. We have set out our updated thinking on CBA, refining the CBA guidance issued for RIIO-GD1 in order to adopt a simpler approach for RIIO-ED1. We have outlined the key input parameters we intend the DNOs to use to ensure that where applicable, consistent assumptions are applied to CBA models. We set out key parameters in line with latest publications on CBA methodologies, which include the HM Treasury Green Book[18], however we recognise that we will be continuing to work with DNOs to finalise these parameters.

5.55. We are minded to introduce a materiality test for CBA as this is aligned with the RIIO proportionality principle. We will work with DNOs to establish the materiality thresholds. We intends to set the maximum period of CBA to 45 years as this represents the useful economic life of an asset and is in line with asset life assumptions used in the finance models.

5.56. Our latest thinking is that DNOs should assume that 50 per cent of the benefits calculated for year one (ie six months worth of benefits) are realised in the first year of the project. This is consistent with guidance issued for RIIO-GD1 where it was assumed that a project may be complete part way through the financial period and as such not all the benefits associated with this project are likely to be realised in year one of the investment. We believe this is a conservative view and intend to fix this assumption issue the to ensure consistency across DNO CBA submissions.

Transform model

5.57. As stated in the introduction to this chapter DNOs must use the Transform model[19] to justify certain costs and narratives in their business plans. The Transform model is a tool for estimating benefits of smart grid solutions and indicative long term low carbon technology driven expenditure trends under

[18] http://www.hm-treasury.gov.uk/d/green_book_complete.pdf
[19] As stated earlier references to the 'Transform model' relate to either the Transform model or other equivalent tools.

different scenarios of low carbon technology uptake. It was developed by the DNOs as part of work stream 3 of the Smart Grids Forum.

5.58. DNOs should use the Transform model as one source of evidence and justification of costs and investment strategy in developing their forecasts for the business plan. There are instances where we require both a CBA and the Transform model to be employed.

5.59. Relevant inputs in the Transform model (eg discount factor) must be set in accordance with the CBA principles and guidance in this chapter. Other inputs can be adjusted by DNOs as appropriate. Key changes to the model will need to be explained and justified in the commentary accompanying the scenarios table in the business plan data templates as will the use of any other tools. In particular we expect DNOs to use their own unit costs to populate the solution cost inputs in the model for all scenarios. A DNO should use the same network characteristics parameters for all scenarios.

5.60. DNOs will have to provide us with versions of the Transform model as set up for each of the scenarios and indicate whether in developing their forecast for a particular scenario any of the inputs or assumptions were flexed.

Scenarios

5.61. The model allows DNOs to produce expenditure forecasts across the four scenarios for low carbon technology uptake developed by the Department of Energy and Climate Change (DECC). We require DNOs to submit information on these scenarios in the business plan data templates to indicate where their best view forecast upon which the business plan is based sits within the scenario range.[20] The DNOs should also use the model when developing the justification and narrative on how their overall investment strategy can flex to accommodate different scenarios.[21]

Smart grid solutions

5.62. The Transform model must be used to provide the net benefit of the use of smart grid solutions. This is captured in the scenarios tables in the business plan data templates for each scenario of low carbon technology uptake. The model should be used in developing the justification for the following narratives to demonstrate consideration of smart grid solutions:[22]

- strategy for the deployment of smart grid solutions in RIIO-ED1
- how the smart grid strategy will flex under different scenarios

[20] Further information on our decision for DNOs to provide information across the scenarios can be found in Chapter 4.
[21] Further information on this narrative can be found in 'Scenarios' section of Chapter 4.
[22] Further information on these narratives can be found in the smart grids section of Appendix 2.

- strategy for meeting the challenges of RIIO-ED2 and ED3.

Other equivalent tools

5.63. With appropriate justification DNOs are able to use other tools instead of the Transform model. Any other tool must be suitable for the uses set out above. It must be consistent with our guidance on CBA and the assumptions used must be submitted to us alongside a commentary on the assumptions used and the workings of the tool.

Appendices

Appendix 1 – Summary of consultation responses

Chapter Two

<u>Question 1:</u> Do you have any comments on the timing and stages of the assessment process?

Most respondents agreed with the process that we set out. Some thought the timetable would be quite challenging, particularly the assessment period. One respondent commented that the four week period between DNOs delivering their business plans to Ofgem and stakeholders' giving their comments is too short. They wanted the consultation period to be extended to at least 8 weeks if the deadline must remain the same.

<u>Question 2:</u> Do you agree with the three stage assessment process for RIIO-ED1?

Most respondents agreed with our new assessment process. However, one DNO did not agree with the streamlined process, fearing it reduced the level of regulatory scrutiny and could possibly reduce the number of fast tracked companies.

<u>Question 3:</u> Do you think the additional reward for fast tracking is appropriate?

The majority of respondents agreed with our proposed process and supported the principle of proportionate treatment.

Whilst some DNO and supplier respondents felt being fast-tracked offered enough rewards without the need for additional incentives; other DNOs were concerned that a DNO whose settlement is concluded later may get a better deal than one that was fast-tracked. They believed this could occur either as a result of new information arising in the interim period, or because we change a decision on an element of the settlement, which could result in the DNO having a better outcome if they had not been fast-tracked.

One DNO thought additional revenues similar to those received by fast-track companies from RIIO-T1 were appropriate. Another DNO thought at this stage a range of between two and four per cent would be more appropriate.

One supplier said they had yet to see any quantified benefits to consumers of fast tracking. With the longer price control period and uncertainty of key investment decisions, consumers will bear the risk of higher prices and/or lower outputs. Another supplier was concerned that fast-tracking may result in inequality in the retail supply market. A major supplier in a DNO area that is fast-tracked may have more certainty over its cost base than a major supplier in an area where the DNO has not been fast-tracked. They thought this could result in consumers in non-fast-tracked areas paying more for their energy due to the risk margin having to be applied by suppliers.

Chapter Three

Question 1: Does the categorisation of the assessment criteria remain appropriate?

All respondents who commented broadly agreed with our proposed criteria and thought that the categorisation remained appropriate. A few of the respondents wanted there to be more detail and explanation of the assessment criteria.

Question 2: Are there any criteria which we should add or amend in the context of RIIO-ED1?

One DNO had concerns regarding the criterion for assessing secondary deliverables. They did not believe a DNO should be rigidly held accountable for movements in these metrics.

One DNO wanted a commitment to safety to be a key requirement of a well-justified plan.

One DNO wanted the criterion on outputs to split the question on resource implications for the delivery of each output into two criteria; one specifically for assessment of resources and another assessing the adequacy of the forecasting of secondary deliverables.

Chapter Four

Question 1: Is there anything else, in the context of the presentation and structure of the business plan, which we should provide guidance on?

Respondents all agreed with the presentation guidance that we set out. One DNO wanted additional guidance regarding the specific summary information, tables and the number and structure of annexes.

Some respondents wanted to include a brief summary of each DNO, the customers they serve and how innovation will influence their plans and maximise benefits for stakeholders.

Some DNOs said they would not like any significant changes to this guidance in the Strategy Decision as they will already be well into the planning stage by this point.

Question 2: Should we require DNOs to conform to the proposed document structure, some other prescribed structure, or let the DNOs structure the plans as they see fit?

The majority of respondents agreed with our proposed structure and thought that DNOs should follow it. Most DNOs were happy with the structure though some stated that they did not think it should be more prescriptive. A few DNOs thought that it should be up to them to structure their business plans, but accepted that our proposed structure strikes the right balance by not being overly prescriptive.

<u>Question 3</u>: Should we set a page limit for the executive summary of the plan? How long should it be? Are there other areas where we should consider setting page limits?

Most respondents thought that the executive summary should be as succinct as possible but did not think that a page limit was necessary. One DNO thought an expected length was more appropriate than a page limit.

<u>Question 4</u>: Do you agree with the information that we are proposing should be required in each DNO's executive summary? What other information would be useful.

Respondents agreed with our proposals for what should be in an executive summary. Some DNOs did not think that we should be too prescriptive with what is in the executive summary.

<u>Question 5:</u> What should be the common metric, calculation and assumptions for determining the impact of the DNOs' proposal on consumer's bills?

We received a range of suggestions with most agreeing that consumers should be able to clearly see the effects on their bills in pounds per year. There was agreement for a common method that DNOs should use to calculate and present these figures to allow consumers to easily compare. Appendix 4 provides instructions on how DNOs should do this.

Chapter Five

<u>Question 1:</u> Do you agree with our proposed approach to cost benefit analysis?

Overall respondents agreed with our proposed approach to CBA assessment however, they suggested there were a number of areas which required further guidance.

<u>Question 2:</u> Do you agree with our proposed approach to have a threshold level of expenditure to determine whether cost benefit analysis is required?

Respondents supported the introduction of a materiality test as this is aligned to a core RIIO principle of proportionality. However two respondents suggested a purely financial metric may not always be appropriate. One respondent suggested an appropriate threshold could be set against percentage of category spend. One respondent agreed that there should be a *de minimis* threshold below which CBA is not expected, although companies should be allowed to undertake the analysis below this threshold where it would be helpful.

One respondent stated that a threshold level would be useful as a guide but suggested that this might exclude areas where CBAs might provide significant stakeholder value. They suggested it would be helpful to specify categories of expenditure that CBAs should be provided for as well as a threshold value.

Question 3: What level of expenditure do you believe should be used as the threshold for determining when cost benefit analysis should be provided as part of the business plan submission?

Two respondents suggested the standard *de minimis* threshold used for re-openers, of one per cent of base demand revenues would be reasonably proportionate while ensuring consistency across different elements of the price control. One respondent suggested that any threshold should be agreed at the cost working groups.

Question 4: Have we identified all of the relevant parameters to ensure consistency in how cost benefit analysis is undertaken?

Respondents did not suggest any additional parameters for consideration.

Question 5: What are your views on the levels the parameters should be set at?

One respondent agreed with the adoption of the Spackman approach and use of the HM Treasury Green Book. Respondents agreed with our proposals for the STPR discount rate and the PTPR for health and safety benefits. One respondent stated that the discount rates must reflect the DNO's WACC with another suggesting that WACC should be set using DCPR5 levels. Two respondents proposed that the common base year for discounting should be 2015-16. One respondent suggested that further work is needed to ensure that there are consistent parameters for monetised benefits.

Appendix 2 – Business plan guidance

This appendix sets out the guidance DNOs should use when drafting their business plan. Following this structure will help make the plans easier to read and finding information easier. This guidance will help DNOs demonstrate their plan is well-justified.

This appendix contains guidance on:

- Presentation – the written style and look of the plans;
- Structure - how the information in the plans should be grouped to allow for a level of consistency and comparability across the plans;
- Navigation – how to make it easier for readers to find the information they require easily.

Presentation

Consideration should be given to the reader who may be reading the document on the screen or in hard copy. Business plans should be clearly written, with considerable emphasis on making them as easy to read as possible. Plans should avoid using over complicated or technical language. This is particularly the case in the stakeholder facing documents, such as the executive summary and chapter summaries. Where technical terms need to be used they should be carefully explained.

We also consider that plans should be concise with the emphasis on keeping the core narrative as short as possible, while presenting proportionate evidence and justification for the proposed expenditure and outputs. Any additional information should be annexed with clear links to the core narrative. A short concise document is easier to read and easier to assess.

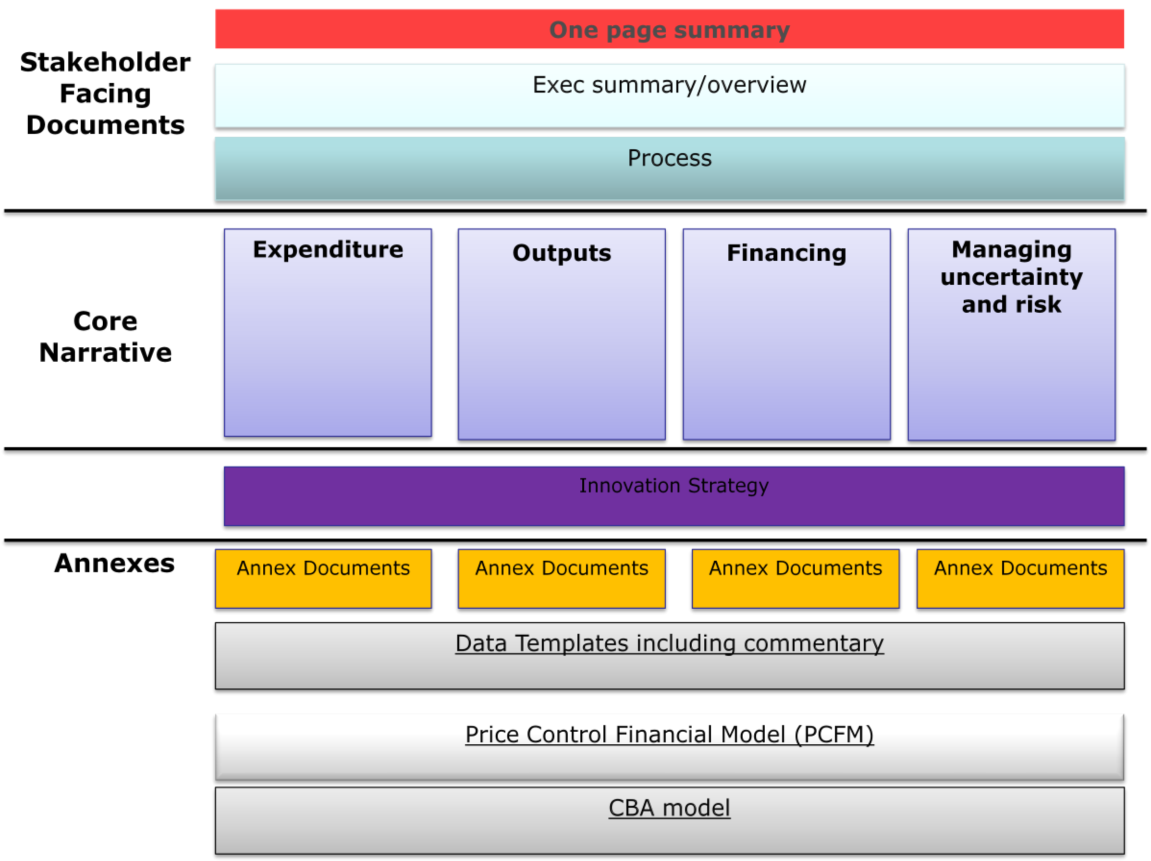
To ensure brevity, information and evidence should be provided on a proportionate basis. If information is particularly important to the plan, has a high materiality (in terms of costs or outputs), or where there is a significant departure from Ofgem policy, then the plans should have a higher level of discussion and evidence to support the DNOs’ proposal. In less material areas, less detail is needed. It is up to the DNO to prioritise the information and evidence presented. The DNO needs to strike the balance between presenting key information whilst ensuring they do not make plans overwhelmingly long and incoherent. The provision of proportionate evidence is key in developing a business plan that is well-justified.

Plans need to be written as documents to be used over the eight year control period. The DNOs should strive to make them as relevant and useful in year eight as they are in year one.

Structure

The DNOs' business plans must conform to a high level structure. This will provide clarity on which section of the document will contain the information required. Figure A2.1 below, sets out the high level business plan structure and a description of what we would expect each of these documents to include.

Figure A2.1: Structure of Business Plans



Stakeholder Facing Documents

1. One page summary/Factsheet

The Factsheet will provide key high level information for stakeholders who do not need all the detail contained in the main plan. We have produced a template which all DNOs must fill in for each one of their licence areas. An example of the template can be found in Appendix 3 of this document. Appendix 4 has further instructions on how the factsheet should be filled in; including how to calculate the impact on consumer bills.

2. Executive summary/overview

The executive summary provides the information stakeholders will need in order to acquire a basic understanding of the key elements of the business plan. DNOs will also set out their vision for the eight year price control period and, at a high level, how they intend to deliver this vision.

For many readers, the executive summary may be the only part of the plan which they read in full. Therefore it must provide an overview of the key points in the plan with clear linkages on where to find more detail in the core narrative of the plan. We consider that, at a minimum, the executive summary should include the following.

- A short summary of the outputs and secondary deliverables the DNO will be delivering during the period and the expenditure required to deliver them.

- An explanation of how the proposed expenditures set out in a DNO's business plan will impact consumer bills. This should be presented upfront and in a clear, consistent and easy to understand format. The information should be provided for both business and domestic consumers.

- The DNO's understanding of uncertainty during the price control period and how they propose to manage it, including a summary of any uncertainty mechanisms they are proposing.

- The key financial proposals the DNO is making. This should include:

    - components of the cost of capital (ie cost of debt, cost of equity, notional gearing)
    - financial policies (such as totex capitalisation rate and any proposed transition on asset lives)
    - the total revenue request being made by the DNO.

  In response to consultation responses, we are not setting a page limit for the executive summary, however we expect the DNOs to follow the format set out above and to ensure the executive summary is written for the reader.

3. Process overview

Each business plan should have a brief overarching section outlining the processes the DNO followed in developing its plan. It should include how the DNO conducted its stakeholder engagement, including who it engaged with, what questions the stakeholder were asked, and what the responses from the stakeholders were.

The internal processes undertaken in the drafting of the plan should demonstrate how the whole of the business was involved in the development of the plan. DNOs should provide written confirmation that the submission includes all requisite information and data tables.

All sections of the plan need to demonstrate they have been informed by the processes outlined in the process overview section (for instance, by stakeholder engagement). It is important the process overview is not just a stand-alone section, these processes need to be evidenced through the discussions in the rest of the business plan.

Core narrative sections

The core narrative sections of the plan are where the DNOs present all the information required, answering all the key questions set out in assessment criteria guidance (Chapter 3 of this document).

Outputs

In this section DNOs should provide clear and comprehensive outputs and secondary deliverables. The RIIO model identifies six key output categories – or key areas of delivery for network DNOs. DNOs should ensure they fully explain how they plan to deliver against these outputs. DNOS can also propose their own outputs if justified by stakeholder engagement. The 'Supplementary annex - Outputs, Incentives and Innovation' outlines sets out the outputs. The table below outlines where in the Outputs, Incentives and Innovation document each output is discussed.

Environment	Chapter 5
Customer satisfaction	Chapter 6
Connections	Chapter 8
Social obligations	Chapter 7
Safety	Chapter 4
Reliability and availability	Chapter 4

Expenditure

In this section we expect DNOs to set out clear and comprehensive costs and volumes, and the associated primary outputs and secondary deliverables these will achieve. This section should describe in detail the information contained in the data tables.

The forecast costs and volumes should be clearly justified by the DNO. Cost information to secondary deliverables (including health indices and load indices) as well as to primary outputs. For some activities, this justification may require a full and comprehensive cost benefit analysis and consideration of the whole life costs. Chapter 5 of this document provides further detail on this.

We do not expect costs in one area to be considered in isolation of other areas. DNOs should put forward a more comprehensive approach to explain their forecast expenditure. For example, with regards to the management of assets, rather than simply being the lowest cost in one isolated area, DNOs should recognise the trade-off between different types of asset intervention such as asset replacement, refurbishment, inspection and maintenance and replacement.

Financing

DNOs' business plans should set out their financial proposals for RIIO-ED1. Broadly, the financial proposals should cover three areas:

- the allowed return (cost of capital)
- evolution of the RAV (ie capitalisation and depreciation)
- financial policies (pensions and taxes).

We expect the DNOs to develop business plans that balance the different elements of the financial proposals in a manner consistent with the RIIO principles. Below, we set out in more detail the elements that should be included in a well-justified business plan. This includes the considerations the DNOs should observe when developing their plans.

The DNOs should provide proposals for the cost of equity and notional gearing components of the allowed return. In line with the RIIO principles, these should reflect an assessment of cash flow risk during RIIO-ED1. In assessing cash flow risk, the DNOs may want to consider, amongst other things: the level of investment (relative to RAV), uncertainty mechanisms, RORE analysis and the cash flow implications of output and incentive mechanisms.

The DNOs should also have regard to evidence from appropriate economic and financial models (particularly the Capital Asset Pricing Model (CAPM) for the cost of equity), as well as evidence from financial markets, including network company transactions where relevant.

With regard to the cost of debt, in line with our strategy document, a DNO may propose alternative weighting to the cost of debt index. This may occur if a DNO can show that its circumstances during RIIO-ED1 are such that the un-weighted trailing average may not reflect its efficient cost of debt under a range of reasonable scenarios. The DNO would be required to show how any such proposal better balances the interests of consumers and investors, and will need to propose a transition to the un-weighted average index by the start of RIIO-ED2.

The DNO should set out in its business plan the capitalisation rate that will be applied during RIIO-ED1. This should be in line with the policy set out in our strategy decision. Likewise, RAV depreciation, the funding of pension deficits, and the allowance for tax should all be applied in line with our policies. Any proposed departures from our policies should be clearly stated and justified.

The DNOs should test their business plans to ensure they should be expected to obtain a 'comfortable investment grade' credit rating (ie in the BBB to A range), as defined by the major credit rating agencies. It is suggested that the DNOs test this under a range of reasonable scenarios and consider both credit metrics and the non-financial factors considered by rating agencies. In addition, the DNOs should test that the business plan is consistent with achieving a range of returns of regulatory equity with a downside around the cost of debt and an upside in the low double digits (both figures in real post-tax terms).

Managing uncertainty and risk

This section of the plan is where DNOs set out how they plan to deal with uncertainty and mitigate against risk. During the RIIO-ED1 period (and beyond) there is significant uncertainty around future capacity requirements driven by the take up of low carbon technology such as heat pumps, photovoltaics, electric vehicles and distribution connected generation (DG).

A core part of the business plan will be the DNOs' plans to accommodate the different forecast scenarios of low carbon technology adoption and resulting network impact.

Scenarios

DNOs must provide details of forecast expenditure and volumes over the RIIO-ED1 price control period for all four scenarios developed by the Department of Energy and Climate Change (DECC), alongside their best view. The DNO's best view scenario is the core forecast they put forward in their business plan reflecting the expenditure and volumes each DNO expects over the RIIO-ED1 period. The medium (high heat pump, central electric vehicle) scenario will be used as a reference case in order to compare costs across DNOs. For comparability, the Transform model must be run using the "incremental" investment approach.

Tables setting out the level of detail required from DNOs across theses scenarios can be found in the business plan templates annex.

We acknowledge that each DNO's best view may not be the scenario that materialises during the RIIO-ED1 period. Therefore, DNOs must present a narrative on how their investment strategy can flex to meet demands associated with any of the DECC scenarios. This should cover how the DNO will monitor the scenario that materialises, including use of notification processes for installation of low carbon technologies. We also expect explanations of how unit costs of managing problems on the network may change across scenarios. DNOs are able to determine how best to construct and present this narrative.

We wish to understand each DNO's forecast long term trend of expenditure and volumes beyond the RIIO-ED1 period. Therefore we require a narrative on longer term forecasts and strategy. We expect DNOs to explain in the ED2 strategy narrative how their best view for RIIO-ED1 fits into their long term strategy for the RIIO-ED2 period.

Smart grids

The Driving sustainable networks chapter in 'Supplementary annex - Outputs, incentives and innovation', sets out a number of elements for smart grids which we expect DNOs to outline in their business plans. This section provides further guidance on how this should be presented.

To help DNOs demonstrate that they have considered alternative solutions to business as usual, we will provide a specific smart grid data cost tab in the business plan data tables. DNOs should complete this tab by setting out the aggregate benefit of smart grids for the RIIO-ED1 period under each low carbon scenario. This will capture overall expenditure for the RIIO-ED1 period based on a business as usual approach compared to a smart grid approach and will calculate the net benefits of the smart approach.

The figures provided will need to be based on a CBA which includes all the anticipated costs, including IT systems and smart metering data, required to facilitate the smart grid solutions DNOs plan to deploy. We will expect DNOs to include the transform and/or equivalents used to undertake this cost benefit (for each scenario) as part of their business plan submission.

In addition to these figures, we will expect DNOs to submit the following narratives within their business plan.

Strategy for the deployment of smart grid solutions in RIIO-ED1

This narrative should outline the type of smart solutions DNOs plan to deploy and the areas of expenditure eg IT systems or load related expenditure where the costs and benefits will materialise. It should also explain the DNOs' strategy for assessing the circumstances where they will deploy smart grid solutions as well as their internal processes to ensure that these circumstances are identified.

How will smart grid strategy 'flex' under different scenarios

This should outline the strategy DNOs will adopt to achieve the aggregate benefit of smart grids, which their analysis demonstrates is possible under each low carbon scenario. This strategy will need to explain how they will adapt their proposed strategy in different scenarios in order to deliver the benefits outlined.

How innovation is being embedded into the core business

DNOs should explain how the outputs of the Innovation Funding Incentive (IFI) and the Low Carbon Network (LCN) Fund and other innovative solutions are being embedded into their core business. This can highlight where there are overlaps with the smart grid strategy ie where specific solutions they plan to deploy have come from LCN Fund projects. However, it should also provide details of wider innovation which would not necessarily be deemed as smart grids.

Strategy for meeting the challenges of RIIO-ED2 & ED3

This is the opportunity for DNOs to make the case for investment in smart grids in RIIO-ED1 to provide future benefits. For instance, if the cost benefit analysis for smart grids in RIIO-ED1 indicates that there will be negative net benefits, this is an opportunity for DNOs to make the case that future benefits will outweigh these costs over the lifetime of the asset. This is likely to include justification for investment in enabling technologies such as IT systems, and explain how they can help DNOs make intelligent use of data. This narrative will need to be supported by a cost benefit analysis which is included in the business plan submission.

Detailing smart grids in business plans

We acknowledge that DNOs may struggle to identify the impact of smart grids on each line item in an expenditure category, particularly for the latter years of the price control. However, we would expect that the overall expenditure they request takes account of any net benefits which their cost benefit analysis indicates smart grids can provide. Consequently, the expenditure totals in each business plan data table should reflect the costs and benefits of implementing their smart grid strategy. The commentaries for each data table will need to provide a more detailed description of how the deployment of certain types of smart grid solutions impact on the costs detailed, and explain how this links back to the overall smart grid strategy. The assumed additional costs or benefits for the expenditure totals can then be applied on a pro-rata basis for the line items which comprise the expenditure totals.

DNOs should take a similar approach when they are including the benefits of innovative solutions which would not be deemed as smart grid solutions. The costs and benefits should be included in the expenditure totals in each data table and the commentaries should provide the detail on what innovation will be deployed.

Innovation strategy

We expect DNOs to clearly demonstrate throughout the core narrative of their business plans that they have considered the use of alternative techniques (such as innovative technical, operational, commercial and contractual arrangements) in all areas of their business; to deliver their outputs more efficiently and reduce costs. We expect this to be demonstrated in all the core narrative of the plan described above. The innovation strategy is intended to provide DNOs with a separate opportunity to demonstrate to their stakeholders and Ofgem the role of innovation in their business; including their innovation implementation strategy and how they will deliver value for money when progressing innovative projects funded by consumers.

Further information on what we will require is set out in Chapter 10 of the Outputs, incentives and innovation document.

Annex documents

DNOs should strive for brevity in the core narrative and stakeholder facing documents. Where the DNO needs to provide further information it should use annexes. Annexes should be clearly signposted and referenced within the core text. More technical information may be provided in the annex documents but the DNO should still strive to make the annexes as clear and readable as the rest of their business plan.

Detailed guidance on completing data templates

We are working with the DNOs to develop a suite of data tables that facilitate a consistent presentation of the cost, volume, output and financial data underpinning the business plan submissions. These templates are broadly consistent with current reporting. We believe this is a proportionate approach and should facilitate easier comparison of forecasts with historical data.

DNOs should fully and accurately complete the detailed data templates to accompany their business plan. Data must be consistent between the main parts of the business plans and the data templates. We will produce a guidance document which DNOs should follow when completing the tables. For example, if the guidance states that network length should be displayed in kilometres, any other metric is not acceptable.

As well as the data tables DNOs will also be required to complete a commentary that explains the data in each. This commentary will allow us to understand what is in the tables, and will be significantly more detailed than the information contained within the main business plan.

CBA model

DNOs should submit their CBA models as part of their July 2013 business plan submission. DNOs must confirm that their analysis is consistent with the framework set out in Chapter 5 of this document or alternatively identify the areas where it is not and the reasons for departing from it. We have developed a CBA spreadsheet model, as was done in RIIO-GD1. We intend to issue this spreadsheet model following ongoing discussions with DNOs.

DNOs should clearly show the links between their CBA, the business plan and business plan data templates. For example, the DNOs should state in their business plan data templates commentary where forecast expenditures have been justified by CBA and make reference to the CBA model number submitted.

PCFM

The final version of the PCFM will be issued to the DNOs in March 2013. The DNOs will be required to submit this alongside their business plans, populated with data consistent with the business plan. DNOs will also be required to publish the PCFM alongside their business plans, at the same time as they submit it to us.

Navigation

Readers of the plan should be able to find the information they require quickly and easily. This will save them a lot of time and effort and also save the DNOs themselves from having to provide further clarification at a later date.

Cross referencing

In order to successfully navigate the plans, DNOs should effectively cross reference between different sections. Stakeholder feedback is that the use of hyperlinks would be a great help to readers. Hyperlinks should be included when referencing any of the data tables, annexes or any further detail which is explored elsewhere in the plan (including the annex documents).

It is important to have clear links between the data tables and the core narrative sections. Data tables should be clearly numbered and any data in the narrative should be clearly linked to the relevant data table number (and hyperlink). For each data table there should also be a link to where in the main narrative this data is mentioned. For some data tables this may be more than one part of the plan that describes the data.

Overview for each section

Each section of the plan should have an overview and contents page. It should be easy for readers to get to the information they require (using hyperlinks).

Each DNO should include a section upfront explaining how its plan fits together. This should include a table that maps our assessment criteria to relevant parts of the plan and another that maps individual cost, output, uncertainty and finance areas to the relevant sections of the plan.

Appendix 3 – Factsheet template

Business Plan Summary

What we plan to do

Key facts about our network

How our plan will be financed

Cost of Equity	%	Notional Gearing	%

How this will impact domestic customer bills

Distribution charges make up 16% of the average overall domestic bill*

	2014/15*	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Percentage change in distribution costs	n/a	%	%	%	%	%	%	%	%
Annual change in £'s	n/a	£	£	£	£	£	£	£	£
Total distribution charge	£	£	£	£	£	£	£	£	£

How much we propose to spend

	Total spend £m over the course of the price control	Annual average Percentage change from DR5
Network Investment*	£ m	%
Operating Costs*	£ m	%

Appendix 4 – Factsheet instructions

This document provides instructions on how DNOs should fill in the one page summary.

The one page summary is designed to provide stakeholders with a quick and easy summary of key stakeholder information that is common to all DNOs. The format of this document is set so that all information is presented in the same way to make comparison very easy. Each DNO should fill in the sections as follows.

What we plan to do

In this section DNOs can explain, in their own words, there key strategy for the price control period. Here DNOs can outline their investment plans, briefly describe key projects and any key challenges they face.

Key facts about our network

This section sets out key facts about each network:

- Ownership (outline which of the six ownership groups the DNO belongs to)
- Number of customers
- Length of underground cables (km)
- Length of overground cables (km)
- Total units distributed annually (GWh)
- Number of employees (FTEs)
- Area covered km^2 and geographical location (link to map showing license area location within GB)
- Peak demand (MW)

How our plans should be financed

This section includes the DNO's cost of equity and notional gearing.

How we propose to spend it

This section includes the DNO's network investment and controllable operating costs.

How this will impact domestic bills

To calculate the impact of their plans on their customers' bills, DNOs should use the respective regional unit rate charge (from each of its license areas' charging statements) multiplied by the national average annual consumption, plus the regional standing charge from their statements. DNOs should forecast the charges for the last year of 2014-15 (the base year). The calculation would therefore be

(Distribution Use of System (DUoS) domestic unit rate x average annual consumption) + regional standing charge

To calculate the change to customer bills over the course of the price control, DNOs should apply the proposed changes in revenue, using their 'best view' scenario. The 'impact on customer bills' table in the factsheet, includes a column for 2014-15. The last year of DCPR5 should be used as the base year. In this column only, the 'total distribution charge' cell can be filled in.

- The 'Percentage change in distribution costs' row should show the annual percentage change for each year. Year 2015-16 would be the percentage change from 2014-15 and each subsequent cell in the row would be the percentage increase from the previous year.
- The 'Annual change in £'s' row should show the annual change in pounds and pence starting with the change from the base year.
- The 'Total distribution charge' should be the forecasted total domestic DUoS charge per household for each year starting with the charge in the last year of DCPR5.