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development community,
investors and other interested
parties

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Dear colleague

RIIO-T1: Decision on fast-tracking for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd

The next transmission price control (RIIO-T1) is the first price control¹ to be conducted under our new RIIO (Revenue = Incentives + Innovation + Outputs) model. The price control is due to run from 1 April 2013 to 31 March 2021. The objective of RIIO is to encourage network companies to play a full role in the delivery of a sustainable energy sector, and to do so in a way that delivers value for money for existing and future consumers.

This letter sets out the Authority's decision that the business plans of SP Transmission Ltd (SPTL) and Scottish Hydro Electric Transmission Ltd (SHETL) are of sufficient quality to be consulted upon through fast-tracking Initial Proposals with a view to reaching early settlement of their price controls, ie that their business plans are suitable for "fast-tracking". It provides a high-level summary of our assessment of the companies' business plans. It also sets out the key components of their plans that will form our Initial Proposals for their price controls. Our decision to fast-track SPTL's and SHETL's plans, subject to consultation, reflects the significant improvement in the plans in both cases since their initial submission in July 2011, and the value that the plans provide to consumers and wider stakeholders.

As set out in our October letter², in RIIO-T1 we have provided for greater iteration between the first business plan submission and our fast-track decision than we intend in the future, including in RIIO-GD1 and RIIO-ED1. As network companies learn what is expected from them under RIIO, for example in terms of a more joined up assessment, testing different options and employing long-term thinking across the whole plan, we do not consider there will be a requirement for significant iteration as the quality of the initial submissions should be higher. Importantly, this does not mean that we are lowering the bar for a company to be fast-tracked in RIIO-T1.

SPTL and SHETL have published revised versions of their RIIO-T1 business plans. These will be available at the following links:

¹ We are currently in the process of setting price controls for the gas distribution companies – RIIO-GD1 – but that process is being taken forward on a separate timetable.

² Initial assessment of RIIO-T1 business plans and proportionate treatment
<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/busplanletter.pdf>

- SPTL – http://www.spenergynetworks.co.uk/publicinformation/stakeholder_riio.asp
- SHETL – <http://www.ssepd.co.uk/Projects/TransmissionPriceControlReview/>

We intend to publish our consultation on Initial Proposals for both SPTL and SHETL on 6 February, and will seek views from stakeholders at that point. In the meantime, if you would like to discuss any aspect of this letter, please contact Grant McEachran on 0141 331 6008 or by e-mailing grant.mceachran@ofgem.gov.uk.

Background

Under the RIIO process, network companies are required to take into account the needs and views of stakeholders in order to submit to us well-justified business plans. We are taking a proportionate approach to our scrutiny of companies' plans, i.e. the level of our regulatory scrutiny varies according to the quality of plans. Companies that submit very high quality plans will be able to agree price controls early, i.e. achieving fast-tracking.

In March 2011, we set out our Strategy Decision for RIIO-T1.³ This set out decisions on the key aspects of the regulatory framework. It also set out what we expected to see in a well-justified business plan and the criteria against which we would assess such a plan. We used five broad criteria to assess the plans:

- Process: has the company followed a robust process?
- Outputs: does the plan deliver the required outputs?
- Resources (efficient expenditure): are the costs of delivering the outputs efficient?
- Resources (efficient financial costs): are the proposed financing arrangements efficient?
- Uncertainty/risk: how well does the plan deal with uncertainty and risk?

We received the transmission owners' (TOs) RIIO-T1 business plans at the end of July 2011. Our assessment in October concluded that none of the plans was suitable for fast-tracking in their existing format. However, we also took into consideration that this was the first time any company had submitted a business plan under the RIIO framework and that the scale of the outstanding issues for SPTL and SHETL may allow them to resolve these in a timeframe consistent with fast-tracking. On this basis we retained SPTL and SHETL in the fast-tracking process. Our assessment outlined the issues SPTL and SHETL would need to address in order for us potentially to develop Initial Proposals in early 2012.

We considered that the outstanding issues for National Grid Electricity Transmission plc (NGET) and National Grid Gas Transmission plc (NGG) were not resolvable in this timeframe. Consequently, NGET and NGG reverted to the non-fast-tracking process.

SPTL and SHETL's revised business plans

Following the publication of our initial assessment of the companies' plans both SPTL and SHETL have undertaken a significant amount of further work to revise their plans. Both have undertaken more work in key areas, provided further supporting information and carried out further stakeholder engagement. Both companies have submitted revised versions of their business plans.

Our updated assessment is based on all of the information provided to us as part of this process. It is also informed by responses to our October business plan assessment and views received from the Consumer Challenge Group (CCG)⁴.

³ Decision on strategy for the next transmission price control: RIIO-T1 – Ofgem, 31 March 2011 Ref:46/11 <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decision.pdf>

⁴ The CCG comprises consumer and environmental experts acting as a critical friend to Ofgem in the RIIO-T1 and RIIO-GD1 processes.

Assessment of revised business plans

This section summarises our updated assessment of each of SPTL's and SHETL's revised business plans. This covers the five criteria we used in the initial assessment. SPTL and SHETL have taken different approaches to their business plans. In taking a decision on fast-tracking we have therefore assessed each plan as a package. We are satisfied that both packages as a whole provide value for money to both existing and future consumers and demonstrate how they will meet the challenges associated with facilitating the move to a low carbon economy.

SP Transmission Ltd (SPTL)

In relation to its process SPTL has addressed our key concerns. It has undertaken further stakeholder engagement and increased its stakeholder database. It has also provided information in relation to omissions from the key content in its July business plan.

SPTL has made changes to a number of its output and incentive parameters which provide better value to customers. In particular, it has changed its proposals in relation to the primary outputs for reliability and connections which bring it into line with the positions set out in our Strategy Decision document. It has provided more information in relation to its processes for developing a network availability policy and customer satisfaction survey. It has also provided more information on their environmental outputs and recognises there is room to refine these further.

The area where SPTL has made most progress since October is in relation to its justification around cost efficiency. It has provided a wide range of additional material including evidence of the robustness of its processes to ensure efficiency, shown that a large proportion of its cost base is subject to competitive tenders and provided additional information to demonstrate how it will deliver its plan. SPTL's unit costs are comfortably within our consultants' range.

SPTL has revised elements of its financial proposals. It has reduced its cost of equity assumption, increased notional gearing and introduced a fixed rate of totex capitalisation.

SPTL has made revisions to its approach to dealing with risk and uncertainty. It has proposed volume drivers that are tightly defined both in terms of scope and unit costs and set out a similarly well defined mechanism for wider works.

Scottish Hydro Electric Transmission Ltd (SHETL)

In relation to its process SHETL has undertaken further stakeholder engagement and increased its stakeholder database. It has also provided information in relation to omissions from the key content in their July business plan.

SHETL has made changes to a number of its output and incentive parameters. Several of these, including its environmental outputs, network availability policy and customer satisfaction, will be strengthened by further detail in the coming months.

SHETL has provided more information and revised plans in relation to both its costs and risk and uncertainty to address our concerns that its July plan transferred a disproportionate risk onto consumers.

SHETL has made substantial changes to its financial package since the July plan, bringing it in line with our policies and ranges. Among the key changes it has made are applying straight line depreciation to new assets, with a 16-year transition; reducing the assumed cost of equity from 8.25% over the first four years of the RIIO-T1 period and 7.5% thereafter to 7% throughout the RIIO-T1 period; increasing notional gearing from 50% in the first four years of the RIIO-T1 period and 55% thereafter to 55% throughout the RIIO-

T1 period; removing the uplift to the cost of debt index; and applying a fixed totex capitalisation rate.

Decision on fast-tracking and proportionate treatment

SPTL

SPTL has addressed the key outstanding issues we had with their July business plan. In a wide range of areas it has provided more detail and in a number of areas it has changed its proposals. We note there are areas where SPTL could improve and we are outlining below some areas in relation to stakeholder engagement and outputs where we expect further work to be undertaken.

Overall we consider the package put forward by SPTL provides good value for consumers. On this basis, we are putting forward SPTL's business plan for fast-tracking and intend to publish Initial Proposals shortly.

SHETL

SHETL has made significant progress in addressing the outstanding issues we had with its July business plan. It has provided more detail in various areas of the plan and put forward innovative proposals in a number of areas. Most notably SHETL has proposed significant changes to its financial package. As with SPTL there are areas where SHETL could improve. We outline below some areas in relation to stakeholder engagement and outputs where we expect further work to be undertaken.

Overall we consider the package put forward by SHETL provides good value for consumers. On this basis, we are putting forward SHETL's business plan for fast-tracking and intend to publish Initial Proposals shortly.

Summary of SPTL and SHETL's business plans

The fast-tracking Initial Proposals for SPTL and SHETL will be developed and published shortly, based on the information set out in their business plans. The key elements of those plans are summarised in Table 1 below.

Table 1: Summary of SPTL and SHETL’s business plans

Area	SPTL	SHETL
Outputs	Complete range of RIIO outputs including baseline deliverables and the strength of the financial incentives	Complete range of RIIO outputs including baseline deliverables and the strength of the financial incentives
Environmental strategy	Some areas of best practice in its environmental outputs i.e. baseline for SF ₆ emissions and commitment to mitigation measures for visual amenity	Some areas of best practice in its environmental outputs i.e. transmission losses and a visual amenity statement
Expenditure (nominal prices)		
Baseline capex	£1.8bn	£1.1bn
Capex subject to uncertainty mechanisms	£0.7bn (SPTL best view)	£4.0bn (SHETL best view)
Controllable Opex	£0.3bn	£0.4bn
Financial parameters		
Cost of equity (post-tax real)	7%	7%
Notional gearing	55%	55%
Cost of debt (pre-tax real)	Indexed using 10 year simple trailing average	Indexed with bespoke weightings tracking Totex profile
Depreciation profile	Straight line: 20 years on existing assets, 45 years on new assets	Straight line: 20 years on existing assets, 45 years on new assets
Asset life transition	one price control period	two price control periods
Totex capitalisation rate	90%	90%
Efficiency incentive rate	50%	50%
Uncertainty mechanisms	Including, but not limited to, a volume driver for generation connections, a within-period revenue determination for specified large overhead line replacement projects and wider reinforcement works.	Including, but not limited to, volume drivers for generation connections, within-period revenue determinations for specified large wider reinforcement projects including where possible costs associated with visual amenity.
Innovation	Set out an innovation strategy and requested an Innovation Allowance of 0.75%	Set out an innovation strategy and requested an innovation allowance of 1% and a reprofiling of the allowance over the period.

SPTL and SHETL’s proposals are set out in more detail in their revised business plans which are published on their websites.

Areas for further work

While we consider both SPTL and SHETL’s plans are suitable to be put forward for fast-tracking we recognise there are areas for further work in both plans. Under RIIO, we expect significant changes from network companies in terms of the way they operate and engage with consumers. While both companies have made considerable strides forward over the last year, there is inevitably more that they could do.

The areas where we will be expecting both SPTL and SHETL to undertake further work are:

- Environmental strategy – While both plans set out baselines for some of the environmental outputs required in the RIIO-T1 strategy, both have further work to do to firm up the performance levels they will deliver across all of the environmental outputs. We expect the companies to provide more detail on their processes to finalise the outstanding areas to inform our decisions on Final Proposals.
- Stakeholder engagement – We note the significant progress both companies have made in this area and welcome their commitments to do more going forward.
- Network availability and customer satisfaction – These are areas where all of the TOs continue to work together to further develop the outputs. We expect that work to continue over the coming months to ensure the new arrangements are in place for the start of RIIO-T1.

Both companies requested network innovation allowances of greater than the minimum which was provided for in the March strategy document. Having reviewed the companies' innovation strategies, we do not consider that either company has yet provided sufficient justification for their proposed allowance. However, if either company considers that they can justify a higher level of allowance then they may put forward further evidence. We will consider that evidence, alongside any consultation feedback, in setting the Final Proposals.

Next steps

In light of our assessment we will consult on Initial Proposals for SPTL and SHETL. We intend to publish those proposals along with further detail on our assessment of the revised plans on 6 February 2012. We will provide a six week consultation period and will require responses by 19 March. We will set out our final decision on fast-tracking and, if appropriate, Final Proposals for one or both companies in April 2012. If, in light of feedback to our Initial Proposals, we decide not to fast-track SPTL and/or SHETL then they will revert to the non fast-track process.

Alongside our Initial Proposals we also intend to consult on additional financial incentives to sharpen the environmental considerations demonstrated by the transmission companies throughout the RIIO-T1 period. We had set out our intention to consult in this area in our March 2011 Strategy Decision document. The proposal set out in this document would apply to NGET as well as SPTL and SHETL. We will also publish our Final Proposals in this area in April 2012.

NGET and NGG are required to resubmit their business plans by 5 March 2012. We will consult on Initial Proposals for NGET and NGG in July 2012.

Yours sincerely



Hannah Nixon
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