

# Strategy consultation for the RIIO-ED1 electricity distribution price control

## Business plans and proportionate treatment

### Supplementary annex to RIIO-ED1 overview paper

**Reference:** 122/12  
**Publication date:** 28 September 2012  
**Response deadline:** 23 November 2012

**Contact:** Anna Rossington  
**Team:** RIIO-ED1  
**Tel:** 020 7901 7401  
**Email:** RIIO.ED1@ofgem.gov.uk

#### Overview:

RIIO-ED1 is the first price control review in electricity distribution to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model. RIIO is designed to drive real benefits for consumers by 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.

The business plans that each Distribution Network Operator (DNO) will produce are an important part of the RIIO process. The business plans are where we expect the DNOs to demonstrate that they have responded to the key RIIO objectives.

This document sets out the stages and timing of the processes we will follow to assess the business plans (including the timetable for fast tracking). It also explains the criteria against which we assess the plans and consults on our proposed guidance on how business plans should be written, presented and structured. Finally, it sets out our proposals on cost benefit analysis and whole life costs which the DNOs will need to follow.

## Associated documents

---

### Strategy consultation for RIIO-ED1 - Overview

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConOverview.pdf>

### Links to supplementary annexes

- Strategy consultation for RIIO-ED1 - Outputs, incentives and innovation  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConOutputsIncentives.pdf>
- Strategy consultation for RIIO-ED1 - Business plans and proportionate treatment  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConBusinessPlans.pdf>
- Strategy consultation for RIIO-ED1 - Uncertainty mechanisms  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConUncertaintyMechanisms.pdf>
- Strategy consultation for RIIO-ED1 - Financial issues  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConFinancialIssues.pdf>
- Strategy consultation for RIIO-ED1 - Impact assessment  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConImpactAssessment.pdf>
- Strategy consultation for RIIO-ED1 - Tools for cost assessment  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConCostAssessment.pdf>
- Strategy consultation for RIIO-ED1 - Reliability and safety  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConReliabilitySafety.pdf>
- RIIO-ED1 Glossary of terms  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConGlossary.pdf>

### Links to other associated documents

- Open letter consultation on the way forward for RIIO-ED1  
<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1LaunchOpenLetter.pdf>
- Handbook for implementing the RIIO model  
<http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf>
- Electricity Distribution Price Control Review 5 (DPCR5) Final Proposals  
[http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/FP\\_1\\_Core%20document%20SS%20FINAL.pdf](http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/FP_1_Core%20document%20SS%20FINAL.pdf)

# Contents

---

<b>1. Introduction</b>	<b>4</b>
Structure of this document	6
<b>2. Building on our experience from RIIO-T1 and GD1</b>	<b>7</b>
Introduction	7
General issues identified	7
Specific issues identified	10
<b>3. Business plan assessment – process</b>	<b>11</b>
Background	11
Proportionate Treatment and Fast Tracking	11
Assessment process	13
Licence conditions	16
<b>4. Assessment Criteria</b>	<b>18</b>
Introduction	18
Overview of criteria	19
Explanation of criteria	20
<b>5. Guidance on presentation and structure</b>	<b>27</b>
Introduction	27
Stakeholder views	28
Presentation	29
Structure	30
Navigation	37
<b>6. Cost benefit analysis</b>	<b>38</b>
Introduction	38
Identification of options	40
Identification and quantification of costs and benefits	40
Period for discounting costs and benefits	42
Assessing risks and uncertainties, and sensitivity analysis	43
Decision rule	44
Affordability	45
Links to business plan	45
<b>Appendices</b>	<b>46</b>
<b>Appendix 1 - Consultation Response and Questions</b>	<b>47</b>

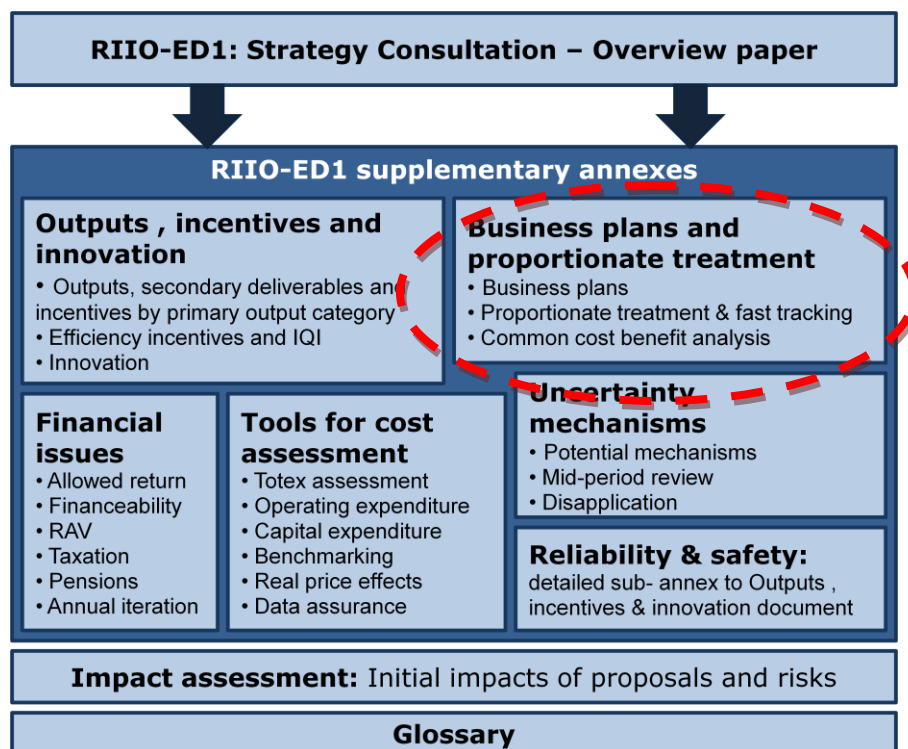
# 1. Introduction


## Chapter Summary

This supplementary annex, to the RIIO-ED1 overview paper, sets out our proposals on guidance for the business plans and the role of proportionate treatment in our assessment process.

**Question box** There are no questions in this chapter

- 1.1. The next electricity distribution price control, RIIO-ED1 will reflect the new RIIO model. We have further developed some elements of the model, particularly with respect to business plans and their assessment following the implementation of the RIIO-T1 and GD1 price control reviews. This supplementary annex to the Strategy consultation – Overview, sets out the stages and timing of the processes we will follow to assess the plans (including the timetable for fast tracking). It also explains the criteria against which we assess the business plans. Finally, it consults on our proposed guidance on how business plans should be written, presented and structured, and our proposals on cost benefit analysis.
- 1.2. Figure 1.1 below provides a map showing the relationship between this document and the other documents published as part of this consultation.





Strategy consultation for the RIIO-ED1 electricity distribution price control  
Business plans and proportionate treatment

- 1.3. This document sets out the important role that the DNOs' business plans will play in the RIIO-ED1 process and explains our intention to apply the RIIO principle of proportionate treatment in assessing these plans. Under the RIIO approach, the business plan that each DNO will submit in July 2013 is hugely important. It is an opportunity for the DNOs to show how they have responded to the key objectives of RIIO and the specific challenges that their businesses face.
- 1.4. We will only be able to conclude a DNO's settlement when it has provided us with a robust and well justified business plan. The quality of the plan, the robustness of the data within it, and how well it is justified, will influence the degree of regulatory scrutiny we apply during the review ('proportionate treatment'). Where a DNO produces a high quality business plan we propose to subject their business plans to a lower level of scrutiny, and focus attention on the areas that deserve further analysis. In some cases, where a DNO produces a very high quality business plan, we will consider whether it is appropriate to conclude that DNO's price control process early ('fast-tracking').
- 1.5. In addition to their regulatory role, business plans should be documents for the business and their stakeholders to refer to throughout the price control period. These documents should be more than a submission to the regulator. The RIIO framework seeks to encourage DNOs to write business plans that are informed by, and used by, each DNO and its' stakeholders.
- 1.6. Given the important role that the business plans have for all parties in this process, we believe that it is appropriate to use this strategy consultation to set out and consult on our expectations in terms of:
  - what we expect to see from the DNOs in developing their well justified business plans
  - the process that we will be following in assessing the plans (including our assessment of the plans for the purposes of proportionate treatment).
- 1.7. We set out guidance for well-justified business plans in the RIIO-T1 and GD1 Strategy Decisions (published in March 2010). As we set out in the RIIO-ED1 launch letter<sup>1</sup> we plan to build upon and improve that guidance for RIIO-ED1, in light of stakeholder feedback from RIIO-T1 and GD1 and lessons we have learnt.

---

<sup>1</sup> [Open letter consultation on the way forward for the next electricity distribution price control review – RIIO-ED1](#)

## Structure of this document

- 1.8. **Chapter 2** of this document sets out what we learnt from the RIIO-T1 and GD1 assessment process. Our experience of the first reviews under the RIIO model highlighted a number of areas where we think improvements could be made to the business planning process. Whilst a full lessons-learned exercise will follow the completion of RIIO-T1 and GD1, we consider it useful to highlight our initial views in the context of preparations for the development and assessment of the RIIO-ED1 business plans.
- 1.9. **Chapter 3** of this document sets out the role of DNOs' business plans in the price control review process. It discusses what we expect of the DNOs. It also explains the approach that we propose to use when assessing business plans. This includes the way we would apply proportionate treatment (including fast-tracking). Through proportionate treatment, we intend to reward those DNOs who produce a well-justified business plan and focus the heaviest scrutiny on those who produce less well-justified plans.
- 1.10. In RIIO-T1 and GD1, we set out the broad assessment criteria which we would use in assessing the business plans. This gave companies a sense of what needed to be included in their plans. We propose to adopt the same core criteria in our RIIO-ED1 assessment. **Chapter 4** of this document sets out our core criteria and provides detailed guidance on what Ofgem will be considering in assessing business plans in each of these areas.
- 1.11. Feedback from stakeholders, and our own experience from the RIIO-T1 and GD1 reviews, indicates that an increased level of guidance on how the DNO's business plans should be presented and structured would be beneficial. **Chapter 5** of this paper sets out our proposals for this guidance. Our proposals are focussed on making the plans more accessible and comparable without influencing the companies' proposals.
- 1.12. **Chapter 6** sets out our proposals on cost benefit analysis. It sets out the parameters that may need to be specified in order to ensure consistency in how DNOs undertake this critical input to their business plan submissions. It also sets out areas where further work is required ahead of us reaching a decision.

## 2. Building on our experience of RIIO-T1 and GD1

---

### Chapter Summary

This chapter highlights how we have used our experience from the RIIO-T1 and GD1 business planning and assessment processes to develop the approach for consultation here. We are highlighting these so that DNOs can consider our experience in developing their business plans.

There are no questions in this chapter

### Introduction


- 2.1. Developing business plans in RIIO-T1 and GD1 and the assessment of those business plans has been an important part of the price control work over the last two years. We believe that this process has generally worked well. The experience gleaned, including areas where we identified the business plans could be improved, is useful in informing RIIO-ED1. This is particularly the case given these controls are the first time we have implemented the RIIO approach in practice.
- 2.2. We intend to carry out a consultation on the lessons learned from the RIIO-T1 and GD1 processes once the controls are implemented. However, our experience to date can be used now to help with preparations for the development and assessment of the RIIO-ED1 business plans. The RIIO-T1 and GD1 processes to date have highlighted a number of areas which could be built on, or improved, which are set out in the remainder of this chapter. We would urge DNOs to consider these views in their approach to developing their business plans.

### General Issues Identified

- 2.3. We have identified several generic issues which apply to all parts of the business plan.

### Presentation of the business plans

- 2.4. For RIIO price controls, we require companies to submit a complete plan with a clear, logical and easy to follow structure. We require accurate and



## Strategy consultation for the RIIO-ED1 electricity distribution price control Business plans and proportionate treatment

complete business plan templates, completion of the Price Control Financial Model (PCFM)<sup>2</sup> and business plan narrative.

- 2.5. For RIIO-ED1 we want to focus on presentation and structural guidance for the DNO's business plans. Our view is that the business plans submitted under RIIO-T1 and GD1 provided more information in a more accessible format than those presented under previous price controls.
- 2.6. However, in assessing some of the initial submissions we had concerns over the volume of unprocessed information submitted (without clear signposting as to how it related to or had been incorporated into the business plans), and the clarity of elements of the plans that we received. Stakeholders also raised concerns about the absence of effective signposting around the business plans (eg through appropriate use of hyperlinks). Excessive or disproportionate volume of information which is not presented in a coherent way could impact on various elements of the assessment of the business plan. This includes our consideration of fast-tracking and proportionate treatment at the initial assessment.

### **Stakeholder engagement**

- 2.7. One of the key aspects of RIIO is the requirement for network companies' business plans to be informed by stakeholder engagement. Companies need to provide evidence not only that they have engaged with a broad range of stakeholders, but that their plans have been shaped by the views of their stakeholders. We expect network companies to engage proactively with consumers and other stakeholders not only in developing their business plans, but also on an ongoing basis to inform business decisions within the price control period.
- 2.8. Stakeholder engagement increased markedly through the RIIO-T1 and GD1 process and has helped improve the overall quality of the business plans that have been published. However, we consider that, in places, the stakeholder engagement process could have been either better utilised, or better presented, in order to more effectively support the proposals that companies made in their business plans.
- 2.9. We found that individual stakeholder's opinions were often quoted to support a particular approach favoured by the company. Whilst this may provide some limited evidence to support a company in following a particular approach, it does not demonstrate a consensus view or show how the company has considered all stakeholder feedback informing its approach. What we expect to see as part of RIIO-ED1 is a balanced discussion. DNOs should highlight where different points of view exist, and explain how they have decided between these or adopted an alternate approach. It may be that the DNO

---

<sup>2</sup> Further information on the PCFM is set out in the supplementary annex – financial issues



doesn't adopt the approach favoured by the majority. This is of course acceptable. But the DNO needs to explain the thought process it has gone through in developing its plan, and demonstrate how stakeholder views have been considered or influenced its approach. An explanation should be given where views have been disregarded.

### **Innovation and alternative techniques**

- 2.10. Another key aspect of the RIIO framework is the focus on innovation. The RIIO framework has been designed to recognise the significant challenges faced by Britain's gas and electricity network operators over the coming years. Many elements of the framework are intended to encourage innovation. These include the strong emphasis on delivering outputs and lengthening the price control period, to provide companies with more certainty of the rewards for successful innovation. The framework provides a strong incentive to innovate and for DNOs to adopt a range of innovative and conventional approaches across all aspects of their business.
- 2.11. We expect RIIO companies to clearly demonstrate throughout their business plans that they have considered the use of alternative techniques in all areas of their business to deliver their outputs more efficiently and reduce costs. This could be through innovative technical, operational, commercial and contractual arrangements.
- 2.12. In addition, we also asked companies to develop an Innovation Strategy. The Innovation Strategy is intended to provide companies with an opportunity to demonstrate to their stakeholders and Ofgem the role of innovation in their business, including their implementation strategy. It should also demonstrate how they will deliver value for money when progressing innovative projects which have been funded by consumers. This includes their approach to utilising the specific funding for higher risk innovation project provided through the innovation stimulus.
- 2.13. Our experience around innovation in RIIO-T1 and GD1 was mixed. All companies provided an innovation strategy and our views on the strength and weaknesses of these have been set out in our various initial and final proposal documents. However, in some cases, we didn't consider that a consideration of alternative or innovative techniques as part of business as usual was woven into the rest of the business plan.
- 2.14. We expect RIIO companies to clearly demonstrate throughout their business plans that they have considered the use of alternative or innovative techniques. It may be that they have chosen not to adopt these for good reasons, but we expect evidence of that consideration to be demonstrated. This is a separate aspect of the business plan to the innovation strategy.

## Specific Issues Identified

2.15. We have also briefly highlighted several specific issues which apply to certain areas of the business plans:

- Outputs – In some cases expenditure plans were not initially set against a long term context. In ED1 we expect the DNOs to demonstrate their long term strategy for managing their assets. We also expect to see a risk based approach for justifying delivery of all outputs.
- Cost Assessment - In some cases we found that the justification of costs was not proportionate. The plan should clearly be set in the longer-term and wider industry context and explain the DNO's strategy for each area of costs. Justification of costs and outputs should be proportionate with appropriate explanation for larger schemes or areas of significant expenditure. There should be clear justification that all costs are efficient including the DNO providing their own evidence that their plan is good value for money for consumers, such as benchmarking evidence, independent studies etc.
- Finance – In some cases we found that financial proposals had not been supported by engagement with a range of stakeholders. In ED1 we expect to see financial proposals tested on a range of stakeholders, not just investors. Also, we would urge the DNOs to spend time familiarising themselves with the draft PCFM. The DNOs are required to submit completed PCFMs alongside their business plans.

## 3. Business Plan assessment process

---

### Chapter Summary

This chapter sets out the process that we will use when assessing the business plans. It sets out the proportionate approach that we will use whereby the intensity and timescale of the assessment will reflect the quality of a DNO's business plan and the DNO's record of efficient output delivery.

**Question 1:** Do you have any comments on the timing and stages of the assessment process?

**Question 2:** Do you agree with the three stage assessment process for RIIO-ED1?

**Question 3:** Do you think the additional reward for fast tracking is appropriate?

### Background

- 3.1. 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 DNO's business plan and the DNO's record for efficient output delivery. We will also take into account the quality of a DNO's proposed approach to addressing issues with past performance. This approach is consistent with better regulation principles, as it allows us to focus greatest regulatory scrutiny where it is likely to produce the greatest value.
- 3.2. Where a DNO produces a high quality business plan, we propose to subject their business plans to a lower level of scrutiny and focus attention on the areas that deserve further analysis. In some cases, where a DNO produces a very high quality business plan, we will consider whether it is appropriate to conclude that DNO's price control process early (ie the company would be fast-tracked). DNOs whose business plans are not high quality will receive a high degree of regulatory scrutiny and are likely to be required to make substantial improvements to their plans following our initial assessment.

### Proportionate Treatment and Fast Tracking

#### Proportionate treatment

- 3.3. The scope for proportionate treatment and, to a greater degree, fast-tracking provides the DNOs with incentives to step up to the challenge of submitting realistic and well-justified business plans. This is because these approaches will allow DNOs 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 (DNOs that are subject to proportionate treatment should gain relatively early assurance that certain elements of their plans are likely to be approved),
  - be a significant driver of its own review outcome,
  - gain positive reputational advantage associated with achieving a fast-tracked settlement or having lower-proportionate scrutiny.
- 3.4. The scope for proportionate treatment may also provide incentives for DNOs to reveal information that would not be available otherwise (or only become available late in the price control review process) which might assist with the assessment of the other DNOs.

### **Fast-tracking**

- 3.5. Where a DNO produces a well-justified plan we propose not just to focus less regulatory resource on them, but also to undertake an investigation to decide whether it is appropriate to reach an early, fast-tracked, settlement. The key features of fast-tracking will be:
- a DNO's price control will be finalised approximately nine months ahead of non-fast-tracked DNOs,
  - we will consult on whether any company should be fast-tracked.
- 3.6. This early settlement does not change the price control implementation date of 1 April 2015. However, it means that all review of a fast-tracked DNO's business plan would be complete by February 2014.
- 3.7. We believe that the fast-track option has many advantages for a DNO as it allows them to:
- get on with business as usual without focusing resources on the remainder of the price control process,
  - plan with certainty over that extra time,
  - be the key driver of their review outcome by designing their proposal and not spending a year seeing their plans changed by regulatory scrutiny.
- 3.8. It is possible that no DNO will be fast-tracked if our assessment is that none have met the required standard.

### **Mitigating the perceived risk of being Fast-tracked**

- 3.9. Despite the advantages set out above, some DNOs are concerned that fast-tracking could disadvantage them against the DNOs which remain in the process. They are concerned that another DNO, whose settlement is concluded later, may get a better deal. They believe this could occur either because of new information arising, or because we change our minds on some element of the settlement which means they would have been better off not being fast-tracked.
- 3.10. We think it is very unlikely that a DNO would do worse under a fast-track settlement. There are a number of important mechanisms, including the cost of debt index that will automatically adjust for changes that happen between concluding the fast-track settlement and the beginning of the price control. It is also the case that a DNO that we are taking through the fast-track process can signal that it is uncomfortable with the adjustments we are looking to make to its business plan and pull out of the process at any point. When presented with final proposals in February 2014 any fast-tracked DNO will be able to reject the settlement on offer. For these reasons, the agreed settlement for the fast-tracked company is likely to be close to the DNO's view of the revenue it needs to run its network and contain sufficient consideration for the risk that the DNO believes it is facing (including in the period up to the start of the price control period).
- 3.11. For the RIIO-T1 price control review the fast-tracked companies received a reward of two and a half per cent of totex. We would welcome views on whether this level of reward is appropriate for RIIO-ED1 and the extent of differential with non fast-track DNOs.

### **Assessment process**

- 3.12. In RIIO-T1 and GD1 we set out four stages in the assessment process which included an 'initial sweep' stage and then a further stage of analysis before a decision on proportionate treatment (including fast tracking). We noted when retaining the fast-tracking option for the two Scottish transmission operators (TOs) in RIIO-T1<sup>3</sup> that it was the first time that companies had had to produce business plans under the RIIO framework. We decided that we would, provide for further iteration between the first business plan submission and our fast-track decision than we intended to do in the future.
- 3.13. We expect the DNOs to have learned, from observing the RIIO-T1 and GD1 process, what is expected from them under RIIO. We therefore do not plan to provide the DNOs the opportunity to revise elements of their plans, once submitted, prior to taking our decision on proportionate treatment. Therefore,

---

<sup>3</sup> [Open letter consultation on the way forward for the next electricity distribution price control review – RIIO-ED1](#)

for RIIO-ED1 we propose to shorten the assessment process to three stages, as outlined below.

3.14. The process that we will follow in assessing the business plans will be dependent on our initial review of the plans. A different process will be followed dependent on whether the plans qualify for a form of proportionate treatment. The high level steps in our process can be summarised as follows:

- Step 1: Initial assessment
- Step 2: Consultation and decisions on any proportionate treatment
- Step 3: Process for finalising controls (dependent on any proportionate treatment).

3.15. These stages are explained below.

#### **Step 1: Initial assessment**

3.16. In July 2013, the DNOs will submit well-justified business plans, informed by stakeholder engagement. We will undertake our first assessment of the plans and other relevant information shortly after we receive them.

3.17. The initial assessment will be informed by three different evidence sources.

- An assessment of the business plan, including accompanying data and the completed PCFM and business plan narrative (we discuss our proposed assessment criteria in Chapter 4)
- Use of any available comparative evidence (eg benchmarking)
- Assessment of past performance.

3.18. During this process we may seek clarity from the DNOs on a number of aspects of their plans. To ensure we can complete the assessment in a timely manner, we will need the DNOs to respond to requests within a short timescale. We will clearly define the specific timescale at the time as this will depend on the nature of the query. DNOs need to be prepared for this process.

3.19. Also, during this stage all DNOs will have the opportunity to make representations to the Authority on the contents of their business plans.

## **Step 2: Consultation and decision on any proportionate treatment**

3.20. Following our initial assessment, the Authority will publish a consultation on the level of regulatory scrutiny that each DNO will be subject to in reaching a settlement. We expect to publish this document in October 2013. This will set out our proposals on which DNOs, if any, will be subject to fast-tracking or proportionate treatment. There are three broad options that the Authority could adopt. These are explained below.

- **Fast-tracking** - We may decide that a DNO, or DNOs, have provided business plans that are sufficiently highly quality and well justified for them to be fast tracked.
- **Other proportionate treatment** - We may decide that a DNO, or DNOs, have provided business plans that are well justified in certain areas, but which have issues to be addressed in others. Where this is the case, the business plans will be said to be subject to proportionate treatment. Such DNOs will benefit throughout the remainder of the price control process from proportionately lower scrutiny of those parts of their business plans that are well-justified.
- **Full Scrutiny** - Licensees who are neither fast tracked nor subject to proportionate treatment will be subject to full scrutiny of their plans.


3.21. Where we propose to fast-track a DNO we will publish our Draft Determination. The Draft Determination will be subject to an eight week consultation.

3.22. At this stage of the assessment process we will also provide feedback to those DNOs that have not been selected for fast-tracking on the quality of their business plans. This would include setting out any areas of proportionate treatment.

3.23. If, following responses to our consultation, the Authority decides to fast-track the DNO (or DNOs) we will publish a decision and the Final Determination(s). This is currently scheduled for February 2014. If for any reason a company is then not fast-tracked, it would return to the non-fast-tracked process with the other non fast-tracked DNOs. However we assume that, having been considered for fast-tracking, elements of its plan would be subject to proportionate treatment. We would set this out in our decision.

## **Step 3: Non-fast-track process**

3.24. Following publication of the Authority's initial assessment decision on any proportionate treatment there will be a process for finalising each DNO's settlement. The process that follows will be dependent on the level of regulatory scrutiny that the Authority has deemed appropriate. The possibilities are explained below.




## Strategy consultation for the RIIO-ED1 electricity distribution price control Business plans and proportionate treatment

- 3.25. Non fast-tracked DNOs will need to submit revised business plans. The date of re-submission will be set out in the Authority's decision on any proportionate treatment and is expected to be delivered in March 2014.
- 3.26. Those DNOs that are subject to proportionate treatment may only be required to focus their revisions on limited aspects of their plan. However, a whole new business plan should be submitted by all non-fast tracked DNOs, accompanied by a paper summarising the changes that they have made from the first submission.
- 3.27. Following resubmission, we will undertake further analysis of those DNOs' business plans. This analysis will inform our Draft Determination consultation. The quality of the original plans and the way the DNOs have responded to external challenge with their final plans, will determine the degree of regulatory intervention they face in the publication of our Draft Determination. We may accept the DNO's revised proposals for consultation, or we may make alternate proposals where we still don't consider the DNO's proposals to be sufficiently well justified.
- 3.28. We will publish Draft Determinations for those companies in July 2014. These Draft Determinations will be subject to an eight week consultation.
- 3.29. In November 2014, the Final Determination decision will be made by the Authority. The Final Determination will be informed by feedback from the Draft Determination consultation and any further analysis or material information received from the DNOs.

### **Licence conditions**

- 3.30. We will start drafting licence conditions after the publication of the Strategy Decision. We propose to set up a drafting working group, which may need to work alongside the policy working groups on detailed aspects of implementing the Strategy Decision.
- 3.31. A first draft of the financial model (PCFM) will be issued to the DNO finance working group for review and development in the next few weeks. The final version of the model will be issued in March 2013. DNOs will be required to return this alongside their business plans, populated with data consistent with the business plan.
- 3.32. Subsidiary documents to the licence (known as 'associated documents' for RIIO-T1 and GD1), such as the Regulatory Instructions and Guidance (RIGs), the Financial Handbook and the Innovation Stimulus Governance Documents, will be developed in a parallel process, and may involve separate working groups.





Strategy consultation for the RIIO-ED1 electricity distribution price control  
Business plans and proportionate treatment

- 3.33. We propose to follow a similar timetable to that adopted for RIIO-T1 and GD1, whereby we will have an information consultation on the licence conditions and associated documents in Summer 2014. This will be followed by a final consultation in Autumn, and a statutory consultation in December 2014.
- 3.34. The RIIO-ED1 price controls for both fast-tracked and non-fast-tracked parties will commence from 1 April 2015.

## 4. Assessment criteria

---

### Chapter Summary

Having set out the process that will be followed in assessing the DNOs' business plans, this chapter now focuses on explaining the criteria which Ofgem will use to assess whether we consider that business plans are well justified. This will inform our decision on closing the settlement with each company and any use of proportionate treatment.

**Question 1:** Does the categorisation of the assessment criteria remain appropriate?

**Question 2:** Are there any criteria which we should add or amend in the context of RIIO-ED1?

### Introduction

- 4.1. The RIIO model outlines the criteria against which business plans should be assessed. The assessment of the business plans (including accompanying data and the company's submission of the PCFM) is one of the three elements we will use when making a judgement on proportionate treatment. This is along with the use of any available comparative evidence (eg benchmarking), and an assessment of past performance.
- 4.2. The RIIO handbook set out nine core principles<sup>4</sup> of a 'well-justified' plan<sup>5</sup>. From these principles we have set out criteria against which we expect to use in assessing the business plans.
- 4.3. Table 4.1 sets out the five core criteria we will be assessing the DNOs' business plans against and the key questions we will be asking when we come to consider a DNO's performance in each area. Following this summary table a more detailed explanation of each of the criteria and key questions is provided.
- 4.4. Our assessment will be based on the quality of the plan against the criteria set out in this chapter. We recognise that in providing these criteria we might not have foreseen everything that might contribute to a well-justified plan. In such cases, we will consider the quality of justification made and set out clearly how we have dealt with the proposal overall.

---

<sup>4</sup> Page 48-49 of the [handbook](#).

<sup>5</sup> These are: focus on output delivery; consider secondary deliverables; contain an open minded consideration of available options; present a clear and well evidenced case for proposals; link costs and primary outputs; consider the longer term; provide value for money; and demonstrate effective engagement with a range of stakeholders and working with others.

- 4.5. We have simplified the criteria to reflect stakeholder feedback and lessons learnt from RIIO-T1 and GD1 (as set out in chapter 2 of this document). For RIIO-ED1 we have five core criteria with further questions under these as opposed to the 15 criteria we originally had for RIIO-T1 and GD1.

## Overview of Criteria

- 4.6. Table 3.1 sets out the five core criteria against which the business plans will be assessed and provides the key questions that we will consider in assessing each DNO's business plan against the criteria.

**Table 4.1: The assessment criteria**

Criterion
<b>Process: Has the company followed a robust process?</b>
Is the business plan clearly presented, with all key content included?
Has the DNO engaged with stakeholders, and explained how this has influenced its business plan?
Has the DNO submitted, and justified, all data templates and the PCFM?
Does the business plan provide a strategy for long-term delivery?
<b>Outputs: Does the plan deliver the required outputs?</b>
Has the business plan covered the outputs specified in our strategy decision or provided clear and compelling justification for any departures from the strategy decision?
Has the DNO explained the resource implications for delivery of each output identified?
Has the DNO explained how it will deliver outputs, and justified output baseline/forecast?
Has the DNO explained the quality of its existing outputs and secondary deliverable information (including information on asset health, criticality and asset risk) and how it plans to improve this information in future?
<b>Resources (efficient expenditure): Are the costs of delivering the outputs efficient?</b>
Has the DNO demonstrated that cost projections are efficient?
How does the plan compare with others/ does it reflect wider best-practice?
Has the DNO provided evidence that costs are efficient (eg through market-testing)?
Has the company explained cost projections in context of historical performance?
Has the company demonstrated a consideration of alternative approaches to achieving value for money in the delivery of its outputs?
Has the company clearly linked its expenditure to relevant outputs and secondary deliverables?

<b>Resources (efficient financing): Are the proposed financing arrangements efficient?</b>
Does the business plan conform with the financial policies specified in the strategy, are any departures well-justified?
Has the DNO provided evidence that financial costs are efficient?
How does the plan reflect best-practice?
<b>Uncertainty &amp; risk: How well does the plan deal with uncertainty and risk?</b>
Has the DNO clearly articulated the key uncertainties it faces and considered how it will address them (eg including uncertainty mechanisms)?
Has the DNO considered risk and how to mitigate those risks?

## Explanation of criteria

### Criterion 1 - Process

- 4.7. DNOs need to demonstrate through their well justified business plan that a strong and robust development process has been followed in planning for the RIIO-ED1 period. This process should include the engagement of the business and its stakeholders and ensure that proposals are clearly communicated and evidenced. This process needs to be evidenced throughout the plan so that readers can clearly see how the DNO has arrived at its conclusions.

*Is the business plan clearly presented with all key content included?*

- 4.8. Plans should be clearly and simply written. Technical language should be kept to minimum and clearly explained where it is used. Plans should include all the main elements of well-justified plan set out in the RIIO handbook and all elements of our strategy decision. Chapter 5 of this document has further guidance on how business plans should be presented.

*Has the company engaged with stakeholders, and explained how this has influenced its business plan?*

- 4.9. The DNOs should develop business plans reflecting their engagement with their stakeholders. As highlighted in chapter 2, it will not be sufficient for DNOs to just set out the stakeholder engagement activities they have carried out. We expect the DNOs to demonstrate what they have learned from their engagement, how they have reflected it in business plans, or why they have decided not to respond to stakeholder views if this is the case, eg mapping the impact. We also expect DNOs to demonstrate they have effectively engaged with a wide range of stakeholders when formulating their plans.

*Has the DNO submitted, and justified, all data templates and the PCFM?*

- 4.10. The DNO must ensure that all data templates submitted are well-justified in the text and that there is clear linkage between the data templates and the text where needed. It is important that the DNOs maintain consistent terminology between their business plan narrative and the data templates. The PCFM should be correctly completed. To ensure this we urge all DNOs to spend time familiarising themselves with the draft PCFM.

*Does the business plan provide a strategy for long-term delivery?*

- 4.11. A well-justified plan should detail information on the DNO's long term strategy for developing their networks and delivering long term value for money. We will expect DNOs to link this to their strategy for contributing to meeting the government's carbon and renewable targets.
- 4.12. This will require the DNOs to show that they have not only considered the expenditure they need for the duration of the price control, but also the implications this will have on required investment and associated efficiency beyond the price control period (i.e. in the RIIO-ED2 period). They will need to justify expenditure in the eight-year period in the context of their long term strategy.
- 4.13. DNOs will need to set out how their plans can achieve a range of demand and generation scenarios at efficient cost as set out in the Outputs and Incentives annex of this consultation.<sup>6</sup>

## **Criterion 2 - Outputs**

- 4.14. Where the DNOs set out how they will deliver their outputs over the full price control period and beyond (ie DNO's consideration of RIIO-ED2) is a key part of the business plan. To be considered 'well justified' a DNO's plan needs to clearly describe its outputs and secondary deliverables and explain how it will deliver these.

*Has the business plan covered the outputs specified in our strategy decision or provided clear and compelling justification for any departures from the strategy decision?*

- 4.15. Our strategy decision document will set outputs and secondary deliverables against the primary output categories (e.g. customer service, environment, safety, connections, reliability, etc). We expect DNOs to comply with the final policies that we set. Alternatively, the DNO will need to provide clear and

---

<sup>6</sup> Supplementary annex – Outputs and Incentives

compelling justification for departure from them. Ultimately it will be for us to decide whether to accept a DNO's proposals for new or revised outputs.

*Has the company explained the resource implications for delivery of each output identified?*

- 4.16. A well justified business plan would demonstrate how the DNO will achieve successful output delivery. This means identifying planning and resourcing requirements, especially where the level of activity looks to increase significantly from historical levels. The DNOs will be required to demonstrate that their resourcing requirements are efficient.
- 4.17. As part of their business plans the DNOs are required to set out their views on asset health, criticality and replacement priorities at:
- The start of the price control period, effectively reflecting their view on the current condition, risk and replacement priorities of the network
  - The middle of the price control period with no intervention, effectively reflecting their view on asset degradation over the period
  - The middle of the price control period with intervention as proposed in their well-justified business plan
  - The end of the price control period with no intervention, effectively reflecting their view on asset degradation over the period
  - At the end of the price control period with intervention as proposed in their well-justified business plan.

*Has the company explained how it will deliver outputs, and justified output baseline/forecast?*

- 4.18. The plan should clearly identify how a DNO intends to deliver the primary outputs. We outline these in the document on Outputs and Incentives and will finalise them in February's decision document. Except where we prescribe specific outputs levels, we will expect DNOs in their business plans to propose a target level delivery for each output and to justify this with reference to stakeholder feedback, network performance and a consideration of efficiency. The plan should clearly identify the impact of these outputs on the required expenditure for the price control period. Where we outline output levels in the strategy decision document, we will expect DNOs to provide justification where they consider an alternative level of outputs to be appropriate.

*Has the company explained the quality of its existing outputs and secondary deliverable information (including information on asset health, criticality and asset risk) and how it plans to improve this information in future?*

- 4.19. Good quality information on outputs, secondary deliverables and expenditure is a key part of the regulatory process. This information is essential for DNOs to manage their networks and prepare their forecasts, for customers to understand what will be delivered in return for price control allowances, and for Ofgem to assess business plans, set revenue allowance, output targets and incentives and monitor compliance with the price control settlements. As such DNOs should explain the current quality of their existing output and secondary deliverable information (including information on asset health and deterioration, criticality and asset risk) and how they intend to improve this information in the future to support the objectives discussed above.

### **Criterion 3 - Expenditure**

- 4.20. In its business plan the DNO must clearly set out and explain the costs of delivering its outputs. A well justified business plan will demonstrate, through clear evidence, that a DNO's costs are efficient.

*Has the company demonstrated that cost projections are efficient?*

- 4.21. The costs set out in the business plan should be efficient over the longer-term. DNOs will need to provide evidence that they need to do the work and that they have considered alternative options (e.g. OPEX and CAPEX alternatives, network and non-network solutions) and the costs of delivery are appropriate. This will include taking into account the longer term-development of their networks. We expect DNOs to use a range of tools in demonstrating the efficiency of their costs including internal and external benchmarking evidence and market testing. We would expect the DNOs to take a proportionate approach to providing evidence with greater information for more material areas of costs.
- 4.22. We will consider efficiency through our toolkit approach to cost assessment. This will include both higher level and more disaggregated analysis. It will also include comparisons of both forecasts and historical data across DNOs. If the costs a DNO identified are higher relative to other DNOs and past performance, then it will be for that DNO to demonstrate efficiency in the long term.

*How does the plan compare with others/ does it reflect best-practice?*

- 4.23. A key element in judging business plans will be the comparison of each DNOs plan with best practice. In assessing whether a plan is well justified, we will consider the quality of that plan in comparison with other plans in areas such as cost efficiency. We will also consider the extent to which a DNO has looked to other sectors in their approaches to the delivery of outputs and secondary deliverables.

*Has the company provided evidence that costs are efficient, eg through market-testing?*

- 4.24. The plans should provide sufficient evidence to support the DNO's proposals. The evidence should demonstrate that the forecast outputs are justified and the costs to deliver these outputs are efficient. A well justified business plan will demonstrate that efficient volumes are being proposed as well as appropriate unit cost for undertaking that work.
- 4.25. As set out in our RIIO recommendations, a key component of this evidence is market testing evidence.
- 4.26. The key test for Ofgem will be the level of scrutiny we consider we are required to undertake of a DNO's plan. DNOs should learn from the process undertaken by RIIO-T1 and GD1 companies.

*Has the company explained cost projections in context of historical performance?*

- 4.27. We expect DNOs to demonstrate in their plan how their forecasts relate to their performance under the current controls. For example, if a company recognises that it is likely to have inefficiently high costs relative to its peers for a particular activity it will need to demonstrate how it plans to address this inefficiency. If there is an under spend in the current period, then they will be expected to justify this and put their forecasts in the context of that previous performance.

*Has the company demonstrated a consideration of alternative approaches to achieve value for money in the delivery of its outputs?*

- 4.28. We expect DNOs to clearly demonstrate throughout their business plans that they have considered the use of alternative techniques (such as innovative technical, operational, commercial and contractual arrangements) in all areas of their business to deliver their outputs more efficiently and reduce costs.
- 4.29. We also expect that some of the projects funded under the IFI and LCN Fund will have delivered valuable learning that DNOs can utilise within their businesses. Therefore, we expect to see evidence of this learning (both from their own innovation projects and those of other DNOs) in the development of DNO's business plans.

*Has the company clearly linked its expenditure to relevant outputs and secondary deliverables?*

- 4.30. The DNOs should show how their expenditure forecasts map onto relevant outputs and secondary deliverables. In some cases there will be a direct link, in others some of the expenditure will have an enabling role in supporting the delivery of other work. For example, certain business support expenditure.



#### **Criterion 4 - Financing**

- 4.31. The DNO needs to clearly set out in its business plan how it plans to finance its activities over the price control period. To be considered 'well-justified' a plan must demonstrate, through clear evidence, that the DNO's financing projections are efficient.

*Does the business plan conform with the financial policies specified in the strategy, are any departures well-justified?*

- 4.32. This consultation sets out guidance on financial policies. These include cost of debt index, asset lives, tax, pensions and capitalisation as well as a methodology for arriving at the cost of equity. We expect that a well-justified plan will reflect these or provide robust analysis to support any departures from our policy.

*Has the company demonstrated that their financial costs are efficient?*

- 4.33. We expect DNOs to use a range of tools in demonstrating the efficiency of their financing costs, including: established economic models, evidence from market data and relevant comparators and precedents. We would expect the DNOs to take a proportionate approach to providing evidence with greater information for more material areas.
- 4.34. We would expect robust analysis to support any view on the value of parameters, especially where a company's proposal departs from our policies, is outside the ranges set out in the strategy document, or are out of step with precedent.
- 4.35. The DNO's plan should provide sufficient evidence to support its proposals. The evidence should demonstrate that the estimated financial costs are efficient. The evidence would include key elements of the financial arrangements including an assessment of risk, notional gearing, the cost of equity, financeability analysis and, if needed, any transitional arrangements.

*How does the plan reflect best-practice?*

- 4.36. A key element in judging business plans will be the comparison of each DNO's plan with best practice. In assessing whether a plan is well justified, we will consider the quality and efficiency of the DNOs' projections against appropriate comparators and, thus, whether there would be scope to make improvements in any areas.

## **Criterion 5 - Uncertainty and Risk**

*Has the company clearly articulated the key uncertainties it faces and how it will address them (eg including uncertainty mechanisms)?*

4.37. There will always be uncertainties about the appropriate outputs and expenditure requirements over the price control. A well justified business plan will need to articulate the key uncertainties the DNO faces and how the DNO has taken account of these in developing its long-term business strategy. We have set out our thinking on potential uncertainty mechanisms in this consultation.<sup>7</sup> The DNOs have the opportunity in their business plans to say which of these mechanisms we think are required and to propose additional mechanisms that meet our principles.

*Has the company considered risk and how to mitigate those risks?*

4.38. An important part of any price control settlement involves considering what type and what level of risk it is efficient for DNOs to bear and what risks if any should be borne by customers. A well-justified plan should demonstrate an assessment of risk during the price control period and say what the company intends to do in the light of that risk.

4.39. DNOs should outline how they plan to strike an appropriate risk balance by identifying what they will include in their ex ante allowance and what they will include in uncertainty mechanisms. The consequences of these risks should be clearly modelled and linked to the justification of forecast financing costs.

---

<sup>7</sup> See Outputs and Incentives document of this consultation

## 5. Guidance on presentation and structure

---

### Chapter Summary

This chapter sets out our proposals on guidance on how DNOs should present and structure their business plans. These proposals have been developed in light of stakeholder feedback and our experiences on RIIO-T1 and GD1.

**Question 1:** Is there anything else, in the context of the presentation and structure of the business plan, which we should provide guidance on?

**Question 2:** Should we require DNOs to conform to the proposed document structure (set out in figure 5.1), some other prescribed structure, or let the DNOs structure the plans as they see fit?

**Question 3:** Should we set a page limit for the executive summary of the plan? How long should it be? Are there other areas where we should consider setting page limits?

**Question 4:** Do you agree with the information that we are proposing should be required in each DNO's executive summary? What other information would be useful?

**Question 5:** What should be the common metric, calculation and assumptions for determining the impact of the DNOs proposal on consumer's bills?

### Introduction

- 5.1. As part of the RIIO-T1 and GD1 processes Ofgem provided limited presentation and structural guidance for the DNOs. Our view was that DNOs should be left to develop and present their plans in whatever manner they deemed most appropriate, noting that the presentation of the business plans would be one of the areas that Ofgem would consider in our assessment of the plans. We were keen that the DNOs should develop real business plans for use by their employees and stakeholders, rather than just regulatory submissions.
- 5.2. As set out in chapter 2, our view is that the business plans submitted under RIIO-T1 and GD1 were more accessible than those presented under previous price controls. However, in assessing some of the initial submissions we had concerns over the volume of information submitted, how it was presented and the comparability of elements of the plans that we received.
- 5.3. Clearly there is a balance to be struck between allowing freedom for DNOs to demonstrate their own approaches and corporate identity, and ease of use for Ofgem and other stakeholders during the review process, including the ability to make comparisons between DNOs on similar topics.
- 5.4. Following the RIIO-T1 and GD1 processes we have received a range of feedback from stakeholders on the format of the business plans. In July 2012

we held a workshop attended by DNOs and a range of their stakeholders to discuss the presentation and structure of the business plans. We decided to review the need for presentation and structural guidance in the RIIO-ED1 business planning process based on this feedback from our experience of the RIIO-T1 and GD1 plans.

## Principles of Guidance


- 5.5. In general, we consider that the aim of providing any obligations in terms of business plan guidance should be to ensure that:
- plans are coherent and consistent so as to allow for effective comparison and assessment across DNOs
  - it is easy for Ofgem and other stakeholders to find the information they require
  - DNOs have sufficient guidance on what they need to produce in order to focus their efforts most appropriately.

## Stakeholder views

- 5.6. Through the RIIO-T1 and GD1 processes we received a range of feedback from stakeholders on the business plans. On 13 July 2012 Ofgem held a workshop for DNOs and their stakeholders to discuss potential presentation and structural guidance. We have published all the slides and a summary of the workshop on the RIIO-ED1 website.<sup>8</sup>
- 5.7. In their feedback stakeholders brought up a number of key points. In particular we note that they:
- stressed the importance of consistency of presentation across all business plans to make the plans easy to read and easier to find common information,
  - agreed that Ofgem should set out a common structure for the plans (at least at a high level),
  - felt it of vital importance to be able to find information as quickly and easily as possible (many stakeholders said that hyperlinks would be very useful in helping readers to navigate around the documents),

---

<sup>8</sup> [RIIO-ED1 website](#).



## Strategy consultation for the RIIO-ED1 electricity distribution price control Business plans and proportionate treatment

- stressed the need for plans to clearly be 'working documents' for use/reference by company employees, shareholders and stakeholders, not just submissions to the regulator,
- set out that DNOs should take care to ensure that their plan is easy to read both in hard copy and, importantly, on computer screen (which is the way that most readers are likely to read the plan),
- wanted to see a standardised approach to presenting information and high level data that is clearly linked to, and consistent with, the detailed data submissions,
- expected to see all elements of the business plans, and proposed that only in exceptional circumstances should redactions be made to the publically available plans,
- acknowledged that DNOs would not know everything and to be able to plan ahead with 100 per cent certainty. DNOs should be up front about what they do and don't know, and then set out how they will deal with this uncertainty.

5.8. Following this feedback, and our own consideration, we have developed proposed presentation and structural guidance for the RIIO-ED1 plans. Our proposals are presented in the remainder of this chapter in three key areas:

- Presentation – the written style and look of the plans
- Structure – how the information in the plans should be grouped to allow for a good level of consistency and comparability across the plans
- Navigation – how to make it easier for readers to find the information they require easily (without having to search the whole document(s)).

5.9. The guidance in the rest of this chapter is what we are proposing that DNOs should follow when writing their business plans. However, as well as these proposals, DNOs should also be mindful of any individual stakeholder feedback they receive when considering how to develop their plans.

### **Presentation**

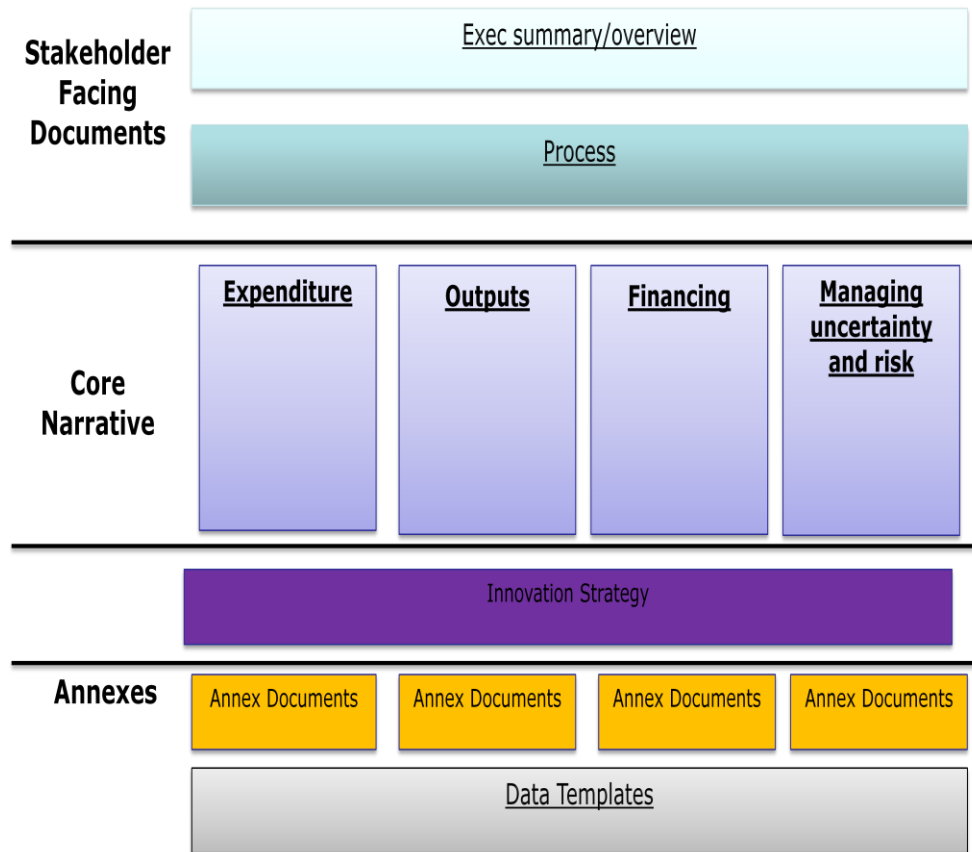
5.10. Consideration should be given to the reader who may be reading the document on the screen or in hard copy. Business plans should be clearly written, with considerable emphasis on making them as easy to read as possible. Plans should avoid using over complicated or technical language. This is particularly the case in the stakeholder facing documents, such as the executive summary and chapter summaries. Where technical terms need to be used they should be carefully explained.

- 5.11. We also consider that plans should be concise with the emphasis on keeping the core narrative as short as possible, while presenting proportionate evidence and justification for the proposed expenditure and outputs. Any additional information should be annexed with clear links to the core narrative. A short concise document is easier to read and easier to assess.
- 5.12. To ensure brevity, information and evidence should be provided on a proportionate basis. If information is particularly important to the plan, has a high materiality (in terms of costs or outputs), or where there is a significant departure from Ofgem policy, then the plans should have a higher level of discussion and evidence to support the DNO's proposal. In less material areas, less detail is needed. It is up to the DNO to prioritise the information and evidence presented. The DNO needs to strike the balance between presenting key information whilst ensuring they do not make plans overwhelmingly long and incoherent. The provision of proportionate evidence is key in developing a business plan that is well justified.
- 5.13. Plans need to be written as documents that will be used over the eight year control period. The DNOs should strive to make them as relevant and useful in year eight as they are in year one.

## Structure

- 5.14. Feedback from RIIO-T1 and GD1 stakeholders was that the structure of the business plan was very important to them. A clear structure made the plans more easily readable by guiding them to the information required. However, it was noted that in RIIO-T1 and GD1 the DNOs structured their business plans in different ways. This made the plans more difficult to compare and was a barrier to readers quickly accessing the information they required.
- 5.15. We think that guidance on structure would help DNOs to produce more consistent plans. This would make the review process easier, particularly during the initial assessment stages when the plans are unfamiliar. However, a balance needs to be struck - we do not want to set too rigid a structure that will prevent the DNOs from providing all the information they think is needed, or stops them making decisions about how best to communicate with their stakeholders. We also recognise the desire for individual companies to reflect their own corporate identities in their plans.
- 5.16. As such we propose that the DNOs' business plans should conform to a high level structure. This should provide clarity on which section of the document will contain the information required. Figure 4.1 sets out a possible high level business plan structure. A description of what we would expect each of these documents might include follows.


**Figure 5.1. Proposed high level structure of business plans**



### Stakeholder Facing Documents

#### *Executive Summary*

- 5.17. The executive summary should be where the DNO provides the key information that stakeholders will need in order to acquire a basic understanding of the key elements of the business plan. DNOs should also set out their vision for the eight year price control period and, at a high level, how they intend to deliver this vision.
- 5.18. For many readers the executive summary may be the only part of the plan which they read in full. It should provide an overview of the key points in the plan with clear linkages on where to find more detail in the core narrative of the plan. We are consulting on the specific information that all DNOs should be required to include in their executive summaries.
- 5.19. We consider that at a minimum the executive summary should include:



## Strategy consultation for the RIIO-ED1 electricity distribution price control Business plans and proportionate treatment

- A summary of the outputs and secondary deliverables the DNO will be delivering during the period and the expenditure required to deliver them
- An explanation of how the proposed expenditures set out in a DNO's business plan will impact on consumer bills. This should be presented upfront and in a clear, consistent and easy to understand format. The information should be provided for both business and domestic consumers. We believe that a common methodology to calculate these metrics (eg. £/customer/year) should be used across all DNO plans, since the DNOs have a common charging methodology
- The DNO's understanding of uncertainty of the price control period and how they propose to manage it including a summary of any uncertainty mechanisms they are proposing
- The key financial proposals that the company is making. This should include:
  - Components of the cost of capital (i.e. cost of debt, cost of equity, notional gearing)
  - Financial policies (such as totex capitalisation rate and any proposed transition on asset lives)
  - The total revenue request that is being made by the company.

5.20. Some stakeholders have noted that some of the executive summaries in the RIIO-T1 and GD1 business plans were overly long. As such we are consulting on whether a page limit should be set for this document.

### *Process overview*

- 5.21. We propose that each business plan should have a brief overarching section outlining the processes that the DNO followed in developing its plan. It should include how the DNO conducted its stakeholder engagement, including who it engaged with, what questions the stakeholder were asked, and what the responses from the stakeholders were.
- 5.22. The internal processes undertaken in the drafting of the plan should demonstrate how the whole of the business was involved in the development of the plan. DNOs should provide written confirmation that the submission includes all requisite information and data tables.
- 5.23. All sections of the plan need to demonstrate that they have been informed by the processes outlined in the process overview section (for instance, by stakeholder engagement). It is important that the process overview is not



just a stand-alone section, these processes need to be evidenced through the discussions in the rest of the business plan.

### **Core Narrative Sections**

5.24. The core narrative sections of the plan is where the DNOs present all the information that is required, answering all the key questions that are set out in assessment criteria guidance (Chapter 4 of this document).

#### *Outputs*

5.25. In this section DNOs should provide clear and comprehensive outputs and secondary deliverables. The RIIO model identifies six key output categories – or key areas of delivery for network DNOs. These are:

- Environment
- Customer satisfaction
- Connections
- Social objectives
- Safety
- Reliability and availability.

5.26. DNOs should ensure that they fully cover how they plan to deliver against these outputs which are set out in more detail in this consultation<sup>9</sup> (and will be finalised in our strategy decision in February).

#### *Expenditure*

5.27. In this section we expect DNOs to set out clear and comprehensive costs and volumes, and the associated primary outputs and secondary deliverables that these will achieve. This section should describe in detail the information contained in the data templates.

5.28. The forecast costs and volumes should be clearly justified by the DNO. Cost information to secondary deliverables (including health indices and load indices) as well as to primary outputs. For some activities, this justification may require a full and comprehensive CBA and consideration of the whole life costs. Chapter 6 of this document provides further detail on this.

---

<sup>9</sup> See Outputs and Incentives document of this consultation

- 5.29. We do not expect costs in one area to be considered in isolation of other areas. DNOs should put forward a more comprehensive approach to explain their forecast expenditure. For example, with regards to the management of assets, rather than simply being the lowest cost in one isolated area, DNOs should recognise the trade-off between different types of asset intervention such as asset replacement, refurbishment, inspection and maintenance and replacement.

### *Financing*

- 5.30. DNOs' business plans should set out their financial proposals for RIIO-ED1. Broadly, the financial proposals should cover three areas - the allowed return (cost of capital), evolution of the RAV (i.e. capitalisation and depreciation) and financial policies (pensions and taxes). We expect the DNOs to develop business plans that balance the different elements of the financial proposals in a manner consistent with the RIIO principles. Below we set out in more detail the elements that should be included in a well-justified business plans, and the considerations that the DNOs should have regard for in developing their plans.
- 5.31. The DNOs should provide proposals for the cost of equity and notional gearing components of the allowed return. In line with the RIIO principles, these should reflect an assessment of cash flow risk during RIIO-ED1. In assessing cash flow risk, the DNOs may want to consider, among other things: the level of investment (relative to RAV), uncertainty mechanisms, and the cash flow implications of output and incentive mechanisms. The DNOs should also have regard to evidence from appropriate economic and financial models (particularly the Capital Asset Pricing Model (CAPM) for the cost of equity), as well as evidence from financial markets, including network company transactions where relevant.
- 5.32. With regard to the cost of debt, in line with our strategy document, a DNO may propose alternative weighting to the cost of debt index if it can show that its circumstances during RIIO-ED1 are such that the unweighted trailing average may not reflect its efficient cost of debt under a range of reasonable scenarios. The DNO would be required to show how any such proposal better balances the interests of consumers and investors, and will need to propose a transition to the unweighted average index by the start of RIIO-ED2.
- 5.33. The DNO should set out in its business plan the capitalisation rate that will be applied during RIIO-ED1. This should be in line with the policy set out in our strategy decision. Likewise, RAV depreciation, the funding of pension deficits, and the allowance for tax should all be applied in line with our policies. Any proposed departures from our policies should be clearly stated and justified.
- 5.34. The DNOs should test their business plans to ensure that they achieve credit ratios that are consistent with a 'comfortable investment grade' credit rating (ie in the BBB to A range), as defined by the major credit rating agencies. It is

suggested that the DNOs test this under a range of reasonable scenarios. In addition, the DNOs should test that the business plan is consistent with achieving a range of returns of regulatory equity with a downside around the cost of debt and an upside in the low double digits (both figures in real post-tax terms).

### *Managing Uncertainty and risk*

- 5.35. This section of the plan is where DNOs set out how they plan to deal with uncertainty and mitigate against risk. During the ED1 period (and beyond) there is significant uncertainty around future capacity requirements driven by the take up of low carbon technology (LCT) such as heat pumps, photovoltaics, electric vehicles and distribution connected generation (DG).

### Scenarios

- 5.36. The government has set out a range of scenarios through which Great Britain can achieve its climate change targets. The mix of low carbon technologies in each scenario will have a different impact on the network and require different amounts of investment. The DNOs have committed to provide Ofgem with the indicative materiality of the impact of each DECC scenario compared to a business as usual base case, in December 2012.
- 5.37. For the submission of business plans, we propose that each DNO selects a 'best view' scenario which reflects their view on the volume of likely impact of accommodating low carbon technologies on their network they expect to be asked to accommodate. This view could be one of the DECC scenarios or a different scenario the DNO has constructed through informed stakeholder engagement. Alongside this best view, we propose that DNOs should also provide an appropriate limited level of information on the forecast relating to the impact of all four DECC scenarios on their area. We anticipate that we will require the business plans to include full details of the cost impact of addressing a common scenario (the 'reference case') from which we can assess each DNO's 'best view'. We propose that this reference case should be the DNO-specific equivalent of the DECC low scenario. This reference case will allow us to compare DNOs' costs against a common scenario. In the strategy decision document We will provide clarity on the level of detail we expect DNOs to provide across all scenarios once we have reviewed the data DNOs submit in December.
- 5.38. We acknowledge that the DNOs 'best view' may not be the scenario which materialises. Therefore, as indicated above, we expect DNOs to present a narrative on how their investment strategy can be flexible to meet demands associated with any of the DECC scenarios. We propose that this should include a mixture of ex ante allowance and uncertainty mechanisms to share the risk of this uncertainty between DNOs and consumers.

### **Innovation strategy**

- 5.39. As set out in chapter 3, we expect DNOs to clearly demonstrate throughout the core narrative of their business plans that they have considered the use of alternative techniques (such as innovative technical, operational, commercial and contractual arrangements) in all areas of their business to deliver their outputs more efficiently and reduce costs. We expect this to be demonstrated in all the core narrative of the plan described above. The innovation strategy is intended to provide DNOs with a separate opportunity to demonstrate to their stakeholders and Ofgem the role of innovation in their business including their innovation implementation strategy and how they will deliver value for money when progressing innovative projects funded by consumers.

### **Annex documents**

- 5.40. DNOs should strive for brevity in the core narrative and stakeholder facing documents. Where the DNO needs to provide further information it should use annex documents. Annexes should be clearly signposted and referenced within the core text. More technical information may be provided in the annex documents but the DNO should still strive to make the annex documents as clear and readable as the rest of their business plan.

### **Data Templates**

- 5.41. DNOs should fully and accurately complete the detailed data templates of the business plan as instructed by any guidance document. For example, if the guidance states that network length in kilometres, any other metric is not acceptable.
- 5.42. We intend to work with DNOs in the coming months to develop a suite of data templates that will facilitate a consistent presentation of the cost, volume, output and financial data underpinning the business plan submissions. At this stage we envisage using the current annual reporting pack and the high level "business as usual" forecast pack as our starting point. Wherever feasible we will request data in a manner consistent with current reporting. We believe this is a proportionate approach and should facilitate easier comparison of forecasts with historical data.

### **The Price Control Financial Instruments**

- 5.43. The Financial handbook and the PCFM are collectively referred to as the Price Control Financial Instruments. DNOs will be required to populate the PCFM with data consistent with the business plan. The financial instruments are proposed to be incorporated into a new 'Governance of Price Control Financial Instruments' licence condition of each licence and will be subject to a formal modification process set out in that condition.

## Navigation

- 5.44. Readers of the plan should be able to find the information they require quickly and easily. This will save them a lot of time and effort and also save the DNOs themselves from having to provide further clarification at a later date.

## Cross referencing

- 5.45. A key part of navigating the plans will be cross referencing between different parts. Strong stakeholder feedback is that the use of hyperlinks would be a great help to readers. Hyperlinks should be included when referencing any of the data tables, annexes or any further detail which is explored elsewhere in the plan (including the annex documents).
- 5.46. It is important to have clear links between the data tables and the main narrative. Data tables should be clearly numbered and any referenced data should be clearly linked to the relevant data table number (and hyperlink). For each data table there should also be a link to where in the main narrative this data is mentioned, for some data tables this may be more than one part of the plan that describes the data.

## Overview for each section

- 5.47. Each section of the plan should have an overview and contents page. It should be easy (using hyperlinks) for readers to get to the information they require.
- 5.48. Each DNO should include a section upfront explaining how its plan fits together, this should include a table that maps our assessment criteria to relevant parts of the plan and another that maps individual cost, output, uncertainty and finance areas to the relevant sections of the plan.

## 6. Cost benefit analysis

---

### Chapter Summary

This chapter sets out our proposals on cost benefit analysis. It sets out the parameters that may need to be specified in order to ensure consistency in how DNOs undertake this critical input to their business plan submissions. It sets out areas where further work is required ahead of us reaching a decision.

**Question 1:** Do you agree with our proposed approach to cost benefit analysis?

**Question 2:** Do you agree with our proposed approach to have a threshold level of expenditure to determine whether cost benefit analysis is required?

**Question 3:** What level of expenditure do you believe should be used as the threshold for determining when cost benefit analysis should be provided as part of the business plan submission?

**Question 4:** Have we identified all of the relevant parameters to ensure consistency in how cost benefit analysis is undertaken?

**Question 5:** What are your views on the levels the parameters should be set at?

### Introduction

- 6.1. In RIIO-GD1 we considered that in order to properly assess and compare the different business plans, we needed the GDNs to adopt a common approach to cost justification. We therefore issued guidance on a common approach to investment appraisal. This was based on guidance published by the Joint Regulatory Group (JRG) "Discounting for CBAs involving private investment, but public benefit"<sup>10</sup> and the HM Treasury Green Book ("the Green Book").<sup>11</sup>
- 6.2. We propose to issue similar guidance for RIIO-ED1, whilst recognising sectoral differences. It is not intended as comprehensive guidance to investment appraisal. We anticipate this guidance will apply for areas of expenditure where the costs forecast to be incurred over the life of the asset/activity are material and where the DNO has discretion over the choices it makes. Such whole life costs should encompass the operational costs required to maintain and service an asset as well as the initial capital costs to buy and install the asset.
- 6.3. We envisage this guidance being applied at an asset class level, as opposed to on group activity level. This approach may need to vary and could, in some circumstances, involve running combined assessments for assets located together, e.g. various items of plant at a substation.

---

<sup>10</sup> <http://stakeholders.ofcom.org.uk/consultations/discounting-for-cbas/summary>

<sup>11</sup> [http://www.hm-treasury.gov.uk/d/green\\_book\\_complete.pdf](http://www.hm-treasury.gov.uk/d/green_book_complete.pdf)

- 6.4. We have set out in this consultation that we expect DNOs to consider, in their business plans, the opportunities presented by smart grids solutions. We appreciate that this is a new area, and that DNOs may not have had experience in justifying these types of expenditure. The Smart Grid Forum (SGF)<sup>12</sup> has developed a model to evaluate the cost benefit of smart grids solutions against scenarios of low carbon technology take-up. We expect the DNOs to continue the development of this model, including the functionality to use the guidance set out here, and to use the model when justifying smart grids solutions in their business plans.
- 6.5. This chapter covers the material issues and differences we identified when reviewing the GDNs' plans (for example in relation to discount rates, economic asset lives, and sensitivity analysis). The additional guidance we set out below is consistent with the Green Book.
- 6.6. Our working group meetings discussed the RIIO-GD1 Real Options and Investment Decision Making paper<sup>13</sup> and the potential range of approaches DNOs may utilise to deliver lowest whole life cost solutions. Areas identified have included the upsizing of cables, deferring asset replacement until future requirements are more certain as well as the use of demand side management and smart grids. We are developing our cost assessment toolkit with a clear mind to all of these factors. The approach we take to cost assessment is intended to treat all options on their merits and DNOs will need to provide evidence in their business plans that they have given due consideration to a range of credible solutions.
- 6.7. We propose that a key aspect of our assessment of DNOs' business plans will be their consistency with the investment appraisal guidance set out in this chapter. As part of their business plan submissions, we propose that DNOs should submit their cost benefit analysis (CBA) spreadsheet models and supporting documents for all areas where they have employed CBA. We would also expect to ask DNOs to confirm that their analysis is consistent with the framework set out (or alternatively identify the areas where it is not, and the reason for departing from it). We anticipate developing a spreadsheet model, as was done in RIIO-GD1, to accompany the business plan guidance which DNOs would submit as part of their July 2013 business plan submission.
- 6.8. This chapter covers the following areas:
- Identification of options
  - Identification and quantification of costs and benefits

---

<sup>12</sup> A forum of leading thinkers on smart grids jointly headed by Ofgem and DECC. More information [here](#)

<sup>13</sup> [http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/Real\\_options\\_investment\\_decision\\_making.pdf](http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/Real_options_investment_decision_making.pdf)

- Time period for discounting costs and benefits
- Sensitivity analysis
- Decision rule
- Affordability
- Link to business plans.

## Identification of options

- 6.9. Consistent with the Green Book, DNOs should clearly identify the range of options that were considered to meet the stated aim. This list should include an option that takes the minimum action necessary (the 'do minimum option') against which other options are compared.
- 6.10. We currently propose that the list of options should include those that have been considered and rejected before full costing, and those that have been considered and costed, with a clear rationale for including/excluding. For example, in considering the options in relation to maintaining the integrity of a HV transformer, the options could include the do minimum option, an option based on (heightened) maintenance of the asset, and replacement of the asset.

## Identification and quantification of costs and benefits

- 6.11. For the short-list of options that have been considered and costed, the DNO would identify the costs and benefits of options relative to the do minimum option. We set out below guidance in relation to discounting the costs and benefits, valuing of marketed and non-marketed goods, and other assumptions. We address the economic period for the CBA (or economic life of the investment) in a later section below.

## Discounting and the cost of capital

- 6.12. CBA is concerned with social costs and benefits and the Treasury specifies a social time preference discount rate (STPR) for comparing such costs and benefits over time. When CBA includes the costs of proposed new assets that will be privately financed the financing costs need to be included. Our proposed guidance adopts the JRG guidance, described as the Spackman approach. This is also the approach adopted by other regulatory bodies, and in comparable circumstances in central government (ie where the investment is private but the benefits are public).



- 6.13. The approach involves discounting all costs (including financing costs as calculated using the weighted average cost of capital (WACC)) and benefits at the STPR. This involves the following two steps:
1. Convert capital costs into annual costs using the company's cost of capital
  2. Use the STPR of 3.5 per cent in discounting all costs and benefits, as recommended by the Green Book.
- 6.14. The capital costs should be converted into the equivalent annual costs that are recovered through customers' bills. We expect to require DNOs to convert the capital cost into the annual cost using the sum-of-the-years' digits (SOYD) depreciation method in line with our regulatory depreciation policies. The annual capital costs would also be calculated over the assumed economic life of the asset (as we discuss below).
- 6.15. To convert capital costs into the annual cost recovered through customers' bills, we envisage requiring DNOs to use the same pre-tax WACC. This could be the level set at DPCR5.

### **Financial costs and benefits**

- 6.16. The financial costs and benefits should correspond to the financial/market values set out in the DNO's business plan (where applicable). For example, the expected reduction in any cost of repairs and maintenance (a benefit) arising from an investment should be consistent with the assumptions on unit repair and maintenance costs set out in the plan.
- 6.17. The financial costs and benefits should also include RPEs net of expected productivity improvements. However, we would expect DNOs to build functionality within their CBA to enable the analysis of alternative assumptions on these issues.
- 6.18. Where expenditures are justified using the reduction of electricity lost, DNOs should use the wholesale price of electricity less the EU Emissions Trading Scheme (ETS) cost of carbon (which is factored into the wholesale price) plus the carbon abatement value described below.

### **Treatment of non-marketed goods**

- 6.19. The CBA should include the non-marketed goods that can be monetised. We expect the principle monetised non-marketed goods to be the value of carbon abatement and the value of preventing fatalities and injuries.

- 6.20. In relation to carbon abatement values, we anticipate requiring DNOs to use the DECC non-traded carbon values.<sup>14</sup> For the benefits associated with preventing fatalities and injuries, we also expect to require DNOs to draw on guidance set out in the Green Book<sup>15</sup> and the CEPA April 2011 report.<sup>16</sup>
- 6.21. The Health and Safety Executive (HSE) and JRG guidance notes that a lower discount rate can be used for health and safety benefits.<sup>17</sup> That is, if we assume that that health and safety impacts measured in today's monetary value have a constant marginal utility impact over time, such benefits may simply be discounted at the "pure time preference rate" or PTPR<sup>18</sup> for marginal utility. The Green Book estimates the PTPR at 1.5 per cent.
- 6.22. Our view at this stage, and consistent with RIIO-GD1, is that DNOs should not use the PTPR for discounting DECC's carbon values but instead should use the STPR. This approach is consistent with DECC and Green Book guidance.
- 6.23. At this point we expect that DNOs would also set out any non-marketed impacts or factors that cannot be monetised within the wider investment appraisal.

#### **Other assumptions regarding discounting**

- 6.24. A common base year should be used and at this stage we are proposing to set it at 2015. The DNOs should assume that a specified percentage of benefits are realised in the first year of the project. For RIIO-GD1 this was assumed to be 50 per cent and we propose to continue with this assumption for RIIO-ED1.

#### **Period for discounting costs and benefits**

- 6.25. The period for the CBA should be the useful economic life of the asset. We intend to specify a maximum value that should be used.
- 6.26. As discussed in the Flexibility and Capacity chapter of the 'Supplementary annex - Outputs and incentives' paper there is significant uncertainty over the rate of take up and the geographic distribution of low carbon technology, and thus the economic life of new assets and the prospective benefits.

---

<sup>14</sup> [http://www.decc.gov.uk/assets/decc/what%20we%20do/a%20low%20carbon%20uk/carbon%20valuation/1\\_20100610131858\\_e\\_@@\\_carbonvalues.pdf](http://www.decc.gov.uk/assets/decc/what%20we%20do/a%20low%20carbon%20uk/carbon%20valuation/1_20100610131858_e_@@_carbonvalues.pdf)

<sup>15</sup> [http://www.hm-treasury.gov.uk/d/green\\_book\\_complete.pdf](http://www.hm-treasury.gov.uk/d/green_book_complete.pdf)

<sup>16</sup> <http://www.hse.gov.uk/research/rrpdf/rr888.pdf>

<sup>17</sup> <http://www.hse.gov.uk/risk/theory/alarpcba.htm>

<sup>18</sup> NERA (9 August 2007) Discount Rates for the Office of Rail Regulation, p.3

- 6.27. We propose to require DNOs to consider the uncertainty over the future use of electricity networks in modelling the prospective benefits and in the assumption relating to the economic life of the investment.
- 6.28. We note that not all investment decisions will be affected by the uncertainty over the future of electricity networks. As one potential example, the costs and benefits associated with tree cutting might be largely unaffected by uncertainty over future network use. This is because tree cutting will still need to be undertaken regardless of the penetration of low carbon technologies.
- 6.29. We also propose that DNOs present sensitivity analysis relative to the central assumption for the economic life of the asset.

### Assessing risks and uncertainties, and sensitivity analysis

- 6.30. We propose that the DNOs should set out sensitivity analysis for the key risks and uncertainties. Based on our experience to date in RIIO-GD1 and discussions with the DNOs to date, we consider that the main uncertainties/risks relate to:
- The economic life of the asset (as discussed above)
  - The current assumed performance of the asset (for example in terms of repairs and maintenance, losses, customer interruptions, fault rates etc), and the expected deterioration in the performance of the asset over time.
- 6.31. To accommodate uncertainty over the economic life, we propose that DNOs should include functionality within their CBA model to analyse the net present value (NPV) for different pay-back periods. We intend to discuss this issue in the coming months and expect to specify what these should be in the final Business Plan guidance. We propose that DNOs should also set out the switching value for the economic life of the asset.<sup>19</sup>
- 6.32. In RIIO-GD1 we took a view that for investment in network assets, taking into account the uncertainty over future network use, that we would expect the project to have a positive NPV over a much shorter economic life than 45 years, which had been specified as the maximum, in order to justify inclusion in GDNs' plans. Adopting a shorter economic life provides a heuristic approach to dealing with uncertainty over future network use. Such an approach incorporates an implicit option value or insurance value of deferring the

---

<sup>19</sup> The HMT Green Book states: *The calculation of switching values shows by how much a variable would have to fall (if it is a benefit) or rise (if it is a cost) to make it not worth undertaking an option. This should be considered a crucial input into the decision as to whether a proposal should proceed. It therefore needs to be a prominent part of an appraisal.* Source: HM Treasury Green Book (2003) paragraph 5.79.

investment decision (until a future date when the uncertainty will be at least partially resolved) within the investment decision.

- 6.33. Given the uncertainties in relation to future requirements of the electricity distribution networks, we may need to apply a similar approach for RIIO-ED1. This will be discussed further in the working group meetings before reaching a decision.
- 6.34. In relation to asset performance, we would expect DNOs to set out a sensitivity based on the assumption of no further deterioration in the asset's performance relative to the base year assumption.

## Decision rule

### Overall rule

- 6.35. The CBA analysis may need to be undertaken at a project level or at an asset class/activity level where the same /similar characteristics are displayed (eg HV transformers that are H15 and CI4 might be presented together under one CBS). In any case (subject to any significant factors that are not monetised) the overall investment plan should constitute all projects which have positive (or strictly non-negative) NPVs. In other words, at a strategic level the DNO should invest up to the point that the marginal project has a NPV greater or equal to zero.
- 6.36. Where the project has a marginally positive or negative NPV the DNOs should consider the inclusion/exclusion of such a scheme drawing on identification of any non-monetised benefits or costs. As an example, such non-monetised costs/benefits might include (non-monetised) engineering judgement on what constitutes an efficient project. We envisage that DNOs would clearly set out such judgements as part of their submission.

### Project components

- 6.37. There may be instances where DNOs propose the replacement of an entire population of an asset class on the basis that at the population level the NPV is positive. We expect there will be separable projects which have a negative NPV and should be excluded. Consistent with the above decision rule, we propose that each individual project within the population should have a positive NPV.
- 6.38. A project can also comprise a number of different components. For example, a DNO might propose a project with the principal aim of replacing a specific faulty cable, but also propose the replacement of a contiguous cable within the same project on the basis that the marginal cost of replacing the contiguous cable is low. In such a case, there are two clear components: the faulty cable, and the contiguous cable. In this instance we propose that the DNO will need

to demonstrate that the separable components have a positive NPV. If the NPV of the contiguous cable component has a negative NPV this should be excluded even where the overall NPV of the components taken together is positive.

- 6.39. We accept that in some instances the rationale for the replacement of the contiguous cable might be based on engineering judgement rather than explicit cost benefit analysis. In such cases, the engineering judgement supporting the contiguous cable inclusion (in this example) needs to be set out.

### **Benefit cost ratios (BCRs)**

- 6.40. DNOs should also present benefit cost ratios (BCR) for the proposed schemes. The BCR is the ratio of discounted benefits to discounted financial costs, and will be greater than one for projects with a positive NPV. The BCR should be used to help prioritise projects where there is a funding or delivery constraint. For example, in the context of EHV and above general reinforcement, the BCR will help identify those schemes that should be prioritised ahead of others.

### **Affordability**

- 6.41. We propose that the DNO should show the actual customer bill impacts of the proposed investment for each individual asset class as well as the overall investment plan for the period RIIO-ED1 and RIIO-ED2. The impact of the investment programme on customers' bills should be evident from the proposed approach to CBA as discussed above where costs and benefits are set out in terms of customers' bills.) To ensure that this is the case, in our Business plan guidance document we propose including a common customer impact table.

### **Links to business plan**

- 6.42. DNOs should clearly show the links between their CBA and the business plan and business plan data templates. For example, the DNOs should show how the workload and cost reductions underpinning the proposed asset investment and CBA plans feed through into the overall business plan proposals.

## Appendices

---

<b>Appendix</b>	<b>Name of Appendix</b>	<b>Page Number</b>
1	Consultation response and questions	47

## 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 writers and readers of the business plans.

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 23 November 2012 and should be sent, preferably by email, to:

- Anna Rossington
- Head of RIIO-ED1
- Ofgem, 9 Milbank, LONDON, SW1P 3GE
- 020 7901 7401
- [RIIO.ED1@ofgem.gov.uk](mailto:RIIO.ED1@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](http://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. Any questions on this document should, in the first instance, be directed to:

- Sam Cope
- Senior Manager, Policy Development
- Ofgem, 9 Milbank, LONDON, SW1P 3GE
- 020 7901 7239
- [RIIO.ED1@ofgem.gov.uk](mailto:RIIO.ED1@ofgem.gov.uk)

### **CHAPTER: One**

No questions

### **CHAPTER: Two**

No questions

### **CHAPTER: Three**

**Question 1:** Do you have any comments on the timing and stages of the assessment process?

**Question 2:** Do you agree with the three stage assessment process for RIIO-ED1?

**Question 3:** Do you think the additional reward for fast tracking is appropriate?

### **CHAPTER: Four**

**Question 1:** Does the categorisation of the assessment criteria remain appropriate?

**Question 2:** Are there any criteria which we should add or amend in the context of RIIO-ED1?

### **CHAPTER: Five**

**Question 1:** Is there anything else, in the context of the presentation and structure of the business plan, which we should provide guidance on?

**Question 2:** Should we require DNOs to conform to the proposed document structure (set out in figure 4.1), some other prescribed structure, or let the DNOs structure the plans as they see fit?

**Question 3:** Should we set a page limit for the executive summary of the plan? How long should it be? Are there other areas where we should consider setting page limits?

**Question 4:** Do you agree with the information that we are proposing should be required in each DNO's executive summary? What other information would be useful.

**Question 5:** What should be the common metric, calculation and assumptions for determining the impact of the DNOs' proposal on consumer's bills?

### **CHAPTER: Six**

**Question 1:** Do you agree with our proposed approach to cost benefit analysis?

**Question 2:** Do you agree with our proposed approach to have a threshold level of expenditure to determine whether cost benefit analysis is required?

**Question 3:** What level of expenditure do you believe should be used as the threshold for determining when cost benefit analysis should be provided as part of the business plan submission?

**Question 4:** Have we identified all of the relevant parameters to ensure consistency in how cost benefit analysis is undertaken?

**Question 5:** What are your views on the levels the parameters should be set at?