To generators, shippers, suppliers, network companies, consumers and their representatives, the sustainable development community, investors and other interested parties.

Promoting choice and value for all gas and electricity customers

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Date: 21 December 2012

Dear colleague

RIIO-T1: Final Proposals update letter in respect of the statutory consultation on the licence modifications for SP Transmission Ltd and Scottish Hydro Electric Transmission Plc

Ofgem has today published a statutory consultation on the proposed modifications to the electricity transmission licences, pursuant to section 11A of the Electricity Act 1989. These are necessary to implement the RIIO-T1 electricity transmission price control proposals that we published on 23 April 2012 for SP Transmission Ltd (SPTL) and Scottish Hydro Electric Transmission Plc (SHE Transmission)[1] and on 17 December 2012 for National Grid Electricity Transmission Plc.[2]

In respect of SPTL and SHE Transmission, as the Final Proposals were published in April 2012, there are a number of areas where we are providing an update on our positions in the statutory consultations being published today. The purpose of this letter is to outline those areas.

The areas covered by this letter are:

- Financial updates
- Office of National Statistics (ONS) review of RPI
- Sole Use Exit Connections
- Close out of existing Transmission Investment for Renewable Generation (TIRG) schemes
- Disposals from RAV
- Pensions principles
- Tax trigger deadbands
- Stakeholder Satisfaction Output
- Network Access Policy (NAP)
- Incentive level of Sulphur Hexaflouride (SF_6) and Energy Not Supplied (ENS)
- Initial expenditure cap for visual amenity in designated areas
- Sub-sea cable maintenance – SHE Transmission only
- Network Replacement Outputs – SHE Transmission only

[1] RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd – April 2012 http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/SPTSHETLFP.pdf
[2] RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas – December 2012 http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/1_RIIOT1_FP_overview_dec12.pdf

Financial

As indicated in the Final Proposals Finance Supporting Document[3] for NGET and NGGT (paragraph 5.30) we have updated some values for SPTL and SHE Transmission to reflect more current data (in effect avoiding a true up process at a later date). The changes we have made to data can be summarised as:

- reflecting 2011-12 data relating to expenditure (on a provisional basis), RPI and tax opening pools
- updating the cost of debt to reflect the initial index to be used for RIIO-T1 ie 2.92%
- updating the forecast expenditure on Transmission Investment in Renewable Generation (TIRG) projects
- updating the TPCR4 pension true up (if these values need to be further updated this will be reflected following the first triennial pensions review)
- amending allowances for latest information on the Western HVDC link and the Series compensation project
- updating the forecast for RPI to 2.8%
- updating the forecast corporation tax rates in line with the Chancellor's Autumn Statement.

The impact of these changes on the 'Best View' for SPTL and SHE Transmission set out in our Final Proposals is shown in Appendix 1.

Office of National Statistics (ONS) review of RPI

We published a consultation on 30 October on how we should address any changes to the retail prices index (RPI) arising from the Office for National Statistics (ONS) review of its RPI methodology.[4]

Following our review of responses, we set out a commitment within NGET's and NGGT's Final Proposals to consult on this issue in the event that the ONS makes a change to the way it calculates RPI. The reason for our proposed approach is that the effect of any change on network companies is difficult to assess at this stage, and as a consequence it is difficult for us to write a complete licence condition which captures the range of potential changes that we might need to make to the Price Control Financial Model (PCFM) to implement changes to the price control settlement. By setting out a commitment in Final Proposals, we also ensure that we can clarify the position for all network companies at the same time, rather than individual licensees making reopener applications.

Our review of potential changes to the price control settlement following the ONS decision on the RPI methodology will be subject to the following process:

- Following the announcement of any change to the RPI index by the ONS, we intend to publish a consultation in relation to the impact of the ONS decision on the price control settlement (taking into account our statutory duties, including our principal objective to protect consumers' interests and our duties to have regard to the need for licensees to finance their regulated activities and to promote efficiency and economy on their part). We expect to publish our consultation within 6 months of any decision by the ONS to change the RPI methodology. That is, assuming the ONS publishes its decision by January 2013, we would expect to publish a consultation document by August 2013. If we do not publish a consultation within 6 months of a decision by the ONS, we will write to the companies setting out our revised timetable for consultation.

[3] RIIO-T1: Final Proposals for NGET and NGGT – Finance Supporting Document
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/4_RIIOT1_FP_Finance_dec12.pdf
[4] RIIO-T1 and GD1: ONS review of Retail Prices Index methodology (Oct 2012):
http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=329&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes

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- Consistent with the definition of RPI in the Special Conditions of each licence, following any change to the methodology for calculating the RPI, we will use the "revised" RPI determined by the ONS to set allowed revenues. For the avoidance of doubt, we will use the "revised" RPI even in the event that the ONS continues to publish an RPI measure based on its existing methodology. However, we will consider within our consultation the option of retaining the use of an RPI based on the existing methodology (for the period for which it is available).

- We expect the consultation will consider, inter alia, the implications of the ONS change on the allowances for real price effects (RPEs) set at the price control review compared to any effect on companies' expected costs in relation to RPEs, the implications for our cost of debt and equity allowances and companies' debt and equity costs, as well as indexation of the Regulated Asset Value (RAV).

- Our review could result in an increase or decrease in companies' allowed revenues. That is, if, following consultation, we determine the outcome of the ONS change to its RPI methodology results in the over recovery (or the expectation of over recovery) of costs then we may consider reducing allowed revenues relative to those included in the price control settlement.

- We will only make changes to the price control settlement if we determine, following consultation, the impact on companies' net revenues over the Price Control Period is greater than one per cent of average annual allowed revenue. Our calculation of the net revenue impact of the change in RPI will include the effect on the value of the RAV at the end of the Price Control Period, ie we will consider the difference between the value of the RAV under the revised RPI methodology compared to the value of the RAV if the existing RPI were retained.

- The purpose of the materiality test is to avoid making trivial changes to allowed revenues, and thus minimise regulatory costs. The proposed materiality test is consistent with the materiality test associated with other uncertainty mechanisms.

- The review will only consider changes to companies' net revenues arising from the ONS decision in relation to its review of RPI. We will not take into account factors, such as companies' financial performance against the price control within the context of this review.

Sole Use Exit Connections

Within the allowances for load-related expenditure there is a forecast for capital expenditure (less capital contributions) on exit connections to single users. The net expenditure for these connections is funded directly by the customer over the life of the asset in accordance with a pre-determined charging methodology. This income is treated as an excluded service income and we net the forecast income from the total allowed revenue. Whilst this approach has been practical in the past it has been suggested that (since the level of activity over the RIIO-T1 period is more uncertain than in the past) this exposes companies to increased risk that the forecast additional income will not be achieved. Additionally since there is no facility to reflect varying volumes companies are also exposed to potential gains or losses through the sharing mechanism.

We agree that these are material concerns and therefore propose to address these issues by a true-up at the RIIO-T2 Price Control. This will entail resetting allowances to mirror the actual net capex and to reflect the removal of actual excluded service income from total allowed revenue (subject to normal RAV requirements).

We also propose to amend the RAV methodology to confirm that excluded service costs (with the exception of the capex relating to Sole Use Exit Connections) are not included in totex.

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Close out of existing TIRG schemes

The shadow RAV calculations for SPTL and SHE Transmission show various TIRG projects that transfer into main RAV in the RIIO-T1 period. We will adjust for any differences between forecast and actual spend on these schemes as part of the RIIO-T2 price control. This will entail amending the transfer value into RAV and amending allowed revenue for the resultant impacts on remuneration.

Disposals from RAV

The RAV methodology deducts the net cash proceeds of sale (or market value of intra-group transfer) of operational assets (where disposal is allowed) from RAV. For the RIIO-T1 period we have not included a forecast for such disposals. We will deduct the proceeds of any disposals as part of the RIIO-T2 review (on an NPV neutral basis).

Pension Principles

Alongside the RIIO-T1 Final Proposals document for NGET and NGGT we have published an updated version of the guidance to the pension principles. These also apply to SPTL and SHE Transmission.

Tax trigger deadbands

We have introduced a tax trigger mechanism as set out in our March 2011 Strategy Document (the March Strategy Document). The detailed methodology is set out in the ET1 and GT1 Price Control Financial Handbooks which are being published alongside the statutory consultation on the RIIO-T1 licence conditions. We have calibrated the deadband as the greater of a 1 per cent change in the rate of mainstream CT and a change of 0.33 per cent in base revenues. We will not revise these amounts through the operation of the Annual Iteration Process; as such, they are fixed throughout the price control for each licensee. The amounts for each TO are based on the Best View and are as set out in Table 1.

Table 1: Tax deadband values

£m 2009-10 prices	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
SHETPLC	0.5	0.8	0.9	1.0	1.0	1.1	1.1	1.2
SPTL	0.7	0.8	0.9	0.9	0.9	0.9	1.0	0.9

Stakeholder Satisfaction Output incentive

As set out in the Final Proposals for SPTL and SHE Transmission, the customer satisfaction output has two incentive elements: (1) a stakeholder survey; and (2) stakeholder engagement.

As was recognised at the time of the Final Proposals for SPTL and SHE Transmission, there was still work for us to do in preparing a stakeholder engagement reward guidance. There was also still work for SHE Transmission and SPTL to progress development of how the stakeholder survey part of the incentive would work.

On the stakeholder engagement reward we are publishing guidance alongside the statutory consultation on licence modifications resulting from RIIO-T1.

The companies have continued through the year to develop a stakeholder survey methodology. This work has included gathering evidence on their respective stakeholders' view as important in terms of their performance.

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As we confirmed in July 2012 in an Annex to NGET'S and NGGT's Initial Proposals[5] we recognise that a stakeholder survey is a new and relatively untested mechanism for measuring performance. We recognised that SPTL and SHE Transmission were carrying out work on supporting information separate from its quantitative survey results to sit alongside the survey results in determining the financial incentive. The subsequent development of these arrangements by SPTL and SHE Transmission has identified a three part incentive using 'key performance indicators' (KPIs) and 'stakeholder external assurance' in addition to the output from the survey. It will be important that where these are used they directly reflect the performance of the companies in relation to stakeholder satisfaction (including through NGET to its customers who are affected by the performance of SPTL and SHE Transmission). NGET's views on KPI design should inform KPIs.

The external assurance should include explicit coverage of how well SPTL and SHE Transmission perform in the views of stakeholders who might not be familiar with industry processes. They should also be a direct reflection of the quality of their respective performance in working with, and meeting the needs of, their customers/stakeholders.

We envisage the following process to be used to inform values still to be populated for effect in the first year of RIIO-T1:

- weightings for survey, KPI and stakeholder external assurance elements of the financial incentive
- baseline values for the survey element.

Within 30 days of 1 April 2013 each company must submit its proposed weightings and baseline values along with final proposed KPIs and confirmation that the external assurance process includes the point raised in this letter above.

On receipt of this information the Authority will determine the relevant values. We recognise that there is limited evidence on which to base these metrics. However, it will be important to make sure that the information submitted is complete and robust for at least the first four years of the RIIO-T1 period.

We may consider the stakeholder baseline and related metrics in 2016 looking at the wider evidence that we have at that time about how stakeholders respond to this type of survey under different conditions and company performance.

Network Access Policy (NAP)

The NAP sets out proposed arrangements for coordination, effective and early joint planning and communication between transmission owners (TOs) and the System Operator (SO). SPTL and SHE Transmission have continued to make good progress in developing a joint NAP.

As SPTL and SHE Transmission make progress towards the first published NAP in April 2013, it will be important that SPTL and SHE Transmission continue to test the NAP with NGET and other interested parties. The NAP should inform others what they expect, at least under general circumstances, from the SPTL and SHE Transmission in this area. The NAP explicitly recognises circumstances where a particular aim might not be met.

[5] RIIO-T1: Initial Proposals for National Grid Electricity Transmission and National Grid Gas, Ofgem, July 2012 (http://www.ofgem.gov.uk/NETWORKS/TRANS/PRICECONTROLS/RIIO-T1/CONRES/Documents1/RIIO%20T1%20Initial%20Proposals%20for%20NGGT%20and%20NGET%20Overview%202707212.pdf)

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Setting the level of incentives

In the March Strategy Document we said that the Totex Incentive Mechanism would apply to those incentive rates that have been set to equal the economic value of the output ie the incentive rates for Sulphur Hexafluoride emissions (SF_6) and Energy Not Supplied. This is necessary to ensure that a TO faces the appropriate economic incentives to take decisions on the level of outputs it delivers that are in the interests of consumers. For the same reason, we have also decided to include a tax adjustment on these incentives to address the different tax treatment of any over or under spend and output incentive reward/ penalty. Lastly, we will preserve the economic value of these incentives during the Price Control Period by adjusting for the rate of RPI inflation and applying a Time Value of Money Adjustment from the PCFM Year to which the penalty or reward relates.

Initial expenditure cap for visual amenity in designated areas

In Final Proposals for NGET we have set an initial expenditure cap of £500m to mitigate the impact of pre-existing transmission infrastructure in areas designated. This is a national expenditure cap and therefore available for all three TOs. It can be used to deliver improvements in areas designated a National Park or Area of Outstanding Natural Beauty, and also areas that have a statutory designation as a National Scenic Area under the Town and Country Planning (Scotland) Act 1997. In other words, we are updating the Final Proposals for SPTL and SHE Transmission to enable them to access funding under this expenditure cap.

Sub-sea cable maintenance – SHE Transmission only

In our Final Proposals for SHE Transmission we provided an uncertainty mechanism for exceptional sub-sea faults due to third party and environmental damage.

This mechanism has not been included in the current licence drafting or the ET1 PCFM as this mechanism is not expected to be triggered in the early RIIO-T1 years. We will adjust the PCFM and the licence at the first convenient opportunity to reflect this.

Network Replacement Outputs – SHE Transmission only

Special Condition 2M sets out the Network Replacement Outputs required to be delivered by Licensees. For SHE Transmission we have been unable to reconcile these outputs with sufficient accuracy to be included in the licence condition. As a result, we have not put values in the relevant table in the condition. Instead, we have set a requirement for SHE Transmission to submit proposed values within 30 days of the licence taking effect. We will then determine values for these terms after taking account of this submission.

Yours sincerely,

Ian Marlee
Senior Partner, SG&G Transmission

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APPENDIX 1: Impact on 'Best-View'

Table A1: SPTL 'Best View'

SPTL	RIIO-T1								
£m 2009-10 prices	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**Total**
Totex									
Slow Pot	283	372	317	208	220	220	209	117	1,944
Fast Pot	31	41	35	23	24	24	23	13	216
Totex	314	413	352	231	244	244	232	130	2,160
Regulatory Asset Value (RAV)									
Opening RAV	1,094	1,296	1,576	1,788	1,945	2,048	2,138	2,213	-
Transfers from 'shadow RAV'	-	-	-	69	8	-	-	-	77
Restated opening RAV including transfers	1,094	1,296	1,576	1,856	1,953	2,048	2,138	2,213	-
RAV additions (totex slow pot)	283	372	317	208	220	220	209	117	1,944
Depreciation	(81)	(91)	(105)	(119)	(125)	(130)	(133)	(137)	(922)
Closing RAV	1,296	1,576	1,788	1,945	2,048	2,138	2,213	2,193	-
Allowed Costs									
Fast pot expenditure	31	41	35	23	24	24	23	13	216
Non-controllable opex	24	24	24	24	24	24	24	24	193
RAV depreciation	81	91	105	119	125	130	133	137	922
Return	55	67	78	88	93	97	101	102	682
Other (including Pensions, IQI & adjustments from previous price controls)	27	10	24	9	8	8	8	6	98
Tax allowance	12	13	9	8	8	9	8	8	75
Price Control Revenue									
Total costs	231	246	275	271	282	292	298	291	2,186
Less excluded services	(5)	(6)	(6)	(6)	(7)	(7)	(7)	(8)	(53)
Base Revenue	226	241	269	264	276	285	290	283	2,133
TIRG	-	-	-	-	-	-	-	-	-
Regulatory Revenue	226	241	269	264	276	285	290	283	2,133
Excluded Services	5	6	6	6	7	7	7	8	53
Total revenue	231	246	275	271	282	292	298	291	2,186

Table A2: SPTL 'Best View'

SHETPLC	RIIO-T1								
£m 2009-10 prices	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**Total**
Totex									
Slow Pot	545	677	614	491	374	354	350	415	3,820
Fast Pot	61	75	68	55	42	39	39	46	424
Totex	606	753	683	546	415	393	389	461	4,245
Regulatory Asset Value (RAV)									
Opening RAV	682	1,184	1,795	2,326	2,697	2,932	3,135	3,322	-
Transfers from 'shadow RAV'	-	-	13	-	-	-	-	-	13
Restated opening RAV including transfers	682	1,184	1,807	2,326	2,697	2,932	3,135	3,322	-
RAV additions (totex slow pot)	545	677	614	491	374	354	350	415	3,820
Depreciation	(43)	(67)	(96)	(120)	(138)	(151)	(163)	(173)	(951)
Closing RAV	1,184	1,795	2,326	2,697	2,932	3,135	3,322	3,564	-
Allowed Costs									
Fast pot expenditure	61	75	68	55	42	39	39	46	424
Non-controllable opex	9	9	13	13	13	13	13	13	95
RAV depreciation	43	67	96	120	138	151	163	173	951
Return	43	69	96	117	131	141	150	160	906
Other (including Pensions, IQI & adjustments from previous price controls)	8	19	21	16	10	6	6	5	91
Tax allowance	9	9	7	5	3	4	6	8	51
Price Control Revenue									
Total costs	172	248	301	325	337	355	376	405	2,518
Less excluded services	(11)	(14)	(23)	(27)	(28)	(31)	(31)	(33)	(197)
Base Revenue	162	233	278	298	309	324	344	372	2,321
TIRG	-	-	-	-	-	-	-	-	-
Regulatory Revenue	162	233	278	298	309	324	344	372	2,321
Excluded Services	11	14	23	27	28	31	31	33	197
Total revenue	172	248	301	325	337	355	376	405	2,518

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