Promoting choice and value
for all gas and electricity customers

Initial assessment of RIIO-T1 business plans

Supplementary Annex

Reference:	136A/11	**Contact:**	Chris Watts
Publication date:	24/10/11	**Team:**	RIIO-T1
		Tel:	0207 901 7498
		Email:	Chris.Watts@ofgem.gov.uk

Overview:

This document summarises our initial assessment of the companies' business plans for the next transmission price control (RIIO-T1). We are publishing this supplementary annex alongside our letter 'Initial assessment of RIIO-T1 business plans and proportionate treatment'.

A core element of the new RIIO framework is the concept of proportionate treatment, ie that the level of regulatory scrutiny we apply will be proportionate to the quality of their plans. We also set out the possibility of settling price controls early – "fast-tracking" – for companies that submit particularly high quality plans.

As well as providing details of our assessment of the companies' business plans for RIIO-T1, this document also sets out our decision on which companies' plans are suitable to be retained in the fast-tracking process.

Associated documents

Main letter

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

London Economics Report

Review of company surveys on consumers' willingness to pay to reduce the impacts of existing transmission infrastructure on visual amenity in designated landscapes – Report by London Economics on behalf of Ofgem
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/visualamenity.pdf

Other associated documents

RIIO-T1: Transmission companies' business plans - publication and next steps
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIOT1busplans.pdf

Decision on strategy for the next gas distribution price control - RIIO-T1 Overview paper
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decision.pdf

Providing a greater role for third parties in electricity transmission: Early thinking and options
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/thirdpartyrole.pdf

Consultation on strategy for the next transmission price control - RIIO-T1 Overview paper (and supporting documents)
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIOT1%20overview.pdf

Handbook for implementing the RIIO model - Ofgem, October 2010
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf

Glossary

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

Contents

1. Introduction

Chapter Summary

This chapter outlines the purpose of this paper and its link to our RIIO-T1 assessment letter.

1.1. A key part of RIIO is for companies to develop a well-justified business plan. This should be informed by enhanced stakeholder engagement. The four transmission companies (TOs) submitted and published their business plans for the next transmission price control (RIIO-T1) by 31 July 2011.

1.2. The assessment of business plans is a key stage in the RIIO-T1 process. Companies which rise to this challenge may benefit from proportionate treatment and potentially "fast-tracking".

1.3. We have published a letter setting out a summary of our assessment of TOs' business plans for RIIO-T1[1]. The letter also sets out our decision that:

- SPTL and SHETL will be retained in the fast-tracking process
- NGG and NGET will not be retained in the fast-tracking process
- all companies have areas of their plans that are suitable for proportionate treatment.

1.4. The purpose of this supplementary annex is to set out a more detailed summary of our initial assessment of the companies' business plans and, in doing so, to highlight the reasons for our decision on the application of proportionate treatment and fast-tracking.

Structure of this document

1.5. Chapter 2 of this supplementary annex sets out an explanation of the process we used for assessing the RIIO-T1 business plans. Chapter 3 provides a high-level summary of our assessment of the plans in relation to our five broad assessment areas.

1.6. Chapters 4-7 set out an individual assessment of each of the four TOs' plans.

1.7. Chapter 8 sets out next steps.

1.8. Appendix 1 sets out a summary of respondents' views on the plans.

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

2. Overview of business plan assessment

Chapter Summary

This chapter outlines how the business plan assessment fits into the wider process for RIIO-T1. It also provides details of how we approached the assessment and our criteria for rating the companies' plans.

RIIO-T1 and business plan assessment

2.1. The assessment of business plans is a key stage in the RIIO-T1 process. A core component of the new RIIO process is the requirements on network companies to take into account the needs and views of their stakeholders in order to develop well-justified business plans. Each network company is required to develop and publish a detailed plan which demonstrates how they will deliver in the interests of both existing and future consumers and how they will meet the challenges associated with facilitating the move to a low carbon economy.

2.2. In December 2010, we consulted on the regulatory framework for RIIO-T1. In March 2011, in light of consultation responses, we set out our decisions on the key aspects of that framework. We also set out the criteria we would use to assess the RIIO-T1 business plans. Our decision confirmed 31 July 2011 as the deadline for submitting the business plans. It also provided business plan guidance and the tools we would use for assessing network companies' plans.

2.3. Under RIIO we are taking a proportionate approach to our scrutiny of companies' plans, ie that the level of our regulatory scrutiny will vary according to the quality of their plans. We set out that companies that submit particularly high quality plans may have the opportunity of settling price controls early ie "fast-tracking". Proportionate treatment and fast-tracking provide strong incentives for companies to submit well-justified plans.

Assessment process

Level of assessment

2.4. Our assessment was undertaken in the ten week period between receipt of the business plans on 31 July and 30 September. The level of assessment has been limited to that of an 'initial sweep'. This is consistent with the concept of proportionate treatment which is a key element of RIIO. The purpose of the initial sweep was to identify those companies that we might subject to less scrutiny during the price control review and those that might need to be subject to more intensive scrutiny and whether companies may be suitable for fast-tracking. In other words, its purpose was to identify where it would be most appropriate for us to focus our scrutiny at the next stage of our process to add the greatest value for consumers.

Publication of the plans and stakeholder views

2.5. Stakeholder engagement is a central part of RIIO. We have undertaken and will continue to undertake stakeholder engagement throughout RIIO-T1.

2.6. Shortly after the transmission companies published their business plans on their websites we published an open letter[2] welcoming stakeholder views on any aspects of the plans. We received nine responses to our open letter. Separate from our stakeholder engagement processes, we have also benefited from feedback from the Consumer Challenge Group (CCG), which comprises consumer and environmental experts acting as a critical friend to Ofgem.

2.7. We have considered the views provided by stakeholders and the CCG in scoring our assessment of the companies' plans. In some places, where relevant to our assessment, stakeholders' views and those of the CCG are explicitly identified in this document. A full summary of stakeholders' views is set out in Appendix 1.

Assessment criteria

2.8. In our March Strategy Decision document, we identified fifteen criteria that we would use to assess companies' plans. In order to help structure our assessment and for ease of presenting our findings, we have categorised these fifteen criteria under the following five broad headings:

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

2.9. Table 1 below highlights how the fifteen assessment criteria map to these five broad categories.

---

[2] RIIO-T1: Transmission companies' business plans - publication and next steps http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIOT1busplans.pdf

Criterion	Description
Process: Has the company followed a robust process?	
Criteria 1: Key content	Has the company included main elements of well-justified business plan?
Criteria 3: Structure and proportionately	Is the business plan well-structured?
Criteria 8: Effective engagement	Has the company engaged with stakeholders, and explained how this has influenced its business plan?
Criteria 11: Accurate, timely and complete business plan templates	Has the company submitted and justified all templates and the financial model?
Outputs: Does the plan deliver the required outputs?	
Criteria 2: Reflection of our policies	Does the business plan conform with the outputs specified in our March strategy document and are any departures well-justified?
Criteria 5: Long-term context	Does the business plan provide a strategy for long-term delivery?
Criteria 7: Output delivery	Has the company explained resource implications for output delivery, and demonstrated these are efficient?
Criteria 12: Quality of info on primary outputs	Has the company explained how it will deliver outputs, and justified output baseline/forecast?
Criteria 13: Quality of info on secondary deliverables	Has the company explained and justified use of secondary deliverables?
Resources (efficient expenditure): Are the costs of delivering the outputs efficient?	
Criteria 4: Efficiency of costs	Has the company demonstrated that cost projections are efficient?
Criteria 10: Reflecting best-practice	How the does plan compare with others/ best-practice?
Criteria 14: Evidence	Has the company provided evidence costs (inc financial costs) are efficient, eg through market-testing?
Criteria 15: Linking forecasts to historical performance	Has the company explained cost projections in context of historical performance?
Resources (efficient financing): Are the proposed financing arrangements efficient?	
Criteria 2: Reflection of our policies	Reflection of our policies – Does the business plan conform with the financial policies specified in March strategy document and are any departures well-justified?
Criteria 4: Efficiency of costs	Has the company demonstrated that cost projections are efficient?
Criteria 14: Evidence	Has company provided evidence costs (inc fin costs) are efficient, eg through market-testing?
Criteria 15: Linking forecasts to historical performance	Has the company explained cost projections in context of historical performance?
Uncertainty & risk: How well does the plan deal with uncertainty and risk?	
Criteria 6 - Reflect uncertainty	Has the company considered how it will address uncertainty (eg incl. uncertainty mechanisms)?
Criteria 9 – Risk	Has the company considered risk and how to mitigate those risks?

Proportionate treatment

2.10. A key principle of RIIO is for companies to develop a well-justified business plan through enhanced stakeholder engagement. Companies which rise to this challenge may benefit from proportionate treatment and potentially "fast-tracking". We will apply proportionate treatment to areas of the plans we have assessed which are already broadly acceptable to us. Fast-tracking provides strong incentives for the companies by allowing them to conclude their price control up to a year ahead of the standard timetable.

Scoring the business plan criteria

2.11. We have derived a 'traffic light' score for each of the five broad categories outlined above. These traffic lights produce a scorecard for each of the companies' performance. The scoring is as follows:

- Green – areas of companies' plans that are broadly acceptable to us without the requirement for further (detailed) analysis. A 'green' area is deemed suitable for proportionate treatment.
- Amber – areas where we or the companies need to undertake further analysis or the companies need to provide further evidence in order for us to take a decision on whether this aspect of their plan is acceptable or not.
- Red – areas that are not acceptable to us and which we will not be able to resolve in the customer interest within the fast-tracking process.

2.12. In addition to our initial assessment, since the submission of their business plans we have met with each of the transmission companies and provided initial feedback on their plans and indicated areas where we needed to resolve our key concerns. The feedback was based on our own assessment, the view of the CCG, meetings the companies had with our Committee of the Authority and responses to our August letter.

2.13. As part of our traffic light assessment we also identified areas where there may be further work to be done but where, subject to the provision of further information, the companies could resolve the issues by January 2012. As this is our first assessment and the TOs are adjusting to the new RIIO process we have decided that where key issues are identified as potentially resolvable then those companies' plans should be retained in the fast-tracking process at this stage. Areas that we have identified as resolvable are marked with an 'R' in our assessment.

2.14. For the next gas distribution price control (RIIO-GD1) and the next electricity distribution price control (RIIO-ED1) the companies will have the advantage of learning from the RIIO-T1. Consequently, we would not propose to undertake an assessment of whether outstanding issues in their plan were resolvable with a view to retaining those plans within the fast-tracking process unless they achieve the required standard at our initial assessment stage.

3. Summary of assessment

Chapter Summary

This chapter provides a high-level summary of our assessment of all plans by assessment area.

Process

Requirements of a well-justified plan

3.1. Throughout the development of RIIO-T1 we have provided guidance on what a well-justified business plan should look like. We included an annex on this issue in our initial open letter consultation in July 2010 and further detail in our December 2010 and March 2011 Strategy documents. In addition to the guidance on the business plan we provided data templates for supporting data and a financial model for network companies to complete.

3.2. A well-justified business plan should cover the required content, follow a clear and logical structure with an appropriate level of focus given to each area and be supported by effective stakeholder engagement.

Overview of companies' performance in relation to process

3.3. **Key content**: All of the companies' plans include information on the majority of the key content outlined in our guidance. NGET and NGG's plans provide the most comprehensive coverage. SPTL and SHETL have broadly the same notable omissions including efficiency analysis, market testing and willingness to pay analysis in relation to visual amenity.

3.4. The companies submitted their business plan templates at the same time as their business plans. All included a supporting narrative. The tables submitted by SPTL and SHETL contained few inconsistencies. NGET and NGG had a number of inconsistencies. These were most significant for the complex NGET plan and covered a number of areas. NGET also applied a number of efficiency and phasing overlays that were not fed into the detail of their plan, which has hampered our assessment.

3.5. **Structure and proportionality:** The companies all adopted very different structures for their plans. National Grid's gas and electricity plans both adopted the same structure and indeed had a number of common documents. Third parties have commented that National Grid's plans are comprehensive and well structured. SPTL's plan is broadly well structured but with some areas of repetition and overlap between sections of the plan. SHETL's plan has divided opinion with some respondents praising it as well written and the plan most targeted at stakeholders while others considered it was too high-level in places and lacked the necessary detail. One issue raised by respondents and highlighted particularly by the CCG was that the plans were long, particularly given the lack of signposting between the different parts of the plan. This makes it difficult for stakeholders and the company themselves to make proper use of the business plan.

3.6. **Stakeholder engagement:** All of the companies have sought to engage more effectively with a wider range of stakeholders. NGET and NGG have been most effective. Third parties, including the CCG, identified a number of positives in National Grid's process including that they started engagement early and demonstrated a multifaceted and iterative process for engagement. There are also positives for both SPTL and SHETL in the way they have sought to develop their engagement processes.

3.7. There is scope for further development in all of the stakeholder engagement processes. All of the companies could do more to both demonstrate how their engagement has impacted areas of their plans. Currently, views are generally quoted anonymously and in most cases where they agree with the company's position. The companies need to demonstrate the range of views received and how they challenged stakeholders' views to reach a position. In addition, for SPTL and SHETL there is a need to engage with a wider range of parties and demonstrate how intelligence gained from the process has been used to shape plans and improve performance. The CCG noted that all companies could do more to engage with local communities and the voluntary sector. They further noted that the interaction with both distribution and supply companies was important and that more evidence should be provided on their interactions with these parties.

3.8. The CCG also highlighted the need for all of the TOs to explore and explain in more depth how their business planning reflected their understanding of the needs and interests of future consumers and system users, particularly in the light of the significant new investment being proposed and the associated cost recovery models.

Outputs

Requirements of a well-justified plan

3.9. Under the RIIO model, we committed to setting out clear and comprehensive outputs that the network companies will be held to account for delivering. In our strategy decision we set out output measures informed by TOs and their stakeholders. We also set out the central role of innovation to the new RIIO approach. We noted that it was important for TOs to consider openly different approaches to the delivery of outputs including the role of innovation both in terms of presenting a strategy for delivering innovation and evidence throughout the plan of having considered innovative solutions vis-à-vis business as usual approaches.

3.10. The business plan is the opportunity for the TOs to respond to our strategy decision on outputs. In some cases it is the first opportunity for the companies to propose an initial baseline level of performance (where performance under or over this baseline is penalised or rewarded). Such baselines should be challenging to deliver and the plans should demonstrate stakeholder involvement in influencing this baseline. In relation to all outputs, the business plans should set out clearly how they will be delivered including against uncertainties and how this delivery impacts on the rest of the plan.

Overview of companies' performance in relation to outputs

3.11. Each company's plan has strengths and weaknesses when considering outputs and when linking the rest of the plan to output delivery. In general, a strength of the TO's plans is their use of stakeholder views in developing the output proposals. In the high quality plans, TOs recognise the difficulty of obtaining stakeholder views that are robust on output delivery over the period to 2021. For example, NGG recognised that a single workshop on network flexibility and its implications was unlikely to be sufficient and responded to the stakeholder call for further quantitative evidence and a more focussed subsequent session. Another area of strength was the coverage of safety in the plans. All TOs put forward proposals consistent with meeting the required safety obligations.

3.12. The weakest area in all plans was demonstrating the implications in the plan of alternative outputs. There is limited consideration of changes to the level of output delivery and resulting cost implications. A well-justified plan should:

- consider changes to outputs with appropriate explanation and justification for any change
- assess the impact (where relevant) of delivering more (and less) than the baseline to fully justify the baseline proposed as the best outcome for consumers; this is particularly important for reliability and for environmental emissions.

3.13. In relation to environmental outputs we note that the companies largely focused on connecting renewable generation. We recognise that this will be a very important consideration. An area that was lacking in all of the plans, and a point also noted by the CCG, was the limited evidence of an overarching strategy to deliver environmental responsibilities through a mix of direct responsibilities and broader ones.

3.14. As part of our assessment of environmental outputs we are publishing a report produced for us by London Economics. This assists us in our assessment of an appropriate allowance for mitigating the impact of existing transmission infrastructure in designated areas (national parks or areas of outstanding natural beauty (AONB)). The report reviews willingness to pay evidence submitted in the TO business plans against best practice and makes recommendations on next steps to develop a level for the allowance in relation to each of the TOs.

3.15. In relation to customer satisfaction we note that all TOs have further work to do but that they are working constructively together to develop customer satisfaction surveys. The CCG highlighted the importance of ensuring these surveys considered the broad spectrum of customers.

3.16. In relation to innovation, we note that all companies included innovation strategies in their plans. None of these was comprehensive and, in particular, there was little evidence of how stakeholder had informed the strategies. The CCG noted that the focus of the strategies was largely on technical innovation with little consideration of commercial innovation. There was also little evidence of innovation running through the business plans although all the TOs provide examples of having understood and delivered more efficient outcomes through innovation.

Resources – value for money in delivering outputs

Requirements of a well-justified plan

3.17. To meet our requirements for a well-justified plan, we expected companies to provide evidence to us that they are delivery outputs at value for money over the longer-term. In particular, we were interested in:

- the processes and tools they used to determine their efficiency
- external benchmarking evidence such as comparisons with other industries or across the same industry domestically and internationally, and the actions arising from this evidence
- evidence of market testing, for example through tendering
- a clear demonstration that the longer-term had been considered in developing the plan.

3.18. As well as the requirements above, we sought further information on certain categories of expenditure. This included a well-justified choice of scenarios, consideration of the most appropriate capex funding mechanisms and clear linkage of costs to the resulting outputs. For non-load related expenditure, we were looking for companies to demonstrate high quality processes in their asset management functions. We also expected companies to justify changes in operating expenditure, and provide evidence for their forecast additional expenditure arising from Real Price Effects (RPEs).

Overview of companies' performance in relation to expenditure

3.19. There was a significant difference in the quality of companies' plans in relation to evidence of value for money. NGET and NGG provided extensive benchmarking evidence (though not always sharing the full reports) and set out that a large proportion of their cost bases had been market tested or was subject to alliance contracting, but SPTL and SHETL produced very little evidence.

3.20. Regarding load-related capex, the companies generally managed to provide good explanations of the chosen scenarios. However, we found numerous inconsistencies in the detail of the plans, and the linkage of expenditure to outputs was not always clearly explained. In particular, NGET's plan included overlays relating to efficiency and phasing, which meant that the detailed numbers in the plan did not tie up to forecast totals or outputs.

3.21. For non-load related capex, the overall quality of the plans was mixed, with companies providing limited justification in some instances and unclear or inaccurate data in others. In particular, there was no linkage in NGG's plan between expenditure on compressor replacement, the resulting change in emissions outputs, and the related expenditure on network flexibility.

3.22. Although the TOs generally provided good quality information on their asset management functions, NGET did not provide information that adequately justified the scale of its under-delivery of volumes in TPCR4, and less detail than we would have wanted on the linkage between capex and opex. All of the companies forecast significant increases in opex. However, there was generally very little justification of these increases. The quality and weight of evidence on RPEs was also mixed.

Resources – efficient financial costs

Requirements of a well-justified plan

3.23. Financial costs consist of two distinct elements: technical accounting costs (RAV, capitalisation pensions and tax), and corporate finance costs (allowed return, depreciation, financeability and transitional arrangements). A well-justified business plan would include, with regard to both technical accounting and corporate finance all the key content, reflect our policies and represent efficient costs to consumers supported by relevant evidence.

Overview of companies' performance in relation to financial costs

Technical accounting

3.24. **Key content:** All of the companies provided the data required although there were a number of inconsistencies and some data issues with for example opening RAV balances. The narrative in the business plan was in general appropriate for the issues with the exception of SHETL, although justification for some factors such as RAV capitalisation rates and increasing pension costs could have been better justified.

3.25. **Reflect our policies:** In general all companies accepted our policies in these areas with a few limited exceptions.

3.26. **Efficiency of costs:** We did not have major issues in this area as companies were primarily following our established policies. The main areas of concern were over capitalisation rates and increases in on-going pension contribution rates.

Corporate finance

3.27. **Key Content:** All of the companies provided material produced by external consultants to support their cost of equity proposals. SPTL, NGET and NGG provided the most comprehensive plans, including: alternative material to support their consultants' estimate of the cost of equity, various theoretical arguments to support a higher allowed return in RIIO-T1 relative to TPCR4, and risk assessment including Return on Regulatory Equity (RoRE) analysis. Additionally, NGET and NGG assessed financeability under a number of scenarios. In contrast, SHETL provided very little content to support its proposals, which in many cases are not consistent with our suggested approach (see below).

3.28. **Reflect our policies:** The main policies are our proposals to introduce economic depreciation in electricity transmission based upon a 45 year average expected economic asset life with a straight line depreciation profile, and an annual re-set of the cost of debt based on an index. Both SPTL and NGET accepted our proposals for cost of debt indexation and economic asset lives. However, both seek transition to the new asset lives: eight years in the case of SPTL and 16 years for NGET. In both cases they argued transition was needed to achieve financeability, although only NGET carried out this analysis in detail.

3.29. SHETL departed significantly from our policies in a number of material respects. SHETL used 45-year asset lives for new assets, but proposed a sum of digits profile (on a permanent basis rather than as a transition) which front-loads depreciation. SHETL also proposed an alternative weighting to the cost of debt index, to account for the fact that most of SHETL's debt would be issued during RIIO-T1. Furthermore, SHETL also proposed adding a 72bps uplift to the cost of debt index. There was little justification for these significant departures from our policies.

3.30. **Efficiency of costs:** There are two broad areas where we need to ensure costs are efficient – the cost of equity proposals and the overall financing approach including notional gearing, dividends, equity issuance and any transitional arrangements (for electricity transmission only). Only SPTL produced a cost of equity proposal (7.2%) within the range set out in our Strategy Decision (6.0-7.2%). NGET and NGG sought 7.5%. We did not find the evidence sufficiently convincing to justify accepting these proposals as efficient.

3.31. SHETL proposed a base cost of equity of 7.5%, but sought an uplift to 8.25% for the first four years of RIIO-T1, which it identified as a period of 'intense growth' (ie substantial capex relative to its RAV). The supporting evidence for the uplift was thin and the rationale behind the specific numbers was unconvincing.

3.32. None of the companies placed the proposed notional equity issuances and dividend policy in the context of the investment programme that they expected to undertake during RIIO-T1. In particular, none of the companies provided any economic rationale for the options selected particularly in respect of the proposed notional dividend policy. In the main, the companies based their financeability assessment on meeting overall credit metrics after fixing dividends and the cost of equity. NGET and NGG provided the most detailed assessment using several scenarios, whilst SHETL did not provide any financeability assessment. We did not consider any of the plans provided sufficient evidence to merit us changing our position on the cost of equity range (6.0-7.2%) our cost of debt indexation approach or our depreciation policy.

3.33. Overall we were not convinced that any of the companies had justified their proposals as being efficient.

Uncertainty/risk

Requirements of a well-justified plan

3.34. There are always uncertainties during a price control. In relation to the treatment of uncertainty and risk in business plans we were looking for companies to set out:

- a reasonable overview of the uncertainties to manage over RIIO-T1
- a robust assessment of key risks with quantification of the potential impacts on output delivery, forecast costs and planned expenditure
- a risk management approach aligned with RIIO principles that risk should be borne by the party best able to manage them
- a clear justification for any proposed uncertainty mechanisms.

Overview of companies' performance in relation to uncertainty and risk

3.35. NGET and NGG provided a comprehensive assessment of uncertainties and risks as part of their respective business plans. Both companies set out a risk mitigation strategy including the management actions they intend to take to deal with key uncertainties as well as proposals for uncertainty mechanisms to share the remaining risk with customers. Both TOs provided analysis to show how their proposals would benefit customers by ensuring they only pay for network services that are needed. However, both companies proposed a significant number of mechanisms which would potentially transfer a lot of risks to customers without considering the potential link to their requested cost of equity. Finally, neither NGET nor NGG has tested these proposals with stakeholders but they intend to seek stakeholders' views in the autumn to inform their March business plans.

3.36. SPTL considered risks and uncertainties in relation to different areas of their business plan. However, SPTL did not assess or quantify these more broadly in terms of the potential impacts on output delivery and proposed expenditure (they do quantify a subset of risks in terms of the implications for their financial performance). SPTL proposed the fewest number of mechanisms to manage uncertainty and opted for a continuation of existing mechanisms that operate within TPCR4. However, SPTL did not explain why these mechanisms would be appropriate under RIIO-T1 or provide any supporting analysis of the potential benefits or downsides for consumers that might arise from using these mechanisms. It is also not clear whether stakeholders supported SPTL's proposed approach.

3.37. SHETL looked at risk and uncertainty in relation to specific areas of their business plan but generally only qualitatively. SHETL provide a degree of detail about uncertainties in relation to its load related investment and proposed a low baseline for its investment programme with a relatively large proportion to be accommodated through uncertainty mechanisms. SHETL argues that this would be better for customers as it would ensure that they only pay for network services that are necessary. SHETL has tested this approach with stakeholders, who broadly agreed with its proposals.

3.38. The most material uncertainty across all the electricity TOs over RIIO-T1 relates to the amount of new generation seeking connection and the volume of transmission infrastructure development required to accommodate this. The electricity TOs have proposed two mechanisms to manage the uncertainty around load related investments under their Best View business plans. These are a connections volume driver and a within period determination mechanism for wider reinforcement works. NGET has also proposed a boundary volume driver to take forward incremental reinforcement works in accordance with a network planning policy. A number of TOs also highlighted knock-on effects to non-load related expenditure.

3.39. For all of the companies, further analysis is needed on how the proposed uncertainty mechanisms would deliver value for money and how the impacts of uncertainty mechanisms on charging volatility might be mitigated.

4. Assessment of NGET's business plan

Chapter Summary

This chapter provides our assessment of National Grid Electricity Transmission (NGET)'s business plan.

Overall assessment of NGET's plan

4.1. NGET submitted a generally clear and detailed plan which covered the vast majority of the key content we had identified. NGET's plan is available at the following link http://www.talkingnetworkstx.com/.

4.2. There are a number of significant positives in NGET's plan these include their stakeholder engagement processes, their approach to risk assessment and risk management, their coverage of safety and their treatment of asset lives. It is our intention that each of these areas will be subject to a proportionate level of scrutiny.

4.3. The areas of NGET's plan where most work is required going forward are:

- addressing the inconsistencies in their data templates in particular in relation to the re-phasing of overlays and how they tie in with load- and non-load related network outputs
- the need to provide a detailed explanation required for under-delivery of asset replacement volumes, together with a plan for catch-up expenditure
- need to provide significant increases in direct opex with lack of clarity on key components
- providing further information and reviewing and revising elements of their financial proposals.

4.4. While a number of these and the other issues in NGET's plan could be addressed, there are a number of inconsistencies in the way the data was presented that are too significant to enable resolution before our fast-tracking consultation. On this basis, **we are not retaining NGET in the fast-tracking process.**

Category	NGET[3]
Process	
Outputs	
Resources – efficient expenditure	
Resources – efficient financial costs	R
Uncertainty/Risk	R

[3] In two areas of the assessment we considered NGET's performance to as be between Amber and Red or between Amber and Green. We have identified these areas with appropriate shading.

Overview of plan

4.5. NGET's business plan comprises three core documents (its Detailed Plan, its Headlines and an Overview paper). It also includes nine supporting documents covering issues such as its stakeholder engagement process, the future of energy, its innovation strategy, its financial components, managing risk and uncertainty, a network availability policy and its delivery strategy.

Respondents' views

4.6. Seven respondents commented on NGET's plan. The key points raised were:

- a number of positive comments on NGET's process for engaging with the industry and developing a process accessible by all types of user but a concern from one respondent that NGET has paid inadequate attention to consultees not involved in the consultant-managed part of the process
- a lack of detail on how new investments relate to the outputs, the objectives against which they would be measured and associated benefits
- NGET's assertion that currently reliability was "about right" was not reasonable given the lack of analysis of the additional costs/savings of an incremental change in the level of reliability or consideration of the impact of changed levels of investment/operational security on reliability
- welcome proposals to be more innovative in managing the network but note the lack of specific details on the projects to invest in their IT system and data centres
- only NGET acknowledged the role of the networks in meeting the low carbon agenda but provides little detail as to how this would be achieved
- the risks of SF_6 leakage had not been prioritised by NGET
- only NGET had adopted an explicit policy direction on undergrounding cables
- plan goes some way to acknowledging the need for anticipatory investments in sites that are likely to need investment in the future, together with managing the associated risks
- broad support for many of the arguments NGET made on the increasing risks and uncertainties but some risks had been overlooked including losing part of an outage season because of foot and mouth or similar events
- plan recognises the level of investment required but does not clearly demonstrate whether NGET intended to undertake certain investments
- some potential flaws in NGET's return on regulatory equity (RORE) analysis including overestimating the impact of a variance in RORE in driving the cost of equity and failing to reflect the differences between TPCR4 and RIIO-T1.

Assessment of process in NGET's plan

Key content

4.7. NGET's plan covered all of the key areas required by the business plan guidance. There were no obvious high-level omissions. NGET's plan also demonstrates a consideration of the content in which their plan has been developed including relevant offshore, European and other political interactions. However, the detail on the European context was light in a number of areas including on working with European TSOs on interconnector development, the impact of network codes under development and the interactions with the work to develop a Ten Year Network Development Plan.

Structure and proportionality

4.8. NGET's plan is generally very well written with a good level of detail in the majority of areas although it is variable between subject areas. NGET's plan generally focussed most attention in the right areas.

4.9. The structure of NGET's business plan and the links between the key documents is set out on its website. Further, NGET's 'Overview' document outlines the structure of all of the documents they have published and where to find specific information. Throughout the 'Overview' document there are references to the other annexes – although direct links are not provided. The separate 'Assumptions and Definitions' paper is a useful tool for accessing the other parts of the plan.

Completion of data template and financial model

4.10. The standard of the completion of the business plan templates is the weakest aspect of NGET's process. NGET's narrative is often inconsistent with its data tables. There were a number of data inconsistencies that were identified by NGET in their narrative rather than corrected in the data tables before submission. In addition, NGET made a number of top-down efficiency and delivery overlaps which were not properly reflected in the detail of the plan and made assessment difficult.

4.11. There are also inconsistencies in other parts of the plan. We have been able to resolve some of the data inconsistencies through interaction with NGET since the submission of the plan. However, some issues remain outstanding and are too challenging to resolve in the short-term.

Effective engagement and reflection of stakeholders' views

4.12. National Grid demonstrated a detailed, multi-faceted and inclusive process of stakeholder engagement. They also make a strong commitment to enduring stakeholder engagement. We note that respondents, the CCG and our consultants have noted a lot of positive elements with National Grid's stakeholder engagement process eg timely process, use of consultants, included consideration of existing and future consumers and include both a Stakeholder Policy Statement and Principles for their engagement.

4.13. NGET has provided an overview of all key stakeholder messages and, in many cases, demonstrated how these influenced the plan. However, one less positive aspect of NGET's reflection of stakeholder views is that they tend only to quote stakeholders where they agree with NGET's own views. This has been highlighted by a number of different stakeholders including the CCG. NGET need to provide evidence of where stakeholders had a different perspective and an explanation as to why they had adopted a different approach. NGET also need to provide more evidence of challenging stakeholder views to determine how they reached a final position in their plan.

Assessment of outputs in NGET's plan

4.14. NGET's plan demonstrates the company's commitment to the principles of a RIIO outputs-led framework. In relation to outputs the plan only raises a material issue on environmental emissions.

4.15. In some particularly difficult areas, NGET developed good proposals informed by a thorough understanding of the context and while further work will be needed this is not a reflection of a weak plan. NGET deserve merit in such cases despite the more limited scope for proportionate treatment.

Reliability

4.16. NGET has provided a baseline for the energy not supplied measure, and has supported our incentive strength and decision on applying a collar. This is an area which may benefit from proportionate treatment when we assess the resubmitted business plan.

Safety

4.17. The proposals appear to be consistent with meeting the required safety obligations. We have identified no further issues but intend to discuss this with relevant stakeholders, in particular the Health and Safety Executive (HSE).

Wider works

4.18. NGET has built its best view business plan on the 'gone green' projection of future generation connections. This is consistent with meeting the UK's 2020 renewable energy targets and receives support from a large number of stakeholders for business planning purposes. NGET provides a good level of detail on key drivers for reinforcements at specific boundaries and show where reinforcements are interdependent.

4.19. To get to the necessary quality in this area we need to see improvements particularly:

- showing how stakeholder interaction has influenced NGET's scenario development
- using the refreshed 'gone green' scenario updated in May 2011
- more breadth in the scenarios eg different demand assumptions or sensitivity analysis
- showing the incremental impact of reinforcements (other than in aggregate)
- providing more information including on the efficiency of delivery costs.

4.20. NGET has made a good start in its network planning policy. It would have been helpful if more of the policy had been subject to and informed by stakeholder scrutiny.

4.21. We want NGET to consider the level of baseline expenditure and outputs versus the degree to which its proposed projects would be considered during the control period through a Transmission Investment Incentives (TII)[4] type mechanism.

Network availability

4.22. Across the system operator (SO) incentives and the TO outputs, we are aiming to design a regime that supports the best combined outcomes for consumers. Our strategy decision required the TOs to develop network availability policies to inform the TO part of this.

4.23. NGET provided a helpful and detailed network availability policy (despite its common ownership meaning it is within a different context to the Scottish TO plans). It does not provide a clear TO baseline deliverable. It is important that this is remedied quickly in the process. NGET should work with the other TOs to review and challenge the current business plans and develop improved network availability policies, particularly in relation to identifying a clear TO baseline deliverable.

Environmental

4.24. Environmental issues include emissions, the impact of transmission infrastructure eg visual impact and potentially the broader role that energy networks can play in contributing fully to the overall change to a sustainable energy sector.

4.25. On all elements of emissions we feel that NGET's plan leaves scope for significant further work. This is work to demonstrate to us that the proposed targets are challenging and that they are fully reflected within investment decisions in a way likely to deliver long-term value for money.

---

[4] In April 2010, we introduced the TII framework for providing funding, within TPCR4 for critical large-scale investments that the TOs identify are required to support achievement of the Government's 2020 renewable energy targets.

4.26. On SF_6, NGET need to include the economic breakeven point for procuring SF_6 equipment with low leakage rates and the assumptions used to calculate the baseline. The discount rates and the load and non-load related investment assumptions need to be fully justified.

4.27. In relation to transmission losses we recognise the plan states that NGET factors the whole life of assets where it makes economic and business sense to do so. However, this does not give us a clear understanding of how NGET appraise investments or how it includes consideration of its investment programme on modelled losses.

4.28. NGET provides a target for its business carbon footprint (BCF). Further work needed for its March business plan update in this area includes:

- details of the context for the proposed target
- state what level of stretch is involved
- current performance levels against that proposed target
- involve stakeholders (or demonstrate how, if this has already happened) in agreeing this target.

4.29. More fundamentally, NGET needs to set out its strategy for delivering this target and then show that it has tested this and that it is consistent with its expectations of achieving long-term value for money.

4.30. NGET demonstrates that it recognises the significance of the impact, visual and otherwise, of its infrastructure (new and existing) on a variety of stakeholders. This is a part of its plan where NGET have made comprehensive proposals including both proposed spend and an uncertainty mechanism to take account of changes as the company learns from the new planning process in England and Wales. This is an area where further work is needed but this is not a criticism of NGET's plan. It just reflects the significance of the issue. In particular, NGET recognise the need to incorporate up to date costs (a study is due to be published in late 2011), an understanding of new technologies and further stakeholder feedback.

4.31. NGET was the only TO to submit a willingness to pay study to inform the development of an allowance for mitigating the impact of existing infrastructure in national parks and areas of outstanding natural beauty (AONB). The report by London Economics provides a critique of this study against best practice and makes recommendations which we look forward to discussing with NGET.

Connections

4.32. NGET's plan is strong in this area showing an understanding of the historical context and an acceptance of the strategy decision in full including scope for financial penalties. An attempt is made to show a proportion of costs relating to this output, but we would welcome more work to understand the impact on the overall plan of delivering against this output (including all aspects of licence obligations ie not just the application process).

Customer satisfaction

4.33. NGET played an important role in helping us develop our strategy decision in this area. It had already produced and used a company-wide survey of its performance with its customers. However, translating this into a survey that provides a reasonable indication of stakeholder views of the TO function across its different activities is still a major task. NGET is working with the other TOs to develop a 'dry run' survey and work on the incentive to be applied. Unfortunately, limited detail of this was provided in the business plan. Given the ongoing work, we did not expect all the answers to be provided here. However, examples of the activities that might be included in a survey and types of questions along with some of the problems still to work on would have been helpful in allowing stakeholders to engage and influence the survey. We expect this to happen as NGET develops its March business plan update.

Innovation

4.34. NGET provided an innovation strategy. NGET's was the strongest of the strategies submitted as it recognised the challenges of innovation and there was some evidence of having reflecting stakeholder involvement. More work is required particularly on confirming what happens without innovation and considering options for output measures to use in relation to innovation rather than jumping straight to solutions.

4.35. There was little evidence of a consideration of innovation running through NGET's plan. However, NGET do demonstrate an understanding of past innovations and what benefits they have delivered.

Assessment of efficient expenditure in NGET's plan

4.36. NGET's plan has a number of areas of high quality. In many areas the plan narrative is extensive and clear, and elements of best practice can be seen in business areas such as asset management and risk. In addition, NGET has provided evidence of market testing of its expenditure, and has set out a reliability incentive in line with our expectations.

4.37. However, the effect of the late re-phasing of the capex plan (detailed below) and the introduction of an efficiency overlay means that the total forecast expenditure is not supported by the detailed data in the submitted tables or, in many places, but the supporting narrative in the plan. The insertion of the overlays and re-phasing at a total rather than bottom up level also causes us concerns regarding the quality of NGET's business planning process, and specifically the integration and combination of different areas of expenditure.

Evidence of efficiency

4.38. NGET has provided good evidence in relation to benchmarking and market testing. It cites benchmarking studies in operational areas and support functions such as IT and property, although in some cases we do not have full access to external reports. A section of its business plan outlines its approach to market testing and providing value for money, highlighting areas where market testing during TPCR4 showed areas for improvement and the actions that resulted.

Load-related capex

4.39. NGET's best-view forecast is for load-related capex of £8.1bn (£1.0bn per year). This is nearly twice the annual average figure for TPCR4 and Rollover. Large-scale projects include three HVDC links, reinforcement schemes in Somerset and Suffolk, and an extension of the 400kV underground network.

4.40. NGET has gone into greater detail and explored wider considerations in its discussion of delivery of the plan than the other TOs. It notes that the size of its Alliance partners provides comfort that significant increases in workload can be accommodated, and also sets out its early actions around recruitment and training.

4.41. Generally, the load-related capex sections of the plan are comprehensive and well written, with good justifications of scenarios, clear links between expenditure and outputs and evidence of extensive stakeholder engagement. However, there are inconsistencies between the plan narrative and the data tables in the presentation of large schemes which erodes transparency and makes detailed analysis of specific areas of expenditure problematic.

Non-load related capex

4.42. NGET is forecasting £5.2bn (£0.65bn per year) of non-load related capex during RIIO T-1. This is 85 per cent higher than the annual average expenditure during TPCR4 and Rollover.

4.43. Notwithstanding the re-phasing of expenditure, we found that NGET's plan demonstrated many asset management techniques and approaches that are at, or close to, best practice. We also found the narrative for this section of the plan was well-written and comprehensive.

4.44. Our initial analysis of unit costs suggests that NGET's forecasts for switchgear, overhead lines (OHL) and cables are all higher than other TOs and TPCR4 costs. There are also several categories of expenditure where there is insufficient explanation or justification of costs.

4.45. We also have concerns over the link between replacement expenditure and reliability outputs. NGET has forecast a decline in asset health over the period, with significant increases in the number of assets (of all major types) in the lowest asset health category. However, it does not believe that this will lead to an increase in energy not supplied (ENS). This decline does not take into account further degradation in asset health likely as a result of the deferral of expenditure to the end of the RIIO-T1 period signalled by the delivery overlay. Furthermore, the justification for the RIIO-T1 plan runs counter to that presented at the beginning of TPCR4, where NGET argued that a large increase in expenditure was necessary to address reliability and performance issues. NGET's replacement volumes during TPCR4 have turned out to be significantly lower than its allowance (which in turn was significantly lower than what NGET had argued for).

Opex

4.46. The increase in direct opex is driven by substantial increases in expenditure for planned inspections and maintenance, security and allowed innovation cost. While an increase in opex may be expected as a consequence of deferring replacement capex, this trade off is not examined in detail or justified. We note that the effect of the re-phasing is reflected in the opex tables.

4.47. Increases in indirect opex are driven by higher expenditure on operational training, network design and planning. Although an increase is to be expected given the higher planned capex, the relationship between capex and these categories is not explained. Business support costs are forecast to be largely flat during the period.

Real price effects (RPEs) and ongoing efficiency

4.48. NGET has based its RPE forecast on a range of internal and external evidence. However, the proposed RPEs are higher than those of both the Scottish TOs and Ofgem estimates. The plan generally deals with efficiency in a well-structured and detailed manner, although for capex the difference between ongoing and 'catch up' efficiency is unclear.

System Operator (SO) capex

4.49. NGET SO capex is forecast to increase significantly from £22m per year during TPCR4 and Rollover to £37m per year during RIIO-T1. The business case being proposed by NGET has not changed significantly since the Rollover submission, where we were concerned at the level of expenditure, the lack of justification and the risk of replacing or upgrading several systems simultaneously.

Assessment of efficient financial costs in NGET's plan

Summary

4.50. NGET submitted a separate finance appendix which was comprehensive and extensive. It did contain some data inconsistencies which made assessment of the plan difficult. The proposals on overall financeability are not compelling and do not convince us that the proposals are efficient.

Technical accounting

RAV, Tax, Pensions and totex capitalisation

4.51. In general NGET complied with our policies across the technical accounting areas. However, we had a number of concerns over various calculations and data items, for example, opening RAV balances, justification of capitalisation rates and tax allocations to capital allowances pools.

Corporate finance

Key content

4.52. Across this area NGET provided reasonably comprehensive material, including consultancy papers produced by Oxera covering the cost of equity, the impact of duration on risk and the impact of cost of debt indexation. NGET sought to justify its cost of equity submission with additional analysis using the dividend growth model, investors' comments and a risk-based analysis of how allowed return in RIIO-T1 compared to TPCR4. NGET also provided useful risk analysis including Return on Regulatory Equity (RoRE) analysis, and tested sensible credit metrics against a number of different scenarios, with some limited consumer impact analysis. The main omissions are a lack of reflection of input from other non-investor stakeholders; limited discussion of the economic fundamentals that impact on the choice of dividend policy and other related factors such as notional equity injection and notional gearing.

Reflects our policies

4.53. The key policies are our introduction of average expected economic asset lives of 45 years with a straight line depreciation profile and cost of debt indexation. NGET accepted both of these policies, albeit proposing a 16 year transition period for introduction of the economic asset life.

Efficiency of costs

4.54. As NGET has accepted our policies in the main, the key areas of assessment are whether the proposed cost of equity is efficient and whether the transitional arrangements and financing structure are appropriate.

4.55. **Cost of equity:** NGET proposes a cost of equity figure of 7.5%, which is outside the range (6.0–7.2%) we set out in the Strategy Decision paper. In terms of the Capital Asset Pricing Model (CAPM), the figure is largely based on material previously submitted to us and produced by Oxera. It uses risk-free rate and equity risk premium that are at the top of our range, and a higher equity beta. We note that Oxera's equity beta of 1 is calculated based on 65% notional gearing. If calculated at NGET's proposed 55% notional gearing, the equity beta would be 0.78 and the cost of equity 6.3%.

4.56. The core reasoning in NGET's arguments with regard to the cost of equity is that RIIO represents greater risk and uncertainty for network companies and investors than RPI-X. NGET argues that, coupled with the need to raise substantial funding given the size of NGET's investment programme in RIIO-T1, the increased risk (or perception of risk) requires a higher cost of equity assumption. However, our view is that all of these considerations are already captured in our range – for example, the market equity beta for a network company is around 0.5-0.6, while we used a range of 0.9-0.95 in the Strategy Decision paper. Overall, we consider that the arguments used by NGET were already rejected in the Strategy Decision and they do not provide an adequate or compelling justification that a cost of equity of 7.5% is an efficient cost.

4.57. It is important that the cost of equity is set in the context of risk. NGET provides thorough risk analysis, which includes detailed RoRE analysis and a comparison of risk between the TPCR4 settlement and NGET's business plan proposal. In NGET's risk analysis it argues that risk is increased under RIIO and propose a number of uncertainty mechanisms to reduce risk, which in their own analysis result in RIIO-T1 having a lower risk profile than TPCR4. We consider it a particular weakness of National Grid's argument that NGG and NGET are seen to face the same risk profile in RIIO-T1 despite NGET's capex programme being substantially larger than NGG's. In addition, National Grid argues that RIIO-T1 represents the same increase in risk relative to TPCR4 for both NGET and NGG, despite the fact that the duration of cash flows for NGG would not change, while it would lengthen for NGET.

4.58. **Financeability assessment and transitional arrangements:** Any assessment of the overall transitional arrangements is the result of a number of choices that interact with each other including cost of equity, notional gearing, dividend policy and notional equity issuance in the context of the level of investment. The five per cent dividend policy appears high in the context of an average annual RAV growth of around 7.5%. Although NGET provides detailed financeability assessment, in which the impact of various combinations of notional gearing, equity issuance and transitional arrangements on credit and equity metrics are assessed, we do not consider that its proposed corporate finance costs are efficient.

Assessment of uncertainty and risk in NGET's plan

Management of risk and uncertainty over RIIO-T1

4.59. NGET provided a comprehensive assessment of risk and uncertainty in a standalone annex to its business plan. This identifies the major uncertainties it expects it might need to manage over RIIO-T1 and links these, where relevant, to outputs and planned expenditure. The document as a whole gave a good overview of their risk modelling, management strategy including corporate risk management processes, management responses and how they propose the remaining risk is shared.

4.60. While overall we consider NGET’s treatment of risk and uncertainty to be generally very good quality we have also identified several areas for improvement. These include:

- increasing the breadth of scenarios and sensitivities eg different demand assumptions or impact of changes in charging regime (Transmit)
- including more explanation and justification of the risk model
- considering whether setting a baseline closer to its upper forecast than its lower forecast has implications for the design of the uncertainty mechanisms. For example, does this mean the uncertainty mechanism has to deal with greater downside risk? And why is this preferable to setting a baseline with a more symmetric balance of uncertainty?
- greater stakeholder testing and input on proposals.

4.61. The most material uncertainty NGET expects to face over RIIO-T1 is the pattern of future generation connections (volume, location and timing) and the impacts on the level of load related investment that will be required. Other uncertainties include planning consent requirements, offshore interactions, changes in security or design standards, physical infrastructure upgrades for security of supply, or requirements for flood and erosion protection.

Proposed uncertainty mechanisms

4.62. NGET has proposed a number of mechanisms to allow it to adjust its baseline over RIIO-T1 as needed to manage the uncertainties above. NGET provided a good degree of detail on the design and parameters of uncertainty mechanisms as well as some analysis of how their proposed mechanisms could help manage the potential volatility in expenditure. But due to materiality of the expenditure further analysis is needed to finalise mechanisms. For example, NGET expect uncertainty mechanisms to meet approximately £1.5bn of load related investment under their Best View.

5. Assessment of NGG's business plan

Chapter Summary

This chapter provides our assessment of National Grid Gas Transmission (NGG)'s RIIO-T1 business plan.

Overall assessment of NGG's plan

5.1. NGG submitted a generally clear and detailed plan which covered the vast majority of the key content we had identified. NGG's plan is available at the following link http://www.talkingnetworkstx.com/.

5.2. There are a number of significant positives in NGG's plan which largely echoes those in NGET's plan including their stakeholder engagement processes, approach to risk assessment and risk management, coverage of safety, treatment of asset lives and depreciation and their proposed connection output. It is our intention that each of these areas will be subject to a proportionate level of scrutiny.

5.3. The areas of NGG's plan where most work is required going forward are:

- addressing the inconsistencies in their data templates
- the requirement for significantly more information required on treatment of network flexibility
- to provide detailed justification required for the planned compressor replacement programme and the linkages with flexibility requirements and asset replacement.
- providing further information and reviewing and revising elements of their financial proposals.

5.4. While some of these and the other issues in NGG's plan could be addressed, the scale of required work to address the network flexibility and data inconsistencies is too significant to enable resolution before our fast-tracking consultation. On this basis, **we are not retaining NGG in the fast-tracking process.**

Category	**NGG[5]**
Process	
Outputs	
Resources – efficient expenditure	
Resources – efficient financial costs	**R**
Uncertainty/Risk	**R**

[5] In relation to uncertainty and risk we considered NGG's performance as being between Amber and Green. We have identified this with appropriate shading.

Overview of plan

5.5. The structure of NGG’s business plan is broadly identical to NGET’s plan. There are a number of elements of the documentation that are identical between the two plans including its stakeholder engagement process and the future of energy document.

Respondents’ views

5.6. Five respondents raised specific points on NGG’s plan. The key points were:

- the plan is extremely light on specific and measureable outputs
- support NGG’s view that there are other factors, alongside the ‘1 in 20 scenarios’ that should be taken into consideration when planning for capacity to ensure the safety and reliability of the network
- the case has not been made for additional network investment to manage network flexibility constraints and other solutions should be considered such as onshore gas storage close to the source of localised constraints
- the need to ensure greater rigour around the use of force majeure in relation to network constraints to prevent NGG insulating itself from the financial impact of certain events
- to ensure more efficient overall costs to consumers NGG need to provide more information on the impact of the distribution networks on their investments to enable gas distribution network companies (GDNs) to reflect alternatives in their plans
- support NGG’s proposals for the use of a specific re-opener but consider that Ofgem would need to rigorously police allowable expenditure to protect network users and consumers
- note NGG’s intention to revisit the existing commercial arrangements and that while there were areas where the commercial arrangements could be developed, stakeholders should be fully involved in that process.

Assessment of process in NGG’s plan

Key content

5.7. NGG’s plan has covered all of the key areas required by the business plan guidance. There were no obvious high-level omissions. NGG’s plan also demonstrates a consideration of the context in which their plan has been developed including relevant offshore, European and other political interactions. However, NGG could provide further information on relevant European interactions eg the impact of network codes under development and the interactions with the work to develop a Ten Year Network Development Plan.

Structure and proportionality of plan

5.8. NGG's plan is generally very well written with a good level of detail in the majority of areas although it is variable between subject areas. NGET's plan generally focussed most attention in the right areas.

5.9. The structure of NGG's business plan is broadly identical to NGET's and the links between the key documents are set out on its website.

Completion of data template and financial model

5.10. NGG submitted all of their templates along with the business plans but there are a number of inconsistencies in NGG's data tables including a lack of unit cost data, the formatting of the RPE data, missing data on project listings and a number of differences between templates, narrative and the financial model eg direct opex data. These are not as significant as in the case of NGET, but they make the assessment difficult in a number of areas, in particular flexibility capacity but also in relation to capex and opex efficiencies.

5.11. In addition, NGG provided their own financial model which did not fully reconcile to business plan data templates.

Effective engagement and reflection of stakeholders' views

5.12. National Grid adopted a single stakeholder engagement process across gas and electricity. We assessed National Grid's engagement process as part of the assessment of NGET's plan in Chapter 4.

5.13. One specific point to note for gas is the limited evidence of engagement with key stakeholders such as GDNs although there is evidence of this improving.

Assessment of outputs in NGG's plan

Summary

5.14. NGG's plan is set in the presence of a wide range of uncertainties. They set out how they will meet the different output requirements in a way that demonstrates a good level of engagement with stakeholders and some areas of good justification. The case for additional 'network flexibility' funding is an important issue. It is an area where more evidence is needed to inform our decision on whether there is need for any additional revenue. Environmental emissions changes in the plan are driven particularly by legislative changes.

Background

Reliability and network flexibility

5.15. This is an important part of NGG's plan. Network flexibility, in particular, has been a central issue in NGG's stakeholder engagement and its justification in the plan reflects much of this work.

5.16. There is a mixture of quality in the justification of expenditure requirements for reliability and availability. We will apply proportionate treatment to some of the better justified elements such as the non-load related expenditure not related to emissions (eg the Humber feeder) and some of the load-related expenditure related to incremental entry.

5.17. We will apply more detailed scrutiny to the £224m related to network flexibility in the plan. We think that more evidence would be required for us to conclude that this additional revenue (over and above user signals) was justified. In particular these are:

- greater understanding of the existing capability across the network (including against the current changes)
- consideration of possible upside opportunities arising from the possible changes rather than just the additional risk
- more evidence on the linkage between the challenges identified and what the company needs to do as a result (and why its proposed approach is necessary and efficient)
- better justification of the investments needed including evidence of any project synergies available
- consideration of the role that existing or new commercial solutions or arrangements could contribute in this area.

Safety

5.18. In general, the proposals appear to be consistent with meeting the required safety obligations. We will continue to discuss this with relevant stakeholders, in particular the Health and Safety Executive (HSE).

Connections

5.19. The plan shows a strong understanding of the issues in this area and the need for additional process milestones. This is the subject of ongoing industry processes and we are keen for all stakeholders to feed in to these developments which can, as appropriate, be reflected in the output in this area.

Environmental

5.20. Commitments to environmental performance are a core part of network delivery under RIIO. The plan focuses on legislative requirements and their implications on the NTS equipment. In this area we need far more evidence on precisely how the legislative changes require the types of change proposed. It should also consider whether there are synergies that have been looked at that could be exploited for the benefits of consumers. A broader question to NGG is whether it has pushed the boundaries on the environmental improvements it could make.

Customer satisfaction

5.21. The coverage of customer satisfaction was broadly identical in NGG's plan to that set out in NGET plan. Our views on NGET's coverage of customer satisfaction were set out in Chapter 4.

Innovation

5.22. NGG's innovation strategy was very similar to that provided by NGET. Once again NGG's plan recognised the challenges of innovation and there was some evidence of having reflecting stakeholder involvement. However, their plan was more limited that NGET's in setting out the associated deliverables and outputs. Generally the plan was lacking supporting evidence in this area.

5.23. There was little evidence of a consideration of innovation running through NGG's plan, although again like NGET they demonstrate an understanding of past innovations and what benefits they have delivered.

Assessment of efficient expenditure in NGG's plan

5.24. NGG's plan has a number of areas of high quality. In many areas the plan narrative is extensive and clear, and elements of best practice can be seen in business areas such as asset management and risk.

5.25. However, there is insufficient justification for significant expenditure relating to network flexibility, the Industrial Emissions Directive (IED) and compressor replacement. There is also a lack of linkage between costs and outputs.

Evidence of efficiency

5.26. NGG has provided some good evidence in relation to benchmarking and market testing although we have not had the full reports in some cases. It cites benchmarking studies in operational areas and support functions such as IT and property. A section of its business plan outlines its approach to market testing and providing value for money, and in particular how its Alliance model is the most suitable one given the risk and variability of the workload.

Load-related capex

5.27. NGG is forecasting total load-related capex over the RIIO-T1 period of £3.3bn. The majority of this (£2.8bn) is expected to be funded through revenue drivers which are triggered only when the investment has been largely underwritten by user commitments. The largest item in the remaining expenditure, which NGG proposes to fund through ex ante allowances, comprises £224m for network flexibility.

5.28. We consider that network flexibility has not been clearly defined by NGG, and the business plan fails to demonstrate how the proposed expenditure delivers the best value for energy consumers or outline possible alternatives to the proposed capex investment. There is no link between the proposed expenditure and output measures, or with the proposed compressor replacement programme. Unit costs appear high, and some material items are undefined and unjustified. Stakeholder engagement on this issue is still ongoing, and some stakeholders remain unconvinced by NGG's justification.

Non-load related capex

5.29. NGG is forecasting non-load related capex of £1.5bn (£184m per year) during RIIO-T1. The largest area of expenditure is £925m for emissions related expenditure. Out of this, £610m is projected to replace 21 existing compressors with 17 new ones in order to comply with the IED. The remaining expenditure relates to existing legislation. However, there is uncertainty regarding the number of compressor sites which may be affected, with a possible cost range between £203m and £1,433m. NGG is proposing an uncertainty mechanism to deal with this.

5.30. We found NGG's justification for this expenditure to be very poor. The compressor replacement strategy is undeveloped (NGG admits that it is not complete), and there is insufficient justification of unit costs, which appear high. There is very little linkage of this expenditure with the existing replacement programme under the Integrated Pollution Prevention Control Directive (IPPC)[6] and other areas of the plan such as network flexibility, and NGG has not demonstrated how reduced emissions will result from the expenditure.

5.31. More generally, the plan is lacking in detail over linkages between non-load related capex, load-related capex and opex, and on how asset health and criticality assessments drive decisions on investment or maintenance. We also have concerns over the lack of information on unit costs.

5.32. NGG is forecasting to spend £117m on the Feeder 9 project, replacing a pipeline under the Humber River. We found the expenditure on this project to be

---

[6] EU legislation driving emissions reduction investment - implemented in the UK through the Environment Permitting Regulations (2010)

generally well-justified, and consider that this area could benefit from proportionate treatment in subsequent phases with a small amount of further explanation.

Opex

5.33. NGG is forecasting a rise in direct opex due to significant increases in fault repairs, planned inspections and maintenance, and security. The plan is lacking in detailed justification for the changes to these areas.

5.34. Indirect costs are forecast to be flat on a gross basis and fall slightly after capitalisation. As for NGET, with the exception of IT and property costs, we consider that this area may be suitable for a proportionate level of scrutiny. NGG has presented limited evidence on the efficiency of its IT expenditure, and there appear to be some projects with limited justification.

RPEs and ongoing efficiency

5.35. NGG has based its RPE forecast on a range of internal and external evidence. However, the proposed RPEs are higher than those of both the Scottish TOs and Ofgem estimates. The plan generally deals with efficiency in a well-structured and detailed manner, although for capex the difference between ongoing and 'catch up' efficiency is unclear.

System Operator (SO) capex

5.36. NGG SO capex is forecast to increase significantly from £19m per year during TPCR4 and Rollover to £32m per year during RIIO-T1. The business case being proposed by NGG has not changed significantly since the Rollover submission, where we were concerned at the level of expenditure, the lack of justification and the risk of replacing or upgrading several systems simultaneously.

Assessment of efficient financial costs in NGG's plan

Summary

5.37. NGG submitted a separate finance appendix which was comprehensive and extensive. It did contain some data inconsistencies which made assessment of the plan difficult. The proposals on overall financeability are not compelling and do not convince us that the proposals are efficient.

Technical accounting

RAV, Tax, Pensions and totex capitalisation

5.38. In general NGG complied with our policies across the technical accounting areas. However, we had a number of concerns over various calculations and data items, for example, opening RAV balances, justification of capitalisation rates and tax allocations to capital allowances pools. We have yet to agree with NGG on their calculation of the pensions regulatory fraction. Following subsequent discussions their methodology for computing this will need to be revised downwards, which it is anticipated will be material, around £5m per annum.

Corporate finance

Key content

5.39. Across this area NGG provided reasonably comprehensive material, including consultancy papers produced by Oxera covering the cost of equity, the impact of the duration of the control on risk and the impact of cost of debt indexation. NGG sought to justify its cost of equity submission with additional analysis using the dividend growth model, investors' comments and a risk-based analysis of how allowed return in RIIO-T1 should compare to TPCR4. NGG also provided useful risk analysis including RoRE analysis, and tested sensible credit metrics against a number of different scenarios, with some limited consumer impact analysis. The main omissions are a lack of reflection of input from other non-investor stakeholders; limited discussion of the economic fundamentals that impact on the choice of dividend policy and other related factors such as notional equity injection and notional gearing.

Reflects our policies

5.40. The key policy is our introduction of cost of debt indexation, which NGG accepted in its business plan.

Efficiency of costs

5.41. As NGG have accepted our policy in the main, the key areas of assessment are whether the proposed cost of equity is efficient and the financing structure is appropriate.

5.42. **Cost of equity:** NGG proposes a cost of equity figure of 7.5%, which is outside the range (6.0–7.2%) we set out in the Strategy Decision paper. In terms of the CAPM, the figure is largely based on material previously submitted to us and produced by Oxera. It uses risk-free rate and equity risk premium that are at the top of our range, and a higher equity beta. We note that Oxera's equity beta of 1 is calculated based on 65% notional gearing. If calculated at NGG's proposed 55% notional gearing, the equity beta would be 0.78 and the cost of equity 6.3%.

5.43. The core reasoning in NGG's arguments with regard to the cost of equity is that RIIO represents greater risk and uncertainty for network companies and investors than RPI-X. NGG argues that, coupled with the need to raise substantial funding given the size of NGG's investment programme in RIIO-T1, the increased risk (or perception of risk) requires a higher cost of equity assumption. However, our view is that all of these considerations are already captured in our range – for example, the market equity beta for a network company is around 0.5-0.6, while we used a range of 0.9-0.95 in the Strategy Decision paper. Overall, we consider that the arguments used by NGG were already rejected in the Strategy Decision paper and they do not provide an adequate or compelling justification that a cost of equity of 7.5% is an efficient cost.

5.44. It is important that the cost of equity is set in the context of risk. NGG provides thorough risk analysis, which includes detailed RoRE analysis and a comparison of risk between the TPCR4 settlement and NGG's business plan proposal. In NGG's risk analysis it argues that risk is increased under RIIO and propose a number of uncertainty mechanisms to reduce risk, which in their own analysis result in RIIO-T1 having a lower risk profile than TPCR4. We consider it a particular weakness of National Grid's argument that NGG and NGET are seen to face the same risk profile in RIIO-T1 despite NGET's capex programme being substantially larger than NGG's. In addition, National Grid argues that RIIO-T1 represents the same increase in risk relative to TPCR4 for both NGET and NGG, despite the fact that the duration of cash flows for NGG would not change, while it would lengthen for NGET.

5.45. **Financeability assessment:** The cost of equity and notional dividends are an input into NGG's financeability assessment and no link is made between these and notional gearing and investment. The five per cent dividend policy appears high in the context of an average annual RAV growth of 6 per cent, particularly as NGG's own analysis shows a large drop-off in money generated by the company towards the end of the price control period. NGG has proposed a lower totex capitalisation rate as a specific financeability adjustment. Although NGG provides detailed financeability assessment, in which the impact of various combinations of notional gearing, equity issuance and financeability adjustments on credit and equity metrics are assessed, we do not consider that its proposed corporate finance costs are efficient.

Assessment of uncertainty and risk in NGG's plan

Management of risk and uncertainty over RIIO-T1

5.46. Similar to NGET, NGG provided a comprehensive assessment of risk and uncertainty which gave a good overview of their risk management strategy including corporate risk management processes, management responses and how they propose the remaining risk is shared.

5.47. The key uncertainties for NGG's business plan over RIIO-T1 are around incremental capacity, the level of investment required to meet compliance with EU environmental legislation and network flexibility.

5.48. While overall we consider NGG's treatment of risk and uncertainty to be generally good quality we have also identified several areas for improvement. These include:

- more explanation and justification of the risk model
- more information on triggers/conditions to be applied to uncertainty mechanisms
- further consideration of commercial arrangements to deal with uncertainty future network flexibility investment
- greater stakeholder testing and input on uncertainty mechanism proposals.

Proposed uncertainty mechanisms

5.49. NGG has proposed a number of uncertainty mechanisms to adjust its baseline for several issues including incremental capacity, the costs of complying with the IED and network flexibility investment.

5.50. We consider NGG's proposed approach to managing uncertainty around the first two issues are reasonable subject to further analysis of its proposed modifications to the existing revenue driver and a much more detailed assessment of legislative requirements on the compressor fleet and possible synergies with network flexibility. However, we have concerns about NGG's proposals in relation to network flexibility, particularly around their justification for the proposed baseline investment and uncertainty mechanism.

6. Assessment of SPTL's business plan

Chapter Summary

This chapter provides our assessment of SP Transmission Limited (SPTL)'s business plan.

Overall assessment of SPTL's plan

6.1. SPTL's plan was generally well written but in many areas still reads as a submission to Ofgem rather than an outwards facing document for engaging with stakeholders. SPTL's plan is available at the following link http://www.spenergynetworks.com/publicinformation/stakeholder_home.asp.

6.2. There are a range of key positives in SPTL's plan including its coverage of safety, the quality of the completion of its data tables and a number of aspects of its technical financial proposals including its RAV, tax coverage and its treatment of asset lives. It is our intention that each of these areas will be subject to a proportionate level of scrutiny.

6.3. There are a range of areas where SPTL will be required to undertake further work on their plans. A number of the key areas are:

- providing evidence of cost efficiency throughout the plan and the appropriateness of the delivery model
- considering the impact of existing infrastructure on visual amenity
- developing a more detailed innovation strategy
- providing further information on a number of the outputs including connections and reliability
- providing further information and reviewing and revising elements of their financial proposals.

6.4. We note that there a number of areas to be addressed in SPTL's plan. However, the company has demonstrated that the scale of these might allow them to resolve these in a timeframe consistent with fast-tracking. On this basis, **we are retaining SPTL in the fast-tracking process.**

Category	SPTL
Process	R
Outputs	R
Resources – efficient expenditure	R
Resources – efficient financial costs	R
Uncertainty/Risk	R

Overview of plan

6.5. SPTL's business plan comprises one core document - an Executive Summary. It also includes nine supporting documents covering issues such as its stakeholder engagement process, its output strategy, separate papers for load related, non-load related and opex expenditure, its innovation strategy and its delivery strategy. All of these documents were published on SPTL's website.

Respondents' views

6.6. Four respondents raise specific points on SPTL's plan. The points were:

- coverage of environmental issues was very general and that it was difficult to get a feel for what they were proposing to do and where
- SPTL could make more of the need for anticipatory investments in sites that are likely to need investment in the future
- only SPTL had identified the potential to encourage or even participate in demand side management (DSM) activities under its Network Innovation Competition. However, the respondent noted that this should ideally represent a core activity
- one respondent, in highlighting the levels of interactions they had with the TOs on environmental issues noted that they had little or no contact with SPTL.

Assessment of process in SPTL's plan

Key content

6.7. SPTL submitted the majority of the key aspects of the plan but there were some key omissions notably market testing, efficiency and willingness to pay analysis in relation to visual amenity. The lack of information on efficiency is a particularly significant omission as it is central to assessing the quality of the plan.

Structure and proportionality

6.8. SPTL's 'Executive Summary' provides an overview of all of the key areas. Further the supporting documents largely focus on all the right elements. The supporting papers are labelled in such a way that it is reasonably clear where to go for the relevant information of each of the key content of their plans. One strong positive was the inclusion of a separate 'Outputs Strategy' papers. However, there are a number of downsides to the structure including limited links between the key documents and the fact that the website does not explain the interaction between the documents.

6.9. In relation to proportionality, SPTL's plan does not always focus the right level of intention in the right areas. For example, there is a varying level of detail on each output area and whereas the customer satisfaction section provides a good level of detail, the connection section is very limited. There is not enough focus on innovation in a plan and a clear strategy is required.

Completion of data template and financial model

6.10. SPTL completed the required tables. We did not find any significant data inconsistencies in the main opex and capex tables. SPTL also provided all supporting narrative specified in the form of tabulated commentary for specific items issued for each data table. These explanations are clearly presented albeit concise. They do not address anything beyond the explicit Ofgem requirements.

Effective engagement and reflection of stakeholders' views

6.11. In SPTL's plan there is evidence that the company has undertaken significantly more stakeholder engagement than it usually has during a price control process. SPTL demonstrated the use of different techniques including consultation, two workshops and targeted events with specific stakeholders eg two events covering political stakeholder. They have also an action plan for the next stage of engagement beginning in the autumn and for a process of enduring engagement.

6.12. However, much of the process described by SPTL could be regarded as business as usual as it largely focuses on existing customer contacts and there is no obvious consideration of future stakeholders. SPTL needed to do more to build contacts with broad interest groups, consumer organisations and bill payers. Also, despite their review of stakeholder interactions a number of the contacts on their database need to be updated. These points are all consistent with views raised by the CCG.

6.13. SPTL have not provided consistent evidence of how intelligence gained from the engagement process has been used to shape their plans and improve their performance. Further, SPTL's approach mostly focussed on where they have reflected feedback rather than where they have taken a different view. There is limited evidence of SPTL challenging stakeholders' views and of why they have adopted a specific approach when they have received a range of views.

Assessment of outputs in SPTL's plan

Summary

6.14. SPTL's business plan did not provide a comprehensive and well-justified account of the outputs that they would be accountable for delivering. Some areas appear sound eg safety, but in some of the outputs it was unclear what SPTL's proposal meant or whether they had understood the intent of our strategy decision. A number of these aspects have been discussed during the initial assessment process and the company has been able to clarify its position (either agreeing with the strategy decision in relation to connections or acknowledging the need for further work, eg visual amenity). There is a significant scale of improvement needed in this area but SPTL has shown significant willing to work on these.

Background

Reliability

6.15. SPTL's plan provides enough to inform the basic parameters of the energy not supplied mechanism and is consistent with the strategy decision in these areas. The plan proposed a collar that provides greater limitation on the incentive than our strategy decision. Following clarification, SPTL no longer seeks this departure.

Safety

6.16. The proposals appear to be consistent with meeting the required safety obligations. We have identified no further issues here though we will discuss this area with relevant stakeholders, in particular the Health and Safety Executive (HSE).

Wider works

6.17. The plan is built on a sound basis but needs more detail in a number of areas. These are particularly:

- detail on what the baseline includes in terms of preconstruction funding and what will be delivered eg planning consents
- interaction with TII-funding and project milestones needs further elaboration
- filling the omission of either a wider works volume driver or a network planning policy.

Network availability

6.18. SPTL produced a draft network availability policy. It has lots of relevant material about how the company plans and prioritises its work.

6.19. This is a good starting point but does not provide a clear TO baseline to which it can be held accountable for delivering. This is an area that would benefit from joint work with NGET (both SO and TO) and SHETL. When doing this work it will important for SPTL to demonstrate that the baseline is challenging and be open to challenge by NGET in its SO capacity.

Environmental

6.20. SPTL provided very little information about its BCF other than confirming it will provide annual reporting of BCF and will identify measures to improve its overall BCF, where appropriate. SPTL's forecasts show that their BCF will fall by around 10 per cent. We need more detailed consideration of BCF in the business plan. SPTL should explain why as a company they have chosen not to set a target or ambition to reduce the carbon emissions from their business. This particularly includes more information on the actions they are taking to manage their BCF and information on stakeholders' views about what the company should be doing in relation to their BCF.

6.21. SPTL's SF_6 proposals broadly align with the strategy decision document. The calculated baseline takes into account old and expected new inventories: For all new assets, SPTL say they have applied the following design rating leakage rates: 1 per cent for indoor equipment and 1.5 per cent for outdoor equipment.

6.22. The current plan does not provide detail on the assumptions underlying the baseline about load and non-load capex over the period. We would also need more information on why the baseline does not improve more than historical performance under the TPCR4 incentive ie 1.45 per cent of total inventory.

6.23. On transmission losses, SPTL stated they will consider the whole life costs (incl. losses) of transmission equipment and will utilise appropriate equipment on the network. SPTL also say they will continue to consider the impact of losses when developing the network and will work with NGET to develop optimal designs to support a cost efficient network.

6.24. Improvement is needed in relation to providing information on:

- stakeholders' views on what TOs should be doing to contribute to fewer losses and how this has informed their business plan
- modelled avoided losses and their investment appraisal process and working assumptions in relation to specific investments.

6.25. SPTL included some awareness of the possible need for undergrounding in their project proposals. However, the analysis and proposals were limited. They also failed to submit a willingness to pay study as requested. We look forward to working with SPTL including in the light of the report produced for us by London Economics.

6.26. SPTL could provide more information on challenges of ensuring timely investment and the risks of stranded assets. It should also give more consideration as to how their business plan would change if financial incentives were attached to a broad environmental measure.

Connections

6.27. SPTL's plan was very limited in this area. It reads more as a regulatory response than a business plan. While it highlighted previous successes, it needs to recognise the range of obligations in the licence. This is not solely the time period by which the TO needs to offer terms on constructing new and/or modifying existing connections. It also covers the interactions between TO and SO for example. In subsequent discussions, SPTL has confirmed that it agrees with, and was not seeking to depart from our strategy decision. It also recognises that its plan in general needs to reflect meeting this obligation.

Customer satisfaction

6.28. SPTL is the only company to include research and development and technical innovation in developing its customer satisfaction survey. We think this could be a useful addition to all the surveys. The CCG noted that SPTL's approach seemed to focus on renewable developers and needed to take a wider 'whole system' perspective as they further develop their customer satisfaction plan.

6.29. It will be important for stakeholders' views on the business plan to be incorporated into the further work in this area.

Innovation

6.30. SPTL provided an innovation strategy in its business plan. However, its innovation strategy was limited. It focused more on listing future projects than setting how it would go about appraising planning and delivering innovation. The tie in with the stakeholder engagement could be much clearer and there is a need to consider the need for innovation based on consideration of what happens in its absence.

6.31. There was little evidence of a consideration of innovation running through SPTL's plan.

Assessment of efficient expenditure in SPTL's plan

6.32. SPTL's plan contains several positive aspects, including reasonable unit costs and forecast replacement volumes, and good linkage of wider works to outputs. However, detail is lacking in a large number of areas and further evidence and justification is necessary.

Evidence of efficiency

6.33. Although the increase in SPTL's proposed expenditure is not as great as for NGET or SHETL, we would still expect clear evidence that its costs are efficient. However, SPTL has not provided any significant evidence of its cost efficiency such as external benchmarking studies. It has also provided very little evidence of market testing of its plan, relying on the assertion that its affiliate company will deliver the plan efficiently. Although it is testing its procurement strategy with suppliers, this will not be complete until November 2011.

6.34. In SPTL's plan there is recognition of the importance of the long-term picture given investment requirements and that its plans are set within the context of a longer-term delivery strategy. There is reasonable evidence that the long-term context has been considered with respect to non-load-related expenditure, including use of age-based modelling and setting out long-term risks and their consequences. However, there is little consideration of the longer term in relation to load-related expenditure, opex or outputs.

Load-related capex

6.35. SPTL's business plan forecasts £1.3bn of load-related capex over RIIO-T1. This represents a threefold increase over the average annual spend during TPCR4. SPTL's submission is strong in a number of areas. There is good justification of capex against different scenarios, although there is a large gap between expenditure under the upper and lower scenarios. SPTL has also provided a good linkage of wider investments to outputs, with the level of investment and boundary capability delivered being clearly set out.

6.36. There are two key negative aspects to the load-related elements of SPTL's plan. Firstly, that it relies very heavily on Iberdrola to procure the necessary resources to deliver the plan, but there is little consideration of the risks of using an affiliated company, or the benefits to customers of this approach. Secondly, despite the high degree of uncertainty in the plan, there is little discussion of the proposed uncertainty mechanisms and risk.

Non-load related capex

6.37. SPTL is forecasting £0.65bn (£0.08bn per year) of non-load-related capex in its business plan. This is 12% higher than TPCR4 annual averages. SPTL generally has a well-developed approach to asset management and replacement expenditure, using cost benefit analysis to inform its decisions on asset replacement, supported in the business case by case studies. In addition, risks in the plan (in terms of asset performance) were clearly identified with mitigation measures described.

6.38. Our initial analysis of unit costs shows them to be reasonable in comparison to TPCR4, other TOs and the modelling undertaken by our consultants. Replacement volumes also generally appeared to be reasonable based on our aged-based modelling, although there was insufficient linkage of expenditure to replacement priorities. However, the plan did not give a full explanation of the linkage between planned replacement volumes and outputs. Furthermore, SPTL's plan relies on a reactive approach to replacement, leading to possible inefficiencies if its forecast is not accurate. The plan also does not address the under-delivery of historical overhead line replacement.

Opex

6.39. SPTL is forecasting a significant rise in direct opex. This is explained as being due to a higher level of fault repairs and maintenance arising from a greater number of renewable energy connections. This expenditure is not linked to asset health, criticality and replacement priorities.

6.40. SPTL's business plan also provides for a significant increase in closely associated indirect costs. This is due to its strategic decision to change from a traditional turnkey procurement and delivery model to delivering its plans through an affiliate.

6.41. The section in SPTL's business plan on operating costs is lacking in detail, with some significant omissions from the material provided. While there is a reasonable level of detail for direct opex, the sections on indirect opex, which represent a significantly higher level of expenditure, do not contain adequate justification. There is also very little linkage of expenditure to outputs, and little recognition of the interaction and trade-offs between opex and capex.

RPEs and ongoing efficiency

6.42. In its submission, SPTL has relied solely on a report produced for all the TOs by First Economics. While we consider that the report provides reasonable evidence to support SHETL's proposed RPEs, there is very little discussion of the report or further justification. SPTL has proposed an uncertainty mechanism relating to very volatile RPEs, but has not provided details on how such a mechanism would operate, nor how it would represent value for money to consumers.

Assessment of efficient financial costs in SPTL's plan

Summary

6.43. SPTL's finance business plan was the most complete and accurate in terms of the data submitted to us. While SPTL has stayed within our corporate finance parameters and complied with our policies, we found the overall business plan not compelling in respect of efficient costs.

Technical accounting

RAV, Tax, Pensions and totex capitalisation

6.44. In general, SPTL complied with our policies across the technical accounting areas with very few data issues. The main concern is over an increase in ongoing pension costs in the plan for which the underlying calculations have not been provided, albeit the pension costs are not a material element of the business plan.

Corporate finance

Key content

6.45. SPTL provided a reasonable amount of material and a generally good level of detail with regard to the corporate finance elements of its business plan. Alongside its business plan, SPTL provided a detailed presentation by its consultants, NERA. This presentation focuses on the cost of equity, but also addresses notional gearing and the cost of debt index. However, SPTL's business plan proposes parameters that are within our ranges rather than those argued for by NERA (particularly on the cost of equity). SPTL includes risk analysis, in the form of both RoRE analysis and a detailed Monte Carlo simulation of risk scenarios. Both expected dividend payments and equity issuances are clearly identified in SPTL's business plan narrative, and included in its financial model. The main omissions are a lack of input from wider stakeholders on financial parameters, a lack of discussion of the economic/financial rationale for the proposed dividend policy and a credit assessment of other potential scenarios or combinations of financeability parameters.

Reflects our policies

6.46. The key policies are our introduction of economic asset lives of 45 years with a straight line depreciation profile and cost of debt indexation. SPTL accepts both of these policies, while proposing an 8-year transition period for the introduction of economic asset lives on new assets.

Efficiency of costs

6.47. As SPTL accepted our policies in the main, the key areas of assessment are whether the proposed cost of equity is efficient and whether the transitional arrangements and financing structure are appropriate.

6.48. **Cost of equity:** SPTL proposes a cost of equity assumption of 7.2%, which is right at the top of our range from the Strategy Decision paper. SPTL provides analysis by NERA which provides a range of estimates for the cost of equity based on both CAPM and the Dividend Growth Model. However, NERA's estimates are all higher than our range, meaning that SPTL's proposal of 7.2% is effectively based on our own analysis.

6.49. It is important that the cost of equity is set in the context of risk. SPTL provides detailed risk analysis, which includes some RoRE analysis and Monte Carlo simulation of individual risks (such as cost over/under spend, real price effects, and the various incentives). However, the parameters that underpin the risk analysis are not always clear and some are questionable. Overall, SPTL identifies four risks which factor into its cost of equity assumption:

- the size of the planned capex programme for RIIO-T1
- SPTL's relatively small RAV compared to NGET
- "compensation" for the increased duration of cash flows due to lengthening the depreciation profile
- the risk of underperforming the cost of debt index.

6.50. While its consultants place values on the above risks, they are not specifically identified as components of SPTL's proposed 7.2% cost of equity. Instead, the business plan suggests that the proposed 7.2% captures SPTL's perception of added risk in RIIO-T1, rather than a numerical assessment. Overall, while SPTL seeks a cost of equity assumption within our range, we do not find the proposal well-justified.

6.51. **Notional gearing:** SPTL proposes using notional gearing of 50%. Notional gearing is not an input into SPTL's financeability assessment and, in fact, it uses a target ratio of 60-68% in its financeability assessment, which it identifies as being consistent with credit rating in the range A/A-. We also note that SPTL's proposal of notional gearing appears inconsistent with its proposal for cost of equity at the top of our range. The two combined result in asset beta of 0.475, which we consider to be unreasonably high for a regulated network company. Overall, we do not find SPTL's notional gearing proposal well-justified.

6.52. **Financeability assessment and transitional arrangements:** Any assessment of the overall transitional arrangements are the result a number of choices that interact with each other including cost of equity, notional gearing, dividend policy and notional equity issuance in the context of the level of investment. SPTL does not appear to derive its financial proposal as a result of financeability assessment. Instead, the financial parameters appear to be inputs, which SPTL then use to show that the assessment does not fail financeability tests. We question some of the credit ratios that SPTL uses. We define financeability as the ability of the network company to achieve a 'comfortable investment grade' credit rating (ie BBB to A). If a company seeks to achieve a particular credit rating (for example, in the case of SPTL, A), it can do so by adopting lower gearing and dividend payments than our notional assumptions. It is not the role of the regulatory regime to cater for the specific financing strategies of each network company.

6.53. The submitted business plan also provides no discussion on the relationship between investment, dividends and equity issuances. It sets the threshold for notional equity issuance at 55% gearing, despite the fact that its own financeability assessment sets 60-68% as the target range for gearing. This results in SPTL seeking a revenue uplift for notional equity issuances that are not related to any financeability concerns.

Assessment of uncertainty and risk in SPTL's plan

Management of risk and uncertainty over RIIO-T1

6.54. SPTL consider risks and uncertainties in relation to different areas of their business plan. However, SPTL do not assess or quantify these more broadly in terms of the potential impacts on output delivery and proposed expenditure (they only quantify risk implications for their financial performance). As a result, the relative materiality and potential impact of various uncertainties for the delivery of the plan is unclear. It is therefore difficult to understand how SPTL has assessed the potential impacts, its mitigation priorities, or whether the responses it proposes in each area are, when combined, the most effective management strategy overall.

6.55. Ideally SPTL should take a more holistic approach to assessing the uncertainty and risk associated with the delivery of their business plan. We think SPTL should develop an assessment framework to quantify the risks and uncertainties to clearly establish the relative materiality and impacts more broadly on output delivery and proposed expenditure. SPTL should also provide more information on the management actions it is taking to manage the risks as well as analysis of the impact these and any proposed uncertainty mechanisms will have on reducing volatility in output delivery, and proposed expenditure.

Proposed uncertainty mechanisms

6.56. SPTL proposed the fewest number of mechanisms to manage uncertainty. They generally expect a continuation of existing mechanisms that operate within TPCR4. SPTL did not explain why they considered these mechanisms were appropriate under RIIO-T1 or provide any supporting analysis of the potential benefits or downsides for consumer that might arise from using these mechanisms.

7. Assessment of SHETL's business plan

Chapter Summary

This chapter provides our assessment of Scottish Hydro Electric Transmission Limited (SHETL)'s RIIO-T1 business plan.

Overall assessment of SHETL's plan

7.1. SHETL's plan was generally well written and clearly stakeholder focussed but there were a number of areas where more detail was required. SHETL's plan is available at the following link http://www.ssepd.co.uk/Projects/TransmissionPriceControlReview/.

7.2. There are a range of key positives in SHETL's plan most notably its coverage of safety, customer satisfaction and its connection outputs. It is our intention that each of these areas will be subject to a proportionate level of scrutiny.

7.3. There are a range of areas where SHETL will be required to undertake further work on their plans. A number of the key areas are:

- providing evidence of cost efficiency throughout the plan and deliverability
- considering the impact of existing infrastructure on visual amenity
- further information on a number of areas of their financial proposals including scenario analysis to show financing proposals are optimal from a consumer perspective, evidence that their bespoke cost of debt index is more appropriate than the Ofgem index and demonstrate achievement of credit metrics with selected financing parameters and the alternative options considered
- providing further information on a number of the outputs including their proposals for an alternative approach to reliability and deliverables associated with baseline load related investment for wider works
- providing further information and reviewing and revising elements of their financial proposals.

7.4. We note that there a number of areas to be addressed in SHETL's plan. However, the company has demonstrated that the scale of these might allow them to resolve these in a timeframe consistent with fast-tracking. On this basis, **we are retaining SHETL in the fast-tracking process**

Category	SHETL
Process	R
Outputs	R
Resources – efficient expenditure	R
Resources – efficient financial costs	R
Uncertainty/Risk	R

Overview of plan

7.5. SHETL's business plan comprises two core documents (an Overview and an Innovation Strategy). It also includes seven supporting documents covering issues such as its stakeholder engagement process, its capital expenditure programme, its environmental impact and the basis for determining its allowed revenue. All of these documents were published on SHETL's website.

Respondents' views

7.6. Two respondents raised specific comments on SHETL's plan. The points were:

- the coverage of environmental issues is much more comprehensive in SHETL's plan but there is little consideration of undergrounding to minimise environmental impact including minimising collision risk on SPA-qualifying bird species
- SHETL had gone some way to acknowledging the need for anticipatory investments in sites that are likely to need investment in the future, together with managing the associated risks.

Assessment of process in SHETL's plan

Key content

7.7. SHETL has submitted the majority of the key aspects of the plan in varying levels of detail. However, there are a number of omissions including market testing and efficiency analysis. SHETL did not undertake willingness to pay analysis in relation to visual amenity but did provide context for this position noting that they did not believe it was value for money and that the planning process was the best place to determine the need for undergrounding.

7.8. SHETL's plan demonstrates a consideration of the context in which their plan has been developed including relevant offshore, European and other political interactions. However, we note that there are limited references to the political context with the exception of the challenges associated with meeting the UK's renewable targets.

Structure and proportionality

7.9. SHETL's plan has very high publication standards. It is very well written, easy to understand and accessible to the interested reader. It is clear that SHETL's plan is very much targeted at stakeholders. This is a significant positive. However, a well-justified business plan must also provide enough detail to enable us to assess the companies' investment proposals and their associated financial requirements. SHETL's plan could have provided an additional level of detail in a number of areas.

Completion of data templates and the financial model

7.10. SHETL have performed well in completing the required data tables. SHETL submitted all data tables with their plan. There were only minor inconsistencies and in most cases where tables have not been completed this has been clearly labelled in narrative.

7.11. There were more issues with SHETL's financial submissions. In particular, SHETL's plan did not include any narrative on risk assessment and it was unclear where risk assessment was incorporated into the model.

Effective engagement and reflection of stakeholders' views

7.12. In SHETL's plan there is evidence of an increased focus on stakeholder engagement. SHETL initiated their stakeholder engagement process at an early stage and set out a multi stage and iterative approach to engagement. One particularly positive aspect of SHETL's process to date is that they have fed back outcomes to stakeholders and specifically asked stakeholders to confirm records of meetings. SHETL have also set out a number of areas for further engagement in the coming months.

7.13. SHETL's plan includes details of correspondence with stakeholders and a list of stakeholders. SHETL have highlighted key stakeholder messages and identified in a number of areas where they have impacted their plan. SHETL have also signposted stakeholder input in key documents including direct quotes where relevant.

7.14. However, there are a number of areas of SHETL's engagement that could be better. Firstly, their stakeholder base could have been wider. They did not provide any evidence of consultation with local communities or voluntary sector other than in relation to new projects. There was also no evidence of research with end users. Further, in some parts of the plans there is no clear link between stakeholder messages and outcomes. In a number of other areas SHETL could have done more to demonstrate where it has challenged stakeholders' views and come to a different view. These points all reflect issues highlighted in discussions with the CCG.

Assessment of outputs in SHETL's plan

Summary

7.15. SHETL has been keen to consider or propose departures from the outputs set out in our strategy decision in a number of key output areas. There is no problem with this in principle. Indeed, it is the sign of initiative that might well be consistent with the RIIO objectives. However, it is important for these departures to be justified. Particularly important is to show why these departures contribute to better outcomes for consumers and other stakeholders. SHETL are strong in some areas eg transmission losses and connections but has significant work to do in a number of other areas including network availability, reliability and wider works (the latter being particularly important given SHETL's proposed allocation between initial baseline revenue and projects being considered during the control period).

Background

Reliability

7.16. SHETL propose an output materially different from our strategy decision of the energy not supplied (ENS) measure. This is not a problem, but it is important for such a departure to be well-justified. This should include a clear reflection of stakeholder views not least because such stakeholders were involved in developing the strategy decisions on outputs. SHETL identified a programme for developing this output in the July plan rather than a clear justification. Since the submission, SHETL has outlined a programme for finalising its proposal, including with stakeholders. This is one of the areas where only with the necessary justification would we consider the company for fast-tracking.

Safety

7.17. The proposals appear to be consistent with meeting the required safety obligations. We have identified no further issues in this area, though we will discuss this with relevant stakeholders, in particular the Health and Safety Executive (HSE).

Wider works

7.18. SHETL's plan contains significant investment in new infrastructure and reinforcing existing infrastructure (particularly relative to the baseline). The wider works output area is very important as the company plans significant in-period investment. SHETL has not adopted the wider works approach of using boundary capability to define what they are delivering. Again differing from the strategy decision is not a problem on its own but it is important that full justification for a departure from that strategy is made.

7.19. The actual investments proposed are well-justified in some areas. For example, it demonstrates a clear longer-term strategy for network development including post 2020.

7.20. However, we would like to see improvements via:

- more detailed information on the proposed projects against other reinforcement options
- timescales for the wider works including procurement, manufacture, build and commissioning phases and
- evidence to support its proposed delivery costs.

7.21. Given the heavy reliance on a type of funding similar to the transmission investment incentives (TII) rather than being agreed up front, SHETL need to provide a clear justification for why this is in the interest of consumers. It also omits a volume driver for wider works and has no network planning policy. We recognise that it does show commitment to strong project governance.

Network availability

7.22. SHETL produced a draft network availability policy. It has provided a lot of relevant material about how the company plans and prioritises its work. SHETL was also the only company to produce a set of 'enhanced' services that it might offer to carry out if incentivised to do so by the SO.

7.23. This is a good starting point but the priority is to get to a clear TO baseline to which it can be held accountable for delivering. Joint work with NGET (both SO and TO) and SPTL would be a useful next step. When doing this work it will also be important for SHETL to demonstrate why some services are enhanced and their cost implications.

Environmental

7.24. On emissions, SHETL's plan is particularly strong in demonstrating a commitment to contributing to fewer transmission losses. In relation to both the BCF and SF_6 the plan needs further work. This would include detail about the impact of the Carbon Reduction Commitment (CRC) on its plans and more detail on what it proposes to do when using the innovation mechanisms in this area.

7.25. While SHETL's plan provides a baseline for the output, there is little to justify which is challenging and/or informed by stakeholder engagement. There is also a departure from our policy in that the target is set in terms of percentage of mass. Such departures need to be fully justified. There are additional steps needed from the company to convert the proposed baseline as a percentage of total mass to leakage mass (kg) as per our strategy decision document. We require further information about the assumptions used to set the baseline, ie legacy assets and load and non-load capex in SF_6 equipment.

7.26. SHETL failed to submit a willingness to pay study as requested but gave justification. We look forward to working with SHETL including in the light of the report produced for us by London Economics.

Connections

7.27. This is a strong aspect of SHETL's plan demonstrating a good understanding of the historical context. SHETL not only commit to the output set out within our strategy decision but go further proposing standards of service for its customers in this area. We welcome this approach and other than the general work to reflect the output properly in the licence we do not intend significant work in this area.

7.28. We would welcome further details on SHETL's proposed standards of service and how they propose to be assessed in line with them. The impact of the delivery of this output is an area of further development.

Customer satisfaction

7.29. SHETL has responded positively to the requirements to develop a customer survey. In includes details in its plan of its different activities, stakeholders related to these and a plan for taking forward. It also includes details of possible questions and a proposed approach for taking this forward. While all the TOs will need to continue working with us to develop a workable output and incentive in this area, this strong start should provide a robust basis for this work. The CCG noted that SHETL's approach to customer satisfaction largely focused on existing relationships and contacts and needed to take a wider 'whole system' perspective as they further develop their customer satisfaction plan.

7.30. It will be important for stakeholders' views on the business plan to be incorporated into the further work in this area.

Innovation

7.31. Although the innovation strategy provided is brief, there is evidence of a strategy, with a start being made in justifying it. However, SHETL need to provide more evidence to support that strategy. SHETL describe the key challenge they see their network facing as a lack of existing infrastructure. They also provide a bulleted list of deliverables for RIIO-T1 but without supporting detail. The tie in with the stakeholder engagement could be much clearer and there is a need to consider the need for innovation based on consideration of what happens in its absence.

7.32. There was little evidence of a consideration of innovation running through SHETL's plan although they did provide some examples of previous innovations.

Assessment of efficient expenditure in SHETL's plan

7.33. SHETL's plan shows a clear view of likely projects and the uncertainties around them, and demonstrates a significant degree of stakeholder engagement. However, there is a lack of detail on some scenarios.

Evidence of efficiency

7.34. SHETL has not provided any evidence of its cost efficiency such as external benchmarking studies. It has also provided very little evidence of market testing of its plan, other than a short section setting out its delivery framework and alignment with suppliers. There is no discussion of third party delivery in the plan.

7.35. While market testing or benchmarking is to be expected as part of a well-justified business plan, we consider it to be especially important in the case of SHETL, where a large proportion of its expenditure comprises new projects of which it has limited experience. We also expected consideration of the relative risks and costs of third party delivery to be included in SHETL's plan, along with a justification for its chosen delivery strategy.

7.36. While the plan covers many of the aspects relevant to the longer-term context, these aspects have only been set out at a very high level, with a lack of supporting evidence.

Load-related capex

7.37. SHETL's capex is dominated by load-related expenditure (95 per cent compared to 60-65 per cent for NGET and SPTL), indicating a transformation in the size and nature of its network during the RIIO-T1 period. SHETL has taken an extremely conservative approach to the proposed funding mechanisms for its load-related capex, with a low ex-ante funded baseline, and sharing factors below those set out in our Strategy Decision document.

7.38. We found that SHETL had clearly set out the funding mechanisms it was requesting for its capex programme, and that it had engaged well with stakeholders in coming up with its plans. We found that there was a good level of detail on its processes, however given the up scaling of its expenditure there was insufficient detail on the impact of uncertainty on the delivery of its programme. We would have expected further explanation of how it would meet the up scaling challenge of RIIO-T1, more detailed justification of schemes, with clear linkages to outputs and evidence of cost efficiency. In some instances the plans lacked the required level of detail, with schemes being presented in isolation and presentation of the programme as a whole not being as comprehensive as we would have envisaged. We would have also expected further information on the scenarios and customer benefits.

7.39. We also have concerns regarding SHETL's proposed funding mechanisms. We accept that SHETL's existing size, the scale and uncertainty of proposed capex and its concentration in a small number of very high value projects are all factors which might lead to a greater proportion of expenditure funded through uncertainty mechanisms including within period determinations. However, SHETL's plan has limited consideration of the detail and impact of the chosen funding mix and its effect on customers and process.

Non-load related capex

7.40. Non-load related capex is forecast to increase from £15-17m per year during TPCR4 to £20-29m per year during RIIO-T1. SHETL's asset replacement plans are well aligned with the health and criticality ratings of its assets, with a decrease in network risk forecast for RIIO-T1. It has also provided a limited explanation of how its plan is linked to outputs, but the plan does not link replacement expenditure to reliability outputs.

Opex

7.41. SHETL is forecasting a significant increase in opex, £8m per year during TPCR4 to £28m per year during RIIO-T1. In its business plan it states that the increased costs are due to the significant increase in the scale and complexity of its network and the increasingly complex regulatory environment. It has provided relatively short, qualitative justifications for various cost increases. While this provides an initial understanding of the proposed increases, the level of detail is sparse.

7.42. SHETL is proposing an 'operating cost escalator', where opex allowances are set at 1 per cent of gross asset value of large construction projects. Given SHETL's substantial capex programme this would give an annual opex allowance of £18m by 2020/21. There is no detail in SHETL's plan on what this money is likely to be spent on, nor on whether this level of cost is appropriate.

RPEs and ongoing efficiency

7.43. Like SPTL, SHETL has relied solely on a report produced for all the TOs by First Economics. While we consider that the report provides reasonable evidence to support SHETL's proposed RPEs, there is very little discussion of the report or further justification. There is also little detail in the plan regarding ongoing efficiency targets.

Assessment of efficient financial costs in SHETL's plan

Summary

7.44. While we have acknowledged that SHETL may need to be treated as a 'special case' in RIIO-T1, due to the size of its potential capex relative to its RAV, its business plan introduces significant deviations from our key financial policies, which are backed by evidence that we find insufficient and not compelling.

Technical accounting

RAV, Tax, Pensions and totex capitalisation

7.45. In general SHETL complied with our policies across the technical accounting areas with the exception of the totex capitalisation rate. We also had a few concerns over various calculations and data items and found limited, if any, narrative in the plan to support these areas.

Corporate finance

Key content

7.46. As discussed further below SHETL has departed from our policies in a number of material aspects but has provided relatively little justification to support its position. Its separate financial appendix contained by far the least amount of supporting material and justification. It based its underlying cost of equity proposal (7.5%) on the same Oxera report as NGET/NGG supported by its own limited analysis to justify a higher cost of equity in the early years of RIIO-T1. SHETL bases its cost of debt proposal on its own analysis but with no quantitative analysis. With regard to asset lives and depreciation, SHETL makes its own arguments, but does not provide any new evidence. In its financial model, SHETL uses 4.2% for the cost of debt. We have been unable to reconcile this number with SHETL's business plan narrative, even after taking into account its alternative weighting approach to the cost of debt index, and the 72bps uplift that it seeks.

7.47. SHETL has not provided financeability assessment as part of its business plan narrative. Its financial model calculates some credit ratios, but does not appear to test these against target levels. SHETL also did not provide any quantitative risk analysis such as RoRE (or an alternative approach). SHETL's references to risk are only qualitative in nature and focus on the size of the capex programme it expects to undertake during RIIO-T1 with no reference to the characteristics of the price control.

Reflects our policies

7.48. In the Strategy Decision paper we noted that companies in particular circumstances are able to propose an alternative weighting to the cost of debt index, if they can show that our index would not sufficiently cover their cost of debt under reasonable scenarios. In its business plan, SHETL proposed alternative weighting to the cost of debt index. However, they provided no quantitative evidence that this approach would better reflect its cost of debt. Additionally, SHETL does not test its proposed approach against reasonable cost of debt scenarios.

7.49. Furthermore, SHETL seeks a 72bps uplift to the cost of debt to reflect a number of items that it argues are not captured in our index. However, SHETL bases this claim on arguments that we rejected in the Strategy Decision document. SHETL's claim is also at odds with NGET/NGG and SPTL's positions, where the risk of underperforming the cost of debt index is captured in the proposed cost of equity.

7.50. SHETL did not fully accept our asset life policy of 45 years. Instead SHETL used a 45 year sum-of digits front loaded profile with no transitional arrangements. (A transitional scenario of a straight line profile with a 22-year transitional period broadly results in the same depreciation profile as included in its business plan.) In support of this different policy, SHETL re-iterated its concerns that our policies on asset lives and depreciation profile do not reflect the uncertainties over the future nature of its network. Along with our Strategy Decision document we presented analysis from CEPA that specifically examined this issue which concluded that a current average expected life of 45 years made allowance for the uncertainties. SHETL did not support its case for using a front-loaded depreciation profile with any calculations or scenario analysis of potential future network usage.

7.51. Overall, we note that SHETL's business plan is significantly out of line with our main corporate finance policies and the deviation is not adequately justified.

Efficiency of costs

7.52. As we do not consider SHETL's proposals for the cost of debt index and depreciation profile to be well-justified, we have not assessed the cost efficiency of these proposals.

7.53. **Cost of equity:** SHETL proposes a base cost of equity of 7.5%, based on the same Oxera analysis as NGET/NGG. However, it also identifies the first four years of RIIO-T1 as a period of 'intense growth' (ie substantial capex relative to its RAV) and seeks a cost of equity of 8.25% (ie a 75bps uplift on its base cost of equity) for this period. Both of these figures are outside the range we outlined in the Strategy Decision paper, the latter significantly so. SHETL bases its assessment on the difference in the asset beta between the top of Oxera's range and the median for a number of construction companies. We have a number of concerns with this approach because unlike construction companies, SHETL does not face competition or the risk of market entry; is not exposed to demand or volume risk; has a guaranteed revenue level for the duration of each price control period; has a significant degree of protection from the totex incentive mechanism; has its market value anchored by the RAV and operates under an established, internationally respected, and well understood regulatory regime.

7.54. SHETL attempts to address this by only applying 15% of the difference in asset beta into its cost of equity uplift to capture its additional risk during the 'intense growth' period. However, SHETL does not present any comparison of cash flow risk between it and the construction companies to justify the selection of 15%. Lastly, we note that a cost of equity of 8.25% would incorporate an equity beta above one (ie representing greater risk than the market average). While SHETL may face unusual levels of risk in RIIO-T1, we do not consider it credible to claim that a company that benefits from all of the factors listed above could be considered more risky than the market average.

7.55. It is important to consider the cost of equity in the context of risk. However, SHETL provides no quantitative analysis of the risk that it may be exposed to during RIIO-T1. SHETL makes a number of references to being exposed to greater risk in RIIO-T1, although this is neither quantified nor discussed in great detail.

7.56. **Financeability assessment and transitional arrangements:** SHETL does not present any form of financeability assessment in either its written business plan or its financial model. Therefore, the corporate finance elements that influence financeability (cost of equity, notional gearing, equity issuance, dividends, and transitional arrangements) are all inputs into its financial model. The result is that in no part of the business plan submitted to us does SHETL consider the financeability implications of its proposal, nor whether the proposal represents efficient costs for consumers. Further, the submitted business plan provides no discussion on the relationship between investment, notional dividends and notional equity issuances.

7.57. Overall, we do not consider that SHETL's corporate finance proposals provide sufficient evidence that they represent efficient costs for consumers.

Assessment of uncertainty and risk in SHETL's plan

Management of risk and uncertainty over RIIO-T1

7.58. SHETL looked at risk and uncertainty in relation to specific areas of their business plan but generally only qualitatively. SHETL gives a degree of detail about uncertainties in relation to its load related investment.

7.59. SHETL proposed a relatively low baseline for its load related capex (ie less than their lower forecast) and a relatively large risk sharing allocation with consumers (through uncertainty mechanisms and an efficiency incentive sharing factor below the range we set out for the Information Quality Incentive (IQI) mechanism set out in the March Strategy). However there is little evidence that SHETL is proposing to share the benefits of greater flexibility with consumers through more efficient financial proposals. SHETL should explain why this approach is preferable to other possible solutions to dealing with load related investment risk eg third party delivery. SHETL should also give some information on the potential impacts of including works that are likely to be in construction phase by 2013 into the baseline, ie projects initiated under 2012/13 round of TII.

7.60. There is a significant difference in the proportion of expenditure SHETL propose to meet through uncertainty mechanisms as compared to NGET. At face value this would suggest the two companies have adopted very different risk management profiles. However, portfolio effects are likely to be a key factor for this difference as well as the size of the capital programme relative to the company's existing RAV.

Proposed uncertainty mechanisms

7.61. SHETL proposed to manage the uncertainty around load related investment through a within-period mechanism. SHETL provided a good discussion of how it expected the mechanism would work, but this was mainly process focused.

7.62. SHETL has also proposed new mechanisms to meet potential costs from subsea cable faults, additional O&M costs associated with network growth and new requirements of European Network Codes.

7.63. Due to the materiality of the expenditure, further analysis is needed to finalise SHETL's baseline and the design and parameters of mechanisms.

8. Next steps

Chapter Summary

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

8.1. In line with the position outlined in our March 2011 Strategy Decision document, there will be a different timetable for companies retained in the fast-track process from those not deemed suitable for fast-tracking.

8.2. SPTL and SHETL will be retained in the fast-tracking process. This decision does not mean that SPTL and SHETL's plans will automatically be fast-tracked. SPTL and SHETL are required to submit further information to us highlighting how they are resolving the outstanding issues in their plans. In light of the additional information provided we will consult on their suitability for fast-tracking in January 2012 and set out initial proposals for those companies where we deem fast tracking is appropriate. This is a slight change to our previous timetable in which this consultation was due to be published in December 2011. The additional time is intended to allow the maximum possible time to allow outstanding issues to be resolved. We will publish our decision on fast-tracking and, if SPTL, SHETL or both are ultimately found suitable for fast-tracking, set out final proposals for those companies in April 2012.

8.3. NGET and NGG will not be retained in the fast-tracking process. Instead, those companies will be on the non fast-tracking timetable whereby they will be required to submit the next versions of their business plans to us by 5 March 2012. We will publish initial proposals for those companies in July 2012 and final proposals in November 2012. If it becomes clear that either or both of SPTL and SHETL are ultimately unable to resolve the outstanding issues in their business plans in a timeframe consistent with a January 2012 consultation then they will also revert to this timetable.

8.4. In making changes to their plans, and in line with the concept of proportionate treatment, we expect all of the transmission companies to focus most effort on the areas of the plans which received a 'red' traffic light score. Equally we expect the companies to give least focus to the areas which received a 'green' score.

8.5. We intend to work with all of the transmission companies between now and their next submissions to help them better understand the areas where we consider the plans can be improved to meet the standard required of a well-justified business plan.

8.6. We expect the companies to undertake further engagement with stakeholders to inform the further development of their plans during this phase.

Appendices

Index

Appendix 1 – Full summary of respondents' views

1.1. There were nine responses to our August letter. The key points raised by respondents were as follows.

Process

1.2. A number of respondents commented on the volume of information published and noted that this hindered the ability to analyse and comment on the proposals. One respondent suggested an alternative approach for future business plan publications involving issuing executive summaries in a standard format, combined with a supporting stakeholder event and a word limit for plans. Another noted it would have been useful to publish a summary of the plans focusing on proposed investments, expected costs and net financial benefits.

1.3. Among the other generic points on process and stakeholder engagements were:

- the plans appear to be well-justified other than the general acceptance of the current SQSS to justify future investment
- stakeholder engagement process remains dominated by industry and that more effort should be put into engaging local authorities
- the documents were generally accessible and well-structured but that it was clear there had been a substantial redaction of information and that this limited the ability of a key stakeholder to review the contents thoroughly – one respondent argued that the plans were largely qualitative and questioned why it was not possible to sanitise or summarise some data rather than redact the information
- welcomed the companies making detailed scenarios and models available to stakeholders but additional explanation was needed to enable stakeholders to gain real understanding from this information
- companies have made genuine and comprehensive efforts to seek the views of stakeholders, although without necessarily being willing to provide all the necessary information for customers to provide an informed opinion.

1.4. Four respondents commented on elements of NGET's process. The points raised were:

- NGET have made significant progress in engaging with the industry and developing a process accessible by all types of user
- NGET appears to have paid inadequate attention to consultees not involved in the consultant-managed part of the process. The respondent noted that there were comparatively few references in the plan to the many written submissions and some central arguments had consequently been overlooked

- two respondents welcomed NGET's development and publication of the ESI model and noted that they found the models very useful, although they noted that further development would have been beneficial
- engagement on reliability had not been sufficiently detailed to date and they welcomed commitment to further engagement on this in the autumn.

1.5. One respondent indicated the level of engagement they had with all TOs. They noted they had met with SHETL and provided written input to their plan, that they had been invited to National Grid's workshops but that they had little or no contact with SPTL.

Outputs

General

1.6. One respondent considered there was a lack of detail in NGET and NGG's plans on how the new investments relate to the outputs, the objectives against which they would be measured and the associated benefits.

Reliability and availability

1.7. One respondent considered that NGET's view that the currently reliability was "about right" was not a reasonable assumption given the lack of analysis of the additional costs or savings of an incremental change in the level of reliability or consideration of how changed levels of investment/operational security would change the level of reliability.

1.8. Another respondent supported NGG's view that there are other factors, alongside the "1 in 20 scenarios", that should be taken into consideration when planning for capacity to ensure the safety and reliability of the network.

1.9. A third respondent noted the lack of consideration of the scope to coordinate with other networks on issues such as outages, connection points and demand management.

1.10. A fourth respondent welcomed NGET's proposal to be more innovative in the way it manages the network but noted that there was no specific detail on the projects to invest in their IT system and data centres or to improve forecasting capability or to develop new commercial contracts.

1.11. One respondent noted that the case had not been made for additional network investment to manage network flexibility constraints. They considered other solutions should be considered such as onshore has storage close to the source of localised constraints.

1.12. Another respondent noted that the RIIO process should introduce greater rigour around the use of force majeure in relation to network constraints to prevent NGG insulating itself from the financial impact of certain events.

Environmental and visual amenity

1.13. Two respondents consider some components of the strategy to deliver a sustainable energy sector were in the plans but that there should have been more to bring together the key elements including making anticipatory investments to maximise low carbon generation as well as operational strategies to minimise constraints.

1.14. Another respondent considered that only NGET explicitly acknowledged the role of the networks in meeting the low carbon agenda and that none discussed their internal organisational incentives to maximise progress. The respondent supported the introduction of a new regulatory incentive to encourage the network companies to work proactively towards the targets.

1.15. A third respondent considered that NGET's plan recognised the need to focus on the environmental impact of its activities but that it had provided little detailed information as to how this would be achieved. The same respondent noted that the risks of Sulphur Hexafluoride (SF_6) leakage had not been prioritised by NGET and that, in delivering its environmental output, NGET's overall impact on the environment should be measured including SF_6 emissions.

1.16. A fourth respondent compared SHETL and SPTL's coverage of environmental issues. They noted that SPTL's was very general and that it was difficult to get a feel for what they were proposing to do and where. They considered SHETL's coverage to be much more comprehensive in taking account of environmental issues but noted there was little consideration of undergrounding to minimise environmental impact including minimising collision risk on SPA-qualifying bird species.

1.17. One respondent noted that although there had been acknowledgement of stakeholder concerns about aesthetics, there was little mention of planning friendly designs and routes and that only NGET had adopted an explicit policy direction on undergrounding cables.

1.18. Another respondent raised a number of issues on visual amenity and specifically with NGET's willingness to pay (WTP) analysis. The key points were:

- the WTP analysis has limited value as the study did not elicit the precise amounts customers were willing to pay for undergrounding
- additional work NGET undertake should also apply to new lines and should follow Defra best practice and be subject to a peer review
- strongly support the whole life value concept but it is not clear how factors will be weighted or indeed valued, a monetary value should be attributed to all associated costs and benefits of an option so that they can be evaluated in a more holistic way
- support an integrated (offshore and onshore) network solution, but note that the ENSG work and the business plans fall under the terms of the SEA Directive and should be subject to the same assessment
- support proposals for community compensation for loss of visual amenity but that this should not be restricted to designated areas.

Connection

1.19. One respondent welcomed the greater focus on a fairer and clearer connection process. However, they argued that connection needed to be "proactively driven" with objectives to bring down connection times. The same respondent noted that SPTL could make more of the need for anticipatory investments in sites that are likely to need investment in the future. The respondent noted that NGET and SHETL had gone some way to acknowledging this need, together with managing the associated risks.

Customer satisfaction

1.20. One respondent welcomed the proposal to use stakeholder surveys but noted that it would be dangerous to use such surveys as the sole measurement tool given the potential reluctance of connectees to jeopardise their relationship with the network company. The respondent suggested other measurements be used including the amount of generation connected and progress towards emissions targets.

Innovation

1.21. One respondent noted that only SPTL identified the potential to encourage or even participate in DSM activity under its NIC. However, the respondent noted that this should ideally represent a core activity.

1.22. Another respondent welcomed the focus on innovation in relation to undergrounding technologies and those that would facilitate the coordinated development of the offshore network. They expressed concern at the 1 per cent cap on the level of investment in research and development given the challenges facing the industry and that it was at the minimum end of the BIS guidance.

Cost assessment

1.23. One respondent disagreed with the view that there was "general industry agreement" with using Gone Green. They noted that gas would continue to provide an important part of the energy mix for many years to come. Further, they noted that there would be a significant role for gas in space heating given the intermittency of renewable.

1.24. Another respondent noted that the significant investment requirements identified mean the expenditure needs to be robustly justified and that a central consideration must be the SQSS. Without justification of the current SQSS the respondent argued that the revenue allowance could not be considered to have been justified in an absolute sense.

1.25. A third respondent recognised the level of investment required and considered NGET's investment plan of £16.8bn to be appropriate. However, the respondent did not consider the plan clearly demonstrated whether the company intended to undertake certain investments eg Eastern HVDC.

1.26. In relation to NGG one respondent noted that there is a perception that there is sufficient capacity within the existing system and therefore a forecast expenditure of £6.7bn might be higher than the industry was expecting.

1.27. Another respondent noted the work NGG and the GDNs had been undertaking jointly to ensure efficient investment for network users. They noted that to ensure more efficient overall costs to consumers NGG need to provide more information on the impact of the distribution networks on their investments to enable GDNs to reflect alternatives in their GDN business plans submission.

Financial

1.28. One respondent considered that there was a flaw with the Inflation Risk Premium (IRP). They argued that the fact the IBOXX index uses nominal bond yields to derive a debt premium which is added to the risk free rate leads to errors in the calculation of the allowed return which leads to an IRP which must be paid by companies when they borrow.

1.29. Another respondent made the following points of the financial proposals:

- equity beta of 1.0 is to high and indeed 0.8 would appear too generous
- NGET has not published the Oxera cost of debt study, there is no supporting evidence for the appropriateness of NGET's approach to the cost of debt
- unconvinced of NGET's case to move to a 45 year depreciation policy over two price control periods rather than one.

1.30. A third respondent argued that they did not support the financial proposals in relation to the upper bound of the cost of equity, the greater exposure to customers of risks in relation to pension deficit repair costs, the need for transitional arrangements for asset lives or the failure to reflect the reduced risk from the indexation of the cost of debt in the other building block of WACC. They noted that they did not support the conclusions the companies had reached in these areas and that the companies' interpretation of recent market developments was unconvincing.

1.31. One company considered NGET had a number of flaws in its RORE analysis including:

- overestimated the impact of a variance in RORE in driving the cost of equity by assuming a straightforward linear relationship when the standard deviation in RORE encompasses all risk factors affecting the company when the equity risk premium should only reflect systematic risk factors
- variance in risk does not justified the proposed cost of equity when comparing the modelled standard deviation used by NGET with comparable indicators of dispersion in the market
- need more transparency of the differences between TPCR4 and RIIO-T1 as extending the length of the control could reduce the level of uncertainty.

Uncertainty

1.32. Three respondents supported many of the arguments NGET made on the increasing risks and uncertainties. One of those respondents noted that the Combined Code Turnbull Guidance was recognised as good practice. However, they also noted that the balance of risks between the TO and consumers needs to be correct. Another of those respondents noted these risks should be reflected in the financing costs of the networks. The third respondent noted that some risks had been overlooked including losing part of an outage season because of foot and mouth or similar events.

1.33. One respondent supported NGG's proposals for the use of a specific re-opener but, citing the reluctance to request a reopener in the case of the Canatxx Fleetwood storage project, noted that, where uncertainty mechanisms were put in place, Ofgem would need to rigorously police allowable expenditure to protect network users and consumers.

Other

1.34. Respondents raised a number of related issues for the business plans. These were:

- Exit Capacity reforms from 2012 – One respondent considered that evidence to date suggested the charges from NGG could vary significantly and that volatility issues should be addressed to ensure stability for consumers.
- Commercial arrangements - NGG's intention to revisit the existing commercial arrangements would result in uncertainty for the networks and that while there were areas where the commercial arrangements could be developed, stakeholders should be fully involved in that process.
- TO Commodity Charge – One respondent argued that the existing arrangements resulted in a high and volatile charge and that if this regime was to change it would have a significant impact on NGG's investment requirements under RIIO-T1.

Appendix 2 - Feedback questionnaire

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

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

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk