



To transmission companies,
distribution companies, generators,
suppliers, customer groups and
other interested parties

*Promoting choice and value for
all gas and electricity customers*

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Date: 30 July 2010

Dear Colleague,

Open letter consultation on Transmission Price Control Review 5 (TPCR5) – the way forward

Following the Authority's decision to roll over the current transmission price control, both the next full transmission price control (TPCR5) and the next gas distribution price control (GDPCR2) are due to commence on 1 April 2013. TPCR5 and GDPCR2 will be run in parallel and will be the first controls to reflect the new regulatory framework resulting from our RPI-X@20 review.

On 26 July 2010, the Authority published its 'minded to' decision on the RPI-X@20 recommendations for consultation, which recommends the implementation of Sustainable Network Regulation using the RIIO model¹ (Revenue = Incentives + Innovation + Outputs). The RIIO model builds on the success of the previous RPI-X regime, but better meets the investment and innovation challenge by placing much more emphasis on incentives to drive the innovation needed to deliver a sustainable energy network at value for money to existing and future consumers. The Authority will take account of responses to the consultation before making its final decision on the new regulatory framework.

To enable us to implement Sustainable Network Regulation effectively for TPCR5, Ofgem and the network companies have recently initiated key work streams². We are proceeding on the assumption that the core components of Sustainable Network Regulation will stand. Should there be changes when the Authority makes its final decision, we will reflect these in our approach to the review.

This letter sets out Ofgem's thinking on the following areas:

- the key issues for the review,
- the proposed approach for developing thinking on outputs,
- the key elements of stakeholder engagement,
- guidance on the development of business plans, and
- the high-level timetable for the review.

This is not intended to be an exhaustive list of the issues for the controls. For example, there will also be work to develop the arrangements to enable greater third party involvement in the delivery of network projects and on the development of a gas and

¹ The consultation document on the RPI-X@20 recommendations can be found at the following link: <http://www.ofgem.gov.uk/networks/rpix20/consultdocs/Documents1/RPI-X@Recommendations.pdf>

² Ofgem has concurrently published a letter setting out thoughts on the key issues for GDPCR2. This can be found at the following link: <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=232&refer=Networks/GasDistr/RIIO-GD1/ConRes>

electricity innovation stimulus package. There are also other issues that may emerge as the review progresses.

The work to roll over TPCR4 is being taken forward separately from TPCR5. In June we published our decision³ on the scope of TPCR4 rollover alongside a consultation on a number of specific policy issues. A key focus of the rollover work is that it should be proportionate to a one-year price control.

Key issues for the reviews

There are a number of key issues that need to be considered for TPCR5. Some of these apply to both gas and electricity transmission whereas some are specific to one of the sectors. These issues are discussed at a high level below.

Electricity transmission issues

Network investment: A key issue remains the growth of generation from renewable sources. There are challenges in facilitating the growth and integration of renewable energy sources and accommodating changes to the overall power generation mix. There remains significant uncertainty over the volume, timing and location of such generation capacity. This uncertainty means it is difficult to be clear about the approach the transmission companies should take, including in the case of load-related investment. This presents challenges in determining primary outputs and secondary deliverables for the controls.

Asset replacement: There is likely to be a requirement for significant replacement investment in the electricity transmission networks in order to maintain high reliability levels. The challenge lies in setting appropriate allowances, outputs and incentives such that necessary asset replacement work is efficiently carried out, including in a longer-term context.

Gas transmission issues

Liquefied natural gas (LNG): The increasing reliance on imports is likely to continue to trigger new projects to deliver additional LNG import capacity and further storage capability. Changing patterns of supply, the decline of UK Continental Shelf (UKCS) production and the growth in imports mean that the existing network will continue to need investment in some areas whilst a decline in use will be seen elsewhere. This may result in low utilisation and asset redundancy for some parts of the network. The assumptions which have been used in determining the way that incentives and remuneration measures are designed have at their core an inherent assumption about future continued utilisation which may have to be reviewed to reflect these changes.

The increasing use of renewable energy sources for electricity generation may result in gas being the marginal fuel source for generation and this will have implications and create new challenges for the flexibility of the gas transmission system. There may need to be new incentives created in order to define these outputs and provide appropriate incentives.

Revenue drivers for incremental investment: The present incentives provide for an enhanced return for the network operator under the GB System Operator control for 5 years, and an adjustment after this time to the TO regulatory asset value (RAV), allowing for continuing remuneration of these new investments (assessed as economic and efficient) under the TO control for the remainder of the life of the asset. The structure and time frames for these incentives will need to be assessed to see if they are appropriate going forward. A further issue which may need to be addressed in TPCR5 is whether to adjust

³ Transmission Price Control 4 – Rollover (2012/13) Scope Decision and Consultation – 30 June 2010 Ref 78/10
<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/TPCR4%20roll-over/Documents1/TPCR4%20Rollover%20Scope%20Decision.pdf>

the current rules which trigger the release of incremental capacity and the ability for NGG to secure an entitlement to revenues in the event that new projects are delayed or do not materialise.

Gas and electricity transmission issues

Environment: In addition to the connection of new renewable generation, there are a number of other environmental issues that TPCR5 will need to consider. The arrangements should provide strong incentives to reduce emissions. Output measures may be appropriate in relation to emissions as well as in addressing noise pollution and visual amenity considerations. Generally the arrangements should encourage new research and development initiatives that bring environmental benefits.

Historical capex assessment: A major piece of work for the price controls will be to assess the efficient capex associated with very large investments which span more than one price control period. These are often large, complex projects of high value, which will need considerable resources to allow a robust assessment to be carried out.

TO/SO interactions: National Grid, in its role as GB System Operator (GBSO), incurs costs in managing constraints on the network and has incentives to manage those costs as part of the Balancing Services Incentive Scheme. However, constraint costs can also be affected by the action/inaction of the TOs. The issue is therefore to ensure that the three TOs consider the cost of constraints when making decisions, e.g. when planning outages on their systems. We will consider how best this is achieved for TPCR5. We will consider a range of options including incorporation of the SO regime as a whole within the TO price control framework. At a minimum, where applicable, the TO's business plans will need to reflect planned developments in this area, for example by including SO related developments.

Financial issues: There are a number of financial issues that will need to be looked at carefully during the TPCR5 review. In transmission these issues arise mainly from either application of the financeability proposals arising from RPI-X@20 recommendations or the recently concluded pensions review.

Determining what networks need to deliver – outputs-led regulation

Under Sustainable Network Regulation the focus is on delivering the outputs required for delivery of more sustainable networks at value for money. The recommendations document sets out six categories of outputs that network companies should deliver – safe network services, reliability and availability, timely and appropriate connection arrangements, customer satisfaction, environmental targets and social obligations – and the principles for setting the primary outputs within them⁴. The price control review will determine the primary outputs in each of these categories that network companies will ultimately be held to account to deliver.

Annex A includes a table that sets out our initial thoughts regarding the appropriate primary outputs for the Transmission Owners (TOs). We are building on the outputs developed for DPCR5 in a number of areas, including an overall measure of customer satisfaction, standards for connections and specific environmental measures. Substantial further work will be required to develop the detail of many of these outputs, and associated secondary indicators. We discuss in the next section our plans for working groups to further develop these outputs. **We would welcome views on the primary outputs suggested.**

⁴ Chapter 6 of our supporting paper on Sustainable Network Regulation provides further detail <http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Implementation.pdf>

Providing for enhanced engagement

Under Sustainable Network Regulation, stakeholder engagement features more prominently across all stages of the new price control process. The key responsibility would lie with network companies to make effective use of engagement in developing their plans. In relation to the Ofgem-led elements, it is intended that a multi-layered approach is adopted and that this will build on mechanisms that have been used in previous controls. The core components include:

- *Stakeholder Fora*: Existing fora should be opened up to stakeholders more widely to ensure the widest range of views is reflected.
- *Price Control Review Forum (PCRFR)*: This group will meet regularly during the review to provide input to Ofgem about a range of aspects of the price control. The group will include a broad range of stakeholder representatives. Annex B sets out draft terms of reference for this group for consultation. **At this stage we would also like to invite any parties with a particular interest in being involved in the PCRFR to indicate this and set out what they believe they could contribute to the group.**
- *Consumer Challenge Group*: We intend to form a group comprising consumer experts that will assist Ofgem in ensuring that the views of consumers are considered fully.
- *Working groups*: We are proposing to establish a range of working groups to review specific issues in depth. These groups will be convened for periods of the review to consider relevant issues. Our initial proposals for working groups are set out below.

In addition to these four main strands of Ofgem's stakeholder engagement, we will be undertaking research to establish consumers' views and willingness to pay on a range of issues. We have begun the process of seeking views on consumers' priorities for the networks. We have undertaken sessions with our Consumer First Panel of domestic consumers and intend to initiate qualitative research with business customers shortly. We will also continue to meet stakeholders bilaterally and to engage with representative groups during the review.

Developing further thinking on outputs - working groups

As a first stage in developing outputs for TPCR5, we propose to establish a series of working groups. These groups will identify and stress-test a set of primary outputs for each of the output categories, to provide clarity to TOs and other stakeholders on the way that performance in each of those categories would be assessed and used to incentivise delivery of outcomes. In addition, the groups will consider the requirement for secondary delivery indicators to provide further information on network company performance in delivering against the primary outputs. We envisage that the working groups will meet approximately monthly from August to November 2010, with the meetings chaired by Ofgem.

In the first instance we propose the following working groups:

- a TPCR5 working group on environmental issues,
- a TPCR5 working group on customer satisfaction and connection issues, and
- a TPCR5 working group on reliability and safety issues combined with a cost assessment working group.

There are currently no specific social obligations on transmission licensees, therefore we do not consider it necessary, at this point in time, to develop a specific working group to consider these issues but we expect the transmission companies to be prepared to develop output measures in this area if social obligations are introduced in the future.

In addition to the working groups focused on outputs, a joint TPCR5/GDPCR2 working group on financial issues will be established. We will also establish a working group for the Regulation Directors/Managers from the TOs to meet with Ofgem regularly on a range of issues and to consider overall issues regarding the progress of TPCR5. Both of these

groups are likely to remain in place for most of the review. It is the intention that all material generated by the groups is published on a designated section of the Ofgem website.

We propose that these groups should not be limited to network companies but should be open to wider stakeholders who can make a significant contribution to considering the issues. This reflects the principles of Sustainable Network Regulation and other work that has demonstrated the importance of encouraging wider 'third party' input at each stage. For example, we consider there should be specific customer representation at the customer satisfaction group. ***We invite any interested parties to indicate by 13 August if they would wish to be involved in any of the working groups set out above and to set out what contribution they could make to the group(s).***

Business plans and proportionate treatment

Under Sustainable Network Regulation, network companies will be required to develop well-justified business plans setting out their primary outputs and how they propose to deliver these. It will ultimately be for the companies to develop their business plans but we recognise that some additional guidance may be helpful in developing those plans. Annex C sets out some guidance on the form and content of well-justified business plans.

We would adopt a transparent and proportionate approach to assessing the price control package, with the intensity and timescale of assessment reflecting the quality of an individual company's business plan and its record for efficient output delivery.

Key milestones for the reviews

Reflecting each of the elements set out above, we have developed a proposed timetable for taking forward TPCR5. A high-level version of this timetable setting out the key milestones for the review is attached as Annex D.

Views invited

We would welcome views on any of the issues set out in this letter but particularly in relation to:

- the key issues we have highlighted for the gas and electricity transmission reviews,
- our proposed approach for taking forward the development of outputs and our initial thoughts on the primary outputs (Annex A),
- our proposed approach to stakeholder engagement including our draft terms of reference for the PCRF (Annex B),
- our high-level business plan guidance (Annex C), and
- the key milestones we have highlighted for the two reviews (Annex D).

We would welcome responses to this letter by 30 September 2010. Unless clearly marked as confidential, responses will be published on our website.

Yours faithfully,



Hannah Nixon
Partner, Transmission

Annex A: Potential primary outputs

The following table sets out our initial views on potential primary outputs for TPCR5. It is noted that there is no entry for social obligations as there are currently no social obligations applicable to transmission.

Indicative primary outputs – Electricity and gas transmission

Output category	Primary outputs
Environmental impact	<p>Help to minimise the environmental impact of our operations and of users on the network by:</p> <ul style="list-style-type: none"> • contributing to environmental targets; • taking into consideration and where appropriate seeking to minimise the visual impacts of infrastructure; • minimising business carbon footprint; and • minimising other emissions.
Reliability and availability	<p>Maintain operational performance for existing and future customers by:</p> <ul style="list-style-type: none"> • responding to incentives to meet targets for reliability; • consideration of multiple reliability trajectories, with the selected trajectory informed by customer feedback; • meeting required standards of asset health, building on the work undertaken during TPCR4; and • achieving long-term congestion targets for the TPCR5 determination period.
Conditions for Connections	<p>Connect users and suppliers of energy in a timely manner and provide high quality information, in a transparent way, on the conditions of connection measured by:</p> <ul style="list-style-type: none"> • compliance with licence requirements; • developing a time of delivery metric over and above licence requirements; • consider adjustment for factors partly/wholly outside companies control, e.g. planning process; and • possible review of information reporting requirements.
Customer Satisfaction	<p>Maintain levels of customer satisfaction by implementing a broad measure of customer satisfaction including:</p> <ul style="list-style-type: none"> • undertaking a customer satisfaction survey covering areas such as interruptions, connections and general enquiries; • developing a complaint metric; and • undertaking stakeholder engagement to better understand what stakeholders want from their network companies.
Safe network services	<p>Operate a safe network by maintaining compliance at all times with the legal safety requirements determined and enforced by the Health and Safety Executive including those under the Electricity Safety, Quality and Continuity Regulations 2002, the Gas Safety (Management) Regulation, the Control of Major Accident Hazard (COMAH) Regulations and the Pipeline Safety Regulations.</p>

Annex B: Draft terms of reference for the Price Control Review Forum

Purpose

- To provide the opportunity for network companies and their stakeholders to feed directly into the price control review process either on specific issues or across a wide range of issues;
- To allow Ofgem and network companies to hear firsthand the views of interested parties; and
- To afford an opportunity for different stakeholders to exchange views and discuss tradeoffs that need to be made in the review.

The forum's role is advisory and while Ofgem will consider the views raised in the PCRf there is no obligation for Ofgem to accept the views raised by the group. Representatives on the group are also encouraged to make separate responses to Ofgem's price control consultations.

Scope

- The PCRf will meet at key points in the price control review process;
- Members will be able to learn about and comment on research done by GDNs/ TOs and Ofgem;
- It provides an opportunity for other members to table papers for discussion;
- Members will get updates from Ofgem on emerging thinking and will have the opportunity to discuss and influence our thinking; and
- The PCRf will enable GDNs/TOs to give presentations on their businesses and business plans.

Role

The PCRf:

- provides an opportunity to bring together all aspects of engagement as representatives on the group may also be engaged in other stakeholder engagement fora;
- is a forum for discussing issues for Ofgem to evaluate its outputs and incentives proposals and for Network Operators to evaluate their business plans (although much of this will be the responsibility of network operators in their own engagement); and
- is an opportunity to discuss the trade offs in light of competing stakeholder interests and to fully understand the reasons behind different views.

Objectives

For forum

- Review Ofgem's and network operators' research findings; and
- Provide feedback on Ofgem's emerging thinking.

For Ofgem

- Opportunity for Ofgem to explain how our proposals are being shaped by industry views.

For network operators

- GDNs/TOs present the feedback they are getting from their own stakeholder engagement;
- Provide information on how they run their businesses to facilitate better understanding among the stakeholders to enable them to effectively engage; and
- Provide their views on Ofgem's proposals.

Questions for the PCRf

We intend to seek the forum's views on a range of policy issues and in particular would be grateful for participants' views on the following questions for the first meeting:

- What are the priority issues we should address for the gas distribution and transmission price controls?
- What outputs (outcomes) are you looking for from the GDNs/ TOs?
- Should we have separate meetings for gas distribution and transmission?
- Which are the areas that we need to focus on in terms of incentives and outputs?
- What would you like to see on future agendas?

Membership and structure

Chair and secretariat functions of the PCRf are discharged by Ofgem. We intend to develop the agenda and papers for the PCRf and will circulate a draft agenda two weeks before a PCRf meeting seeking views from attendees about any other issues they would like to raise or present at the meeting. We will circulate a final agenda and the papers one week before the meeting. We will take minutes of the meeting and aim to circulate them to members two weeks after the meeting for comment before we publish them on the Ofgem website.

We aim to have the following key stakeholders represented on the group:

- Network operator representatives (possibly one GDN and one TO nominated from the ENA);
- Gas and electricity companies such as electricity producers, gas shippers, gas and electricity suppliers, renewable generators, independent connections providers etc;
- Gas and electricity users such as small/ medium user representatives, local authority, development agency, vulnerable customer groups;
- Government representatives to advise of government policy such as DECC and HSE;
- Special interest groups such as environmental representatives and area of outstanding natural beauty representatives; and
- Others such as academic advisors.

We would expect the representative on the group to be responsible for reporting back to the group he/she represents, so for example the shipper representative would report back to all shippers and represent all shipper views on the group and not just their own company interests.

Dates of meetings

The PCRf will meet in advance of publication of price control documents (October 10, February 11, October 11, January 12, June 12, October 12) and may convene additional meetings if appropriate.

Nominations

As set out in the covering letter, Ofgem would welcome stakeholders expressing an interest in being in the PCRf. After considering expressions of interest, Ofgem will approach representatives to join the group.

In their expressions of interest stakeholders should include information on:

- who they represent;
- what their interest in the price control review is;
- how they will co-ordinate the comments they receive from the stakeholders they represent and how they will feedback the discussion from the PCRf meetings;
- whether they have experience of undertaking a similar role before; and
- what they can bring to the group.

Annex C: Business Plan Initial Guidance for TPCR5 and GDPCR2

1. Introduction

- 1.1. Our forthcoming price control reviews in electricity and gas transmission (TPCR5) and gas distribution (GDPCR2) are the first reviews to incorporate the RPI-X@20 recommendations.⁵ Under Sustainable Network Regulation, we expect the network companies to submit well-justified business plans. In addition, we would adopt a transparent and proportionate approach to assessing the price control package, with the intensity and timescale of assessment reflecting the quality of an individual company's business plan and its record for efficient output delivery.
- 1.2. We anticipate a complete business plan at Stage 2 of the process (July 2011) (see Annex D for key milestones). Network companies should set out what they intend to deliver, how they intend to deliver it and their view on the cost of delivery, reflecting enhanced engagement and taking account of Ofgem's strategy for the review. Then at Stage 3 (Jan 2012) (unless fast-tracked) network companies will submit a revised business plan reflecting comments and queries raised by Ofgem, potentially updated views from stakeholders, and the further year's data (if relevant).
- 1.3. The plans put forward by network companies will, to a large degree, inform our assessment of the level of outputs they will be required to deliver and the associated revenue to be earned from consumers.
- 1.4. The rewards associated with producing a well-justified business plan were set out in our RPI-X@20 recommendations consultation document.⁶
- 1.5. The development of well-justified business plans will also act in the interests of consumers both now and in the future. This is because to be well-justified the plan will clearly present what the network company will deliver and demonstrate through a range of evidence that this delivery is likely to be consistent with providing long-term value for money to existing and future consumers. It will also provide opportunities to inform the assessment of other companies' plans.
- 1.6. A well-justified plan is not necessarily longer or more detailed than current plans. Instead, it needs to be transparent and focused on what is to be delivered, providing relevant evidence that the approach proposed is likely to deliver long-term value for money. This initial guidance provides more details on how this might be achieved.
- 1.7. While network companies will need to include evidence of considering different ways of delivering within their plans, we would expect a well-justified business plan to include the decision the company came to and justification. We are not expecting a well-justified business plan to contain a range of scenarios where the company has not come to a view on which one to follow.
- 1.8. This guidance provides an early indication of the work involved in producing a well-justified business plan. It particularly focuses on some of the new aspects published in the RPI-X@20 recommendations document on 26 July 2010. It should not be read as providing everything needed for a well-justified plan.
- 1.9. In particular, this guidance does not provide details or make a specific request for data. This will continue to be an important part of our ongoing planned work and more details of the data required and associated narrative will be produced between now and

⁵ Ofgem, Regulating energy networks for the future, RPI-X@20 recommendations, July 2010. This is available on our website at <http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RPI-X@Recommendations.pdf>.

⁶ See particularly Chapter 7 of Regulating energy networks for the future: RPI-X@20 Recommendations: Implementing Sustainable Network Regulation. This is available on our website at <http://www.ofgem.gov.uk/NETWORKS/RPIX20/CONSULTDOCS/Documents1/Implementation.pdf>.

December 2010 when we intend to produce our initial strategy consultation documents (see Annex D). This will include data to support our assessment of efficient cost. New data is likely to be needed to support the comprehensive outputs proposed to be included in future price controls.

1.10. This guidance should be seen as the first stage in work between now and the December consultation on which we will work with companies to understand how to get the best out of these plans. We intend to publish the final business plan guidance and associated tables for the two reviews in March 2010.

2. Purpose of initial guidance

2.1. In our RPI-X@20 recommendations consultation⁷ we set out what we expect a network company to include in a well-justified business plan. This business plan initial guidance provides further detail on a number of aspects of a well-justified business plan to assist the network companies that are starting work on their plans for TPCR5 and GDPCR2. It examines:

- **content**; particularly what the central elements that need to be included in the plan are and how they interrelate;
- **longer-term context**; provides details of how delivery and required expenditure should be set in a longer-term context;
- **primary outputs**; how comprehensive outputs need to be transparently presented in the plan, supported by evidence from enhanced engagement;
- **output justified expenditure**; how the plan should set out the impact of these outputs on required expenditure for the control period;
- **secondary deliverables**; where a company is proposing that expenditure is needed to support delivery of outputs in future periods including through management of network risk, or to support innovation projects;
- **different types of evidence**; more information on the types of evidence likely to be helpful / unnecessary;
- **engagement with stakeholders and joint working**; what evidence is there that engagement with stakeholders has taken place and that the company has made effective use of this in developing what they will deliver and the approach to delivery (including over the long term);
- **proportionate approach**; emphasis on the proportionate basis that network companies should follow when putting the plan together e.g. needing significantly stronger evidence relating to the most material elements of expenditure;
- **company views on key parameters influencing outputs and revenue requirements**; details of what the network company might provide on key parameters that impact on its view of the revenue it argues is needed to efficiently deliver primary outputs (with evidence to justify these views). This will include, for example, views on risk, financing costs and wider incentives arrangements; and
- **other issues**; including consideration of confidentiality.

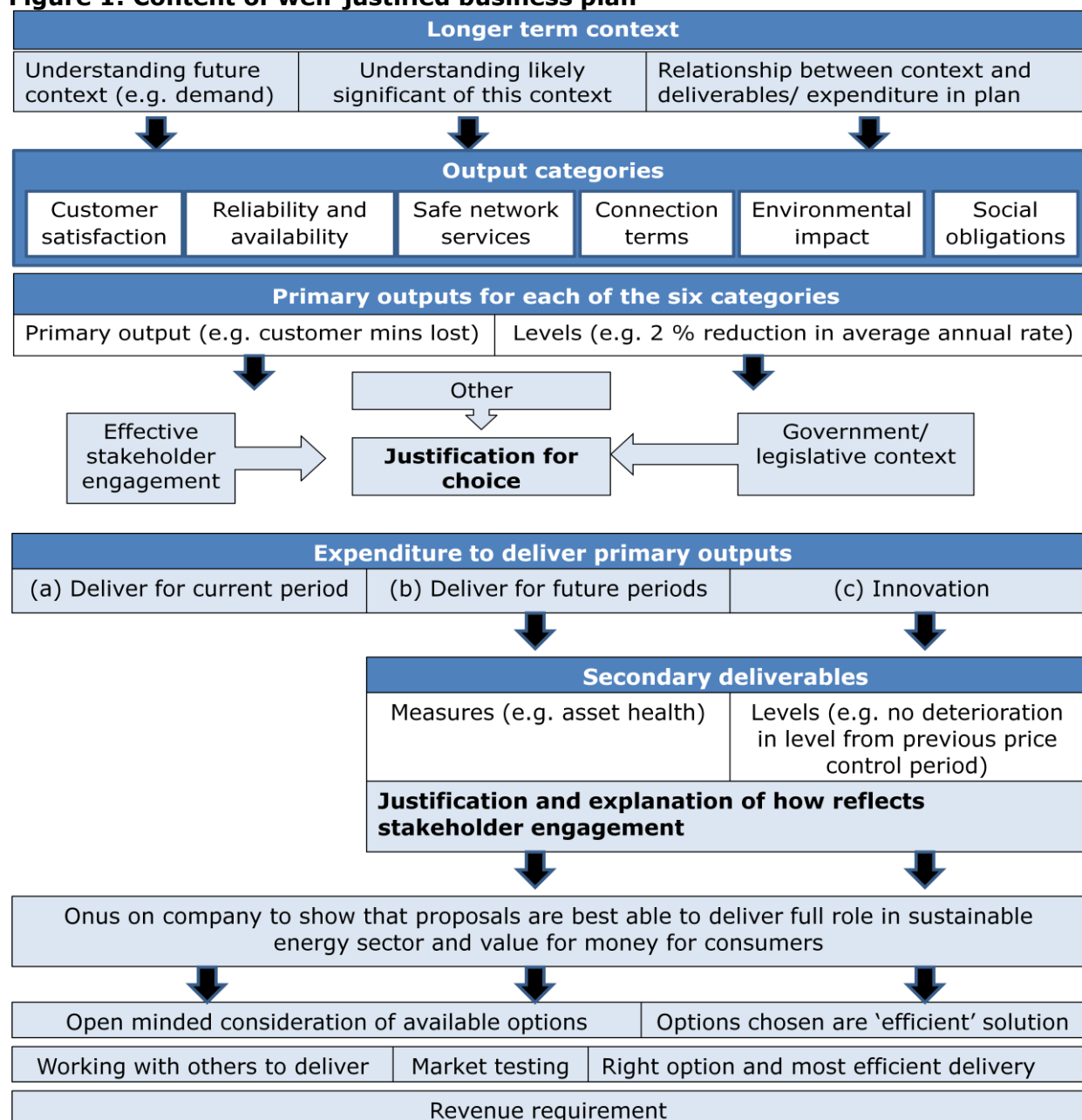
⁷ <http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RPI-X@Recommendations.pdf>

3. Initial guidance

Content

3.1. We do not want to prescribe a template for what a well-justified business plan looks like. This is because it will in part depend on the context and should allow the particular network company sufficient flexibility. However, there are some central components, which are likely to form part of any well-justified business plan. These include consistency and transparency of information in order to facilitate efficient assessment (i.e. so that each companies plan follows broadly the same structure) and benchmarking of forecast and historical costs. Figure 1 exemplifies the expected content of a plan, set out in an order that reflects how we and network companies and stakeholders will be considering issues, starting with outputs and a long-term context. Each component is explained in more detail elsewhere within this initial guidance.

Figure 1: Content of well-justified business plan



Longer term context

- 3.2. As Figure 1 shows, the business plan needs to be set out in longer-term context both applicable to what is to be delivered and how (including the resulting expenditure). This is about network companies setting out their longer-term strategy for playing a full role in delivery of a sustainable energy sector and delivering long-term value for money, reflecting expectations of the nature and scale of future demand for network services.
- 3.3. The plan needs to set out the longer-term context of the company's plan – setting out what it does, what its operating environment looks like, what challenges and opportunities it faces over the long term, etc. – and the long-term strategy of the business, including how it would respond to changes in the context. This might include forecasts of volume/demand for network services. This is key to longer-term context/longer-term thinking and should be upfront to provide context for the rest of plan. It also needs to be informed by the company's view of different possible future scenarios and show how its plans are robust to these. For example, on the transmission side, the longer-term context would also need to consider developments in understanding the interactions between the System Operator (SO) regime, including SO external incentives, and the TPCR framework. Where applicable, the TO's business plans will need to reflect planned developments in this area, for example by including SO related developments.
- 3.4. There is no single definition of what 'longer-term' means in this context. It will be the task of the network company to consider the time horizon most relevant to particular delivery outputs and expenditure plans. However, the context of the environmental targets, e.g. the carbon reduction target for 2050, and the asset lives will be important influences. In some cases, or in relation to some aspects of a plan, e.g. asset management strategy, the justification is generally expected to include an understanding of whole life costing of the assets.
- 3.5. Essentially the different aspects will combine in a rolling longer-term context that will be updated over time but where updates are fully justified.
- 3.6. A well-justified business plan will need to set out the company's long-term strategy for delivery which should be informed by expectations of:
- demand;
 - entry/exit;
 - economy; and
 - technological change.
- 3.7. Clearly, there will be uncertainty about aspects of the operating conditions that network companies expect to face over the price control period and over the longer-term. As part of their long-term business strategy we would expect them to demonstrate how they have taken account of the uncertainty when developing their proposed plan for delivering primary outputs and long-term value for money. As part of this, they would need to set out how they intend to manage uncertainty over the short- to medium-term, including for example keeping options open and trialling new ideas through innovation projects (either in the business plan or through the innovation stimulus package).
- 3.8. This means considering expenditure that they would need for the duration of the control but also the implications that this would have on required investment and associated efficiency beyond the control period. They would be expected to include expenditure for the price control period where this is needed to ensure long-term value for money delivery of primary outputs in future price control periods and/or is needed

to meet anticipated (but potentially uncertain) demand for network services in the future. They would also be expected to justify expenditure in the control period in the context of a longer-term strategy, most notably in the context of a long-term asset management strategy (likely to include forecast costs beyond the control as well as using a longer context to explain the costs within the control period).

- 3.9. We would also encourage network companies to include innovation projects in their core business plan, for example R&D activity, and explain how they are expected to have the potential to deliver long-term value for money. We would expect the network company to set out what the project is and how they intend to take account of, and potentially share, lessons learned from any projects that do not deliver expected benefits.
- 3.10. This long-term context will provide a starting point for discussion and assessment at future price control reviews. In reality circumstances will change. Where the actual context deviates significantly from the context given at the previous review, this materially affects the long-term context of what is being delivered, and expenditure plans for future control periods. We would expect companies to note and explain why strategies are changing and we would expect the impact of these changes for the future control period to be a key part of the assessment.

Primary outputs

- 3.11. We will set out the required level of primary outputs for each sector in our Strategy decision document (March 2011), reflecting work undertaken with network companies and input from key stakeholders.
- 3.12. The primary outputs are in six categories:
- customer satisfaction;
 - reliability and availability of network services;
 - safe network services;
 - connection terms;
 - environmental impact; and
 - social obligations.
- 3.13. Within these categories, Ofgem and the network companies will work in the early stages of a price control review considering what should be included as a relevant methodology for assessing delivery in each of these categories. For each category, this may include a single quantitative measure, a combination of such measures or it might include measures and more qualitative indicators. The decision should, subject to proportionality (see below) be based on comprehensively reflecting what consumers and other stakeholders want the network companies to deliver. Where the decision in the business plan deviates from the views of stakeholders this should be clearly explained.
- 3.14. Ofgem will set out in its Strategy documents the primary outputs and a level of performance. A network company will need to set out in its well-justified plan how it intends to deliver that level, demonstrating that the proposed approach involves efficient delivery over the long-term.
- 3.15. The network company may also wish to set out an alternative level for one or more of the primary outputs – either higher or lower than the level specified in the Strategy documents. In these cases the network company would need to justify, with support from stakeholders where appropriate, why delivery of a different level would be consistent with playing a full role in delivery of a sustainable energy sector and delivery

of long-term value for money. When doing this the network company may wish to set out their review on incentive schemes associated with primary output delivery. Clearly at this stage it will also be important for the company to demonstrate to (and discuss with) stakeholders options for variations in the outputs level and the cost implications. This would be a focused engagement examining output variations and cost implications.

Linking expected expenditure to delivery of primary outputs

3.16. There should be a **clear link between expected efficient expenditure and primary outputs**. Where possible the company should demonstrate how the revenues that it would raise from consumers would allow it to deliver the primary outputs including:

- where possible, total cost of delivering the particular output on a standalone basis or total costs related to a business strategy (e.g. asset maintenance strategy);
- cost interactions from delivery of outputs together;
- costs related to innovation projects that are related to delivery of long-term value for money; and
- the cost impact for each primary output of a small change to the level of that output.

3.17. For high value projects, or projects where there is uncertainty about what is needed the network company should set out details of how costs might vary under different scenarios and signal what the 'base' assumption was underpinning their expenditure forecast. They may also wish to set out how they propose to manage the uncertainty around that base forecast.

3.18. Network companies should decompose their expenditure forecasts into:

- the minimum expenditure needed to deliver primary outputs during the upcoming eight-year price control period; and
- any additional expenditure requirements identified to ensure that primary outputs can be delivered over the long-term at value for money.

3.19. This expenditure should be identified as necessary to fund proposed secondary deliverables. The plan should set out how these secondary deliverables contribute to primary output delivery over the long term.

Engagement with stakeholders and joint working

3.20. A well-justified plan should demonstrate effective engagement with a range of stakeholders. The company would be expected to demonstrate how they have taken account of the views of stakeholders in developing their plan, setting out what engagement was undertaken and how the engagement informed the company plan.

3.21. Effective engagement is not a box ticking exercise or about the number of meetings or stakeholders addressed. Instead it is about obtaining information about stakeholders' preferences and likely future needs and determining the deliverables and proposed approach in the plan reflecting this.

3.22. Clearly, stakeholders will have diverse views and part of demonstrating effective engagement is about showing justification for taking these diverse views and developing a plan for the control period showing how the views influenced the plan and explaining in other areas why you came to a final view in disagreement with particular stakeholders. Another important element of stakeholder engagement is about gaining intelligence about future developments in relevant markets, e.g. local housing demand,

development of industry in certain areas to inform planning. Clearly network companies in balancing stakeholder demands will need to consider their statutory obligations.

3.23. It should also **identify opportunities from working with others**. Network companies would be expected to show that they considered whether and how to work with others in the industry or in other sectors (e.g. communications companies) to identify potential joint solutions that may provide long-term value for money.

3.24. If companies decide not to work with others where working together is possible, the reasoning will also need to be justified.

Secondary deliverables

3.25. **The plan will also need to identify any secondary deliverables** that might be included to support the sustainable delivery of the primary outputs at value for money; including:

- what they are;
- why they are needed; and
- how each are proposed to be used during the control period.

3.26. While the primary outputs will be (as the name suggests) the key deliverables by which the network companies are held to account, these secondary deliverables are needed where the network company determines that one of the justifications set out in paragraph 3.27 below are met). In some cases, Ofgem might suggest the inclusion of a secondary deliverable in our strategy document (see Annex D) and in any case we will look for justification for not including such a deliverable as well as seeking to understand the supporting reasoning when included in a company plan.

3.27. The three justifications we identified in our RPI-X@20 review for secondary deliverables were:

- **managing network risk** to ensure that delivery of primary outputs in future periods is not put at risk by decisions made in the price control period;
- **projects for delivering primary outputs in future periods** with action taken during the price control period; and
- **technical and commercial innovation project**, or other projects which require upfront costs but have the potential, with some uncertainty, to deliver benefits in terms of long-term value for money in future periods.

Different types of evidence

3.28. We are looking for a well-justified business plan to include at least the following evidence.

- **a clear and well-evidenced case for their proposals**, this should include:
 - demonstrating that network companies proposed outputs and proposed approach to delivering outputs is the best option for playing a full role in delivering a sustainable energy sector and providing value for money for consumers;
 - providing robust evidence to support the efficiency of their proposed approach both in terms of the option chosen and delivery efficiency. This is likely to include the long-term costs (where relevant), the impact on delivery of primary outputs and associated degree of risk with these, and any margin of error in relation to assumed demand for network services;

- comparative efficiency evidence including benchmarking and other activity based cost comparisons using both internal and external evidence such as wider industry comparisons or comparisons against other sectors; and
 - market testing of a range of activities; we would expect network companies to explore and exploit potential opportunities by market testing proposed delivery solutions where this is expected to provide value for money. This might include evidence from the costs of a joint venture or running a competitive process to procure services to maintain assets from a third party.
- **demonstrate an open-minded consideration of available options:** the company would need to show that they had considered alternative ways to deliver outputs, where relevant, and provide evidence to support that their preferred approach is long-term value for money. For example, they would be expected to consider whether to pursue a capital investment solution or an operating cost solution. In some cases a full cost benefit analysis might be appropriate but this will depend on the scale of the activity following our proportionate approach (see below). They would also be expected to identify synergies across projects, where these can provide long-term value for money without jeopardising delivery of primary outputs.
 - **show that its proposals are value for money:** the company should demonstrate how its proposed approach would ensure the delivery of value for money for consumers over the long term, having considered all of the other options available. This may involve seeking to keep options open for future development of the network where this would deliver value for money for existing and future consumers (see below).
 - **consider keeping options open** where consistent with longer-term value for money e.g. where it allows information to be obtained that reduces uncertainty or enables synergies to be identified.

Environmental costs/benefits

3.29. As well as through primary outputs related to the environmental impact of the network, we will expect to see evidence that companies have considered the environmental cost/benefit implications associated with proposals in the business plan.

Supporting evidence

3.30. Evidence in a well-justified business plan should meet the following principles:

- succinct and concise;
- accessible to a broad audience;
- proportionate (see below); and
- clearly labelled (including data submissions e.g. clear price base/ spreadsheet structure).

3.31. However model answers should be avoided. A key part of the evidence sought is that genuine consideration of different ways of doing things but also of the company's justification for the final approach chosen.

3.32. We do not think that plans should necessarily be longer in the future but this will only be possible where the plans are focused and relevant. We highlight from the start that there are a number of risks in providing excessive information including:

- it increases the likelihood that well-justified arguments are hidden and therefore not recognised; and
- the justification for limiting focus of options will be an important part of the evidence of a company likely to deliver longer term value for money.

Proportionate plans

3.33. The well-justified business plan should be based on the principle of proportionality. More material justification and evidence will be needed to support more material expenditure (see proportionate approach below). While in general the plan will not be at project or programme level, it is likely that some projects/programmes will be of sufficient scale (or perhaps involve particularly innovative approaches which might suggest higher risk) that additional detail will be sought. In these cases primary output information might need to be supported by further details.

3.34. The RPI-X@20 recommendations proposed a proportionate approach to the assessment of efficient costs within a price control. While this has material implications on the way Ofgem will assess costs, it also has implications on the form and content of a well-justified business plan.

3.35. There is a greater onus for the companies to specify:

- what they propose to deliver and why;
- what this means in terms of expenditure and why (including evidence why costs are efficient); and
- implications for revenue required.

3.36. However, in putting the plan together the company should use a proportionate approach. This is likely to involve more detailed evidence where there is:

- higher levels of spend;
- greatest uncertainty;
- innovation (new ways of doing things) involved; and
- action being taken to anticipate the needs of others.

Company views on key parameters

3.37. In support of its outputs and required revenue a network company should set out its views or assumptions on a number of aspects of regulatory methodology. This is likely to be constrained by the initial view of the methodology that we intend to set out in our 'Strategy' consultation. This should reflect the companies' understanding of the plan as a whole, e.g. its financing implications. These may also be used where the company is fast-tracked. Key parameters will include:

- **uncertainty;** explain how they propose to manage uncertainty and how they think this should be reflected in the price control package;
- **incentives;** implications of Ofgem's proposed incentives for decision on what to deliver and how best to deliver, including views on how alternative strategy might be adopted with different incentives;

- **risk and financing implications of package;** provide a view of the necessary financing costs required to attract and retain investors to support the activities in this plan, taking a view on the risks implied; and
- **licence conditions;** where licence conditions would need to be altered to reflect differences in the company's plan from the sectoral baseline outputs, it would be helpful for the company to include an indication of how this difference might be reflected and implemented in its licence.

Confidentiality and communication of plans

3.38. There are benefits in publishing as much of the information as possible. This will allow best practice to be shared across the industry quickly, facilitate the transfer of other relevant information and provide transparency to the network companies' customers and other stakeholders. However, we recognise that there may be some types of information included within the business plans where there is a case to retain confidentiality e.g. property/employment changes.

3.39. In such cases the network company would need to clearly identify the information and explain the justification for retaining confidentiality

3.40. To engage effectively with stakeholders, network companies will have to be able to provide the means for understanding the impact of the revenue level proposed on charges given the prevailing charging structure at the time of the price control period.

Next steps

3.41. We will continue to discuss these issues with the companies before the Strategy documents are published. We will also produce detailed data tables for populating as part of the business plans.

Annex D: Key milestones for TPCR5

Date	Key Milestone
July 2010	Publication – Open letter consultation on the way forward for TPCR5
July–Nov 2010	Meetings of outputs working groups (developing primary outputs and further thinking on business plans)
October 2010	1 st Meeting of the Price Control Review Forum
Dec 2010	Publication - Initial strategy consultation document (including draft business plan templates)
February 2011	2 nd Meeting of the Price Control Review Forum
March 2011	Publication – Strategy decision document (including business plan templates)
End July 2011	Submission of business plans
October 2011	3 rd Meeting of the Price Control Review Forum
Dec 2011	Publication – Consultation on Authority fast tracking decision (if applicable)
January 2012	Revised business plan request sent out to non fast-tracked companies
January 2012	4 th Meeting of the Price Control Review Forum
February 2012	Publication - Authority fast tracking decision (if applicable)
April 2012	Final business plan submissions (non fast-tracked companies)
May 2012	5 th Meeting of the Price Control Review Forum
July 2012	Publication - Initial proposals (non fast-tracked companies)
October 2012	6 th Meeting of the Price Control Review Forum
November 2012	Publication - Final proposals (non fast-tracked companies)
April 2013	Commencement of price control period