Promoting choice and value

for all gas and electricity customers

RIIO-GD1: Initial Proposals – Impact Assessment

Consultation

Publication date: 27 July 2012

Response deadline: 21 Sept 2012

Contact: Joanna Campbell

Team: RIIO-GD1

Tel: 020 7901 7094

Email: RIIO.GD1@ofgem.gov.uk

Overview:

We are publishing this document alongside our Initial Proposals for the gas distribution price control (RIIO-GD1) which runs from 1 April 2013 to 31 March 2021.

This will be the first gas distribution price control to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model. Under RIIO we are adopting a very different process for setting price controls. Companies are required to develop and submit well-justified business plans, supported by the views of stakeholders, setting out what they will deliver.

In a number of areas our Initial Proposals directly reflect the RIIO-GD1 business plans put forward by the eight gas distribution networks (GDNs). In other areas we are putting forward alternative proposals.

This impact assessment considers the benefits and risks that may result from implementation of our RIIO-GD1 Initial Proposals for the GDNs.

Associated documents

Main consultation paper

RIIO-GD1: Initial Proposals - Overview

Supporting documents

RIIO-GD1: Initial Proposals – Supporting document – Outputs, incentives and innovation

RIIO-GD1: Initial Proposals – Supporting document – Cost efficiency

RIIO-GD1: Initial Proposals – Supporting document – Finance and uncertainty

Associated documents

RIIO-T1/GD1: Initial Proposals – Real price effects and ongoing efficiency appendix

RIIO–T1/GD1: Financial model

Cost of capital study for RIIO–T1 and RIIO-GD1

Other associated documents

RIIO-GD1: Initial Proposals for Gas distribution networks (GDNs) - Headlines

Initial Assessment of RIIO-GD1 business plans and proportionate treatment

Decision on strategy for the next gas distribution price control – RIIO-GD1

Handbook for implementing the RIIO model - Ofgem, October 2010

Glossary for all the RIIO-T1 and RIIO-GD1 documents

Contents

Executive summary

Background and context

RIIO-GD1 is the first price control review that we are conducting for the gas distribution networks (GDNs) in which we are applying the principles of the RIIO model. Under RIIO, **R**evenues are set to deliver strong **I**ncentives, **I**nnovation and **O**utputs.[1]

We published an impact assessment (IA) to complement our December 2010 Strategy Consultation document ("Strategy Consultation document").[2] That IA considered the impacts of the key changes that were to be implemented under RIIO-GD1.

This new IA complements our Initial Proposals consultation ("Initial Proposals") for the GDNs. It provides an overview of the RIIO-GD1 Initial Proposals, and the impact that these proposals will have in terms of both benefits and risks. It draws on our assessment of the GDNs April 2012 business plans and our Initial Proposals which this IA accompanies.

In this IA we first consider the impacts that we anticipate will result from the RIIO framework. We then consider the specific Initial Proposals for RIIO-GD1.

Key aspects of the RIIO model

The overarching RIIO objective is to encourage energy network companies to:

- play a full role in the delivery of a sustainable energy sector
- deliver long-term value for money network services for existing and future consumers.

The gas distribution networks have a key role to play in the next decade to meet environmental challenges and to secure energy supplies. The proposals set out in our Strategy Consultation document were designed to ensure that companies can finance the required investment in a timely and efficient way, and are incentivised to deliver the required level of service at value for money for consumers.

Our Initial Proposals set out the way that the GDNs will best achieve these objectives.

---

[1] For more information on the RIIO framework, please see 'Handbook for implementing the RIIO model' available at: http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf
[2] Consultation on strategy for the next transmission and gas distribution price controls – RIIO-T1 and GD1 Impact Assessment
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1%20and%20GD1%20IA.pdf

This impact assessment

In this IA, we seek to assess the impacts and risks that would result from implementation of the RIIO-GD1 price control for the GDNs, as set out in our Initial Proposals. Our assessment highlights that there are potential positive impacts in a number of areas:

- **Impacts on consumers:** We think that the biggest impact on consumers will be linked to the elements of the RIIO model that help to manage network charges that result from their investment programmes. In particular, the focus of the model on the longer term has already encouraged the GDNs to consider the impacts of their investment decisions over a longer timeframe, which is likely to lead to more innovation and better value for money. We recognise that longer-term price controls are likely to lead to additional uncertainty, but we are confident that the mid-period review and appropriate uncertainty mechanisms will address these concerns. The ability to take a proportionate approach to the assessment of business plans has had positive impacts by allowing us and the GDNs to focus our efforts in the areas where they are most likely to deliver benefits. We have realised further benefits from the regime as a result of the transparency that investors have had with respect to financeability arrangements.

- **Impacts on sustainable development:** We anticipate the outputs-led regime, which is linked to the overriding objectives of the framework, will have significant benefits for sustainable development. We developed, in consultation with industry parties, a suite of primary outputs and secondary deliverables against which the GDNs will be required to ensure delivery. Combined, these primary outputs should deliver a safe and reliable system, an efficient connections process and high levels of customer satisfaction as well as improved environmental performance. The GDNs developed their business plans developed their business plans for meeting these primary outputs, and we believe that the initial proposals we are consulting on should lead to the anticipated benefits.

We recognised in our December 2010 IA that there were a number of risks associated with the RIIO model, which could reduce the level of benefits achieved under RIIO-GD1. These included the potential for overspends in delivery, non-delivery of outputs, increased regulatory risk due to the new financeability principles and the mid-period review, as well as the possible risk regarding certain elements of the framework development. We have implemented a number of mechanisms to mitigate these risks. To some extent the manner in which the GDNs have largely adopted the suite of outputs and uncertainty mechanisms in our Strategy Consultation document indicates there is agreement overall that the framework is broadly appropriate, and provides the right level of risk and reward.

We would welcome stakeholder views on the assessment in this document and whether this represents an appropriate analysis of the impacts and risks that could be observed through implementation of the RIIO-GD1 Initial Proposals.

1. Key issues and objectives

Chapter summary

This chapter begins by outlining the role that this IA has within the overall consultation that we are carrying out on the RIIO-GD1 Initial Proposals.

1.1. The next gas distribution price control, RIIO-GD1, will be the first to reflect the new RIIO model. We are now consulting on the RIIO-GD1 Initial Proposals for the eight GDNs. We are publishing an Overview document setting out an overview of the Initial Proposals and three Supporting Documents setting out more detail on the key elements of those proposals.[3] Together these documents constitute the Initial Proposals. This Supporting Document sets out our current thinking with respect to the impacts and potential risks associated with implementation of the Initial Proposals.

Development of the RIIO model

1.2. The main driver of the RPI-X@20 review was the need to ensure that the regulatory framework remained fit-for-purpose particularly in light of the challenges that the network companies would face in facilitating the transition to a sustainable energy sector. During RPI-X@20 we undertook extensive engagement with a range of stakeholders to ensure that we had a solid understanding of the way that the RPI-X regime had performed since implementation. We also sought to identify potential challenges that network companies would face in the future and determine the form that the regulatory regime should take to allow them to effectively address these.

1.3. The outcome of this process was the development of the RIIO model, under which, Revenue will be set to deliver strong Incentives, Innovation and Outputs. To provide transparency regarding our expectations of the network companies we defined clear objectives for the framework. These objectives are aligned with our principal objective and wider statutory duties. As such, the objectives specify that the framework should be designed and implemented to encourage energy network companies to:

- play a full role in the delivery of a sustainable energy sector
- deliver long-term value for money network services for existing and future consumers.

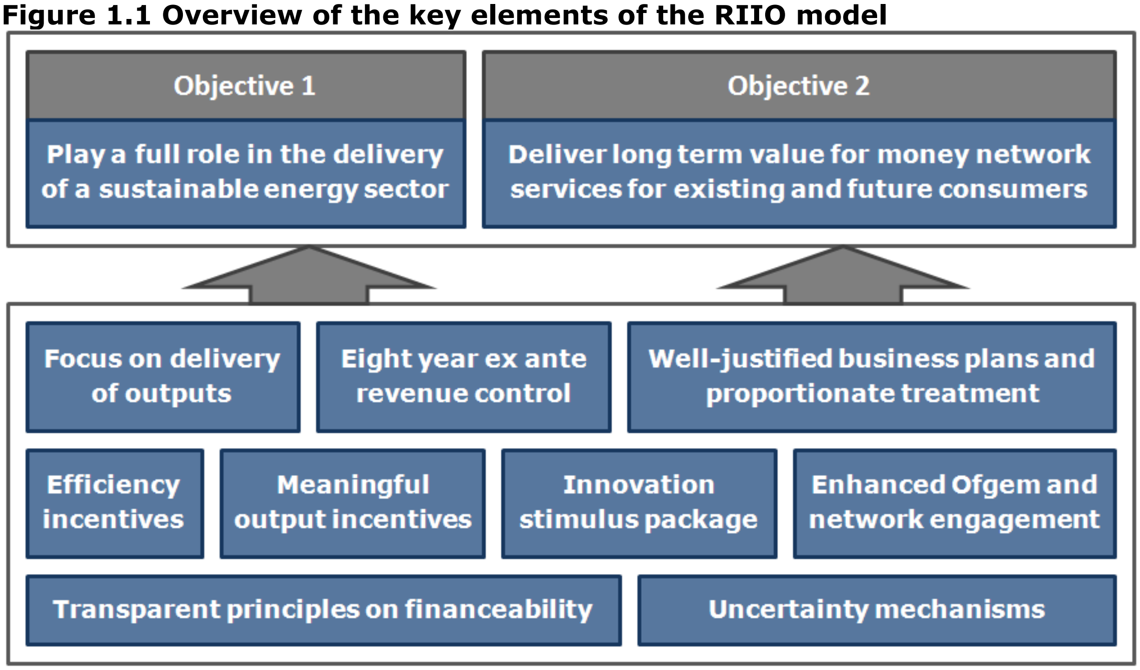
1.4. The RIIO framework contains a number of mechanisms designed to facilitate the delivery of these objectives. As Figure 1.1 below illustrates the RIIO framework is an evolution of the RPI-X regime and builds on the successful elements of this framework, particularly some of the innovative aspects that were implemented as part of the fifth distribution price control review (DPCR5).

[3] See associated documents for links to these documents.

1.5. The RIIO framework maintains an ex ante approach that is informed by business plans and stakeholder engagement. It builds on the success of the low carbon networks (LCN) fund developed during DPCR5 with the introduction of an innovation stimulus package across all four energy network sectors. The framework also builds on the development of outputs during DPCR5 and, in this respect, can be considered outputs-led. The outputs-led regime is complemented by the application of strong incentives to mimic the effects of competitive markets and encourage efficient and innovative delivery. To ensure that the outputs developed under the regime reflect the needs of network users, including consumers, the framework places a strong emphasis on stakeholder engagement, building on the progress made in these areas in the past.

1.6. RIIO includes a strong focus on the longer term to ensure value for money for existing and future consumers and this is underpinned by the use of long-term, well-justified business plans as well as the extension of the price control period from five to eight years. To provide clarity on the approach that we take to determining the financial package, the RIIO framework incorporates a set of transparent financeability principles. A more detailed explanation of the way that the RIIO model works is contained within the RIIO handbook.

Figure 1.1 Overview of the key elements of the RIIO model



Implementation in RIIO-GD1

1.7. The IA that we published alongside our Strategy Consultation document examined the benefits and costs/risks that we anticipated would result from implementing the RIIO framework in RIIO-GD1. This IA takes the analysis one step further by looking at the impacts and risks that are expected to result from implementation of the specific proposals in the RIIO-GD1 Initial Proposals.

1.8. In undertaking this IA we have adhered to a number of additional principles to assess the impact of implementing these RIIO-GD1 Initial Proposals.

- **Taking the package as a whole:** When considering the impact of implementing the RIIO-GD1 Initial Proposals, we have sought to focus on the package as a whole, taking account of interactions between the various elements of the proposals.

- **Specific assessments:** We have considered the qualitative impacts of implementing the RIIO-GD1 Initial Proposals. We have sought, where possible, to quantify the benefits and costs of the implementation.

Stakeholder views

1.9. As part of RIIO's enhanced engagement principles we have sought to actively engage with a range of stakeholders including network companies, network users, consumer representatives, environmental groups, and other interested parties during the development of the RIIO-GD1 proposals.

1.10. We value the input of these stakeholder groups and would welcome further stakeholder views on the issues set out in this IA. We would welcome views on this IA by 21 September 2012.

2. Impact of RIIO-GD1 Initial Proposals

Chapter Summary

This chapter provides an overview of what we consider are the key potential impacts of implementing the RIIO-GD1 Initial Proposals.

2.1. We consider that implementing the RIIO framework in the RIIO-GD1 price control will provide a number of benefits for consumers. It will do so by more effectively facilitating the delivery of the objectives set out in Chapter 1. These objectives are to ensure value for money for consumers and to facilitating the delivery of a sustainable energy sector. We have structured this chapter according to the impacts that would be observed in a number of key areas. The potential impacts are grouped according to the following areas:

- impacts on consumers
- impacts on competition (including effects on small businesses)
- impacts on sustainable development
- impacts on health and safety.

2.2. In December 2010, we published an IA examining the benefits, costs and risks that could arise from the implementation of the RIIO framework in the RIIO-GD1 price control. We consider that the benefits identified in that IA will be realised through the implementation of the RIIO-GD1 Initial Proposals. As such, some sections of this chapter begin with an overview of the benefits that we identified in our previous IA. The sections then go on to assess these impacts in more detail, based upon the specific proposals for the GDNs.

Impacts on consumers

2.3. We consider there are two main areas in which implementation of the RIIO-GD1 Initial Proposals will positively impact on consumers.

- The first is that these RIIO-GD1 Initial Proposals should ensure the delivery of network services at value for money for consumers. Within the context of increasing energy bills, it is important that networks deliver tangible benefits in terms of a sustainable and secure gas distribution system. The RIIO framework is designed to achieve this.

- The second is that there have been greater opportunities for consumers to engage in the price control process and influence these RIIO-GD1 Initial Proposals. This has helped to ensure that the price control better reflects their needs and therefore delivers in line with their expectations. This greater stakeholder engagement will continue up to, and throughout, the price control period, and will provide stakeholders with ongoing opportunities to influence the work of the GDNs.

2.4. Each of these impacts is discussed in turn below.

Management of increases in network charges

2.5. There are significant future challenges facing energy network companies. One of the biggest challenges facing the GDNs is to maintain a safe and secure gas supply whilst facilitating the transition to a low carbon economy. Our Initial Proposals set out a decline in investment expenditure relative to the current price control period although revenues are broadly flat (as reductions in cost take time to feed through into reductions in revenues). We consider that our proposed investment will allow the GDNs to maintain the high standards of security on their networks (including complying with Health and Safety Executive (HSE) legislation, and an improvement in safety risk) while ensuring that increased investment does not result in stranded assets, as we move to a low carbon economy.

2.6. One way to highlight the impact on charges is to demonstrate the impact on the average bill of a domestic customer. We highlight the impact on gas bills below, We also highlight the impact of the RIIO-T1 Initial Proposals on gas and electricity bills.

Impact on gas bills

2.7. Currently, the average domestic gas bill is around £704.[4] Distribution costs currently account for around 19 per cent of this bill, ie around £134 per annum.

2.8. The impact of our Initial Proposals will be to increase the GDNs allowed revenues by around 4 per cent by the end of the RIIO-GD1 period from £2.83bn at present to around £2.94bn in 2020/21.The impact of this is to increase the average annual domestic gas bill by £5 by the end of the RIIO-GD1 period.

Overall impact

2.9. If we include the impact of Initial Proposals for National Grid Gas (NGGT)[5] and National Grid Electricity Transmission (NGET)[6], published alongside our Initial Proposals for GDNs, then the total RIIO package announced today is estimated to lead to an average increase in the average annual domestic gas bill of £7, and an average increase in the average annual electricity bill of £4 (or £8 if the transmission plans of SPTL and SHETL approved in April 2012 are included)[7] when compared to this year.

2.10. We note that a proportion of the increase in allowed revenues will be met by industrial and commercial customers. Charges vary significantly between these customers and therefore it is not possible to provide an indicative impact, but on

---

[4] This is based on the average domestic gas bill for a standard direct debit account. Prices are based on average annual consumption figures, averaged across all the big six suppliers and averaged across Great Britain. Further details are set out in Ofgem's factsheet on updated household energy bills published in May 2012.
http://www.ofgem.gov.uk/Media/FactSheets/Documents1/household-bills.pdf
[5] NGGT operates the GB-wide high pressure gas system, the National Transmission System (NTS).
[6] NGET operates the higher voltage electricity transmission system in England and Wales.
[7] SPTL and SHETL operate the higher voltage transmission system in Scotland.

average the percentage increase will be broadly the same assuming no changes to pricing methodology.

2.11. We are confident that the implementation of the RIIO-GD1 Initial Proposals will, over the long-term, deliver lower average network charges for consumers than if we continued to use RPI-X regulation. This is largely due to the stronger incentives that RIIO places on the network companies to deliver at long-term value for money for consumers, as reflected in Initial Proposals. It is also because the RIIO framework is designed to encourage network companies to do more to deliver a sustainable energy sector, which is also reflected in the RIIO-GD1 Initial Proposals. These value for money benefits can be grouped according to the following areas in which they arise:

- focus on the longer term
    - uncertainty mechanisms
    - mid-period review
- IQI and the efficiency incentive rate
- innovation
- proportionate treatment and fast-tracking
- financeability proposals.

2.12. The following sections provide an overview of these areas, outlining those benefits that were included within the December 2010 IA and providing more detail about the specific impacts that are likely to arise from the implementation of the RIIO-GD1 Initial Proposals.

Focus on the longer term

2.13. The RIIO-GD1 price control period will be eight years, as opposed to five years for previous price controls. This has encouraged the GDNs to think on a longer-term basis. As a result, the GDNs have been encouraged to consider the implications of their proposed expenditure for the coming period on required investment and associated efficiency beyond this control period. Table 2.1 provides an overview of the areas that we have previously identified where we think the implementation of these Initial Proposals will contribute to lower network charges.

Table 2.1 Benefits from longer term focus identified

Element of the regime	Benefit
Business plans	• Place a requirement on the network companies to complete business plans that consider expenditure needed beyond the coming control period.
Outputs and secondary deliverables	• Encourage network companies to take actions that bring benefits in future price control periods (eg enable future delivery at lower costs).
Efficiency incentives	• Encourage network companies to consider the likely lowest cost solutions over the longer term.

2.14. In our Initial Proposals we have set out our proposed outputs and secondary deliverables for the GDNs across the eight output categories. We expect the longer-term focus provided by the outputs framework to have a positive effect on the way the companies run their networks, making them more accountable more cost efficient over a longer time horizon and potentially exposing efficiencies in delivery. Any savings realised will be passed onto consumers through the symmetric efficiency incentives, which will reduce the costs that they face.

2.15. A clear risk associated with the development of a longer-term control period for RIIO-GD1 is that the level of uncertainty regarding expenditure requirements and outputs needed over the course of the control is likely to be greater given the potential for conditions to change during the price control period. We sought to address concerns regarding uncertainty by introducing a suite of uncertainty mechanisms to manage risk between network companies and consumers, including both uncertainty mechanisms and a mid-period review of output requirements. Our Initial Proposals set out proposed uncertainty mechanisms and further details of the mid-period review for RIIO-GD1, as discussed in turn below.

Uncertainty mechanisms

2.16. There are particular areas in which the GDNs will face uncertainty during RIIO-GD1. These are in relation to the Health and Safety Executive’s (HSE’s) policy on iron mains replacement, the impact of the supplier-led roll-out of smart meters and highway authorities adoption of street works legislation.

2.17. To guard against these and other uncertainties we introduced options within RIIO-GD1 to allow uncertainty mechanisms to be used in certain circumstances. These mechanisms can have a number of positive impacts in terms of delivering lower average network charges for consumers. For example, by reducing the risks associated with uncertainty that could be faced over the course of the price control, they could contribute to a lower cost of capital.

2.18. We recognise that uncertainty mechanisms within RIIO-GD1 could also have risks. For example, they could undermine efficiency incentives, increase complexity and lead to volatility in network charges. We outlined potential uncertainty mechanisms and the principles set out in the RIIO handbook as part of the RIIO-GD1 strategy. We also noted that, as part of their business plans, the GDNs could propose additional uncertainty mechanisms.

2.19. The majority of the GDNs were supportive of the uncertainty mechanisms we proposed, but all GDNs agreed that an additional mechanism was required to deal with uncertainty in relation to the roll-out of smart meters. Additionally, some GDNs proposed new mechanisms or alternative mechanisms to the ones we proposed.

2.20. When assessing these mechanisms within the proposed price control packages, we considered whether they would be in the interests of consumers, taking account of both the potential downsides and the RIIO principles. In a number of areas we have in principle accepted the mechanisms proposed by the GDNs, but are using this opportunity to consult on the options available to get wider stakeholders’ views on their proposals. In other areas we have put forward modified proposals to those proposed by the GDNs. Overall we consider that the package of uncertainty mechanisms we are putting forward protect consumers’ interests by providing strong efficiency incentives for the company to manage the risks and uncertainties it can reasonably be expected to manage.

Mid-period review

2.21. The RIIO framework includes provisions for a mid-period review of outputs to take place. The impact of having this mechanism is to ensure that the outputs agreed as part of the RIIO-GD1 package remain applicable for the duration of the price control period.

2.22. As part of our March 2011 Strategy document we noted several stakeholders' concerns that the mid-period review of outputs may not be sufficiently tightly defined, which could lead us to carry out a full price control review at this mid-period point. If this were to happen, the benefits of the longer-term price control would be lost. To address this risk, we clarified that the scope of the mid-period review will be to consider:

- material changes to existing outputs that can be justified by clear changes in Government policy (eg if there is a material change in the HSE's iron mains replacement programme)
- introducing new outputs that may be needed to meet the needs of consumers and other network users.

2.23. We also set out clear and transparent principles for the approach we would adopt at the mid-period review (including timescales). Our Initial Proposals reaffirm these principles. For RIIO-GD1 the mid-period review will take place in 2016, with any resulting changes to allowed revenues being implemented from April 2017. The review will involve an open consultation allowing stakeholders to contribute and comment on the proposals. In addition, we will undertake an IA of the need for a mid-period review to determine whether it is required rather than automatically progressing the process. This will prevent unnecessary resource being committed to the review in the event that it is not required.

2.24. If, following the mid-period review, we considered changes to outputs to be necessary we will only alter other elements of the control to the extent required to accommodate the change to outputs, eg incentive mechanisms or the allowed return.

IQI and the efficiency incentive rate

2.25. The information quality incentive (IQI) was introduced in the fourth electricity distribution price control review (DPCR4) and refined as part of DPCR5. It was also implemented in the first gas distribution price control review (GDPCR1) and, during RPI-X@20, we decided to extend application of the IQI to all of the energy network sectors under the RIIO model.

2.26. The IQI is used to set the ex ante efficiency incentive rate that network companies will face over the course of the price control. It is determined individually for each network company based on the expenditure requirements that they submit within their business plans and the extent to which these costs differ from our forecast of 'efficient' expenditure for the control period. In effect the efficiency incentive rate for a company is the ratio between its expenditure forecast and our assessment of its expenditure requirements as well as the specific parameters of the IQI.

2.27. We stated in our December 2010 IA that where the IQI operates effectively, it would provide incentives to the network companies to submit more accurate expenditure forecasts within their business plans due to the potential to achieve a more favourable efficiency incentive rate. This could ultimately deliver benefits for consumers by ensuring the allowances approved for network companies represent value for money.

2.28. In our March strategy document we set out a range for the initial efficiency incentive rate that network companies would face of between 50 and 60 per cent. This would mean network companies would be able to retain between 50 and 60 per cent of any efficiency savings achieved but would be exposed to an equivalent proportion of any over-spend. The most efficient GDNs would receive an efficiency incentive towards the top-end of this range.

2.29. As part of these Initial Proposals, we propose to increase the efficiency incentive rate range to 60 to 65 per cent for comparability with the current incentive rate GDNs face under GDPCR1. We have calibrated the IQI matrix such that all GDNs face an incentive rate in this range.

2.30. Efficiency incentive rates of these levels should create strong incentives for network companies to expose efficiency savings given the positive impact that this could have on their revenues. Consumers will also gain from any efficiencies achieved given that they will share the benefit. In addition, the strong efficiency incentive rate should create incentives on the network companies to avoid overspend given the significant proportion of these costs that they would face.

2.31. Under RIIO-GD1 we are proposing to amend the way in which the efficiency incentive rate is implemented. The first change will be to implement the efficiency rate through annual revenue adjustments which will be made two years after the expenditure is incurred, reflecting the availability of data. As a result the efficiency incentive rate will impact revenues more quickly and this should provide stronger incentives to network companies to seek out efficiencies. The second change will be that adjustments to the regulatory asset value (RAV) will be influenced by the level of the efficiency incentive rate. As such, allowed revenue will be adjusted to reflect any over or underspend, by 61 to 64 per cent (dependent on the GDN) of the over or underspend.

Innovation

2.32. There are likely to be a number of benefits for value for money as a result of the elements of the RIIO regime that help to encourage innovation.

2.33. Gas and electricity network companies will play an important role in facilitating the delivery of the government's low carbon targets and the transition to the low carbon economy. To do this, they will need to address issues such as connecting increasing volumes of renewable gas, and incorporating demand side management into their businesses.

2.34. To achieve this transition, network companies will need to innovate at an unprecedented rate to facilitate changes in the way networks are used. However, innovative activities such as research, development, trials and demonstration projects are speculative in nature and yield uncertain commercial returns. Consequently, network company shareholders may not be willing to put significant funds at risk for these activities.

2.35. In response to this challenge, we have proposed a package of measures, the innovation stimulus, aimed to encourage the investment in innovation required to deliver this low carbon transition and encourage the development of more effective technology and practices including the dissemination of learnings across the GB energy sector. The innovation has three components: an allowance to fund small scale innovative projects (the network innovation allowance (NIA)); a competition in which funding will be available for larger projects (the network innovation competition(NIC)); and a mechanism to allow additional funding in order to roll-out proven innovative solutions (the innovation roll-out mechanism(IRM)).

2.36. All GDNs have proposed to utilise the mechanisms available through the innovation stimulus. Each GDN, as part of its business plan, developed innovation strategies which set out its approach to innovation, its motivation and objectives.

2.37. We set out in our Strategy Document that in implementing the NIC, we intended to replicate the Low Carbon Network Fund (LCNF) funding model introduced for the last electricity distribution price control, DPCR5. This would involve the transfer of funds from all gas licensees to those licensees who win funding through the NIC. However, we set out in March 2012 that the restriction on gas transporter (GT) to GT transfers constituted a potential barrier to delivering this proposed funding approach in the gas sector.[8] We therefore do not expect to be able to introduce NIC (using the intended funding model) until 2014/15 at the earliest due to the statutory restrictions. We are though consulting on alternative funding models for 2013/14.

Proportionate treatment and fast-tracking

2.38. A key tool in the implementation of the RIIO framework is the use of proportionate treatment (including possible fast-tracking). This means applying regulatory focus and scrutiny proportionately to the quality of the submitted business plan. This tool helps us deliver benefits for consumers.

2.39. Proportionate treatment allows us to focus our regulatory scrutiny where it is likely to add most value. Where a network company produces a high quality business plan we will focus less resource on them, with their business plans subject to a lower level of scrutiny. In practice, we have also applied proportionate treatment to different aspects of the same plan.

2.40. In our December 2010 IA we stated that where network companies submit exceptionally well-justified business plans, it was possible for the price control to be settled early (fast-tracked). To reduce any potential risk of allowing network companies to proceed with a significantly inefficient proposal, all business plans have been subject to a challenging and material minimum level of scrutiny.

[8] Decisions on the Network Innovation Competition: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=346&refer=Networks/nic

2.41. We published our Initial Assessment of the GDNs' business plans in February 2012, including our decision not to fast-track any GDN.[9] We concluded that there were material issues in all GDNs' plans that could not be resolved, in the consumer interest, in the time available.

2.42. However, we have taken a proportionate approach to our assessment of GDNs' plans. In our assessment of the GDNs' updated business plans we have focused greatest regulatory scrutiny on the areas where this was required to obtain greater benefit for consumers.

Financeability proposals

2.43. Our financeability proposals are an important part of the overall RIIO model. Under these proposals we have specified a set of long-term financeability principles which will provide investors with clarity over our intended approach. This should allow investors to provide the capital required to fund the estimated new investment in network assets required in the period to 2020. There are various elements of the financeability proposals upon which we have sought to provide clarity and these are discussed in the following sections.

Cost of debt

2.44. In our Strategy Document we confirmed that we would be introducing indexation to the cost of debt. We considered this change to be particularly relevant given that we are extending the length of the price controls under RIIO. If the cost of debt were set using the traditional method, employed in GDPCR1, we would need to provide headroom due to uncertainty regarding debt costs over an extended price control period. This headroom would result in additional costs for consumers.

2.45. Indexation will allow the cost of debt to be set more closely to actual debt costs over time. It will also allow consumers to benefit in the event that debt costs fall and protect investors in the event that debt costs rise. It should therefore reduce costs for consumers and risk for investors. As the network companies use more debt finance than equity, the benefits for consumers could be substantial.

2.46. All GDNs included our approach to indexing cost of debt as part of their financial packages. However, some GDNs suggested uplifts to our proposed index while one GDN suggested that the index should be based on only BBB rated bonds compared to our proposal which uses BBB and A rated bonds. We do not propose to make any adjustments to our proposed index. The market cost of debt could rise over RIIO-GD1 in which case shareholders will be protected as the allowance adjusts through the indexation mechanism.

Cost of equity and notional gearing

2.47. In our Strategy Document we set out a range of 6.0 to 7.2 per cent for the cost of equity. Under RIIO principles the allowed return should reflect cash flow risk. Having assessed cash flow risk in our Initial Proposals package, we consider that the

[9] Initial assessment of RIIO-GD1 business plans and proportionate treatment: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=352&refer=NETWORKS/GASDISTR/RIIO-GD1/CONRES

GDNs will face notably lower cash flow risk than the transmission companies, over the same price control period, and lower cash flow risk than in GDPCR1. We consider the appropriate packages to be: a 6.7 per cent cost of equity; and notional gearing of 65 per cent.

2.48. We believe these values strike an appropriate balance in the context of the GDNs' investment programme and other elements of the financial package and uncertainty mechanisms.

Asset life and depreciation

2.49. In the RIIO handbook, we set out that regulatory depreciation would be based on economic asset lives. We engaged consultants to advise us on appropriate average technical and economic asset lives and decided to leave unchanged the asset life for gas distribution at 45 years for post 2002 assets, and 56 years for pre-2002 assets, for regulatory depreciation.

2.50. The use of economic asset lives is intended to ensure intergenerational equity by ensuring that consumers pay the appropriate charge for the use they make of the assets and to provide more stability for investors. We set out in our Strategy Document that for post 2002 assets we proposed to use front loaded depreciation as a change from using straight line depreciation. All GDNs adopted this approach in their business plans.

Greater opportunities for stakeholder involvement in the price control

2.51. Under the RIIO model, we have included opportunities for stakeholders to play a greater role in the development of the price control policy through enhanced engagement opportunities with us.

2.52. The RIIO model also places enhanced incentives on network companies to more effectively engage with their stakeholders as compared with the RPI-X regime. Through the RIIO framework demonstration of effective stakeholder engagement by the network companies has been a key area of focus. All GDNs have demonstrated that their business plans have sought to incorporate the views of stakeholders to a much greater degree than at GDPCR1. Relative to previous price controls we have seen markedly more (and a higher quality) stakeholder engagement by network companies, as well as robust explanations in the business plans as to how and why they have accommodated various parties' views.

2.53. We consider that the increased focus on effective stakeholder engagement under RIIO, has had a positive impact on consumers. We expect it to have produced business plans that more closely reflect their views and preferences and therefore will deliver value for money in line with their expectations. It has also provided us with greater confidence in the companies' plans and investment programmes over RIIO-GD1.

Impacts on competition

2.54. Our principal objective is to protect the interests of consumers, wherever appropriate, by promoting competition where this would best protects their interests or by other means if there is another manner to better protect those interests. It is therefore important that we consider the impact that implementation of RIIO-GD1 could have on competition.

2.55. We note that the energy network companies are not currently subject to competitive pressures, except at the extremes of the distribution networks where independent companies compete for the opportunity to extend the network and connect new customers, eg new housing developments. During RPI-X@20 we recognised that the extent for competition to develop further would be somewhat limited but highlighted that there may be benefits for consumers from extending these competitive pressures more broadly.

2.56. In this regard, we considered two areas where we thought competitive pressures could be drawn upon to deliver potential benefits for consumers. These areas are as follows.

- **Proportionate treatment:** As outlined above, our proposals on proportionate treatment and fast-tracking were designed to incentivise the network companies to deliver high quality business plans and thus potentially mimic some of the pressures of competitive market.
- **Third party delivery of network assets:** In developing the RIIO framework, we considered whether benefits could be achieved through increasing the role that competition plays in network regulation. However, for gas distribution we noted in our Strategy Document that there is already substantive third party involvement, eg in the connections market. We also stated that because of the integrated nature of distribution networks, there was limited scope for further third party delivery.

2.57. Although no GDN was fast-tracked we did see a marked improvement in the quality of the business plans that the GDNs submitted, and this was likely to be driven by the RIIO framework.

2.58. There are not substantial elements of the Initial Proposals specifically devoted to competition. We consider that implementation of RIIO-GD1 will therefore not have significant positive impacts on competition, but we do not foresee that there will be any negative impacts.

Impacts on sustainable development

2.59. One of the key drivers of the RIIO framework is to encourage network companies to play a full role in facilitating the transition to a sustainable energy sector.

2.60. To translate this high level objective into meaningful outcomes against which companies can deliver, we have developed an outputs-led regime. This regime is intended to highlight all of the areas in which the network companies will need to ensure delivery to play a full role in facilitating the transition to a sustainable energy sector. The regime is discussed in more detail in the following sections and we anticipate that it will deliver significant benefits for sustainable development.

Overview of the outputs-led regime

2.61. The key drivers of the RIIO framework are the objectives that we outlined in Chapter 1. These objectives provide a high level steer to the network companies about our expectations with respect to their performance. They are translated into an outputs led-regime through the development of the following elements.

- **A set of output categories:** The output categories capture the key areas within which consumers expect the delivery of high quality services in line with the objectives set out in Chapter 1. The output categories for RIIO-GD1 are: customer service, social obligations, safety, reliability, conditions for connections, and environmental impacts.
- **Primary outputs within these categories:** These are measures against which we can monitor performance in each of the output categories during the price control. GDNs will be required to deliver these outputs in return for their revenue allowances.
- **Secondary deliverables (where needed):** These put a requirement on the GDNs to report specified measures to allow monitoring of their performance against primary outputs.

Key benefits identified in the RPI-X@20 IA

2.62. One of the clear benefits that we identified within the RPI-X@20 IA was that the objectives of the regime would ensure that the network companies remained focused on the delivery of value for money to consumers whilst also considering the role they should play in the delivery of a sustainable energy sector. Where these objectives were effectively translated into outputs we considered that a number of benefits would be achieved. The key benefits are outlined in Table 2.3 below.

Table 2.3 Benefits from delivery of outputs identified in the RPI-X@20 IA

Element of the regime	Benefit
Output categories	• Provides transparency about the areas in which companies should ensure delivery.
Primary outputs	• Allow us to monitor delivery within each of the output categories. • Can be developed to reflect consumer views therefore helping to deliver value for money network services.

The RIIO-GD1 primary outputs

2.63. Our Strategy Document for RIIO-GD1 set out the key elements of the price control that the GDNs would need to understand in order to develop their business plans. The suite of primary output measures and regulatory framework was derived in consultation with interested stakeholders including through the Price Control

Review Forum, the outputs Working Groups and the Consumer Challenge Group. Given that the outputs have been developed using the RIIO principles of enhanced stakeholder engagement we are confident that they will ultimately deliver the benefits identified in the high level RIIO model, outlined in Table 2.3 above.

2.64. The following sections provide an overview of the Initial Proposals on outputs for RIIO-GD1 and our views on the impact that these proposals will have for sustainable development.

Customer satisfaction and social obligations

2.65. During RPI-X@20, we identified customer service and social obligations as two areas in which network companies should ensure delivery. Output categories were therefore included for each of these areas and primary outputs have been developed for each of these areas. The following sections provide an overview and outline the impacts they will have for sustainable development.

Customer satisfaction

2.66. Under the RPI-X framework, the level of customer service provided by the GDNs is monitored through a customer satisfaction survey and a guaranteed standard of performance relating to complaint handling. There is no financial reward or penalty associated with the level of performance observed through the customer satisfaction survey, but compensation is payable to customers where network companies do not respond to complaints in a specified time period.

2.67. As part of RIIO-GD1, we are building on these existing measures. We are introducing an output which will allow us and stakeholders to monitor GDNs' performance in terms of customer satisfaction. The output is made up of three parts and has the following impact on network companies' allowed revenue:

- a customer satisfaction survey with a symmetric incentive rate of up to +/-0.5% of its allowed base revenue
- a complaints metric, which can penalise a GDN up to -0.5% of its allowed base revenue
- a stakeholder engagement reward (via a discretionary reward scheme), worth up to 0.5% of its allowed base revenue for each year.

2.68. We consider that this output will have a positive impact in terms of ensuring that all customers and stakeholders receive a service, over the price control, that is aligned with their expectations. In implementing this output, we continue to recognise the risk that a GDN could be unduly rewarded or penalised for their performance in terms of customer satisfaction.

2.69. To mitigate this risk, in relation to the customer satisfaction survey, we conducted a six month trial survey between October 2011 and March 2012. We have used the data from this survey in establishing target performance levels for the GDNs. This data indicates that GDNs are already performing to a reasonably high standard. Therefore , we are also proposing that the target for maximum reward/penalty be set asymmetrically. This will ensure that the maximum penalty will only be imposed if performance falls some way below current levels. However, to ensure there is an appropriate incentive on the GDNs to improve a relatively smaller improvement will be required.

Social obligations

2.70. We have set out previously that we considered there were two key social issues for the GDNs to consider in RIIO-GD1: the Fuel Poor Network Extension Scheme in which the GDNs provide connections to fuel poor and vulnerable customers; and in helping to raise awareness of the risks of carbon monoxide (CO).

2.71. Our Initial Proposals outline funding through the Fuel Poor Network Extension Scheme for the connection of around 80,000 households to the gas network over RIIO-GD1. This will ensure that the GDNs are able to help alleviate the number of consumers that are in fuel poverty. We are conscious, however, that this scheme should continue to represent value for money. To minimise the risk of consumers' funding a scheme in which the costs do not outweigh the benefits we are proposing to conduct a review of the scheme during RIIO-GD1.

2.72. Our Initial Proposals also outline a common output measure for CO awareness. The measure will allow flexibility in how the GDNs approach delivering this output, in order that they are able to meet the specific needs of their customers. We are not proposing any financial reward/penalty in this area as we do not consider that this would be in the best interests of consumers.

Safety and reliability

2.73. During RPI-X@20, we recognised that an important element in the delivery of a sustainable energy sector was the maintenance of a reliable system that would allow a high quality service to be provided to consumers as well as incorporating sufficient capacity to allow network users to utilise the system as needed. Linked closely to this, we also clearly understood the need for the system to be operated safely. Although both of these aspects of delivery are linked, we note that we have greater discretion in developing arrangements related to reliability. Primary responsibility for the development of safety standards sits with the Health and Safety Executive (HSE). We recognise, however, that safety is an important factor in determining the costs that network companies will incur over the course of the price control and is therefore an area of service that should be considered.

Reliability

2.74. We set out in our Strategy Document that we proposed to develop outputs for two key areas in relation to reliability: network condition and loss of supply; and availability of capacity. In our Initial Proposals we have set out outputs in relation to these two key areas.

2.75. For network condition and loss of supply we are proposing outputs in relation to the volume of planned and unplanned interruptions and a requirement for the GDNs to maintain asset health and risk metrics. For availability of capacity we are proposing outputs in relation a requirement to maintain capacity at a level to meet 1 in 20 winter day demand (a measure of the capacity requirement at peak time). This will have positive outcomes in terms of helping to ensure that capacity is available where it is needed but avoid the potential for consumers to pay more than is necessary for a reliable supply of gas.

2.76. We have also introduced a suite of secondary deliverables to monitor overall network risk, operational performance and ensuring network records are maintained. This will positively impact sustainable development by ensuring the ongoing reliability of the system and security of supply.

Safety

2.77. As part of our Strategy Document, we recognised that the HSE is the principal regulator of safety and consider it important to support but not to duplicate the functions that it performs. We therefore proposed that the primary outputs for safety should relate to compliance with the HSE standards set out in the GDNs' safety case.

2.78. In June 2011, the HSE confirmed a change to their iron mains replacement programme, named the three-tier approach. As proposed, we have set a primary output in relation to the level of risk removed from the network due to the replacement of iron mains. For Initial Proposals we have made a number of changes to the GDNs' proposals, to reflect this new approach, including adjustments to the primary outputs that they proposed.

2.79. In relation to safety our Initial Proposals outline three further primary outputs:

- a requirement to respond to 97 per cent of reported gas escapes within one hour for uncontrolled escapes, and within two hours for controlled escapes
- a maintenance of current risk scores in relation to mains repair
- a requirement to prepare a Major Accident Hazard Prevention policy document.

2.80. We consider that the outputs set out in the Initial Proposals will allow the GDNs to comply with safety requirements while delivering at value for money for consumers.

Conditions for connection

2.81. During RPI-X@20 we recognised that network companies should be required to provide an efficient connections service in relation to both demand and supply. We noted that on the supply side this would ensure they could connect generators, interconnectors and storage facilities and this would have important impacts on security of supply. Where network companies demonstrate high levels of performance in this area it could have positive impacts on the environment and the development of a low carbon energy sector.

2.82. During the last gas distribution price control, we introduced mandatory Gas Performance Standards in relation to gas connections.[10] There is a requirement on the GDNs to meet these performance standards in at least 90 per cent of cases.

[10] The standards are set out in the Gas Standards of Performance Regulations 2008, available from: http://www.legislation.gov.uk/uksi/2008/696/pdfs/uksi_20080696_en.pdf

These standards place a requirement on Independent Gas Transporters (IGTs) and GDNs to quote for and complete works within specified timeframes, thus providing valuable information for consumers. The GDNs are incentivised to comply with these standards as failure results in a financial penalty

2.83. We have considered, in developing Initial Proposals, whether any changes were required to the arrangements for connections. We have decided to continue with existing arrangements as we consider these arrangements provide incentives for the GDNs to deliver a consistent connections service that is in line with customer expectations.

2.84. In recognising the potential for growth in the connection of distributed gas we set out in our Strategy Document our expectation that the GDNs should develop a voluntary standards of service for distributed gas connections. We welcome the commitment made by GDNs to develop these voluntary standards and expect them to work together, and along side distributed gas customers, to ensure appropriate standards and related measures are put in place. We consider that this will have positive impacts for security of supply and quality of service.

Environmental impacts

2.85. One of the key drivers of the establishment of the RIIO framework is the desire to ensure that the regulatory regime remains fit-for-purpose within the context of the 2020 and 2050 targets on renewable deployment and carbon abatement. This therefore provided a clear rationale for the inclusion of a specific output category related to environmental impacts. The following sections set out the impact that we consider the environmental outputs measures will have with respect to sustainable development.

2.86. Gas losses (or shrinkage) from the GDNs' networks currently account for around 1% of UK green house gas emissions. There are existing incentive mechanisms to reduce levels of gas shrinkage and we propose to retain an incentive. Our Initial Proposals outline our proposed rolling incentive in relation to gas shrinkage. We consider that this mechanism is an improvement on the current mechanism as it will incentives the GDNs to reduce shrinkage in each year of the price control. Ultimately, a fall in shrinkage levels will have a positive impact on carbon emissions from the system and, in turn, on sustainable development.

2.87. We are also proposing primary outputs in relation to reporting of connections of low carbon generation, a continuation of the discretionary reward scheme (which, amongst other impacts, provides a reward to a GDN who demonstrates best practice in reducing the environmental impact of its network), establishment of standards in relation to the connection of biomethane and publication of GDNs' performance in relation to their business carbon footprint. These measures are all designed to positively impact sustainable development by facilitating the connection of additional low carbon generation.

Other benefits from the outputs regime

2.88. In our December 2010 IA, we predicted wider gains from the new approach to producing business plans. These included thinking about different ways of delivery and placing greater weight on the longer-term. While none of the GDNs' business plans met the standard required for fast-tracking, each had some strong areas and represented a step change when compared to GDPCR1.

Impacts on health and safety

2.89. The maintenance of safety standards is clearly of utmost importance when it comes to the energy networks. As outlined above, responsibility for regulation of this area of network operation primarily rests with the HSE and they have arrangements in place with the network companies to ensure the delivery of network services in line with predefined safety standards. However, we do recognise that investment in assets to ensure the ongoing safety of the network is exceptionally important and this is why we have a specific output category regarding safety. We think that inclusion of this output category ensures that the appropriate focus on safety is retained under the RIIO-GD1 Initial Proposals.

3. Potential risks

Chapter Summary

This chapter provides an overview of potential risks of implementing RIIO-GD1 Initial Proposals and explains the mitigating actions that have been incorporated into the framework to manage these risks.

3.1. In this chapter we set out some of the potential risks associated with implementing the RIIO-GD1 Initial Proposals. If these risks were realised they could lead to costs for consumers and ultimately reduce the benefits of implementation outlined in Chapter 2.

3.2. Where possible, we have sought to implement protections to guard against these risks and, in the event that they materialise, we would have tools at our disposal to manage their impact. We think the benefits of implementing these Initial Proposals, as set out in Chapter 2, significantly outweigh any potential risks that may arise. This is particularly the case when these risks are considered within the context of the protections that we have put in place to mitigate them.

3.3. As part of the December 2010 IA, we noted a number of risks that could result from implementation of the RIIO framework through RIIO-GD1. This chapter looks in turn at the risks identified. This includes the following potential risks:

- the GDNs do not deliver their primary outputs
- we have over/underestimated the allowances required by the GDNs
- that there is increased regulatory risk due to the presence of the mid-period review of outputs
- that the financeability proposals may deter investment
- that the needs of future consumers may not be anticipated.

Potential non-delivery of the primary outputs

3.4. In the RPI-X@20 IA we noted stakeholder comments that, where network companies sought to adopt new and innovative approaches, this could potentially lead to the non-delivery of outputs. We have summarised the main points raised in Table 3.1 below.

Table 3.1 Risks associated with the non-delivery of primary outputs

Risk	Mitigation under RIIO
Adopting innovative approaches that are not consistent with business as usual could lead to non-delivery of outputs.	• Thorough assessment of business plans with a high hurdle for companies to demonstrate their ability to deliver against the outputs. • Non-delivery of outputs will be penalised.

3.5. As set out in Table 3.1, we consider that the potential risk of non-delivery of outputs is mitigated through a thorough ex ante assessment of the business plans and the implementation of rewards/penalties that are, where possible, specified upfront. These incentives will encourage the network companies to efficiently deliver through the potential to achieve rewards and dissuade non-delivery through the application of meaningful penalties. In a similar way to the efficiency incentive, the output incentives will be applied transparently on a yearly basis and therefore this should strengthen the incentive to deliver outputs. We also intend to monitor delivery of outputs over the course of the price control period using a balanced scorecard approach. This will provide a clear and simple way to convey information on the performance of the network companies and will highlight any potential problems with respect to output delivery should they arise.

Over/under estimation of allowances

3.6. Stakeholders have previously stated that under the RIIO model there is a potential risk that network companies may be able to include in their business plans overinflated costs for the delivery of outputs. They suggested that information asymmetry, combined with the greater focus on outputs under RIIO, would mean that we may not have clarity on the likely costs that network companies would incur. In addition, the extension of the price control period could lead to a greater risk of network companies over/underestimating the costs that they could face over the coming period. We have summarised the main points in Table 3.2 below.

Table 3.2 Potential risks of over/underestimation of allowances

Risk	Mitigation under RIIO
We may agree to overestimated costs submitted by the company	• Outputs will provide visibility on what network companies propose to deliver and associated costs. • Longer-term business plans will allow us to assess network companies against a longer-term strategy. • We will use a variety of tools to assess the business plans to ensure reasonableness. • The IQI will help protect against inflated costs.
Increasing the price control from five to eight years could lead to base revenues being set too high/low due to forecasting difficulties	• We will calibrate the strength of the upfront efficiency incentives in light of this uncertainty. • We will develop uncertainty mechanisms to manage these risks without undermining the benefits of a longer-term control.

3.7. We have confidence that the outputs-led nature of the RIIO model will provide visibility on what the network companies intend to deliver and, combined with the longer term business plans and secondary deliverables, will provide an understanding of their plans for the future. In our Strategy Document, we provided transparency on our expectations of the business plans and on our approach to assessing these as part of RIIO-GD1. We have used the range of tools at our disposal, including the comparative benchmarking and the IQI, to assess the efficiency of the GDNs' business plans.

3.8. We recognise that predicting the costs that network companies will face over a longer-term price control is likely to be difficult due to potential uncertainties about the way circumstances may change over a longer time period. In conducting our analysis of the GDNs business plans we relied on a range of information to minimise the risk of over or under estimating allowances. As part of Initial Proposals we have also provided a range of uncertainty mechanism where, for specific circumstances, we are able to make adjustments to the GDNs allowed revenues.

3.9. We are also proposing a mid-period review. The scope of this review is tightly defined to consider:

- material changes to existing outputs that can be justified by clear changes in Government policy, eg the carbon target increases
- introducing new outputs that may be needed to meet the needs of consumers and other network users.

3.10. Both the uncertainty mechanisms and the mid-period review will allow us to make amendments to network company allowances where circumstances change, either due to changes in general industry conditions or due to the need to establish new outputs or amend existing ones. We also note the significant consumer benefits that could be achieved through the combination of factors intended to encourage network companies to take a longer-term perspective. The extended price control period is just one of a number of important elements that will facilitate this outcome but we consider it to be an important aspect of the RIIO-GD1 package.

Potential regulatory risk

3.11. In the December 2010 IA, we noted a number of areas of the RIIO model that could potentially lead to increased regulatory risk. These included potential risks associated with the mid-period review of outputs, the financeability proposals and in anticipating the needs of future consumers. We address each of these in turn below.

Mid-period review of output requirements

3.12. The reason for, and design of, the mid-period review of outputs requirements has been discussed throughout the RPI-X@20 and RIIO-GD1 project. In general, stakeholders have agreed that having a mid-period review will help to address uncertainties regarding the requirements of the networks during an eight-year price control period. However, some stakeholders noted concerns that the review would not be sufficiently tightly defined and may therefore lead to a full price control review after four years, and undermine the benefits of having an eight-year price control.

3.13. To mitigate the perceived risks associated with the mid-period review, we have been clear that it is important for us to be transparent about the issues that could be addressed and the process we will follow. In our Finance and Uncertainty Supplementary Document we set out a tightly defined scope for the mid-period review. We also set out clear and transparent principles for the approach that we would adopt in undertaking the review.

Potential risk of financeability proposals

3.14. In the RPI-X@20 IA we recognised stakeholder views with respect to our proposed approach to financeability and the impacts that this could potentially have on investor decisions. The issues are summarised in Table 3.3 below.

Table 3.3 Potential risks associated with the financeability package

Risk	Mitigation under RIIO
The financeability	• The package provides commitment to investors.

principles could deter investors from the sector	• The package provides a transparent set of principles that will increase predictability and reduce risk. • We will implement appropriate transition arrangements to ensure investors are not deterred from the sector.

3.15. We believe that our approach to financeability, rather than deterring investors will encourage investment, through the provision of a commitment to a set of transparent principles that we will use in determining the financeability package. We have specifically proposed transitional arrangements in relation to the change in capitalisation arrangements for repex to ensure that the GDNs' cash flows are not unduly impacted by the transition to these new arrangements.

Anticipating the needs of future consumers

3.16. Some stakeholders considered that the needs of future consumers may not be adequately represented when determining the price control settlements in RIIO-GD1. The issues are set out in Table 3.4 below.

Table 3.4 Potential risks associated with representation of future consumer needs

Risk	Mitigation under RIIO
Enhanced engagement could give insufficient weight to the views of future consumers	The Authority will continue to take a balanced approach to assessing the price control and the way it has considered the needs of existing and future consumers.

3.17. We note that this is a risk that would be encountered under any regulatory regime. The Authority has an obligation to consider future consumers' interests as part of its role, and has been mindful of this obligation in making its decision on these Initial Proposals. We recognise that the Authority may not have absolute clarity regarding what the needs of these consumers will be in the future, but consideration of future consumer interests will ensure their needs are assessed as part of decisions taken.

Potential risk of interpretation and application of certain elements of the regime

3.18. In response to the RPI-X@20 recommendations document many stakeholders expressed support for the rationale underpinning a number of aspects of the RIIO model. However, they noted that achieving benefits from this new regime was not linked to the principles developed for the RIIO model but rather was dependent on the way these principles were interpreted and applied in practice. We recognise that there are potential risks associated with the way that the regime is applied and the detail of the framework developed, eg with respect to the way outputs are defined.

3.19. To guard against this potential risk, we have engaged extensively with a range of stakeholders to understand their views and perspectives on the way we should implement the regime. These Initial Proposals are informed by this engagement process.

3.20. Since the start of RIIO-GD1, we have adopted a multi-layered process of engagement to ensure that all affected parties have appropriate opportunities to engage in the review. When we have engaged with stakeholders, we have sought to adhere to our principles for effective enhanced engagement set out in the RIIO handbook.

3.21. The key elements of our process have been:

- consultations on the approach to the review and our strategy for implementing RIIO
- a series of stakeholder working groups on outputs and incentives, sustainable development and on financial issues
- a number of meetings with the Price Control Review Forum (PCRF)
- events designed for a City audience to capture the views of investors
- meetings for the network companies and the Consumer Challenge Group (CCG) with our Committee of the Authority
- a range of bilateral meetings with the network companies and stakeholders.

3.22. Furthermore, as part of RIIO, significant onus has been placed on the network companies to demonstrate, through their business plans, that they have effectively engaged and considered the views of their stakeholders in setting out what they will deliver. The demonstrated success of the GDNs stakeholder engagement has formed an important part of our assessment of their plans.

4. Post implementation review

Chapter Summary

This chapter sets out our current thinking on the costs that will be associated with implementation of the RIIO-GD1 Initial Proposals. It also provides an overview of the approach that we intend to take to reviewing price control settlements that are ultimately implemented for RIIO-GD1.

4.1. It is important along with thinking about the impacts and potential risks that would result from implementation of these RIIO-GD1 Initial Proposals, to also consider the direct costs of implementing this package. Specifically, taking into consideration whether application of these Initial Proposals would be prohibitively expensive. In addition, to ensure that the benefits identified in Chapter 2 are achieved and the risks highlighted in Chapter 3 are minimised, we consider it important to undertake a post-implementation review of the proposals at an appropriate point in the future.

4.2. This chapter discusses both the costs that may be incurred in implementation of the RIIO-GD1 Initial Proposals, as well as the approach that we will take in carrying out a post implementation review and learning lessons from the experience of implementing the RIIO framework.

Other impacts, costs and benefits

4.3. As with any new regime, there are likely to be costs associated with the implementation of the RIIO-GD1 Initial Proposals. We do not anticipate that significant direct costs will be incurred in terms of the need to develop new IT programmes or invest in new technologies, but costs may be incurred as a result of the need to transition to a new regime. In this respect, we think that costs could arise in the following areas.

- **Enhanced engagement:** Under the RIIO framework there are provisions for both network companies and Ofgem to take forward enhanced engagement with a range of stakeholders. All GDNs have undertaken increased stakeholder engagement in the development of their RIIO-GD1 business plans, and this should continue in advance of (and throughout) RIIO-GD1. Effectively taking forward and continuing this type of engagement involves increased resource and cost for us, the network companies, and other interested stakeholders. This increased resource is needed to prepare materials, assimilate views and attend meetings. The outcome of these processes thus far has been the development of Initial Proposals that more closely reflect the views of stakeholders. Therefore, we consider this extra resource has been justified.

- **Potential costs associated with the outputs regime:** We note that additional costs may be incurred by the GDNs in order to deliver the outputs that they have proposed. We have considered these additional costs, in our efficiency assessment of the GDNs’ business plans, and are satisfied that where costs are incurred these will be offset by benefits delivered. These are discussed further in Chapter 3.

4.4. We recognise that direct costs of implementing the RIIO-GD1 Initial Proposals may arise in a number of areas. We do not think that these costs will be significant as compared with the benefits that are likely to be achieved from the implementation of these Initial Proposals. We would also note that a large proportion of these costs would have been incurred in the event that the price controls were developed using the RPI-X regime. In addition, there are elements of these Initial Proposals that are likely to mean lower direct costs are incurred which will ultimately deliver benefits for consumers.

Post-implementation review

Monitoring delivery of the objectives

4.5. We will publish Final Proposals for the GDNs in December 2012. The controls will be implemented from 1 April 2013. Following implementation of the RIIO-GD1 Final Proposals we will need to ensure that we fully understand the extent to which the objectives of the framework are being met. To achieve this, after implementation we intend to:

- monitor the performance of GDNs in delivering against the primary outputs, and secondary deliverables, and the extent to which this facilitates delivery of the objectives
- analyse the extent to which the GDNs are acting in response to longer-term issues
- understand the GDNs' performance in delivering their well-justified business plans and the role this has played in exposing innovative operational solutions
- assess the development and application of uncertainty mechanisms and the role they are playing in providing flexibility within the price control
- assess the extent to which the principles on financeability are ensuring that the GDNs are able to finance their activities at a reasonable cost to consumers.

4.6. The role that we will take in monitoring the outcomes of the proposed RIIO-GD1 price control settlements will allow us to better understand the extent to which they are delivering the benefits anticipated in this IA. It will also allow us to make any amendments to the framework in the future (eg for RIIO-ED1, the next price control review for the electricity distribution networks), where this may be needed to better facilitate delivery against the objectives.

Adapting the framework over time

4.7. Given uncertainty about the best way to develop the networks to facilitate the transition to a sustainable energy sector, it is important that the RIIO model is able to adapt to changing circumstances. This will enable us to refine regulatory arrangements over time, learn lessons from previous price control periods and adapt to changing government policy.

4.8. While we expect the overriding objectives and associated principles underpinning the RIIO model to be long-lived, and adaptable to changing circumstances, the way the principles are implemented may need to be amended to reflect changing industry conditions. There are likely to be significant benefits where the regulatory regime is adaptable and these could be more effectively delivered where there is transparency about how this adaptation could take place. The following list outlines the principles with which we always seek to conform, and with which we will seek to conform in adapting the regulatory framework over time. In particular, we will:

- consider the principles of better regulation[11]
- ensure our decision making is open and transparent
- ensure accountability to stakeholders
- take decisions based on robust and auditable evidence
- provide clear and reasoned explanations for changes that we make
- consider the impact of changes on regulatory commitment and credibility
- ensure the proportionality of any changes.

4.9. We anticipate that adherence to these principles will provide transparency to stakeholders with respect to the areas in which changes may be made and the rationale for these changes. It would also allow stakeholders to identify, and propose, areas in which adaptation of the regulatory regime may be appropriate in the future.

[11] The principles of better regulation are: transparent, accountable, proportionate, consistent, and targeted. Adhering to these principles is consistent with our duties under Section 3A (5A) of the Electricity Act 1989 and Section 4AA (5A) of the Gas Act 1986.

5. Conclusions

Chapter Summary

This chapter sets out our conclusions regarding the impact that implementation of the RIIO-GD1 Initial Proposals could have on consumers, competition and sustainable development.

5.1. In this IA we have explored the potential impacts that may be observed as a result of the implementation of the RIIO-GD1 Initial Proposals. Where possible, this IA has sought to qualify potential impacts.

5.2. There are likely to be positive impacts in a number of areas as a result of the implementation of these Initial Proposals. In particular, we anticipate significant benefits for consumers resulting from the minimisation of the costs associated with the transition to a sustainable energy sector. These benefits may stem from a number of elements of these Initial Proposals, including the longer-term focus, the suite of incentives that will be implemented, the use of proportionate treatment and the transparent financeability package. We also note that the implementation of the RIIO model for the RIIO-GD1 price control has provided greater opportunities for consumers to engage in the development of RIIO-GD1. This has provided a route for consumers to influence the package and seek to ensure that it represents value for money.

5.3. We anticipate that implementation of these Initial Proposals will also have a number of positive impacts in terms of sustainable development. The outputs-led regime places emphasis on the delivery of outputs that are consistent with the transition to a sustainable energy sector. These outputs cover social, environmental and economic issues as well as recognising the importance of the ongoing safety of the networks.

5.4. We recognise that there are a number of identifiable risks which could threaten the achievement of these benefits. These include, amongst other things, the risk that allowances are set inaccurately and the risk of output non-delivery. However, we note that many of these risks would also be observed if a price control were being progressed in accordance with the principles of the RPI-X regime. In addition, we have put a number of mechanisms in place to mitigate these potential risks, as discussed in Chapter 3 of this IA.

5.5. With any framework, there is real merit in adapting and evolving the regime over time to reflect past experience and changing circumstances and this is an approach we are seeking to take with respect to the RIIO model, and the first application of its principles in the RIIO-GD1 and T1 price controls.