Consultation on strategy for the next transmission price control - RIIO-T1 Overview paper

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Target audience: Consumers and their representatives, transmission companies, generators and offshore gas producers/importers, suppliers, shippers, debt and equity investors, environmental organisations, distribution network companies, government policy makers and other interested parties.

Overview:

This paper aims to provide an accessible overview of our proposed approach to the next gas and electricity transmission price control (RIIO-T1). The price control will set the outputs that the four transmission companies need to deliver for their consumers and the associated revenues they are allowed to collect for the eight-year period from 1 April 2013 to 31 March 2021.

This will be the first transmission price control to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model. RIIO is designed to drive real benefits for consumers; providing network companies with strong incentives to step up and meet the challenges of delivering a low carbon, sustainable energy sector at a lower cost than would have been the case under our previous approach. RIIO puts sustainability alongside consumers at the heart of what network companies do. It also provides a transparent and predictable framework, with appropriate rewards to promote timely investment in the networks.

Under the RIIO model, network companies will be required to develop well- justified business plans setting out their outputs and how they propose to deliver these. This document sets out, for consultation, the key elements of the regulatory framework that the network companies will need to understand in order to develop their business plans.

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Links to supplementary annexes

- Consultation on strategy for the next transmission price control - RIIO-T1 Outputs and incentives
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1%20Outputs%20incentives.pdf
- Consultation on strategy for the next transmission price control - RIIO-T1 Tools for cost assessment
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1%20Cost%20assessment.pdf
- Consultation on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Business plans, innovation and efficiency incentives
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1%20and%20GD1%20BP%20prop.pdf
- Consultation on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Financial issues
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1%20and%20GD1%20finance.pdf
- Consultation on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Uncertainty mechanisms
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1%20and%20GD1%20uncert.pdf
- 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

Links to other associated documents

- Consultation on strategy for the next gas distribution price control - RIIO-GD1 Overview paper
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/RIIOGD1%20overview.pdf
- Handbook for implementing the RIIO model - Ofgem, October 2010
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf
- RIIO: A new way to regulate energy networks: Final decision
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf
- Approach and timetable for TPCR5: decision document (21/10)
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR5/Documents1/TPCR5%20Approach%20and%20Timetable%20-%20Decision%20Document%20-%20FINAL.pdf

A glossary of terms for all the RIIO-T1 and GD1 documents is on our website:
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/Glossary.pdf

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Summary

Significant investment is needed in Britain's gas and electricity networks over the next decade. This investment is needed to develop smarter networks to ensure continued security of supply and to meet environmental challenges. It is not just a matter of doing more. The way networks are designed, operated and priced is likely to need to change. The scale of this investment means higher energy bills are almost certain. Against this backdrop, it is more important than ever that network companies can show consumers that they are getting value for money and that prices are contained.

Meeting these challenges will require companies to manage uncertainty around what needs to be built, how and when. It will also require them to think longer term, understand what their customers value, innovate and work with others.

To support and encourage network companies to meet these challenges, we recently announced a change in the way we regulate. Our new RIIO model (Revenue = Incentives + Innovation + Outputs) is designed to drive real benefits for consumers; providing companies with strong incentives to meet the challenges of delivering a sustainable energy sector at a lower cost than under our previous approach. RIIO puts sustainability alongside consumers at the heart of what network companies do. It provides a transparent and predictable framework that rewards timely delivery.

The transmission and gas distribution price controls (RIIO-T1 and RIIO-GD1) are the first price controls under the RIIO model. RIIO-T1 will set the outputs that the gas and electricity transmission owners (TOs) must deliver over the eight-year period 2013-2021 and the associated revenues they may collect from consumers. RIIO-GD1 will do the same for gas distribution.

We are committed to ensuring all stakeholders have appropriate opportunities to voice their views. Our proposals reflect considerable input from a wide variety of stakeholders. These include consumer and environmental groups, industry, government, unions and special interest groups, as well as the network companies. We have also benefited from feedback from the Consumer Challenge Group, which comprises consumer and environmental experts acting as a critical friend to Ofgem.

The proposals we set out here for consultation are aimed at encouraging the TOs to deliver safe, reliable and sustainable network services at long-term value for money to consumers; enabling them to finance required investment in a timely and efficient way; and rewarding them according to their delivery for consumers.

An important part of the RIIO model is to look to the companies to take responsibility for developing and justifying a long-term strategy for delivering the network services that their customers' value. To do this, companies need to understand the key elements of the regulatory framework. This document therefore sets out, for consultation, the outputs we think the TOs should deliver and our thinking on core elements of the framework.

We will require the TOs to deliver a range of outputs. We propose that these outputs should be designed to encourage them:

- to work with the wider industry to facilitate the move to a low carbon energy sector, as well as manage their own carbon footprint
- to provide safe, secure and reliable services based on efficient asset management
- to connect new generation to the network in a timely and efficient manner, and provide timely and accessible information to potential connectees
- to work with the system operator to ensure efficient constraint management.

We will attach incentives to the delivery of agreed outputs, minimising bias towards any particular delivery method. The strength of the incentives will reflect the value consumers attach to delivery and TOs' degree of control. We will implement mechanisms to ensure efficient risk sharing between companies and consumers.

In the interests of consumers, we are committed to ensuring efficient companies are able to raise timely finance and are remunerated appropriately; and we have a fair balance of costs between current and future consumers. We are setting out our proposals on our approach to the financial elements of the regulatory package. In particular, we are consulting on extending the depreciation period for electricity transmission to 45-55 years and retaining the 45-year period for gas transmission. We recognise this is likely to have a significant impact on cash flow for electricity TOs. Where this is the case, we will consider appropriate transition arrangements.

We are also consulting on the indexation mechanism for remunerating the cost of debt and our methodology for determining both notional gearing and the assumed cost of equity. We set out an indicative cost of equity range of 4.0%-7.2% (post tax real) based on the expected future risk profile of the TOs. It is for the TOs to set out in their business plans their proposals for notional gearing and where we should land within this cost of equity range, based on detailed evidence of their cash flow risk. It is only when we have received this information that we will be in a position to establish an appropriate range for the allowed return for the price control settlement.

We recognise that RIIO marks a considerable change for network companies in the way we approach price control. Those companies that rise to the challenge and provide well-justified business plans will benefit from a lighter-touch regulatory process, with potential for a fast-track settlement that concludes up to a year ahead of the standard timetable. We feel that this proportionate approach is important in encouraging companies to step up to the challenges they face, and has real value to those companies that do so. We are consulting on the criteria for assessing business plans, analysing costs and the approach we take to proportionate treatment. We also recognise that companies may need to make changes to how they run their business in the transition to a sustainable energy sector. We have committed to establishing an innovation stimulus for transmission, and propose funding of up to £680m.

We invite views on any aspect of our proposals. In March 2011, we intend to confirm the Authority's decision on the strategy for RIIO-TI. This will reflect the responses to this consultation and views provided through our wider stakeholder events.

1. Introduction

Chapter Summary

This chapter introduces the document and sets out the high-level strategy and process for the review. It also explains how the document and the supplementary annexes are organised.

Question 1: Do you have any comments on the proposed process and timetable for the review?

Purpose of this document

1.1. This document sets out the basis on which we intend to set the next transmission price control, RIIO-T1. The next price control will apply to the one gas and three electricity Transmission Owners (TOs) and cover the eight-year period from 1 April 2013 to 31 March 2021.

1.2. We are undertaking RIIO-T1 in parallel with the gas distribution price control review, RIIO-GD1.

Introducing RIIO

1.3. We think that network companies will need to invest significantly over the next ten years to ensure continued security of supply and to meet the environmental challenges. The companies will need to extend, reinforce and maintain existing networks and develop smarter networks. The scale of this investment means higher energy bills are almost certain. Against this backdrop, it is more important than ever that network companies can show consumers that they are getting value for money and prices are contained.

1.4. It is not simply a matter of the network companies doing more. The way networks are designed, operated and priced is likely to need to change. In particular, measures to tackle climate change are likely to lead to substantial changes in the way we produce and consume energy.

1.5. The electricity networks will need to connect large volumes of more variable and decentralised generation, often involving emerging generation technologies, in relatively short time-scales. They will need to address public concerns about impacts of network reinforcement and expansion on the local environment and amenity value. They will also need to support consumers in being more efficient in their energy use, for example by developing smart grid technology.

1.6. For the gas sector, the issues are also challenging. The significant proportion of carbon dioxide (CO_2) emissions associated with domestic gas use and gas-fired electricity generation raises questions about the long-term use of the network, as does the emergence of biogas and potential new uses for the transmission pipelines, such as for the sequestration of CO_2.

1.7. Meeting these challenges will require companies to manage the uncertainty around what needs to be built on their networks, how and when. It will also require them to think longer term, to understand what their customers value, to innovate at a level unprecedented in the last 50 years or more of the industry's history, and to work with others to find whole industry solutions.

1.8. Earlier this year we announced a change in the way we will regulate to support and encourage network companies in meeting these challenges. Our new model, the RIIO model, is specifically designed to drive real benefits for consumers; providing network companies with strong incentives to step up and meet the challenges of delivering a low carbon, sustainable energy sector at a lower cost than would have been the case under our previous approach. RIIO puts sustainability alongside consumers at the heart of what network companies do. It also provides a transparent and predictable framework, with appropriate rewards to promote timely investment in the networks.

1.9. RIIO-T1 and RIIO-GD1 are the first price controls to be undertaken under the RIIO model. The proposals that we are consulting on in this paper are designed to:

- encourage the TOs to deliver safe, reliable and sustainable network services at long-term value for money to consumers
- enable them to finance the required investment in a timely and efficient way
- remunerate them according to their delivery for consumers.

1.10. We are committed to ensuring that all stakeholders have appropriate opportunities to engage in the price control reviews. As set out in Chapter 3, the proposals set out here reflect the input we have received from a wide variety of stakeholders since we launched the reviews in July 2010. We appreciate the considerable time and effort that a wide range of parties have invested in the process so far.

1.11. This document sets out, for consultation, the outputs that we think the TOs should deliver over the next price control period as well as our thinking on core elements of the regulatory package. It also sets out the process for the review.

1.12. Below we discuss the high-level strategy we are adopting for the review and the key changes in company behaviour we are looking to incentivise through the package of proposals we have developed.

High-level strategy

1.13. One of the principle aims of the RIIO model is to encourage the TOs to take responsibility for developing and justifying a long-term strategy for delivering the network services that their customers value. In July next year, we will be asking network companies to submit to us well-justified business plans which describe their long-term strategies.

1.14. This document sets out, for consultation, our views on the aspects of the control that network companies need to understand in order to be able to put together their business plans. We will take into consideration responses to this document and issues raised through our wider stakeholder engagement processes before setting out our decision on these issues in March 2011.

1.15. In particular, we are setting out here for consultation:

- the proposed outputs that we expect TOs to deliver and the associated incentive mechanisms that we are considering, to ensure efficient delivery
- the criteria we propose to use to assess the companies' business plans and our proposed approach to cost assessment
- how we will apply the principles of proportionate treatment which will potentially allow companies who meet our assessment criteria a quicker process and/or lighter scrutiny
- our proposed approach to dealing with uncertainty and to encouraging innovation
- our proposed approach to financial issues.

1.16. We are doing this so that the companies can develop business and financial plans with a clear understanding of Ofgem's expectations. This signals a departure from previous price controls where network companies have submitted their cost proposals without linking them clearly to what they expect to deliver – and where the discussion on business plans has been divorced from those on risk and financeability.

1.17. We hope this leads to a more effective review process, with the companies:

- making their own judgement (based on their understanding of their assets and of what their stakeholders want and are willing to pay for) about the level they should target for each output, linking this clearly to their view of cost requirements, and setting out this rationale in their business plans
- developing their own strategies for handling future uncertainties, for example on where renewable generation will look to connect, or what will happen to gas demand, while meeting the RIIO objectives
- bringing forward their own financial plans and justifying where they believe the allowed return should be set.

1.18. We recognise that RIIO marks a considerable change for network companies in the way that we approach price control reviews. Those companies that rise to the challenge of providing us with well-justified business plans in July 2011 will benefit from a proportionate regulatory approach, with the potential for us to offer them either a 'fast-track' regulatory settlement (that concludes up to a year ahead of the standard timetable); or a 'lighter touch' process which involves less intensive scrutiny of their plans. We feel that taking this proportionate approach is an important part of encouraging companies to step up to the challenges they face, and that it has real value to those network companies that do so.

1.19. To guide companies, we are publishing as part of this package of papers, further guidance on what is required in a business plan. We also set out in more detail, the proposed approach for deciding whether a company should be 'fast-tracked' or should receive a 'light touch' approach, and how we will apply proportionate treatment to the assessment of all business plans.

1.20. At this stage, and as we have not received any formal business plan submissions from the companies, we are not making any statements about the efficiency or otherwise of the transmission companies' projected costs. However, as part of this package of papers we have set out our analysis of companies' cost trends, and an overview of historic cost performance against allowances.

1.21. There will always be uncertainties about the appropriate outputs and expenditure requirements over the price control period. These are greater under an eight-year price control. Our proposals include a number of elements to help deal with these uncertainties including uncertainty mechanisms, potential disapplication of the price control and a tightly-defined mid-period review of output requirements. It also places the onus on network companies to set out how they intend to manage risk through the period.

1.22. The RIIO model introduced a number of significant changes to the way in which we will address certain financial issues in setting its price controls. The key features of our financial proposals for transmission on which we are consulting are:

- a move to economic asset lives of 45-55 years for electricity networks, whilst retaining the existing 45 year life for gas networks
- to base the allowed return on a cost of debt index, with revenues updated annually to reflect changes in the index; using our preferred index currently results in a cost of debt of 3.1 per cent real
- to use an indicative post-tax cost of equity range of 4.0-7.2 per cent
- to set out our process for ensuring financeability, including during transition to the new asset lives in electricity.

Process and timetable

1.23. The process for RIIO-T1 differs significantly from that for previous reviews. The key differences are as follows:

- effective stakeholder engagement, both by us and by the companies, will inform each stage of the process

- the beginning of the process focuses on the development of outputs and the overall strategy for the review. This reflects the need to provide enough information about our price control framework for companies to develop their well-justified business plans
- from August 2011 we will undertake an 'initial sweep' of companies' business plans and consult on whether some companies' plans should be 'fast-tracked'. This initial sweep will identify the areas we need to focus on in each company's business plan and help us to take a proportionate approach to those companies that are not 'fast-tracked'
- any companies that are fast-tracked will receive their final proposals approximately nine months ahead of the other companies and a year ahead of the implementation of the controls
- to facilitate fast-tracking, we will develop licence conditions at an earlier stage in the process. This should also help align the policy development with development of legal drafting for the licences.

1.24. These process differences will mean that the timetable for RIIO-T1 is significantly different from that of previous reviews. We published a draft timetable in our July open letter. A more detailed version is set out in Appendix 2.

Structure of this document and associated documents

1.25. This document aims to provide an accessible overview of our proposed strategy for RIIO-T1 aimed at a wide range of interested parties.

1.26. This document is structured as follows:

- Chapter 2 provides a summary of the electricity and gas transmission sectors, the current price control, and TOs recent financial performance. We also set out the key challenges facing the electricity and gas transmission and wider energy sectors, and how we aim to address these challenges in our proposals.
- Chapter 3 sets out the stakeholder engagement that we have undertaken to date, and how we have reflected stakeholders' views in our proposals.
- Chapter 4 discusses the proposed outputs that we expect TOs to deliver and the associated incentive mechanisms to ensure efficient delivery.
- Chapter 5 discusses the criteria we propose to use to assess companies' business plans and our proposed approach to cost assessment. We set out further details on how we will apply proportionate treatment including fast-tracking.
- Chapter 6 sets out our proposed approach to dealing with uncertainty, and how risks should be shared between customers and the TOs.
- Chapter 7 discusses our proposed approach to innovation in RIIO-T1.
- Chapter 8 discusses our approach to financial issues, including our views on efficient debt and equity financing costs, optimal gearing, capitalisation and depreciation policies.
- Chapter 9 sets out next steps in this review.

1.27. We provide further detail on all of these issues in our series of detailed supplementary annexes. These are entitled: 'RIIO-T1 Outputs and incentives', 'RIIO-

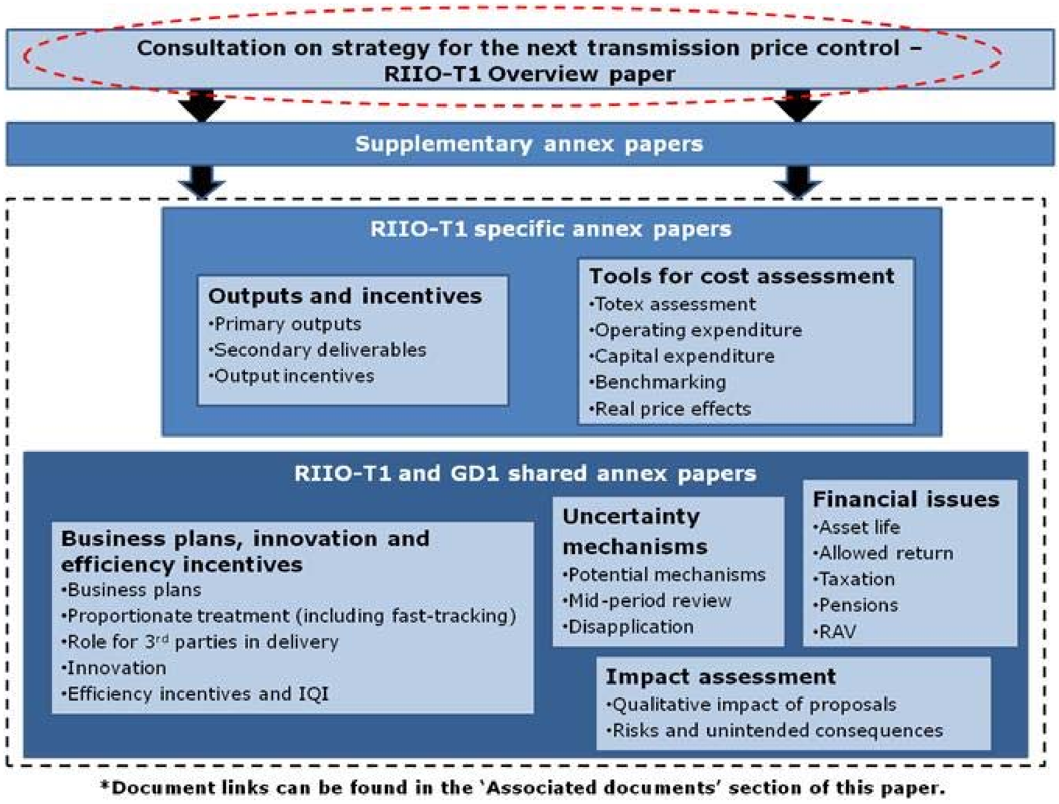
T1 and GD1 Business plans, innovation and efficiency incentives', 'RIIO-T1 Tools for cost assessment', ' RIIO-T1 and GD1 Uncertainty mechanisms' and 'RIIO-T1 and GD1 Financial issues'. Links to these as well as other associated documents were set out in the 'Associated Documents' section in this paper.

1.28. The supplementary annexes are aimed primarily at network companies, investors and others who require a more in-depth understanding of our proposals. They are structured to allow the reader to dip into the parts of most interest to them.

1.29. As we are undertaking RIIO-T1 and GD1 in parallel, we have published a similar suite of documents for RIIO-GD1 alongside those for RIIO-T1. In many instances the issues faced and our strategy for dealing with them are similar for both reviews. Where possible we have provided joint supplementary annexes that span both reviews. We have also published an impact assessment for RIIO-T1 and GD1. This is based on the impact assessment developed for RIIO.

1.30. Figure 1.1 below provides a map of the RIIO-T1 documents and indicates clearly where these are common with those for RIIO-GD1.

Figure 1.1 - RIIO-T1 Supplementary appendix document map



2. Context

Chapter Summary

This chapter outlines the context in which RIIO-T1 is being set. It sets out the role of transmission in the overall energy framework and why it is important in meeting the considerable challenges and opportunities facing the energy industry. It sets out the recent financial performance of the TOs and identifies the differences anticipated in setting the next control under the RIIO framework.

This chapter also sets out the interactions between RIIO-T1 and a number of other policy areas including the next gas distribution price control - RIIO-GD1.

Question 1: Do respondents consider there are any interactions with other policy areas that have not been highlighted in this chapter?
Question 2: Do respondents consider that the transmission and gas distribution price control periods should remain aligned for future review periods?

What is transmission?

2.1. Transmission assets are the high voltage electricity wires and high pressure long distance gas pipelines which convey electricity and gas from power stations and offshore facilities to homes and businesses. They are owned and operated by privately owned companies who have territorial monopolies. Consequently, we regulate them. Their duties and obligations are set out in licences and legislation. Appendix 3 set out the current gas and electricity transmission networks.

2.2. The next price controls apply to the one gas and three electricity Transmission Owners (TOs). The TOs are:

- National Grid Gas plc (NGG), which owns the high pressure gas transportation system across Britain
- National Grid Electricity Transmission plc (NGET), which owns the high voltage electricity network in England and Wales
- SP Transmission Limited (SPTL), which owns the high voltage electricity network in the south of Scotland
- Scottish Hydro Electric Transmission Limited (SHETL), which owns the high voltage electricity network in the north of Scotland.

2.3. The TOs own and maintain the network assets. They are responsible for planning the development of the networks and for providing transmission services to the system operators (SO)s.

2.4. In addition to their TO responsibilities, NGG and NGET are the designated gas and electricity SOs. NGG, as the gas SO, is responsible for the day-to-day operation of the national transmission system (NTS), including balancing supply and operator demand, maintaining satisfactory system pressures and ensuring gas quality standards are met. NGET, as the electricity SO, operates the transmission networks, balances electricity supply and demand and coordinates system outages. NGET is the SO for all three electricity transmission networks.

2.5. The regulatory framework for SO activities distinguishes between internal and external SO costs. The controls for NGG and NGET will also determine internal SO allowances for NGG SO and NGET SO. Internal SO allowances cover costs such as staff and IT that are employed to deliver the SO functions. External SO costs are incentivised through a separate process. These incentives encourage the SO to minimise system operation costs. There are interactions between the SO and TO arrangements which are relevant to consider particularly in setting incentives. This issue is discussed in Chapter 4 of this document.

Why does transmission matter to consumers?

2.6. Transmission charges make up around two per cent and three per cent of an average household energy bill for gas and electricity, respectively. However, the transmission networks have a disproportionately critical role to play in connecting sources of energy to consumers and they will play an important part in the transition to the low carbon economy. The transmission networks also impact consumers in other ways, including through their direct emissions and their visual impact.

2.7. The energy industry faces considerable challenges and opportunities. These are primarily driven by the need to decarbonise Britain's energy sector, while maintaining a safe, secure and affordable system for existing and future consumers. The environmental targets include:

- a European target for the UK to have 15 per cent of its energy to be sourced from renewables by 2020
- an overall reduction of greenhouse gas emissions of at least 80 per cent from 1990 levels by 2050.

Energy network companies in general, and the transmission companies in particular, have a key role to play in meeting these targets and in meeting the sustainability challenges. They provide the physical link between those producing energy, those selling energy services, and businesses and households who use energy.

2.8. We estimate that around £30bn of investment is needed across transmission and distribution by 2020 to connect new sources of generation and accommodate continued increases in gas import capacity. Network companies will need to work actively with others in the industry and more widely to make the energy sector more sustainable while continuing to promote and facilitate competition.

The current price control - TPCR4

2.9. The current transmission price control (TPCR4) was set for the period 1 April 2007 to 31 March 2012. It authorised funding for more than £5 billion of investment in Britain's gas and electricity transmission systems.

2.10. At the time this represented an unprecedented 100 per cent increase in investment on the previous price control period. This investment was authorised to enable network companies to maintain high levels of performance on their networks by replacing ageing assets. A significant proportion of the investment was also directed towards helping the UK meet its climate change objectives by connecting and delivering more low-carbon generation.

2.11. To accommodate fully the conclusions of the RIIO review in the next transmission price control we announced on 21 December 2009, following consultation, a one-year 'adapted roll-over' of TPCR4 from 1 April 2012 until 31 March 2013.

Performance of companies under existing controls

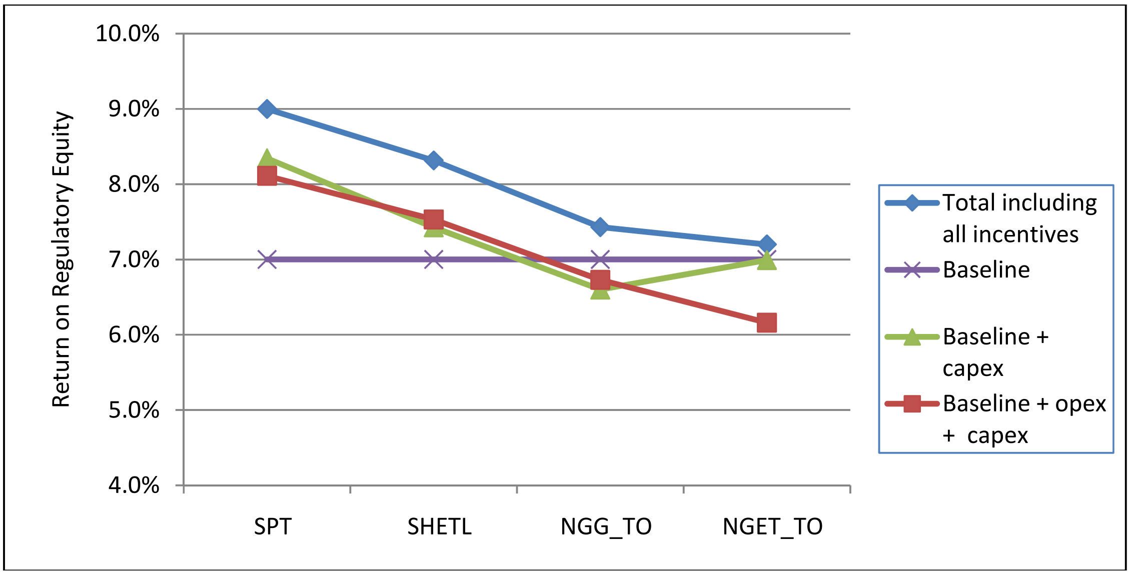
2.12. One way to look holistically at how companies are performing under a price control is to compare each company's return on regulatory equity (RoRE) - a measure of the return earned by companies' shareholders through the regulatory settlement - against the assumed equity return used in setting allowed revenues.

2.13. Figure 2.1 shows the total return on regulated equity achieved to date compared to the baseline allowed equity return at the time the price control was set. The baseline plus capex line shows how much of the variation is due entirely to differences in capex. This show that the two Scottish companies have under spent on capex and achieved additional equity returns whereas the two National Grid companies have overspent. The baseline plus capex plus opex line shows the impact of variation in both opex and capex and hence the impact of opex alone can be found by the difference between these two lines. In the graph below this shows that there is very little difference due to opex except for NGET. The difference between the baseline plus capex plus opex line and the total shows how much of the variation is due to factors other than opex and capex, for example changes in tax and interest rates.

2.14. This is only for the first three years of a five year price control and it is not unusual to see companies under spending in the early years of the control and for their expenditure to catch up in the later years of a control period. One of the aims of specifying outputs under the RIIO model is so that we can be sure any underspend is a result of efficiency improvements rather than because a company is failing to keep the networks in good working order or to deliver the outputs expected when revenues were set.

2.15. These calculations are based upon initial regulatory reporting submissions and have not been analysed and adjusted by Ofgem. Any adjustments and final figures will be published in March 2011.

Figure 2.1: Performance under TPCR4 - RoRE analysis



Interaction with related policy areas

2.16. In setting the transmission price control, we will take into account the interactions with a number of other work areas. The key interactions are listed below and set out in further detailed in Appendix 4:

- the one-year 'adapted roll-over' of TPCR4 from 1 April 2012 until 31 March 2013
- the joint Ofgem/Department of Energy and Climate Change (DECC) Transmission Access Review (TAR)
- our transmission investment incentives (TII) work stream
- ‘Project TransmiT’ - our independent and comprehensive review of transmission charging arrangements and associated connection arrangements
- activities currently incentivised in some way through the SO incentives
- EU legislation and, in particular, the 'third package' of internal energy market legislation
- the new regulatory regime for offshore transmission networks
- the holistic and coordinated review of the National Electricity Transmission System (NETS) Security and Quality of Supply Standards (SQSS) - the 'fundamental review'
- our review of regulated prices for Liquefied Natural Gas (LNG) and the proposals to develop the next control concurrent with RIIO-T1 and RIIO-GD1 for implementation in 2013.

3. Making sure stakeholders' views are heard

Chapter Summary

This chapter outlines the process and timetable for RIIO-T1. It highlights that the process is very different from previous controls reflecting the introduction of an outputs-led framework, the introduction of proportionate treatment and the role of stakeholder engagement.

This chapter also sets out the stakeholder engagement process in more detail. It provides an outline of the mechanisms for engagement as well as the key issues highlighted by stakeholders.

Question 1: Do you have any comments of the overall approach to stakeholder engagement?
Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?

Role of stakeholders in the price control review

3.1. The network price controls will impact on a wide range of parties. Under RIIO, stakeholders have greater opportunity to influence our and network companies' decisions. We expect network companies to engage proactively with consumers on an ongoing basis. Our approach to enhanced engagement will be developed for each price control review but it will be particularly important that different types of stakeholders get to engage on the issues that matter to them. Both the company and our approach to engagement are discussed below.

Company led engagement

3.2. Under the RIIO model, we expect network companies to engage with their consumers and wider stakeholders on an ongoing basis. While we do not want to be prescriptive about how network companies engage with their stakeholders, effective engagement must have informed their well-justified business plans. Our draft guidance for network company business plans[1] provides an indication of our expectations of network company engagement with their customers. It is not a 'box ticking' exercise but about seeking to understand and, where appropriate, act on the information that is gathered.

3.3. The network companies have already initiated their stakeholder engagement programmes. We expect this engagement will increase as they start to develop their business plans.

[1] http://www.ofgem.gov.uk/NETWORKS/TRANS/PRICECONTROLS/RIIO-T1/CONRES/Documents1/Open%20letter%20TPCR5%20way%20forward.pdf

Ofgem-led engagement

3.4. Since the start of the RIIO-T1 review we have adopted a multi-layered process 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.[2]

3.5. The objectives of our engagement for RIIO-T1 to date have broadly been to:

- introduce the RIIO model, set out how it works and the process that will be followed during the RIIO-T1 review
- ensure that the views of consumers are fully reflected in the process
- consider stakeholders' views on the output categories and develop thinking on the measures
- ensure that stakeholders are familiar with policy developments so that they are able to contribute effectively as the price control review progresses.

3.6. Appendix 5 summarises the different ways we have engaged stakeholders, the issues addressed, and the stakeholders involved. A high-level summary of responses to our July 2010 open letter on RIIO-T1 is provided in Appendix 6.[3]

Third party modification requests

3.7. As part of our RIIO decision document we published guidance[4] on how third parties, and network companies, could make representations about a price control settlement and could request the Authority to exercise its power to make a modification reference to the Competition Commission. The guidance was developed to provide parties with a clear route to challenging the merits of our price control decisions should they feel they may operate against the public interest. This is an important part of the RIIO model, with its over-riding objective being to facilitate increased and more effective stakeholder engagement by us and network companies.

3.8. As part of the implementation of the EU Third Package, DECC are looking to introduce (by March 2011) a new process for appealing licence modifications and have published a consultation on the process.[5] We will provide an update on this in our March 2011 strategy decision document. When the new process has been settled we will make any required changes to our guidance document.

[2] See page 13, Box 2 of the handbook:
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf
[3] Open letter consultation on Transmission Price Control Review 5 (TPCR5) – the way forward - July 2010 #100/10
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Open%20letter%20TPCR5%20way%20forward.pdf
[4] A Guide to Price Control Modification References to the Competition Commission - Licensee and Third Party Triggered Reference
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/final%20mod%20guidance.pdf
[5] http://www.decc.gov.uk/en/content/cms/consultations/imp_eu_third/imp_eu_third.aspx

4. Determining and incentivising output delivery

Chapter Summary

This chapter sets out our views on the type of outputs the companies should deliver over the next price control period, and the mechanisms by which we propose to incentivise or require the companies to deliver. More detail on the issues discussed in this chapter is in the supplementary annex entitled 'RIIO-T1 Outputs and Incentives'.

Question 1: Do you consider the proposed outputs and associated incentives, along with the other elements of the proposals, will ensure companies deliver value-for-money for consumers and play their role in delivering a sustainable energy sector?
Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate?
Question 3: Do you have any views on the proposed outputs or incentive mechanisms?

Introduction

4.1. A core component of the RIIO framework is the development of an outputs-based regulatory framework. This chapter summarises our proposals for the output measures and associated incentive mechanisms for RIIO-T1 for consultation.

4.2. Outputs-based regulation is an effective way of promoting efficiency. By defining what network companies are required to deliver, companies face powerful incentives to innovate and seek least-cost solutions to delivering the services required by customers. The adoption of an outputs-based framework also makes it easier for stakeholders to express views about what they want from the network companies and hence for them to engage with the price control review process. This should result in the delivery of services that are valued by customers.

4.3. Under the RIIO model, we are committed to setting out clear and comprehensive outputs that the network companies will be held to account for delivering. These outputs, taken together, need to ensure the companies deliver the high-level RIIO objectives. These are:

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

4.4. These objectives are interrelated. To meet the demands of moving to a low carbon economy there will need to be significant investment in the networks. The scale of the required investment means that higher energy bills are almost certain. In making that investment companies will have to show consumers that they are getting value for money over the longer term, setting out clearly what is being delivered and at what cost. Further, companies will be expected to innovate to identify which technologies will prove most effective in delivering the low carbon economy while providing best value for consumers.

4.5. The RIIO model identifies six key output categories – or key areas of delivery for network companies. These are environmental impact, customer satisfaction, safety, reliability, conditions for connection, environmental impact and social obligations. For each of these output groups, we have identified a number of specific behaviours that we are seeking to encourage:

- **Environmental impact**: encouraging companies to play their role in the achievement of broader environmental objectives, namely the reduction in carbon emissions, as well as minimising the 'narrow' environmental impact of the companies' activities by managing their own carbon footprint. There are a number of elements on our proposals that are aimed at facilitating the delivery of the environmental targets. These include the combination of outputs and incentivise the companies' requirement to address this as part of their business plans and an innovation stimulus which will provide financing for trialling of technologies relating to the delivery of a low carbon future. Appendix 7 sets out a summary of the various elements. We are also seeking to encourage companies to reduce their emissions, including to reduce the production of methane in gas transmission and sulphur hexafluoride (SF_6) in electricity transmission and also to reduce the levels of the energy lost through the operation of the networks.
- **Customer satisfaction**: maintaining high levels of customer satisfaction, and improving the service levels provided where required. We also seek to encourage companies to undertake effective engagement with their stakeholders, and reflect stakeholders' views in the day-to-day operation of their business.
- **Connections**: encouraging networks to connect customers in a timely and efficient way, including responding to specific needs of distributed gas customers;
- **Safety**: ensuring the provision of a safe network in compliance with legal safety requirements, and by controlling network risk through managing asset health.
- **Reliability and availability**: promoting a reliable network, such as by minimising the number and duration of interruptions and optimising costs associated with network unavailability.
- **Social obligations**: we are not proposing that we place any social obligations on the TOs. This is because there are currently no specific social obligations on the companies in transmission and we do not see any specific rationale for introducing any.

4.6. We established working groups[6] in July to identify outputs and incentive mechanisms for each of the six output categories. The working groups included the network companies, as well as other stakeholders, including environmental, social, and customer representative groups and the Health and Safety Executive (HSE). Our recommendations reflect the working group discussions as well as views expressed at other stakeholder forums.

[6] Further information on the RIIO-T1 working groups can be found on Ofgem's website at: http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/WorkingGroups/Pages/WG.aspx

4.7. The outputs framework comprises both primary outputs and secondary deliverables. Primary outputs concern aspects of the services that network companies provide directly to customers. Secondary deliverables are indicators of performance which may be used in support of the companies' required primary outputs. For example, the reliability of the networks directly impact customers whereas asset health is a factor impacting reliability.

4.8. In identifying primary outputs, we have drawn on the principles set out in the RIIO handbook.[7] This includes, inter alia, ensuring they are controllable by the network companies (or where we have concerns about controllability, we consider carefully the applicability of financial rewards/penalties); measurable; auditable; and comparable.

4.9. We expect network companies to include in their business plans the costs required to deliver primary outputs in future price control periods. To ensure consumers do not pay unnecessarily high prices, companies will be expected to set out the rationale for expenditure in the context of a long-term strategy for delivery.

Setting future performance levels (or baselines)

4.10. Our work has focussed on how the outputs for each category are defined and measured. For most output measures, we do not propose to prescribe output levels (or baselines). Instead, companies will need to set out the required level of outputs in their business plans, justifying the proposed level in terms of the costs and benefits to network users, and informed by their stakeholder engagement. We will consider whether these are appropriate and if necessary set an alternative.

Incentive mechanisms

4.11. For each output category, we have considered a range of incentive mechanisms to encourage network companies to deliver the primary outputs and secondary deliverables. These incentives include financial rewards/penalties and 'reputational' incentives, for example publishing league tables of companies' performance. Where we seek to contain the financial risk or reward to companies, we have proposed caps and collars on the size of the reward and penalty payments.

4.12. We have not proposed financial incentive mechanisms for all output measures. For example, we have not proposed any financial incentives for the set of safety related outputs. For these outputs, the TOs need to comply with legal obligations, and are subject to HSE enforcement action in the event of non-compliance. We do not consider that it is reasonable or necessary for us to impose an additional penalty. Equally, we do not think it is appropriate to reward companies for outperforming safety requirements.

[7] See page 35 of the handbook: http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf

4.13. We will monitor secondary deliverables annually and engage with the TOs where we have any concerns regarding delivery. In setting the next price control we propose to assume they had delivered in line with their business plans. Consequently, they will be automatically rewarded if they delivered above that set out in their plans or penalised if they have not delivered against them. This will provide strong incentives for companies to deliver against their secondary deliverables.

Monitoring delivery of outputs

4.14. The RIIO model proposes a balanced scorecard approach to assessing companies' performance on output delivery. The purpose of the scorecard is to provide a clear and simple way to convey information about network company performance and to facilitate a meaningful comparison of performance.

4.15. The development of the scorecard is relevant to delivering the other parts of the RIIO framework, including facilitating discussion during enhanced engagement, supporting our approach to proportionate assessment, and providing scope to attach financial incentives to overall performance.

4.16. We propose that the scorecard focuses on the delivery of primary outputs with secondary deliverables used only where they are particularly useful in illustrating network company performance. In line with the RIIO recommendations, we propose that the scorecard take the form of a 'traffic light' system with companies' performance judged on whether their delivery is low (red), medium (amber) or green (high). We set out further detail on the approach to developing the balance in the supplementary annex entitled 'RIIO-T1 Outputs and Incentives'.

Quality of reporting data

4.17. The proposed outputs package places greater emphasis on the quality of reporting by companies to ensure that we can monitor and evaluate their performance against the regulatory contract. Consequently, we are also consulting on ways to ensure the quality of information provision, including whether companies should appoint independent auditors (or 'reporters') to verify their output and cost data. We will be considering this further and intend to set out proposals in our March strategy decision document.

Issues for setting RIIO-T1 outputs

4.18. A number of issues impact the way we set outputs for TOs. Most notably:

- **Controllability** - most of the things that TOs do for their customers involve actions that are partially and often significantly outside their control; here we think that it continues to be appropriate to have output measures but that care is needed in whether to apply financial incentives and, where applicable, the design of such incentives.

- **Interaction between outputs** - for example, TO contributions to environmental/energy targets are made through the way different output categories interact together (connection timing, reliability and availability, customer satisfaction as well as through the environmental impact category).
- **System Operator (SO) incentives and transmission price control** - we are examining different options for alignment between the SO incentives and the transmission price control. In taking this forward we need to consider the appropriate party or parties to be incentivised for the given output measure and the appropriate methodology for incentivisation. This work is ongoing but where the work to develop outputs is relevant to this issue we have highlighted the current situation and possible options that might improve the way we incentivise the SO and the TOs in their roles to the overall benefit of consumers. We are continuing to develop our thinking in this area and therefore additional options may be identified as the process moves forward.

Proposed outputs for RIIO-T1

4.19. The supplementary annex entitled 'RIIO-T1 Outputs and incentives' provides more detail on our proposed outputs for electricity and gas transmission and our thinking on the incentives mechanisms which will be linked to these outputs. These outputs are summarised below.

Safety

4.20. For both gas and electricity transmission we propose a primary output of complying with their legal safety requirements. We do not intend to attach financial incentives to the primary safety outputs as other agencies and mechanisms (the HSE and legal obligations) incentivise the companies to deliver.

4.21. We propose secondary deliverables of asset health criticality and replacement priorities/risk. The condition of assets with dangerous failure modes needs to be managed within the TOs' asset management frameworks.

Reliability and availability

Electricity

4.22. We propose a primary output based on energy not supplied (ENS) for all TOs. We propose setting an ex ante financial incentive for all TOs broadly based on the scheme currently in place for NGET.

4.23. We propose a suite of secondary deliverables. These are asset health, criticality, replacement priorities/risk, failures and faults, and average circuit unreliability and system unavailability. We also propose secondary deliverables that are defined in terms of agreed increases in transfer capability across specified electricity transmission network boundaries. This is intended to encourage TOs to carry out wider network reinforcement work that is in the interests of consumers, for example by reducing future constraints costs. We would ensure there are financial incentives for the timely delivery of the agreed increases in boundary capability.

Gas

4.24. We propose that one primary reliability output for gas transmission should be for NGG to comply with its obligations to convey gas volumes as required at system entry and exit points under the Uniform Network Code (UNC), its Gas Transporter Licence (GT Licence) and ultimately, the Gas Act 1986.

4.25. Under its licence NGG is required to plan and develop its pipeline system to enable it to meet '1 in 20' peak aggregate daily demand.[8] The licence also sets out 'baseline' capacity obligations on NGG in respect of entry and exit capacity which, subject to the provision of other conditions within the licence, NGG NTS is obliged to meet. The commercial regimes applying under the UNC for the allocation of NTS entry and exit capacity also place firm obligations on NGG NTS in respect of meeting the new capacity needs of NTS users. It is our view that these obligations (including capacity baselines and the NTS commercial arrangements such as operational and incremental buy-back costs which are undertaken by NGG NTS in its SO role) largely fulfil the need for output measures and associated incentives for the NTS in relation to meeting the 1 in 20 peak demand as well as user requirements at entry and exit.

4.26. We propose secondary deliverables for asset condition based on asset health, criticality and replacement profiles similar to our proposal for electricity transmission.

4.27. Forecast changes in gas flow patterns on the NTS are predicted to impact on the future availability and need for system flexibility. We intend requiring NGG to report additional information and develop associated outputs and deliverables as part of justifying any proposed investment in these areas.

Environmental impacts

4.28. For both gas and electricity transmission we are consulting on a set of primary outputs for TOs to deliver better environmental performance. The main environmental impacts stakeholders want RIIO-T1 to focus on are TOs' contribution to environmental and energy targets, direct network emissions (including the company's business carbon footprint), and the adverse impacts of the network on the local environment such as issues of visual amenity.

[8] The peak aggregate demand level which, having regard to historical weather data from at least the previous 50 years, is likely to be exceeded (whether on one or more days) only in 1 year out of 20 years.

Contribution to environmental and energy targets

4.29. Many of the ways that TOs can play a full role in meeting broad environmental objectives are covered in our outputs overall. However, we recognise the need for care in developing financial incentives in areas where the outcome is dependent on numerous factors many of which operate independently of the TO. Discussions with stakeholders have indicated divergent views about the best way to incentivise the TOs to support broad environmental aims. We are therefore inviting views on whether we should go further in this area. In particular, one stakeholder has put forward a proposal for an incentive based on providing a performance bonus which would reward the TOs for their contribution to the broader environmental objectives. We seek views on this and on other approaches for incentivising the TOs in this area.

Direct network emissions

4.30. Direct network emissions from the transmission network largely result from SO activities. However, investment in the network can reduce these emissions for example by providing the SO with alternative choices for SO actions which may result in reduced emissions or by investing in more up to date technologies which can reduce the emissions. We are considering the extent to which emissions reductions can be brought about by investment or SO actions in order to ensure that sufficient incentives are in place on both parties. We are consulting on financial incentives on losses in electricity and shrinkage in gas. We note that these are areas where the SOs have more influence and where existing incentive arrangements apply to the SO activities. We are aiming to develop arrangements that encourage TOs to reduce/minimise the controllable element while recognising the wider influences.

4.31. We are also consulting on outputs to reduce emissions of methane in gas and leakage of sulphur hexafluoride (SF_6) in electricity. In the case of methane, there are interactions with the incentives on NGG as SO to minimise the volume of gas that it vents. In relation to SF_6, two TOs have faced an incentive to reduce of SF_6 leakage rates established at TPCR4. We consider that moving to a marginal incentive may be appropriate to continue to encourage improvements in this area. But in developing this, we will seek to build on lessons from TPCR4 and the process for the adapted rollover of that control currently underway.

4.32. We are consulting on a reputational incentive on a TO's business carbon footprint. We intend this will only apply to the element of carbon emissions not covered by other mechanisms such as the Carbon Reduction Commitment (CRC)[9], Energy Efficiency Scheme or the EU Emission Trading Scheme.

[9] The CRC is the UK's mandatory climate change and energy saving scheme. It is central to the UK's strategy for improving energy efficiency and reducing carbon emissions - set out in the Climate Change Act 2008.

Wider impact of the network

4.33. Transmission network infrastructure can have an adverse impact on local landscape, habitat, visual amenity and noise levels. We do not propose a primary output for mitigating network's impacts on the local environment or visual amenity as it is not clear what from such a measure might take. We seek views on this.

Connection

4.34. We propose a primary output based on timely delivery of connections both in electricity transmission and gas transmission. Given the recent connect and manage arrangements, the focus in electricity has been to consider whether a financial incentive should be set to encourage better than required performance at the pre connection phase between application and offer. In gas focus has been on the 42 month delivery of incremental entry capacity and whether the existing incentives are sufficient to encourage NGG to deliver. This is an issue that cuts across TransmiT and RIIO-T1. We have sought further information for both areas of work through a letter of 14 December 2010.[10]

Customer satisfaction

4.35. We propose a primary output based on a 'broad measure' of satisfaction encompassing survey evidence, stakeholder engagement and complaints handling.

4.36. In transmission, the relationship between TOs and end-users is more distant than distribution. The relationship between the TOs and their customers can also be different. In addition, the separation of TO and SO roles means that designing an output that reflects customers' views of TO's actual performance is more challenging as it is also influenced by SO performance. However, we consider it is important to include a customer satisfaction metric in the suite of outputs for TOs. We will also consider whether and on what measures the SO should be similarly incentivised. We will base the measurement of customer satisfaction on survey evidence.

4.37. We will also offer discretionary rewards for effective stakeholder engagement although we will reduce the level of financial reward if complaints are poorly handled. We do not propose a direct penalty regime for complaints handling.

Social obligations

4.38. There are currently no specific social obligations on the transmission companies. We do not propose to introduce any specific social outputs for RIIO-T1. *We seek respondents' views on whether specific measures are required. For example, there are measures proposed in RIIO-GD1 in relation to fuel poverty and seek views on the requirement for an equivalent output in transmission.*

[10] Consultation on the issue of timely connection to the electricity transmission network
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=77&refer=Networks/Trans/PT

5. Assessing efficient costs

Chapter Summary

This chapter sets out the proposed process for assessing efficient costs in RIIO-T1. There are a number of elements. We intend to adopt a proportionate approach to assessing the price control package, with the intensity of the assessment reflecting the quality of a company's business plan and its record for delivery. Under this approach a number of companies' business plans may be subject to lower scrutiny. Strong performing companies that submit sufficiently well-justified business plans may be 'fast-tracked' through the price control process. This chapter also considers the role for facilitating a greater role for third parties in delivery.

More detail on the issues discussed in this chapter is set out in the supplementary annexes entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives' and 'RIIO-T1 Tools for cost assessment'.

Question 1: Is our proposed approach to cost assessment appropriate?
Question 2: Do you have any views on our proposed process for proportionate treatment?
Question 3: Do you have any views on the criteria for assessing business plans? Are any of the criteria highlighted inappropriate? Are there any additional criteria that should be added?
Question 4: Do you have any views on the proposed role for competition in third party delivery?

RIIO model for assessing efficient costs

5.1. The RIIO model introduces some important new principles to guide the price control process. Under the RIIO model the onus is on the network companies to determine how best to deliver outputs over time, reflecting on the results of their stakeholder engagement. We expect the companies to develop well-justified business plans which show an understanding of their assets and which reflect feedback from their stakeholders. We will use companies' plans as well as other available information, including past performance, to form a view of the expected efficient costs of delivering outputs and long-term value for money.

5.2. We will adopt a proportionate approach to assessing business plans. We will focus attention and effort where it is expected to generate most value. In doing so we will provide those companies that step up to the challenge of providing well-justified business plans the opportunity for a lighter-touch regulatory approach, potentially offering some companies a 'fast-track' settlement, ie we will agree the terms of their price control up to a year earlier than for other network companies. We consider that a proportionate approach is an important part of encouraging companies to step up to the challenges they face, and has real value for those network companies that do so.

5.3. This chapter sets out an overview of how business plans, cost assessment and proportionate treatment fit into the RIIO-T1 process. It also notes the facilitation of a greater role for third parties in delivery.

Well-justified business plans

5.4. Under RIIO, the onus is on network companies to develop well-justified business plans. Each company will be required to demonstrate that its plan will deliver in the interests of both current and future customers and how it will meet the challenges associated with facilitating the move to a low carbon economy. Companies will also be required to demonstrate that their proposals take account of the various risks and uncertainties and, given these, provide a strategy to deal with these efficiently and maintain delivery.

5.5. We set out initial draft business plan guidance in our July open letters.[11] This was welcomed by stakeholders. It has helped companies start to understand what we are expecting of them.

5.6. Key points of our business plan guidance to emphasise are:

- companies need to justify their proposed strategy for delivering their output baselines against a thorough understanding of the long-term trends (and risks and uncertainties) that they face. They also need to show that they understand their role, and are looking to be proactive in contributing to the UK's carbon reduction targets
- we expect the companies to demonstrate that, in drawing up their business plans, they have considered the views of stakeholders and the opportunities to use innovative technologies, techniques or commercial arrangements to deliver their outputs at long-term value for money
- the plan should present a holistic view of the package the company believes to be appropriate, ie for the first time the company's view on financeability metrics will be included alongside views on expenditure and outputs with the former justified against their plan and backed up by other evidence.

Proportionate treatment

5.7. The RIIO model envisages a proportionate approach to assessing the price control package. Under this approach the intensity and timescale of the assessment will reflect the quality of a company's business plan and the company's record for efficient output delivery. This approach is consistent with better regulation principles as it allows us to focus greatest regulatory scrutiny where it is likely to produce greatest value.

[11] Ofgem, open letter consultation on the transmission price control review 5 (TPCR5), the way forward. http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=1&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes (and companion letter on the gas distribution price control review).

5.8. Where a company produces a high quality business plan we propose to focus less resource on them such that their business plan is subject to a lower level of scrutiny. In some cases where a company produces a particularly high quality business plan we would consider whether it would be appropriate to conclude that company's price control process early, ie the company would be fast-tracked. This is discussed in further detail below.

Incentives associated with proportionate treatment

5.9. The scope for lighter-touch scrutiny and, to a greater degree, fast-tracking provides network companies with incentives to step up to the challenge of submitting realistic and well-justified business plans. This is because these approaches will allow companies to:

- get on with business as usual without focusing as much resource on the price control process
- plan with greater certainty earlier in the process
- be a significant driver of its own review outcome
- gain positive reputational advantage associated with the kudos of achieving a fast-tracked settlement or having lower-proportionate scrutiny.

5.10. The scope for proportionate treatment will provide strong incentives for network companies to perform better over time and to submit better quality business plans. It may also provide incentives for companies to reveal information that would not be available otherwise, which might assist our assessment of other companies.

Fast-tracking

5.11. As noted above, fast-tracking describes a process whereby the price control for a company that develops a well-justified business plan may be concluded early.

5.12. We propose that the key features of fast-tracking will be:

- a company's price control will be finalised approximately 12 months ahead of non fast-tracked companies although implementation will still be on the same date for all companies - 1 April 2013
- a company's licence conditions as a whole will be finalised at the time of the fast-tracking decision
- we will consult on whether any company should be fast-tracked and on the details of the fast-tracked companies' settlement before taking a final decision
- we will ensure that a company who is fast-tracked does not secure a settlement that means they are worse off than had they remained in the process.

Process and criteria for proportionate treatment

5.13. There will be four key stages to the process for assessing whether a company receives 'lighter-touch' scrutiny and potentially fast-tracking:

- Stage 1 – In July 2011 the network companies will submit complete business plans informed by our March 2011 strategy decision document and their stakeholder engagement. Between July and October 2011 we will undertake an 'initial sweep' of this information. This will consider the overall quality of the companies' plans. At this point we will take a view on whether it might be possible to fast-track any of the companies on the basis of their business plan submissions. We will inform companies of the outcome of this assessment and highlight areas where their business plans require further development.
- Stage 2 – We will undertake further analysis on candidates for 'lighter-touch' scrutiny and fast-tracking and publish recommendations in December 2011. Recommendations will set out our initial proposals for the settlement for any company we consider could be fast-tracked and our initial assessment of the other business plan submissions.
- Stage 3 – We will assess the responses to the fast-tracking and 'lighter touch' recommendations and publish our decisions in February 2012. For fast-tracked companies, that decision will constitute final proposals for those companies.
- Stage 4 – We will develop and publish initial and final proposals for non fast-tracked parties in July 2012 and December 2012 respectively. The price controls for all parties will come into effect on 1 April 2013.

5.14. More detail on each of these stages is set out in our supplementary annex entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives'.

Assessment criteria

5.15. The initial sweep will be informed by three different sources of evidence:

- the quality of the company's business plan (including accompanying data, evidence of stakeholder engagement and their financial model)
- use of any available comparative evidence both our own and additional information provided by the companies including benchmarking data
- our assessment of performance during the previous regulatory control based on pre-established principles.

5.16. There are a range of criteria we propose to use in assessing the quality of the business plans. These criteria are divided into three categories: (1) the approach to process; (2) strategy; and (3) reflection of strategy in the plan. These reflect the RIIO recommendations and the business plan guidance set out in our July open letter. These criteria are set out and discussed in detail in our supplementary annex entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives'.

5.17. It is possible for all, some or no companies to qualify for fast-tracking and a lighter-touch approach. We will base our decision on the absolute quality of individual business plans against the criteria.

Ensuring that no fast-tracked company is worse off

5.18. A key issue for fast-tracking is to ensure that a company that is fast-tracked is no worse off than a company that is not fast-tracked. This is important to provide incentives to network companies to aim for fast-tracking.

5.19. There are a number of reasons why we do not consider it likely that a fast-tracked company would receive a worse settlement. We would expect fast-tracked companies to be able to demonstrate they are operating at the frontier of efficiency. We would also expect these companies to set the benchmark on financial issues. It is unlikely that we will be presented with subsequent evidence to suggest that other companies should be set less onerous efficiency goals or a more generous financial settlement. These reasons are:

- in order to be considered a high quality well-justified plan and suitable for fast-tracking a company's business plan will need to be well informed about potential longer-term trends, ie it would be more likely to anticipate future changes and have built in mechanisms for dealing with these
- those not being fast-tracked will be subject to heavier regulatory scrutiny which is likely to put pressure on their requested allowed revenues
- cost of debt assumptions will update automatically and therefore fast-tracked companies would have the same protection against changes in credit markets.

5.20. We are considering the need for further protections for fast-tracked companies. The options we are seeking views on are:

- whether there are any aspects of the settlement where adjustments might need to be guaranteed to the 'fast-tracked' company to ensure it is not disadvantaged against the others
- providing rewards to any 'fast-tracked' GDN to reflect the rewards that would have been available through our upper quartile benchmarking approach, to the most efficient company - we are not proposing this in transmission as there are fewer and more diverse companies and therefore less scope for meaningful comparison
- whether a more explicit reopener would be required for 'fast-tracked' companies.

5.21. It is likely that we will invite fast-tracked companies to identify aspects of their settlement which may need to be reconsidered in the light of the settlement agreed for non fast-tracked companies.

Cost assessment

5.22. Under the RIIO framework the onus is on companies to demonstrate the cost-efficiency and long-term value for money of their business plans. We intend to place our focus on the companies' forecasts and the use of benchmarking as a means of informing our assessment of the companies' forecasts rather than as a mechanistic means of setting allowances. We will place much more emphasis on the benchmarking of forecasts (as opposed to historic costs) as these are likely to be more relevant in the context of our sustainable development duties and the introduction of new output measures.

5.23. As part of RIIO-T1, we propose a toolkit approach to cost assessment. The toolkit will comprise both total expenditure (totex) analysis and disaggregated approaches (ie separate reviews of operating and capital expenditure). Totex analysis captures the key trade-offs between different areas of costs in establishing the overall levels of efficiency of network operators. As this is the first time we are making full use of the totex techniques, we consider the use of more disaggregated approaches is important in providing a crosscheck to ensure our approach is robust.

Efficiency incentives and Information Quality Incentives (IQI)

5.24. We want to ensure that network companies face strong financial incentives to control their costs and to seek out and implement delivery approaches that provide better value for money for existing and future consumers. The RIIO model proposed a fixed and symmetric 'efficiency incentive rate' for each company. This will give companies a clear and strong financial stake in restraining, and where possible reducing, the costs of delivering outputs over the price control period.

5.25. The efficiency incentives are about risk-sharing. Investors and consumers will share the benefits when the company delivers outputs for less money than we envisaged when setting the price control. Similarly, investors and consumers will share the additional costs if the company spends more money than envisaged. The higher the efficiency incentive rate, the more investors are exposed to the network company delivering at higher cost than expected and the more they stand to gain if the network company can deliver at lower cost.

5.26. We are proposing two changes to the way that the efficiency incentive rate is implemented, compared to efficiency incentives in previous price controls:

- the efficiency incentive rate would be implemented through revenue adjustments made annually during the price control period
- the level of the efficiency incentive rate will determine the extent to which the Regulatory Asset Value (RAV) is adjusted in light of a given over-spend or under-spend. This means that the RAV will not track actual (capital) expenditure.

5.27. We are proposing to introduce the information quality incentive (IQI) in RIIO-T1 (it is currently used for distribution price controls). The aim of the IQI is to encourage companies to submit more accurate expenditure forecasts to Ofgem. A necessary feature of the IQI is that the efficiency incentive rate for each company depends on the difference between its expenditure forecast and Ofgem's assessment of its (efficient) expenditure requirements. We propose that the exact efficiency incentive rate for each company is set as part of the IQI, in a range of 40-60%.

5.28. We want companies to find the lowest cost way of delivering outputs over the longer-term, considering a variety of potential delivery approaches. The same efficiency incentive rate will apply to operating expenditure and capital expenditure. This will reduce the risk that expenditure decisions may be distorted in favour of capital expenditure solutions. At the price control review, our cost assessment will look across all areas of costs. We will seek to avoid an approach to cost assessment that could skew companies' plans, and their subsequent delivery approaches, towards certain categories of expenditure.

5.29. The application of efficiency incentives and IQI are discussed in detail in the supplementary annex entitled 'RIIO-TI Outputs and incentives'.

Role for third parties in delivery

5.30. Providing scope for competition in delivery, ownership and operation of network assets in defined circumstances is an important element of RIIO. The option to require the competitive provision of network services is expected to impose discipline on existing network companies to encourage them to strive for timely delivery, be more innovative and seek out lower long-term cost delivery solutions.

5.31. The RIIO model outlined three key ways in which we could use competition to realise benefits for the consumer. The first two, detailed below, define the information we expect from licensees as part of their well-justified business plans, and are included in the business plan guidance for the first RIIO price control:

- companies will be expected to provide, as part of a well-justified business plan, evidence of efficient procurement
- where we feel a network company has failed to provide robust evidence to support its business plan they may be asked to supply more evidence, including (potentially) market testing evidence.

5.32. Under the third approach, we would have the option to grant a third party licensee funding for ownership and potentially delivery of selected projects. We would only consider initiating steps to explore the potential to give licensed third parties a greater role in delivery where the project meets certain criteria which indicate that this is likely to deliver long term benefits to consumers.

5.33. The factors we would consider in determining whether to use this approach, the nature of the associated benefits and the associated criteria a project would have to meet to be suitable are discussed in our supplementary annex entitled 'RIIO-T1 Business plans, innovation and efficiency incentives'.

6. Managing uncertainty

Chapter Summary

Reflecting the principles outlined in the RIIO framework, this chapter sets out the mechanisms that we propose to include in the RIIO-T1 control to help companies manage uncertainty. This includes the intention to have a tightly scoped mid-period review of outputs.

Question 1: Do you have any views on the uncertainty mechanisms identified?
Question 2: Are there any additional uncertainty mechanisms required that we have not identified?
Question 3: Are there any mechanisms that we have included that are not necessary and, if so, why?

6.1. There are always uncertainties about what will happen during the course of a price control period. During the control period factors will change which can impact a company's outputs and expenditure requirements. Under RIIO, risks should be borne by the party best able to manage them efficiently. In some cases this will be the network company. In other cases it may be that risks are best borne by the consumer or shared.

6.2. The risks are arguably greater under an eight-year price control than under a five-year one. We have taken this into account in setting out our proposed approach to dealing with uncertainty in RIIO-T1.

6.3. The RIIO framework includes a number of elements to help deal with uncertainty. The elements, which are discussed in this chapter, are:

- uncertainty mechanisms
- the potential for disapplication of the price control
- a tightly-defined mid-period review of output requirements.

6.4. The mechanism for sharing any variations between actual and forecast expenditure between the companies and consumers also helps to reduce the impact on uncertainty for network companies. The incentive rate and the basis on which we propose it is discussed in Chapter 5 and in more detail in the supplementary annex entitled 'RIIO-T1 Tools for cost assessment'.

Uncertainty mechanisms

What are uncertainty mechanisms?

6.5. We use the term 'uncertainty mechanisms' to cover a range of mechanisms which allow changes to the revenues a network company is allowed to collect in light of what happens during the price control period. These include:

- volume drivers - a means of linking revenue allowances to a significant change in volumes during a price control period
- revenue drivers - a means of linking revenue allowances under a price control to specific measurable events which are considered to influence costs
- specific re-openers - specific provisions to reset the revenue allowances (or the parameters that give rise to revenue allowances) under a price control
- pass-through items - elements where any changes in costs are recovered fully from customers via pass-through arrangements
- indexation - the adjustment of an economic variable so that the variable rises or falls in accordance with the rate of inflation
- logging-up - a provision under which a company will be compensated for all, or part, of its actual expenditure on a particular activity or area, through the revenue allowance set at the next price control review
- rolling average - an average of a specified number of data points which is updated continuously to reflect the most recent data.

Uncertainty mechanisms under RIIO

6.6. The use of uncertainty mechanisms may benefit consumers in a number of different ways; for example by contributing to a lower cost of capital and reducing consumers' exposure to forecasting uncertainty at the price control review. But, they may also bring downsides, such as undermining efficiency incentives, complexity, risks of unintended consequences and price volatility which can have a significant impact on some stakeholders.

6.7. The overarching principle for uncertainty mechanisms under the RIIO model is that we expect network companies to manage the uncertainty they face. The regulatory regime should not protect network companies against all forms of uncertainty. The use of uncertainty mechanisms should be limited to instances in which they will deliver value for money for existing and future consumers while also protecting the ability of networks to finance efficient delivery.

6.8. The RIIO framework calls for:

- a clear justification of the need for each uncertainty mechanism
- design of each mechanism to mitigate the potential downsides
- a coherent approach across uncertainty mechanisms.

Proposed uncertainty mechanisms

6.9. Our supplementary annex entitled 'RIIO-T1 and GD1 Uncertainty mechanisms' sets out a detailed explanation of the mechanisms that we propose are included in RIIO-T1. Some mechanisms apply to both the electricity and gas transmission sectors whereas others will be specific to each sector. These mechanisms include:

- a revenue driver reflecting uncertainty about where in the gas transmission network NGG will need to develop incremental capacity during the price control
- a combination of mechanisms reflecting uncertainty over wider works expenditure in electricity transmission, possibly incorporating trigger mechanisms, within-period determinations, and revenue drivers
- potential volume drivers reflecting uncertainty over connections expenditure in electricity transmission
- a range of financial uncertainty mechanisms protecting network companies and consumers against variations in financial parameters over the price control.

6.10. Companies will have an opportunity, as part of their business plans, to set out which uncertainty mechanisms they would find valuable in managing risk. We expect companies to justify why any additional mechanisms would be appropriate and the benefits these would bring for consumers.

Disapplication of the price control

6.11. During a price control review we seek to provide a licensee with a revenue stream that is expected to be sufficient to enable it to finance efficient delivery of its obligations. This is in the interests of consumers. If circumstances arise during the control period which means that the revenue allowance set at the price control review is insufficient to enable an efficiently managed company to finance its regulated activities, then we will consider requests from that company for amendments to its price control. This process is a way of managing the impact of highly significant, but unpredictable, events which could occur during the price control period. We expect the use of this mechanism to be rare.

6.12. We issued a guidance document in October 2009 setting out the arrangements for responding in the event that a network company experiences deteriorating financial health.[12] This document provides greater transparency and clarity on the types of circumstances under which we will reopen a price control and the associated process. These circumstances include situations in which:

- it can be demonstrated that adequate provision is not provided by the existing price control settlement
- the cause of financial distress was beyond the company's control

[12] Arrangements for responding in the event that an energy network company experiences deteriorating financial health - Decision document, Ofgem - October 2009 http://www.ofgem.gov.uk/Networks/Policy/Documents1/GUIDANCE%20DOC%20(DECISION%20DOC)%20-%20FINAL.pdf

- re-opening the settlement could reasonably be expected to relieve the financial distress in a timely manner.

6.13. We are not proposing any changes to the disapplication licence condition or our guidance for responding to financial distress of a network company for RIIO-T1.

Mid-period review of outputs to be delivered

6.14. Recognising the scope for significant changes in outputs during an eight-year price control period, the RIIO framework proposed provision for a mid-period review of output requirements. In setting a mid-period review there is a risk that it could undermine the purpose of setting a longer control period. Consequently, we propose the scope for a mid-period review is restricted to changes to outputs that can be justified by clear changes in Government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users.

6.15. We propose a qualitative materiality test to decide whether there is a material change that requires a mid-period adjustment to outputs. We do not think it is possible to capture the consumer interest within a quantitative threshold. In taking decisions on a mid-period review, we will consider the risks and downsides of potential changes, for example instability of the outputs, reducing incentives to improve output performance and administrative costs.

6.16. For RIIO-T1 the mid-period review will take place in 2016, with any changes being implemented in March 2017.

Process for the mid-period review

6.17. If we decide that a material change is needed at the mid-period review of output requirements we will initiate the review and will consult on our proposed actions. Where there is a need for change to outputs, the review process will take up to 12 months. This includes:

- 3 months to consult, understand the issues and decide whether to progress the review
- 6 months to develop policy (Ofgem and the network companies)
- 3 months to consult on proposals and make any amendments.

6.18. Once we have published our decision on the proposed changes, if any, to output requirements, network companies will need to provide notice of changes to their charges such that they can start to recover any changes to their allowed revenue at the start of the following year.

6.19. Further details on the proposed process for the mid-period review are provided in Appendix 7 and the supplementary annex entitled 'RIIO-T1 and GD1 Uncertainty mechanisms'.

7. Innovation

Chapter Summary

This chapter considers the role of innovation in achieving the RIIO objectives and specifically the development of a time-limited innovation stimulus that builds on the Low Carbon Network Fund (LCN Fund).

Question 1: Do you have any views on the role of innovation in RIIO-TI?
Question 2: Do you have any views on the time limited innovation stimulus?

7.1. The network companies are likely to require significant innovation to ensure the delivery of a sustainable energy sector and that their services represent long-term value for money for existing and future consumers.

7.2. The RIIO model has a number of elements that are designed to drive such innovation, including the longer price control period, the outputs focus and strong efficiency incentives. Another important aspect of our approach is to allow companies to highlight in their business plans where they propose to roll out innovative technology, techniques or commercial strategies but which pose higher costs in the price control period than the 'business as usual' approach. In these cases we would expect companies to put forward the longer term business case for the innovation and to commit to outputs relating to this expenditure.

7.3. Where the commercial benefit of innovation is not clear, network companies may not have a strong motivation to pursue innovation in a timely way. The RIIO model includes a time-limited innovation stimulus package to supplement the incentives inherent in the RIIO price control framework.

Time limited innovation stimulus

7.4. As set out in our RIIO decision, we will introduce an innovation stimulus for electricity networks and a separate stimulus for gas networks. The gas stimulus will be available for transmission and distribution projects. Since there is already the LCN Fund in place which incentivises innovation in electricity distribution, the electricity innovation stimulus will initially only be available for electricity transmission. We have committed to retaining the LCN Fund until 2015 when the DPCR5 period ends. From that point onwards, we expect funding arrangements to encourage innovation in the electricity distribution sector to be incorporated into the broader electricity innovation stimulus. Both the gas innovation stimulus and the electricity innovation stimulus will fund all types of innovation and will allow third parties to apply for project funding.

7.5. The stimulus will take the form of regular open competitions for project funding. The package design will seek to adopt many of the principles established in the LCN

Fund for electricity distribution and this type of funding will be extended to other parts of the energy networks.

7.6. We are also proposing to introduce a limited amount of innovation funding (an innovation allowance) directly to each network company. This is similar in principle to the current Innovation Funding Incentive (IFI) and First Tier funding available under the LCN Fund, which provide innovation funding for small projects with companies self-certifying against published criteria. However unlike these mechanisms, we will require companies to set out an innovation strategy as part of their business plan, containing defined outputs which the innovation allowance will fund. We are considering whether to provide a set percentage of revenue for this allowance, or whether to allow a variable level (up to a fixed ceiling) depending on the quality of the innovation strategy.

7.7. The innovation stimulus package is being developed in parallel to the price controls. We recently published a consultation on this subject.[13] There are three key elements that will inform the network operators in developing their business plans:

- *Amount of funding available under each innovation stimulus.* We consider there is greater scope for the application of innovation in distribution than in transmission, and greater scope in electricity than in gas. We are inviting views on our proposal that £25-£35m per year should be available for electricity transmission, around half that currently provided for electricity distribution (£64m), bringing total funding in electricity to between £90m and £100m a year. We are considering setting the level of funding for the gas innovation stimulus at £45-£50m per year, for both gas distribution and transmission. During the RPI-X@20 review we commissioned consultants KEMA to take forward a report looking at the potential for technological innovation on the GB energy networks.[14]
- *Scope for what can be funded.* The innovation stimulus in both electricity and in gas should be focussed on projects that will inform the low carbon future. We recognise that for the gas sector there may be an argument for a broader objective of contribution to long-term network sustainability and we are keen to get views on this option. We are currently consulting more widely on what types of projects the stimulus might fund.
- *Partial funding of projects*. We propose to set a maximum level of project funding from the stimulus of 80 per cent. We consider this provides an appropriate level of risk for companies to be exposed to. We note that under the LCN Fund companies can apply to have 90 per cent of the project funded.

[13] Open letter consultation on the development of gas and electricity innovation stimuli - Ofgem, October 2010
http://www.ofgem.gov.uk/Networks/Policy/Documents1/Innovation%20Stimuli%20%2012102010%20Open%20Letterpdf.pdf
[14] RPI-X@20: Technological change in electricity and gas networks - KEMA report
http://www.ofgem.gov.uk/Networks/rpix20/ConsultReports/Documents1/KEMA%20Technology%20changes%20Final%20Report.pdf

8. Financing efficient delivery

Chapter Summary

This chapter sets out the main financial issues affecting RIIO-T1. These are the basis for using economic asset lives to set depreciation allowances, the approaches for calculating the cost of debt, the cost of equity and for setting the allowed return.

Question 1: Do you consider that the package of financial measures identified will enable required network expenditure to be effectively financed?
Question 2: Do you have any views on our proposed approach to depreciation?
Question 3: Do you have any views on our preferred approach to implement any transition arrangements over one price control period where possible?
Question 4: Do you have any views on our preferred approach to remunerating the cost of debt?
Question 5: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 4.0-7.2 per cent?
Question 6: Do you have any views on other elements of our financial proposals?

Financeability under RIIO

8.1. We are committed to ensuring that efficient companies are able to finance themselves (both through debt and equity). The RIIO decision document set out a number of principles to establish a sustainable longer-term package of financeability parameters which would support the considerable investment required by the network companies over the next few years, including:

- a capitalisation policy based on equalising incentives and more closely aligned with actual split between operating and capital expenditure
- asset lives based on the average expected economic life of the assets in question
- the use of the capital asset pricing model (CAPM) supported by other approaches to determine the cost of equity
- cost of debt based on the long-term trailing average
- gearing based on a company's risk exposure
- the onus on companies to manage short-term requirements within their overall corporate structure and to provide equity as necessary.

8.2. This package of measures is aimed at ensuring that the network investment required by 2020 can be effectively financed.

8.3. The supplementary annex 'RIIO-T1 and GD1 Financial Issues', published alongside this document provides more details on our proposals on these issues and the financial methodologies including tax, pensions and regulatory asset value (RAV).

Asset life and depreciation

8.4. In the RIIO decision document we stated that we would use economic asset lives to set depreciation allowances. The economic life takes into consideration both the technical life of the assets and the estimated period over which the assets will be usefully employed. We have engaged consultants to undertake a full review for us and their report is published today.[15] We have largely accepted their recommendations as a basis for consultation.

8.5. We recognise that we are entering a period of innovation in networks, which may impact on how they are operated in the future. However, we have taken this into account in setting out our proposed range for economic asset lives and do not think that this will have a material impact on the usefulness of the vast majority of the existing network assets.

Gas transmission

8.6. Our consultants have highlighted that, although the technical life of gas transmission assets exceeds the current regulatory asset life of 45 years, there is uncertainty over the long-term use of the assets. In part, this uncertainty relates to the Government's target to decarbonise the energy sector by 2050.

8.7. In undertaking their analysis our consultants have considered scenarios through to 2050. These imply a range of outcomes for gas. In some scenarios the peak day usage is at a similar level to today. In other scenarios the level of gas usage is at significantly reduced levels. Some of the factors affecting the level of gas use include the development of gas CCS, the use of bio-methane and the high cost of providing electricity to meet peak heating requirements. We agree with the consultants that at present there is sufficient potential for gas to be useful into 2050 and we do not need to make any adjustments to the current regulatory asset life of 45 years at this time. We believe the future pathway for gas will be much clearer at the end of RIIO-T1.

8.8. We are, however, concerned that if by the end of the RIIO-T1 period the use of gas does move into decline, there will be too few customers to absorb the increased depreciation charges that would arise. We asked our consultants to consider whether such considerations should influence the depreciation profile. Their recommendation is that either a straight line or front-end loaded profile would be appropriate. For gas transmission we do not believe there is currently a sufficiently strong case to front-end load depreciation. We therefore propose to continue to use a 45 year straight line depreciation profile for gas transmission.

Electricity transmission

8.9. For electricity transmission, our consultants' analysis shows that the technical asset life is significantly above the current regulatory asset life of 20 years. This is

[15] http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/WorkingGroups/Pages/WG.aspx

not surprising as the current regulatory asset life purposely accelerated depreciation to address perceived financeability issues. For transmission, their analysis suggests a technical asset life of 54-60 years. As peak demand for electricity will increase in all future scenarios there are limited economic grounds to reduce the technical asset lives to reflect economic factors. However, there are other considerations, including the potential for an increase in the use of shorter life assets as smart grids become the norm. Taking this and other factors into account they suggest an economic asset life of 45-55 years for electricity transmission. We accept the recommendation as a reasonable basis for consultation and seek views on this range. We also propose to retain the straight line depreciation profile.

Transitional arrangements

8.10. In RIIO we said that where the application of the RIIO financeability principles in a single step would cause an efficient company financing difficulties, we will implement transition arrangements.

8.11. We recognise that a change in the regulatory asset life from 20 years to 45-55 years in electricity transmission is significant and, if implemented in one step, could cause disruption and could lead to a perception of increased regulatory risk. We asked our consultants as part of the asset life study to undertake high-level modelling of the impact on revenues, financeability and consumer charges of a change in regulatory asset life. This shows that the electricity transmission companies' financial ratios may well be affected.

8.12. In RIIO we suggested that we would phase in any changes over one price control period. This is our current preference. Whether this is possible will depend on the information in the business plans we receive next summer. In the first instance it will be for the companies to include proposals for transitional arrangements in their business plans reflecting their own particular circumstances.

8.13. A key input into the assessment of transition arrangements will be maintenance of credit rating ratios and consideration of equity metrics. As with any business undertaking a significant investment programme, we will expect equity injection to play its role in ensuring that appropriate credit metrics are achieved.

The allowed return

8.14. We are taking a fundamentally different approach to setting the allowed return under RIIO. We are introducing indexation of the cost of debt and will set the notional gearing on an assessment of the volatility of the cashflows faced by each business. We will need to balance a number of items in coming to a view on the appropriate notional gearing, including cash flow risk, equity and credit metrics, transitional arrangements and the cost of equity. These are described further below.

Notional gearing

8.15. We will continue to use a notional gearing assumption under the RIIO model. This will be based on an assessment of the risk of the cash flows. Consequently, the level of gearing could vary across sectors and, in some circumstances, between companies within a sector. We will not be able to determine the appropriate level of notional gearing until we have seen and assessed companies' business plans. Indeed, the companies themselves will need to set out what they think the appropriate level of gearing is in their business plans next summer. At this point we are focusing on setting out the approach we will use to determine appropriate notional gearing.

Cost of debt

8.16. Under the RIIO model, the cost of debt assumption included in the allowed return will be based on the trailing average of a cost of debt index, with revenues updated annually to reflect changes in the index. We have evaluated a number of alternative indexes. Our preferred approach is to use a 10-year trailing average of BBB and A rated bonds. We are seeking views on this approach. Using our preferred index currently results in a cost of debt of 3.1 per cent real. We will consider developments such as Basel 3 to ensure that the index will be robust to potential regulatory changes. Further detail of the index and implementation issues are set out in the supplementary annex entitled 'RIIO-T1 and GD1 Financial issues'.

Cost of equity

8.17. As highlighted above, in the RIIO model we need to ensure that there is consistency and balance between the cash flow risk faced by the companies, the level of notional gearing and the cost of equity. At this stage in the process our cost of equity assessment considers only the market factors and the risk generally experienced in the recent past by regulated businesses.

8.18. We have reviewed the cost of equity and recent precedents including the Competition Commission's Bristol Water case.[16] We recognise the companies have made arguments that lengthening the time over which capital is remunerated could raise the riskiness of cashflows and therefore the cost of equity. Our consultants have reviewed these arguments. They have considered the theoretical arguments and sought to find empirical evidence in support of this claim. They have not found any supporting evidence and conclude the theoretical arguments are not compelling. Nevertheless, we retain an open mind on this issue and would be pleased to consider further evidence in support of (or indeed which counters) the companies' claims.

8.19. We are consulting on a cost of equity range of 4.0-7.2 per cent (post tax real). This compares to the range used by the Competition Commission in Bristol Water of 3.6-6.6 per cent and a figure of 7-7.25 per cent used in the previous transmission and gas distribution controls, respectively.

[16] Bristol Water plc - A reference under section 12(3)(a) of the Water Industry Act 1991 - Report http://www.competition-commission.org.uk/rep_pub/reports/2010/fulltext/558_final_report.pdf

Other financial issues

8.20. For other financial issues we are largely following established policies and procedures which are set out in detail in the supplementary annex entitled 'RIIO-T1 and GD1 Financial issues'.

9. Next steps

Chapter Summary

This chapter sets out the next steps in RIIO-T1.

There are no specific questions in this chapter.

Next steps

9.1. We welcome the views of interested parties in relation to any of the issues set out in this document. Responses should be provided no later than **4 February 2011**.

9.2. During January and February there will be a number of stakeholder events. These include:

- the next meeting of the Price Control Review Forum (PCRF) on 24 January 2011
- further meetings of the working groups to develop further thinking on the output measures and their associated incentives
- two meetings of the financial issues working group
- the TOs will have the opportunity to meet with our Committee of the Authority
- a City event in mid-January 2011.

9.3. We expect that the TOs will also continue their stakeholder engagement during this period.

9.4. We intend to publish a document in late March 2011 confirming the Authority's decision on the strategy for RIIO-T1. This will reflect the responses to this consultation and views provided through our wider stakeholder events.

9.5. Our strategy decision document will provide the information required for the TOs to develop their well-justified business plans. The companies will be required to submit their business plans by end-July 2011.

Appendices

Index

Appendix 1 - Consultation response and questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from consumers and their representatives, gas and electricity transmission and distribution companies, generators and offshore gas producers/importers, suppliers, shippers, debt and equity investors, those with sustainable development interests, academics and other interested parties.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 4 February 2011 and should be sent to:

- RIIO.T1@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish a document in late March 2011 confirming the Authority's decision on the strategy for the RIIO-TI review. Any questions on this document should, in the first instance, be directed to:

Grant McEachran
RIIO-T1
107 West Regent St, Glasgow, G2 2BA
0141 331 6008
RIIO.T1@ofgem.gov.uk

CHAPTER: One

Question 1: Do you have any comments on the proposed process and timetable for the review?

CHAPTER: Two

Question 1: Do respondents consider there are any interactions with other policy areas that have not been highlighted in this chapter?
Question 2: Do respondents consider that the transmission and gas distribution price control periods should remain aligned for future review periods?

CHAPTER: Three

Question 1: Do you have any comments of the overall approach to stakeholder engagement?
Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?

CHAPTER: Four

Question 1: Do you consider the proposed outputs and associated incentives, along with the other elements of the proposals, will ensure companies deliver value-for-money for consumers and play their role in delivering a sustainable energy sector?
Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate?
Question 3: Do you have any views on the proposed outputs or incentive mechanisms?

CHAPTER: Five

Question 1: Is our proposed approach to cost assessment appropriate?
Question 2: Do you have any views on our proposed process for proportionate treatment?
Question 3: Do you have any views on the criteria for assessing business plans? Are any of the criteria highlighted inappropriate? Should any additional criteria be added?
Question 4: Do you have any views on the proposed role for competition in third party delivery?

CHAPTER: Six

Question 1: Do you have any views on the uncertainty mechanisms identified?
Question 2: Are there any additional uncertainty mechanisms required that we have not identified?
Question 3: Are there any mechanisms that we have included that are not necessary and, if so, why?

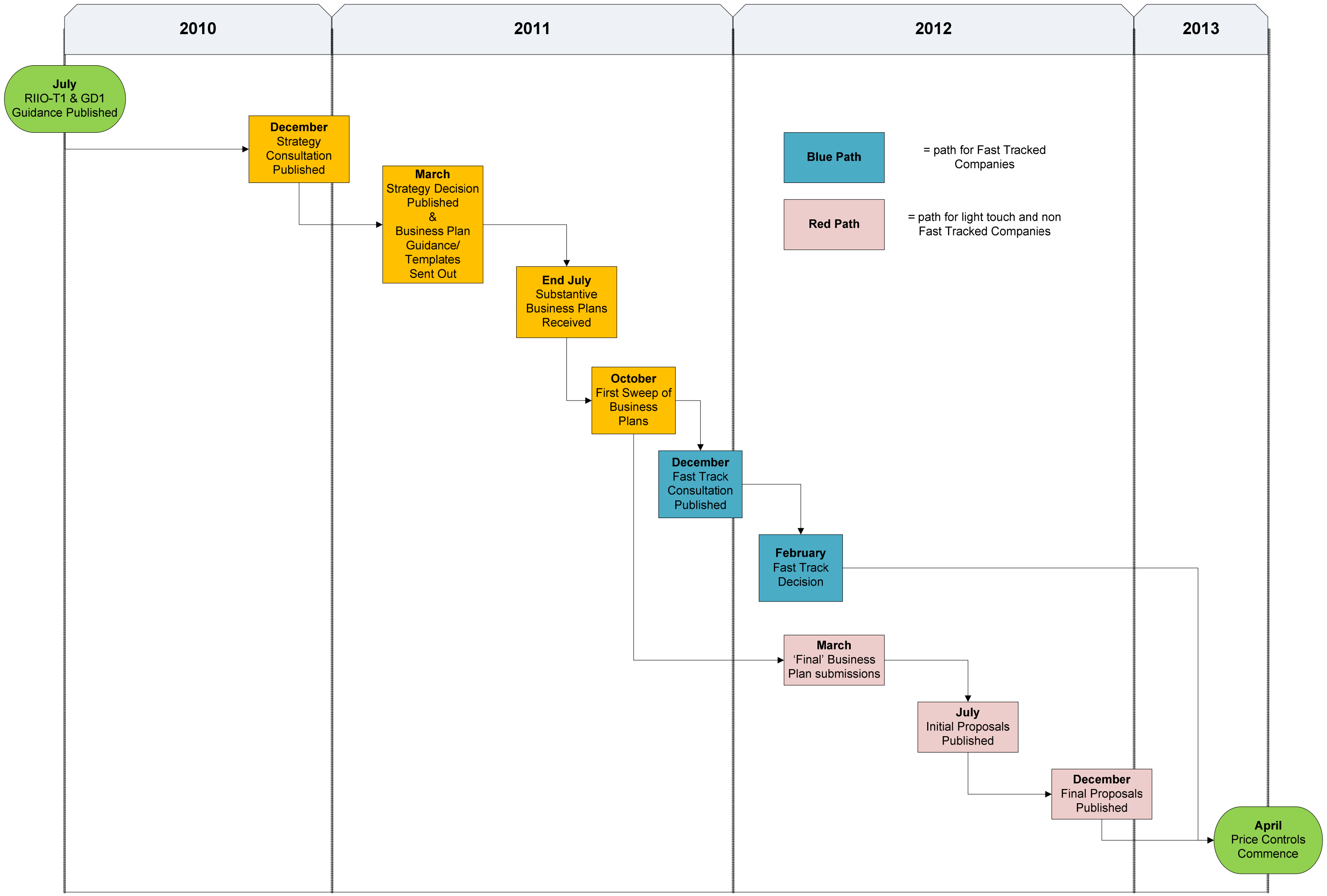
CHAPTER: Seven

Question 1: Do you have any views on the role of innovation in RIIO-TI?
Question 2: Do you have any views on the time limited innovation stimulus?

CHAPTER: Eight

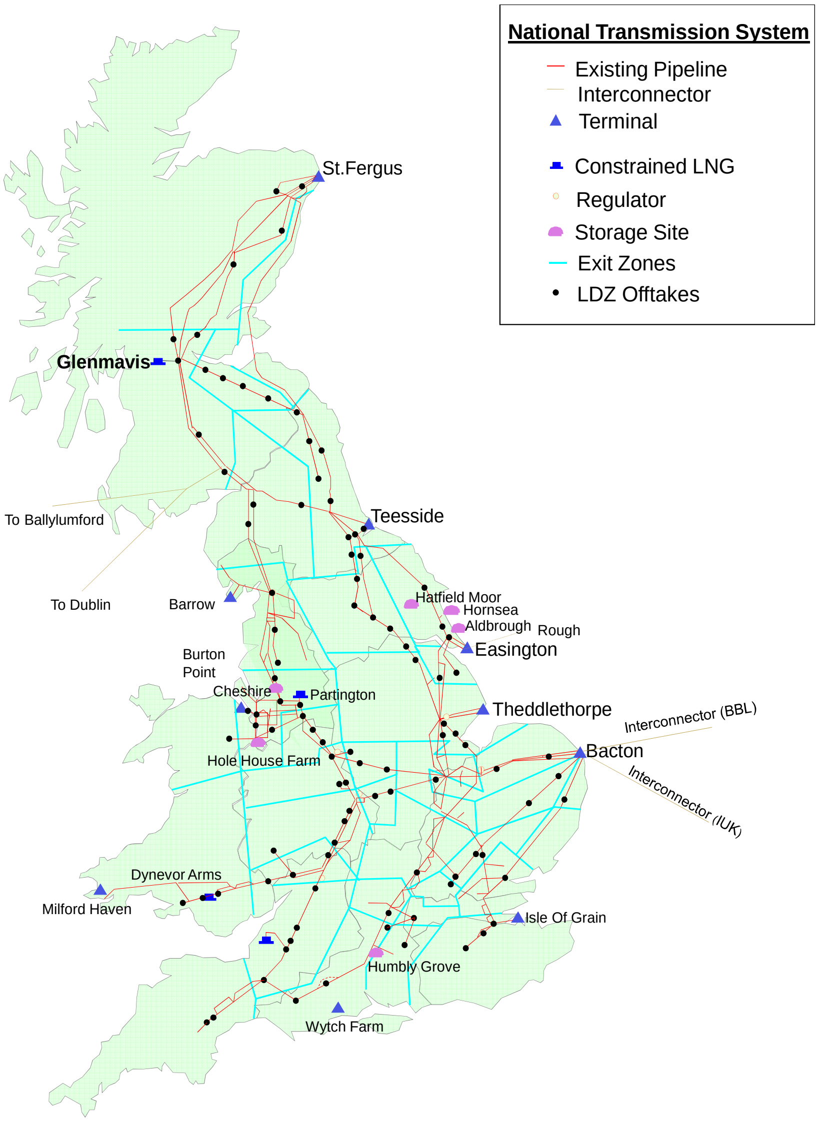
Question 1: Do you consider that the package of financial measures identified will enable required network expenditure to be effectively financed?
Question 2: Do you have any views on our proposed approach to depreciation?
Question 3: Do you have any views on our preferred approach to implement any transition arrangements over one price control period where possible?
Question 4: Do you have any views on our preferred approach to remunerating the cost of debt?
Question 5: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 4.0-7.2 per cent?
Question 6: Do you have any views on other elements of our financial proposals?

Appendix 2 – RIIO-T1 timetable



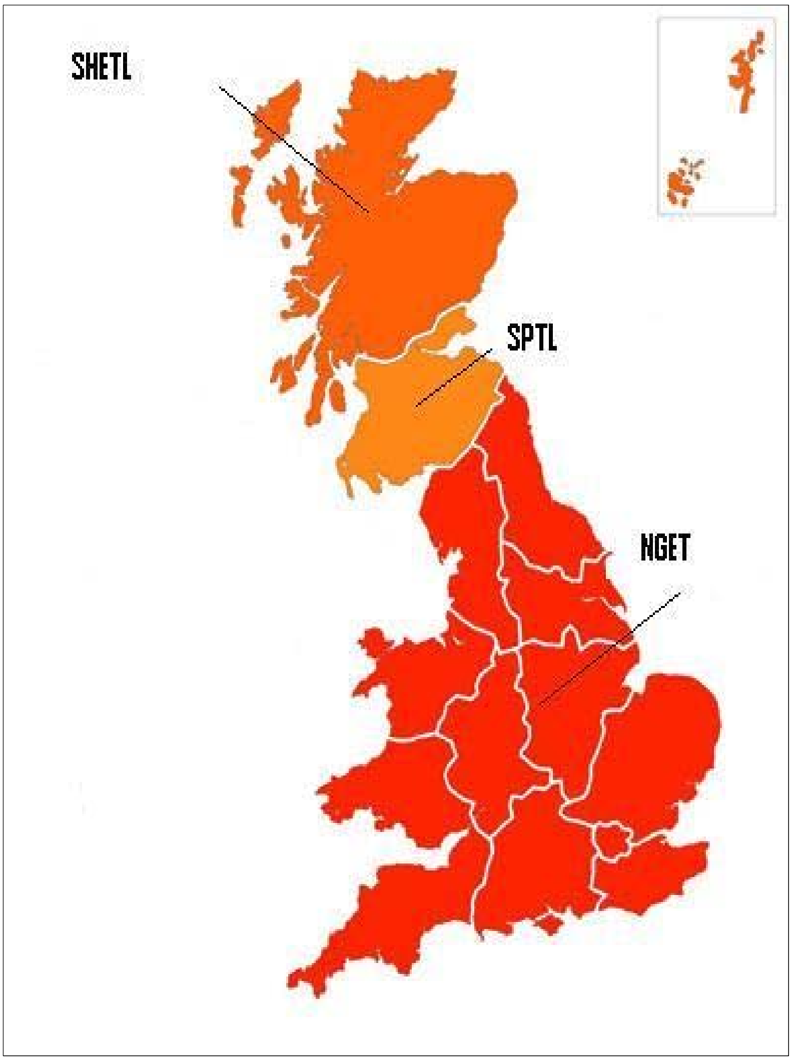
Appendix 3 – Transmission networks

Figure 1.1 Gas transmission network



Source: National Grid

Figure 1.2 Electricity transmission networks



Appendix 4 - Interaction with related policy areas

1.1. In setting a price control a number of interactions with other areas of transmission policy need to be taken into account. The key interactions are set out below.

Adapted rollover of TPCR4

1.2. To accommodate fully the conclusions of the RIIO review in the next transmission price control we announced, following consultation, on 21 December 2009 that we intended to delay implementation of the next transmission price control until 1 April 2013. We announced a one-year 'adapted roll-over' of TPCR4 from 1 April 2012 until 31 March 2013.

1.3. Following consultation, we published our decision on the scope of the adapted rollover in June 2010. The document concluded that the scope of the adapted rollover would be proportionate to a one-year review and that we would not be adopting the RIIO model in determining the rollover price control parameters. Consequently, RIIO-T1 will be the first time the RIIO framework is fully reflected in a transmission price control.

TAR

1.1. The joint Ofgem/Department of Energy and Climate Change (DECC) Transmission Access Review (TAR) explored the case for change to the transmission access arrangements. The review culminated in the TAR final report, published in July 2008, which identified a range of options for enduring access reform.

1.2. Earlier this year DECC implemented Connect and Manage as the enduring transmission access model

Transmission investment incentives

1.3. Following completion of the TAR, we have taken forward work to identify the critical system reinforcements that the electricity TOs identified as likely to be required by 2020, and to provide appropriate funding arrangements to facilitate this programme of investment within the current price control period.

1.4. In January 2010 we published our final proposals on our framework and process for funding critical investments in tranches within TPCR4, under our transmission investment incentives (TII) work stream. We subsequently announced our intention to extend our TII framework to 2012/13 under the TPCR4 rollover, while future funding arrangements, from 2013/14, will be addressed through RIIO-T1. We are currently assessing a number of requests for funding from 2011/12 under TII and we have recently published a proposed approach to dealing with these requests and on our detailed policy recommendations for the arrangements to apply in 2012/13.[17]

[17] Transmission Investment Incentives: funding requests and extension of funding framework to 2012/13 - 3 December 2010

Project TransmiT

1.5. In September 2010 we launched 'Project TransmiT' - our independent and comprehensive review of transmission charging arrangements and associated connection arrangements. The initial focus of Project TransmiT is to consider charging arrangements and those aspects of the associated connection issues that the Government has explicitly left for Ofgem and the industry to resolve.

1.6. Project TransmiT is due to report in summer 2011. It is closely related to the price control work to develop connection outputs. The joint work on this is described in more detail in the supplementary annex entitled 'RIIO-T1 Outputs and Incentives'.

1.7. As an issue that cuts across both Project TransmiT and RIIO-T1, we have recently published a consultation letter[18] on facilitating the timely connection of generation. In the letter we outline options for incentivising TOs to deliver connections in a timeframe that is better aligned with the requirements of generators. We also request data from the TOs on the issues impacting their timeframes for connection. We will consider responses to this letter and the additional information provided by the TOs in setting out a connections output measure in our March 2011 RIIO-T1 strategy decision document.

SO incentives

1.8. Some outputs that we are looking to develop in both transmission sectors include activities that interact with those of the SO. Some of these activities are currently incentivised in some way through the SO incentives, others are not currently being incentivised. As part of RIIO-T1 and in combination with the ongoing SO incentives work, we intend to look at options for aligning the SO incentives with the incentives in RIIO-T1.

1.9. Where there is overlap between the roles of the SO and TO activities we will consider the appropriate incentive arrangements for the overall benefit of consumers. We will also consider whether there is the need for any developments to the relationship between the two roles to ensure that they work together to deliver efficient and economic outcomes.

EU legislation - third package of legislative measures concerning the internal energy market

1.10. Article 9 of the Electricity Directive, which forms part of the 'Third Package' of internal energy market legislation, sets out the framework for the unbundling of transmission interests from generation, production and supply interests.[19]

http://www.ofgem.gov.uk/Networks/Trans/ElecTransPolicy/CriticalInvestments/InvestmentIncentives/Documents1/Dec10_TII_FINAL.pdf

[18] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=77&refer=Networks/Trans/PT

[19] The Third Package requires greater separation of transmission interests from generation, production and supply. In the European Commission's view, without effective separation of transmission networks from the activities of generation, production and supply, there is an inherent risk of discrimination not only in the

1.11. Both the Scottish TOs are vertically integrated, ie they own generation assets and supply businesses, as well as network assets. They have already indicated that they wish to apply for a derogation from Article 9 of the Directive. It is the Authority's decision to grant a derogation, though this must be subsequently approved (or vetoed) by the Commission. If the applications are not successful and they are required to fully ownership unbundle, then this may have significant implications for the Scottish TOs. The deadline for compliance with the unbundling provisions is 3 March 2012. Further details are outlined in our consultation on certification of transmission system operators under the Third Package.[20]

1.12. As part of the implementation of the Third Package, DECC are looking to introduce (by March 2011) a new process for appealing licence modifications.[21] This is discussed further in chapter 3 of this document.

Offshore transmission networks

1.13. In collaboration with DECC, we have established a new regulatory regime for offshore transmission networks. These arrangements are important to meeting the sustainability challenge by ensuring that new offshore renewable generation projects are connected to the GB electricity grid economically and efficiently.

1.14. The proposals set out in this paper relate to the onshore networks. However, investment in the onshore networks is impacted by developments in the offshore networks and hence these cannot be looked at in isolation.

Security and Quality of Supply Standards (SQSS) - Fundamental review

1.15. The transmission companies – both onshore and offshore – are required by their licences to comply with the National Electricity Transmission System Security and Quality of Supply Standards (NETS SQSS). The NETS SQSS sets out criteria and methodologies for planning and operating the GB Transmission System.

1.16. A key issue for the energy industry is integrating new generation technologies, such as wind and other renewable generation, into the electricity networks. The NETS SQSS has a pivotal role in facilitating demand and generation and efficient market operation. Consequently, in 2008 the NETS SQSS review group initiated a holistic and coordinated review of the NETS SQSS - the 'fundamental review' to ensure it remains a robust standard and is able to support the integration of new generation technologies into the electricity networks.

1.17. In undertaking the next phase of the review, the industry review group recognised the importance of the transmission price control in influencing the review work. They recognised that RIIO-T1 stakeholder engagement would among other things inform:

operation of the network but also in the incentives for vertically integrated undertakings to invest adequately in their networks

[20] Consultation on the certification of transmission system operators under the Third Package, Ofgem, July 2010. http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=30&refer=Europe.

[21] For more information on DECC's work in this area see- http://www.decc.gov.uk/en/content/cms/consultations/imp_eu_third/imp_eu_third.aspx

- The value that different stakeholders place on reliability and the role that the NETS SQSS plays in ensuring this reliability
- the appropriate level of detail required to describe the processes used to develop an economic and efficient system
- the nature, and level, of customer choice
- the role of the NETS SQSS in co-ordinating the TOs
- the right balance of risk and benefit that should be made when developing the transmission system
- the potential for provision of further demand services.

1.18. The design of the outputs discussed in this paper and in more detail in the supplementary annex entitled 'RIIO-T1 Outputs and Incentives' will inform the work on the SQSS review with parallel development of these workstreams.

1.19. Further we expect TOs, in developing their well-justified business plans, to put forward plans for delivering outputs which not only reflect the NETS SQSS but which seek to anticipate potential changes which may come forward as part of the outcomes of the current review.

Liquefied Natural Gas (LNG) price control

1.20. NGG owns three LNG facilities that provide a combination of commercial and regulated services. These are Avonmouth, Glenmavis and Partington. All of these services are subject to price review. The regulated services they provide are mainly to NGG to help them operate and manage the gas transmission system and to Scotia Gas Networks (SGN) who uses the tanker loading facility at the Glenmavis site to load road tankers which transport gas to five remote towns in Scotland, known as the Scottish Independent Undertakings (SIUs).

1.21. Regulated LNG prices were last reviewed in 2008. Since 2008, there have been a number of significant changes affecting NGG's LNG business and we have been approached by NGG to reconsider the level of the regulated prices, as it considers that the facilities are no longer commercially viable at the current price levels.

1.22. We have agreed to review the regulated prices for LNG and published an open letter on the review in August 2010[22] and initial proposals in November 2010.[23] In our initial proposals we proposed a two-year duration for the control, to take it to 2013. As a result the next control will coincide with the start of RIIO-T1 and RIIO-GD1.

1.23. Consequently, we have proposed that the next control should be developed concurrent with RIIO-T1 and RIIO-GD1 for implementation in 2013. One option is for the LNG assets to be brought under the remit of the main transmission price control. We are due to publish final proposals on the LNG price controls in February 2011 and will reflect the outcome of that decision in taking forward RIIO-T1 and RIIO-GD1.

[22] www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/FINAL%20National%20Grid%20Liquefied%20Natural%20Gas%20facilities%20price%20control.pdf
[23] http://www.ofgem.gov.uk/Networks/Trans/GasTransPolicy/LNGPriceControl/Documents1/LNGPC%202010%20Initial%20Proposals.pdf

Appendix 5 - Mechanisms for stakeholder engagement

Table 1.1 Mechanisms for engagement

Engagement Process	Description of Process	Areas discussed to date	Stakeholders involved
Consultation documents	Throughout the price control process we will publish consultation documents to allow stakeholders to comment on our current thinking.	Open letter consultation published 30 July 2010 focused on the key issues for the review and its process. We received 14 responses to the RIIO-T1 consultation.	RIIO-T1: Network companies, six environmental groups, two suppliers and HSE.
Stakeholder event	Large open event (90+ people) used to summarise broad aspects of policy (for example, consultation documents) to a wide range of stakeholders. Provides information about key policy areas we have and are considering.	Price control launch and engagement event held 7 October 2010. Presented key issues for review and gave stakeholders opportunities to discuss issues related to the output categories.	Wide range inc.: network companies, suppliers, Govt., consumer reps, the City, unions, generators, shippers, consultants and environmental groups.
Working groups	Focus on specific policy areas - testing ideas and looking at design details. Groups contain a mixture of around 15 to 20 stakeholders. Membership is open to any interested party.	Working Groups to date have looked at each of the output categories & incentives (summaries of discussions are on our website[24]) There was a separate financeability workshop on 24 November.	Includes representatives from network companies, members from interested third parties, for example environmental, safety, the City, and consumer and business groups.
Bilateral meetings	We have had numerous bilateral meeting with interested stakeholders.	Discussions have been driven by the needs of particular stakeholder groups.	Includes: Consumer Focus, network companies, regulators, LUG, SMUG, DECC, HSE.
Ofgem commissioned research	Under RIIO the onus is on network companies and stakeholders to conduct their own research to inform business plans. But,	We commissioned two pieces of qualitative research looking at what outputs are important for network companies to deliver from domestic and	Domestic consumers and businesses

[24] For RIIO-T1: http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/WorkingGroups/Pages/WG.aspx
For RIIO-GD1: http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/WorkingGroups/Pages/WG.aspx

Engagement Process	Description of Process	Areas discussed to date	Stakeholders involved
	there are occasions where we need to commission our own research to elicit stakeholders' views.	business consumers' perspectives[25]. Further details of the outcome from this is summarised below.	
Ofgem's Website	We have sought to post relevant information in an open and timely fashion.	Summaries of the working groups, stakeholder event and the PCRF have been posted on our website and flagged to stakeholders.	

Price Control Review Forum (PCRF)

1.1. The PCRF is a new engagement tool introduced as part of the RIIO model. It provides an opportunity for network companies and stakeholders to feed into the price control review process. Its aims are to:

- allow us and network companies to hear firsthand the views of interested parties
- provide an opportunity to bring together all aspects of stakeholder engagement being undertaken by us, network companies and interested third parties
- provide an opportunity to discuss different outputs (across all the categories) and consider their interactions as a package of measures to meet the objectives of the RIIO model.[26]

1.2. PCRF membership brings together a broad range of stakeholders including network operators, several consumer and business representatives, unions, supplier representatives (including one for small energy suppliers), several environmental groups, and Government. A full membership list is published on our website.[27]

1.3. The first PCRF meeting was held on 4 November and largely focused on questions and discussions around our initial thinking on output measures for each of the output categories. A full summary of the proceedings, along with all the material discussed on the day can be found on our website.[28] The next PCRF is scheduled for 24 January 2011.

[25] Domestic customers:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=39&refer=Sustainability/Cp/CF
Business customers:
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=41&refer=Sustainability/Cp/CF
[26] The overriding objective of the RIIO model 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.
[27] http://www.ofgem.gov.uk/NETWORKS/PRICECONTROLS/PCRF/Documents1/PCRF%20final%20terms%20of%20reference.pdf
[28] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=2&refer=NETWORKS/PRICECONTROLS/PCRF

Consumer Challenge Group

1.4. The Consumer Challenge Group (CCG) was first used during DPCR5 to trial a more intensive form of engagement with consumer advisors. The CCG has a critical role in ensuring that consumers' views are fully considered as part of the price control process.

1.5. A single CCG has been formed for RIIO-T1 and RIIO-GD1 comprising eight members appointed by Ofgem on the basis of their expertise in the interests of existing and future consumers and energy sector knowledge. The members are appointed in an individual capacity and not as representatives of any organisational interest. Their role in the price control review process is to provide Ofgem with advice on consumer priorities for the price control and approaches to protecting existing and future consumer interests. To help achieve this the group seeks to identify the main questions which the price control raises for consumers and how these should be addressed in the various documents published by Ofgem in the price review process.

1.6. The key areas the CCG have considered so far include:

- the potential for an environmental output measure which reflects the extent to which network companies' are actively contribution to facilitating a low carbon future network
- in terms of the way the network companies deal with their consumers, how output incentives output incentives could as far as possible mirror a competitive situation in terms of, for example, the financial impact of loss of market share resulting from poor practice
- the balance between the current focus on capex to more opex solutions – including potential for stronger consideration of commercial and operational approaches to network challenges and the potential for non network solutions (such as demand management)
- the importance of considering network companies business plans for the full eight years – looking at innovation, their abilities to plan for uncertainty, and the needs of future consumers
- how network companies could be judged on the quality of understanding of the consumers they serve rather than just the efficacy of their processes of stakeholder engagement
- striking the right balance in terms of the number of uncertainty mechanisms, recognising the impact of risk on network companies and consumers
- recognition that fast-tracking could be difficult to achieve but that proportionate treatment in itself, reflected in more tailored scrutiny, was a key incentive for companies to develop good quality business plans
- the emphasis on fuel poverty and the interests of vulnerable households
- viewing gas safety issues from a wider perspective than the HSE's iron mains replacement programme.

1.7. There have been two meetings of the CCG to date. The next meeting in January 2011 will discuss policy issues arising from the publication of this document.

Key issues highlighted by our stakeholder engagement

1.8. The key messages to highlight from our stakeholder engagement to date are:

Process

- In general, stakeholders support our approach to the RIIO-T1 review, and the key issues we propose to address. Some respondents raised concerns about the tight timeline of the review.

Outputs

- Stakeholders have been generally supportive of the development of primary outputs and believe the categories are broadly right. A number of stakeholders have proposed additional output categories including a category to minimise the volatility of network charges, a category to facilitate a low carbon economy and the need for a specific category in relation to vulnerable customers.
- Some stakeholders have expressed concern that there are not sufficient financial incentives being proposed to encourage network companies to play a role in delivering a low carbon economy.

Financial issues

- RIIO's financeability proposals remain a contentious area for network companies although, to date, no significant new issues (since those flagged as part of the RIIO consultation) have been raised by any stakeholders.

Uncertainty mechanisms

- There has been general support for our proposed approach to setting uncertainty mechanisms including the role and scope of the mid-period review. The network companies consider there are some areas where there should be additional uncertainty mechanisms while suppliers are keen to see the limited use of uncertainty mechanisms to minimise the volatility of charges.

Business plans and proportionate treatment

- In general respondents have welcomed the draft business plan guidance we published as part of the July open letter.
- Stakeholders strongly support proportionate treatment. Network companies have expressed reservations with the implications of fast-tracking and uncertainties over the process, the benefits and the implications for the review timetables.

Third party competition

- Network companies are against our recommendations that we may consider running a competitive process for the delivery and ownership of large separable assets. Other stakeholder groups have been more supportive of the anticipated benefits from competition, in particular the City.

Innovation

- Stakeholders are generally supportive of the proposals on innovation and particularly the extension of the innovation stimulus across transmission.

Appendix 6 - Summary of responses to July open letter

1.1. This chapter sets out a high level summary of the responses we received to our July open letter entitled 'Open letter consultation on Transmission Price Control Review 5 (TPCR5) – the way forward'. We received 14 responses to the TPCR5 open letter. This included comments from the three TOs, suppliers and representative industry bodies.

1.2. In this appendix we also outline how we have sought to address the points made.

General

1.3. In general, respondents have welcomed the approach adopted for the TPCR5 review, including our early approach to discussing the way forward with stakeholders and the use of working groups. Respondents also agreed with the issues that were highlighted as important to address as part of the TPCR5 review and noted further areas that we should also consider.

1.4. Respondents have highlighted continued support for the RIIO model although some raised concerns about how it would work in practice (in some cases highlighting the particular difficulties around implementing the model for the first time). The issues raised were typically similar to those highlighted as part of the RIIO recommendations consultation.

Our response/ steps taken

1.5. We welcome respondents' continued support for the RIIO model and our proposed approach to RIIO-T1. We note the concerns about how the model will work in practice and intend that this document should provide further clarity in this area.

Timetable / Milestones

1.6. The timetable set out as part of our open letter was generally seen as helpful by respondents but a number of respondents, including all of the network companies, expressed concern that it is tight and where possible flexibility should be introduced. A specific issue was that given this is the first time RIIO is implemented, more time would be desirable to develop well-justified business plans and identify primary outputs. The need for fast-tracking was questioned by a number of stakeholders, with several suggesting that it should be delayed until RIIO-T2 to free up more time in the process (further information on respondent views on fast-tracking can be found below).

Our response/steps taken

1.7. We note the concerns about the tight nature of the timetable for RIIO-T1. We recognise that the timetable is tighter in the early stages of the review than in previous controls. This timetable is necessary to enable us to adopt an approach to proportionate treatment that may enable some companies that submit particularly high quality business plans to be fast-tracked.

1.8. We note that some respondents felt fast-tracking should be postponed to a future control period. We consider fast-tracking is an important incentive as part of the RIIO package and that the benefits of retaining this approach for RIIO-T1 outweigh any downsides from a slightly tighter timetable.

Outputs-led framework

1.9. There was general support for the outputs-led approach (including the use of working groups) and the categories and principles for outputs that are proposed. A couple of respondents expressed concern around the use of incentives attached to the outputs could potentially make the regime more complicated, less transparent and reward companies' twice for areas obligated/incentivised elsewhere. Several respondents made specific suggestions around the design of primary outputs which we will feed into the appropriate working groups.

Our response/ steps taken

1.10. We welcome the support for the outputs-led framework. We recognise there will be some additional complexity associated with the use of incentives but we do not consider this will be less transparent. On the contrary, by requiring companies' performance to be measured against output delivery and also by requiring greater ongoing stakeholder engagement, we consider the adoption of an outputs-led framework will result in greater transparency.

1.11. We note the specific issues raised on the design of outputs. Our working groups which met on a number of occasions over the last six months have discussed these and a wider range of issues. A summary of the outputs from the working groups is available on our website.

Enhanced stakeholder engagement

1.12. Our commitment to enhanced engagement was widely welcomed by stakeholders, including the introduction of the price control review forum. Several respondents noted that we need to take steps to ensure that Ofgem's and network companies' consumer engagement is joined up to minimise resource requirements by ensuring efforts are not duplicated and stakeholders are not unduly burdened. Providing clarity on this area was seen as important.

Our response/ steps taken

1.13. We welcome the support for enhanced engagement. We recognise the concerns about the scope of engagement and needing to ensure it is joined up. This was the principal reason for the formation of the Price Control Review Forum (PCRF). A forum which is comprised of a range of stakeholders and which is tasked with pulling together all messages for the various forms of engagement.

Business plans and proportionate treatment

1.14. The inclusion of our draft business plan guidance in our open letter was widely welcomed by respondents. No opposition was registered to placing more onus on network companies and applying proportionate treatment to business plans.

1.15. The main area of disagreement was the use of fast-tracking. As noted above, there were concerns that the use of fast-tracking makes the timetable for the review very challenging. Other issues included the limited output data in the first round of the review and the level of uncertainty. Several respondents noted that fast-tracking would be better applied at RIIO-T2.

Our response/ steps taken

1.16. Again we welcome support on the business plan guidance. We have sought to provide further information in this document and the associated supplementary annex entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives'. We note the concerns on fast-tracking but, as noted above, we remain of the view that this is an important part of the RIIO framework with significant potential incentive benefits and important to introduce now rather than delaying to a future control. Further we note that fast-tracking is not the only element of proportionate treatment. There is also scope for companies to be subject to a lighter-touch regulatory approach which again should provide strong incentives to companies to produce good quality business plans.

Length of the price control, mid-period reviews and uncertainty mechanisms

1.17. Respondents highlighted that a move to an eight-year price control would require greater use of uncertainty mechanisms which could create additional complexity and charging volatility. A couple of respondents highlighted that we should introduce an uncertainty work stream to begin developing mechanisms. One network company expressed strong concern that, based on our timetable, this work should have begun already.

1.18. A couple of network companies noted the success of Ofgem’s enhanced transmission incentives scheme introduced as part of TPCR4 and suggested that this should be adapted to manage project uncertainty during TPCR5. As in the responses to RIIO recommendations consultation, there remained some concern about how the mid-period review would work.

Our response/ steps taken

1.19. We note the interaction between the length of the control and the scope of uncertainty mechanisms. We note that a longer control period does increase uncertainty but also that having too many mechanisms in itself is not in the interest of efficiency. We held a meeting with the network companies to discuss their views on these mechanisms and have highlighted these in the supplementary annex entitled 'RIIO-T1 and GD1 Uncertainty mechanisms'.

1.20. We note the work on transmission investment incentives and reflect the interactions with that work in this paper and the supplementary annex entitled 'RIIO-T1 Outputs and incentives'.

1.21. We note the concerns about the mid-period review. We share some of these concerns, particularly that it could undermine long-term signals if the scope of that review is too wide. We have sought to define a narrow scope for that review to minimise this downside.

Financeability

1.22. Network companies raised concerns about the RIIO financeability proposals, in particular, our approach around the areas of cost of debt indexation, determining the cost of equity and our deprecation policy impacting cashflows. These were similar issues to those raised to our RIIO recommendation consultation. Network companies were keen that we provide greater clarity on our financeability approach. One large energy supplier, however, welcomed the proposals to align depreciation profiles with economic lives, and the prospect for lower customer bills.

Our response/ steps taken

1.23. We note that our financeability proposals are an important part of the overall RIIO model and we have sought to provide greater clarity to stakeholders as part of this consultation to address their concerns. For example, we have set out how we propose to index the cost of debt as well our approach to measuring asset lives and our depreciation policy. We note that as part our consultation we are setting out our approach for the development of transitional arrangements to ensure that the cash flows of the network companies are not unduly impacted by the move to these arrangements.

1.24. We recently held a finance working group to discuss and understand key areas of concerns around our proposals. We note that financeability remains a contentious area for network companies and we will continue to work with them to ensure that what we a proposing will deliver the desired outcomes of the RIIO model.

1.25. We continue to believe that our approach to financeability, rather than deterring investors will encourage investment, through the provision of a commitment to a clear set of transparent principles.

Appendix 7 – Delivery of the environmental targets

1.1. The price controls have a central role to play in facilitating delivery of the environmental targets. The main elements are as follows:

(1) We set out proposals for outputs and incentives including:

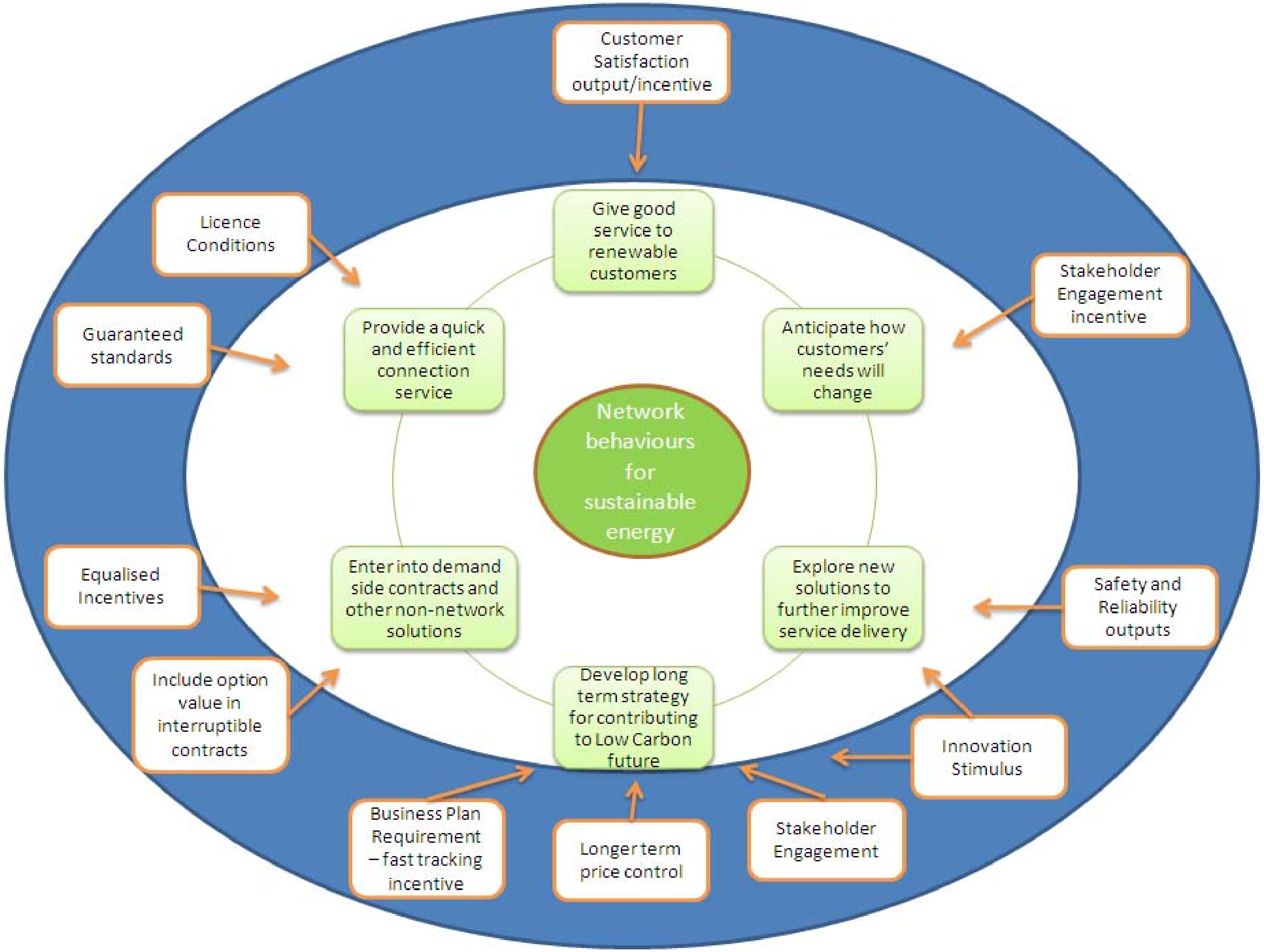
- connection standards - companies are required to consider the connection requirements of renewable energy producers and other new customer types that may emerge as we transition to a low carbon energy sector
- network reliability - companies are given incentives to consider using low carbon technologies and demand side management to meet capacity requirements
- customer service - incentives encouraging companies to be more outward focused to encourage them to be better at providing products and services that help customers adapt to the low carbon energy sector
- environmental outputs - incentives for network companies to reduce their own carbon emissions; requirements for companies to report their own carbon footprint; incentives on network losses; and outputs related to their contribution to meeting UK carbon reduction targets.

(2) We expect the companies, in developing their business plans, to set out how they will contribute to meeting the broader environmental objectives. We have factored environmental issues into the business plan guidance.[29]

(3) We are also designing an innovation stimulus which will provide financing for trialling of technologies relating to the delivery of a low carbon future. Further details are set out in chapter 7 of this document.

[29] July open letter, page 17.
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Open%20letter%20TPCR5%20way%20forward.pdf

Figure 1.1 - Elements of proposals aimed at facilitating the delivery of the environmental targets



Appendix 8 - The Authority's powers and duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008 and 2010) as well as arising from directly effective European Community legislation.

1.3. References to the Gas Act and the Electricity Act in this appendix are to Part 1 of those Acts.[30] Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This appendix must be read accordingly.[31]

1.4. The Authority's principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

1.5. The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with,

- the shipping, transportation or supply of gas conveyed through pipes
- the generation, transmission, distribution or supply of electricity
- the provision or use of electricity interconnectors.

1.6. Before deciding to carry out its functions in a particular manner with a view to promoting competition, the Authority will have to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner (whether or not it would promote competition) in which the Authority could carry out those functions which would better protect those interests.

1.7. In performing these duties, the Authority must have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met
- the need to secure that all reasonable demands for electricity are met

[30] Entitled "Gas Supply" and "Electricity Supply" respectively.
[31] However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them[32]
- the need to contribute to the achievement of sustainable development.

1.8. In performing these duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[33]

1.9. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed[34] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and secure a diverse and viable long-term energy supply, and shall, in carrying out those functions, have regard to the effect on the environment.

1.10. In carrying out these functions the Authority must also have regard to:

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.11. The Authority may, in carrying out a function under the Gas Act and the Electricity Act, have regard to any interests of consumers in relation to communications services and electronic communications apparatus or to water or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

1.12. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[35] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

[32] Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Acts in the case of Electricity Act functions.
[33] The Authority may have regard to other descriptions of consumers.
[34] Or persons authorised by exemptions to carry on any activity.
[35] Council Regulation (EC) 1/2003.

Appendix 9 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

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