To distribution companies, shippers, suppliers, customer groups and other interested parties

Promoting choice and value for all gas and electricity customers

Your ref:
Our ref: 99/10
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Date: 30 July 2010

Dear Colleague,

Open letter consultation on Gas Distribution Price Control Review 2 (GDPCR2) – the way forward

The next gas distribution price control is due to start on 1 April 2013. Following the Authority's decision to rollover the current transmission price controls, the gas distribution price control review (GDPCR2) will run in parallel with TPCR5.[1] These will be the first controls to reflect the new regulatory framework resulting from our RPI-X@20 review.

On 26 July 2010, the Authority published its "minded to" decision on the RPI-X@20 recommendations for consultation, which recommends the implementation of Sustainable Network Regulation using the RIIO model (Revenue = Incentives + Innovation + Outputs).[2] The RIIO model builds on the success of the previous RPI-X regime, but better meets the investment and innovation challenge by placing much more emphasis on incentives to drive the innovation needed to deliver the required outputs in terms of improved customer service and smarter grids. The Authority will take account of responses to the consultation before making its final decision on the new regulatory framework.

To enable us to implement Sustainable Network Regulation effectively for GDPCR2, Ofgem and the network companies have recently initiated key work streams. We are proceeding on the assumption that the core components of Sustainable Network Regulation will stand. Should there be changes when the Authority makes its final decision, we will reflect these in our approach to the review.

This letter sets out Ofgem's thoughts on the following areas for GDPCR2:

- the key issues for the review,
- the outputs the companies should deliver over the next price control period and how we propose to develop output measures (see Annex A),
- the approach we propose to take to stakeholder engagement. Annex B includes draft terms of reference for the Price Control Review Forum (PCRF),
- the high-level timetable for the review, which is set out in Annex D, and

[1] An equivalent letter for TPCR5 has been issued today by Ofgem and can be found at the following link: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=1&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes
[2] The consultation document on the RPI-X@20 recommendations can be found at the following link: http://www.ofgem.gov.uk/networks/rpix20/consultdocs/Documents1/RPI-X@Recommendations.pdf

- how we will apply the principle of proportionate treatment, proposed as part of the RPI-X@20 project. This is set out in Annex C which provides guidance to the network companies on the development of well justified business plans.

We welcome views on any of the issues set out in this letter by 30 September.

Key issues for the review

Customers pay about £120 per year for the provision of the gas distribution networks which accounts for about 15 percent of an average customer's bill.[3] Therefore, the issues discussed below, and particularly the repex programme have the potential to have a significant impact on customers' bills.

Replacement expenditure (Repex)

The Health and Safety Executive (HSE) requires the gas distribution networks (GDNs) to carry out the replacement of 'at risk' iron mains by 2032. Currently, mains are broadly to be decommissioned in an order that reflects the risk each pipe presents. At GDPCR1 we allowed £3.5 billion over five years for repex. This represents an average repex allowance of £90m per annum per GDN against an average revenue allowance of £300m. We now estimate, based on expenditure to date and the remaining iron mains population, that the overall lifetime cost of the programme will amount to £24 billion, over twice Transco's original estimate in 2002.

We have already had constructive discussions with the HSE on this matter. The HSE intends to undertake a review of the iron mains decommissioning programme and expect to reach conclusions during next year. Ofgem will work with the HSE as the leader of the review, GDNs and other stakeholders, to consider how best to effectively and efficiently manage the risks presented by the gas networks while providing value for money. We hope to be able to reach a landing on the review of the decommissioning programme before asking GDNs to prepare their business plans. If this is not possible, we may need to reconsider the GDPCR2 timetable or whether a transition to new arrangements is required.

Environmental issues

Leakage from the gas networks accounts for the vast majority of the companies' greenhouse gas emissions. GDNs are currently incentivised to reduce leakage, with their performance assessed through a modelled approach. Ofgem will consider whether this assessment can be improved, including whether shrinkage should be calculated in a similar way to losses on the electricity distribution networks (using actual settlement data) to provide a clearer incentive on the GDNs to tackle this issue.

We will consider whether specific measures are required to ensure that there are no barriers to the development of economic options for the injection of bio-methane into the distribution networks. While we will review the impact of price control arrangements on bio-methane, we expect the focus of work to be on ensuring appropriate charging arrangements, connection standards and connection boundaries.

We outline in Annex A our initial thoughts about environmental output measures, and this is an area where Ofgem would particularly welcome input from stakeholders. GDNs have also noted the importance of considering the need for specific measures to address climate change adaptation.

Demand uncertainty

It is the role of the GDNs to make sure they have sufficient pipeline capacity to match the use of gas in the worst winter expected in a 20 year period. Many of the business decisions

[3] http://www.ofgem.gov.uk/Media/FactSheets/Documents1/updatedhouseholdbills09.pdf

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the companies make, and a portion of the allowances they are given through the price control, are informed by demand forecasts. We are concerned about the accuracy of the GDNs' demand forecasts and the limited incentives they have to make improvements. To the extent GDNs' costs vary with demand, they will benefit under the current price control if – as is currently the case - outturn demand is lower than forecasts made at the time the price control was set. More importantly, GDNs need to take a longer term view of trends in gas demand in order to make effective decisions between investing in new capacity and other options such as purchasing interruptible contracts, particularly as we do not expect significant load related expenditure in the foreseeable future.

In two of the four scenarios in Ofgem's Project Discovery, gas demand was projected to fall.[4] If these forecast trends for demand materialise then there is an increased risk of redundant or unnecessary investment. Therefore, Ofgem is particularly keen to explore how to encourage GDNs to consider the option value of alternatives to network investment, such as interruptible contracts. We are also keen to find mechanisms to ensure that customers are not exposed to unnecessary risks of funding redundant capacity expansion.

Xoserve

Xoserve provides settlement, customer switching and related services for the gas market. At the last price control review we introduced a new funding model for xoserve that distinguished between core services funded by all customers through the price control and user pays services that are funded directly by the users that request the services. This approach does not appear to have materially improved the quality of service and value for money that users receive from xoserve. We will review xoserve's performance and consider other governance and funding options, such as the potential for more contracting out. We will also need to consider how xoserve's role will evolve with the rollout of smart meters and the implications this has for the amount of customers' money that is allocated for upgrading xoserve's systems.

Network extensions

Working with DECC, Ofgem made changes at GDPCR1 to the economic test for network extensions to facilitate more connections for fuel poor households and communities to help reduce heating costs. While the aim of this initiative, to help address fuel poverty, remains important, Ofgem wants to consider whether this is still the best way of achieving these objectives.

Carbon monoxide

GDPCR1 considered whether GDNs could do more to help reduce the number of deaths and injuries caused by carbon monoxide (CO), either by increasing consumer awareness of the dangers or by reviewing their gas emergency operating practices and procedures. Some progress has been made but we will continue to encourage GDNs to bring forward cost effective proposals that will help to reduce CO poisonings.

Financial issues

There are a number of financial issues that are likely to be significant during the two reviews. These issues arise mainly from application of the financeability proposals coming out of RPI-X@20 or from the recently concluded pensions review. In this context it will be important to consider whether the current approach of treating half of the costs of repex as opex is appropriate or if more of the repex should be added to the RAV with a depreciation allowance. This will also be the first price control review of the GDNs to be informed by

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[4] See http://www.ofgem.gov.uk/Markets/WhlMkts/Discovery/Documents1/Discovery_Scenarios_ConDoc_FINAL.pdf

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analysis of the Return on Regulated Equity (RORE).[5] Ofgem will build on the approach used in DPCR5 to use RORE to inform its understanding of how companies have performed under the current price control and to calibrate the new price control.

Other issues

In addition there are a number of smaller, but nevertheless important, issues to consider. In GDPCR1 we set an allowance for each GDN to conduct a technical survey of the sub-deduct networks[6] attached to their systems. These surveys have now been substantially completed and the findings submitted to Ofgem. This data will be considered within GDPCR2 to determine the most appropriate way forward and also to inform the DECC policy consultation on the Gas Act (Exemptions) (No.1) Order 1996 which expires after 1 March 2011. While our initial view is that the current arrangements for connections are working well, GDPCR2 provides an opportunity to consider any improvements that can be made. GDNs have raised concerns with us about the impact of the loss of meter work on allowed revenues, which we will consider. The costs of compliance with the Traffic Management Act 2004 may also become clearer in time to consider setting firm allowances for GDNs rather than using a re-opener.

Determining what networks need to deliver – outputs-led regulation

A key element of the proposed new regulatory framework is that it should be focused on the delivery of outputs related to desired outcomes. The RPI-X@20 recommendations set out that outputs would fall into one of six categories – safe network services, reliability and availability, timely and appropriate connection arrangements, customer satisfaction, environmental targets and social obligations. The price control review will determine the outputs that network companies will ultimately be held to account to deliver.

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

Providing for enhanced engagement

The RPI-X@20 proposals on enhanced engagement mean that stakeholder engagement will feature more prominently across all stages of the new price control process. The key responsibility will lie with network companies to make effective use of engagement in developing their plans (as discussed in Annex C). For the Ofgem-led elements we are proposing a multi-layered approach that ensures all stakeholders have an opportunity to participate in the review and provides effective feedback to Ofgem throughout the review. We will work with the network companies to ensure that there is engagement with the full range of stakeholders, and that stakeholders understand how the different parts of the engagement fit together. The main strands for Ofgem's engagement will be:

- *Stakeholder events*: These will be open invitation events similar to the workshops during DPCR5, with Ofgem presenting its views and facilitating discussion. A small number of these events will be held at key points during the review, with the first one in September 2010.
- *Price Control Review Forum (PCRF):* This group will meet regularly during the review to provide input to Ofgem about a range of aspects of the price control. The group will include a broad range of stakeholder representatives. Annex B sets out draft terms of

[5] This is a measure Ofgem has developed to assess how companies are performing financially under their price control by calculating the return on equity they have made compared to that under the allowed cost of capital.
[6] See GDPCR1 for a definition of this term.

reference for this group for consultation. ***At this stage we would also like to invite any parties with a particular interest in being involved in the PCRF to indicate this and explain what they believe they could contribute to the group.***

- *Consumer Challenge Group:* We intend to form a small group comprising consumer experts, similar to that used for DPCR5, that will act as a 'sounding board' to ensure that the views of consumers are considered fully by Ofgem in GDPCR2. It will meet regularly during the price control review.
- *Working groups*: We are proposing to establish a range of working groups to review specific issues in depth. These groups will be convened for periods of the review to consider relevant issues. Our initial proposals for working groups are set out below.

In addition to these four main strands of Ofgem led stakeholder engagement, we will be undertaking research to establish consumers' views and willingness to pay on a range of issues. We will also continue to meet stakeholders bilaterally and to engage with representative groups during the review.

Working groups

As a first stage in developing outputs for GDPCR2 we propose establishing a series of separate working groups. These groups will identify and stress-test a set of primary outputs for each of the output categories, to provide clarity to GDNs and other stakeholders on the way that performance in each of those categories would be assessed and used to incentivise delivery of outcomes. In addition, the groups will consider the requirement for secondary delivery indicators to provide further information to us on network company performance in delivering against the primary outputs. We envisage that the working groups will meet approximately monthly from August 2010 to December 2010, with the meetings chaired by Ofgem.

In the first instance we propose the following working groups on:

- customer satisfaction, connection issues and social obligations,
- environmental issues, and
- reliability and safety issues.

In addition to the working groups focused on outputs, a joint TPCR5/GDPCR2 working group on financial issues will be established. There will also be a GDPCR2 working group to discuss our approach to cost assessment. These groups are likely to remain in place for most of the review. It is the intention that all material generated by the groups will be published on a designated section of the Ofgem website.

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

Business plans and proportionate treatment

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

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

Views invited

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

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

We would welcome responses to this letter by 30 September 2010. Unless clearly marked as confidential, responses will be published on our website. Please email responses to gdpcr2@ofgem.gov.uk.

Yours faithfully,

Rachel Fletcher
Partner, Distribution

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Annex A: Potential primary outputs

The following table sets out our initial views on potential primary outputs for GDPCR2.

Indicative primary outputs – Gas distribution

Output category	Primary outputs
Environment	Help to minimise the environmental impact of our operations and of users on the network by: • specific leakage and shrinkage/ losses targets, • contributing to other environmental targets, • taking into consideration and where appropriate seeking to minimise the visual impacts of infrastructure, possibly including contaminated land and landfill sites, • minimising business carbon footprint, and • minimising other emissions.
Reliability	Maintain operational performance for existing and future customers by: • responding to incentives to meet targets for reliability, • considering network reliability trajectories informed by customer feedback, and • developing asset health indices.
Connections	Connect users and suppliers of energy in a timely manner and provide high quality information, in a transparent way, on the conditions of connection measured by: • compliance with licence requirements and guaranteed standards.
Customer Satisfaction	Maintain levels of customer satisfaction by implementing a broad measure of customer satisfaction similar to that adopted at DPCR5, including: • undertaking a customer satisfaction survey covering areas such as interruptions, connections and general enquiries, • developing a complaint metric, and • undertaking stakeholder engagement to better understand what stakeholders want from their network companies. Guaranteed standards, including those for restoration of supply.
Safety	Maintain compliance with an HSE approved safety case. Undertake health surveillance. Consider specific measures including: • number of gas in building incidents, • number of reportable incidents, and • total network risk. Consider any measures associated with carbon monoxide issues.
Social Obligations	Provision of alternative heating and cooking appliances during interruptions. Priority given to vulnerable customers

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

Purpose

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

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

Scope

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

Role

The PCRF:

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

Objectives

<u>For forum</u>

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

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For Ofgem

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

For network operators

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

Questions for the PCRF

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

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

Membership and structure

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

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

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

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

Dates of meetings

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

Nominations

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

In their expressions of interest stakeholders should include information on:

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

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Annex C: Business Plan Initial Guidance for TPCR5 and GDPCR2

1. Introduction

1.1. Our forthcoming price control reviews in electricity and gas transmission (TPCR5) and gas distribution (GDPCR2) are the first reviews to incorporate the RPI-X@20 recommendations. [7] Under Sustainable Network Regulation, we expect the network companies to submit well-justified business plans. In addition, we would adopt a transparent and proportionate approach to assessing the price control package, with the intensity and timescale of assessment reflecting the quality of an individual company's business plan and its record for efficient output delivery.

1.2. We anticipate a complete business plan at Stage 2 of the process (July 2011) (see Annex D for key milestones). Network companies should set out what they intend to deliver, how they intend to deliver it and their view on the cost of delivery, reflecting enhanced engagement and taking account of Ofgem's strategy for the review. Then at Stage 3 (Jan 2012) (unless fast-tracked) network companies will submit a revised business plan reflecting comments and queries raised by Ofgem, potentially updated views from stakeholders, and the further year's data (if relevant).

1.3. The plans put forward by network companies will, to a large degree, inform our assessment of the level of outputs they will be required to deliver and the associated revenue to be earned from consumers.

1.4. The rewards associated with producing a well-justified business plan were set out in our RPI-X@20 recommendations consultation document. [8]

1.5. The development of well-justified business plans will also act in the interests of consumers both now and in the future. This is because to be well-justified the plan will clearly present what the network company will deliver and demonstrate through a range of evidence that this delivery is likely to be consistent with providing long-term value for money to existing and future consumers. It will also provide opportunities to inform the assessment of other companies' plans.

1.6. A well-justified plan is not necessarily longer or more detailed than current plans. Instead, it needs to be transparent and focused on what is to be delivered, providing relevant evidence that the approach proposed is likely to deliver long-term value for money. This initial guidance provides more details on how this might be achieved.

1.7. While network companies will need to include evidence of considering different ways of delivering within their plans, we would expect a well-justified business plan to include the decision the company came to and justification. We are not expecting a well-justified business plan to contain a range of scenarios where the company has not come to a view on which one to follow.

1.8. This guidance provides an early indication of the work involved in producing a well-justified business plan. It particularly focuses on some of the new aspects published in the RPI-X@20 recommendations document on 26 July 2010. It should not be read as providing everything needed for a well-justified plan.

1.9. In particular, this guidance does not provide details or make a specific request for data. This will continue to be an important part of our ongoing planned work and more details of the data required and associated narrative will be produced between now and

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[7] Ofgem, Regulating energy networks for the future, RPI-X@20 recommendations, July 2010. This is available on our website at http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RPI-X@Recommendations.pdf.
[8] See particularly Chapter 7 of Regulating energy networks for the future: RPI-X@20 Recommendations: Implementing Sustainable Network Regulation. This is available on our website at http://www.ofgem.gov.uk/NETWORKS/RPIX20/CONSULTDOCS/Documents1/Implementation.pdf.

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

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

2. Purpose of initial guidance

2.1. In our RPI-X@20 recommendations consultation[9] we set out what we expect a network company to include in a well-justified business plan. This business plan initial guidance provides further detail on a number of aspects of a well-justified business plan to assist the network companies that are starting work on their plans for TPCR5 and GDPCR2. It examines:

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

[9] http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RPI-X@Recommendations.pdf

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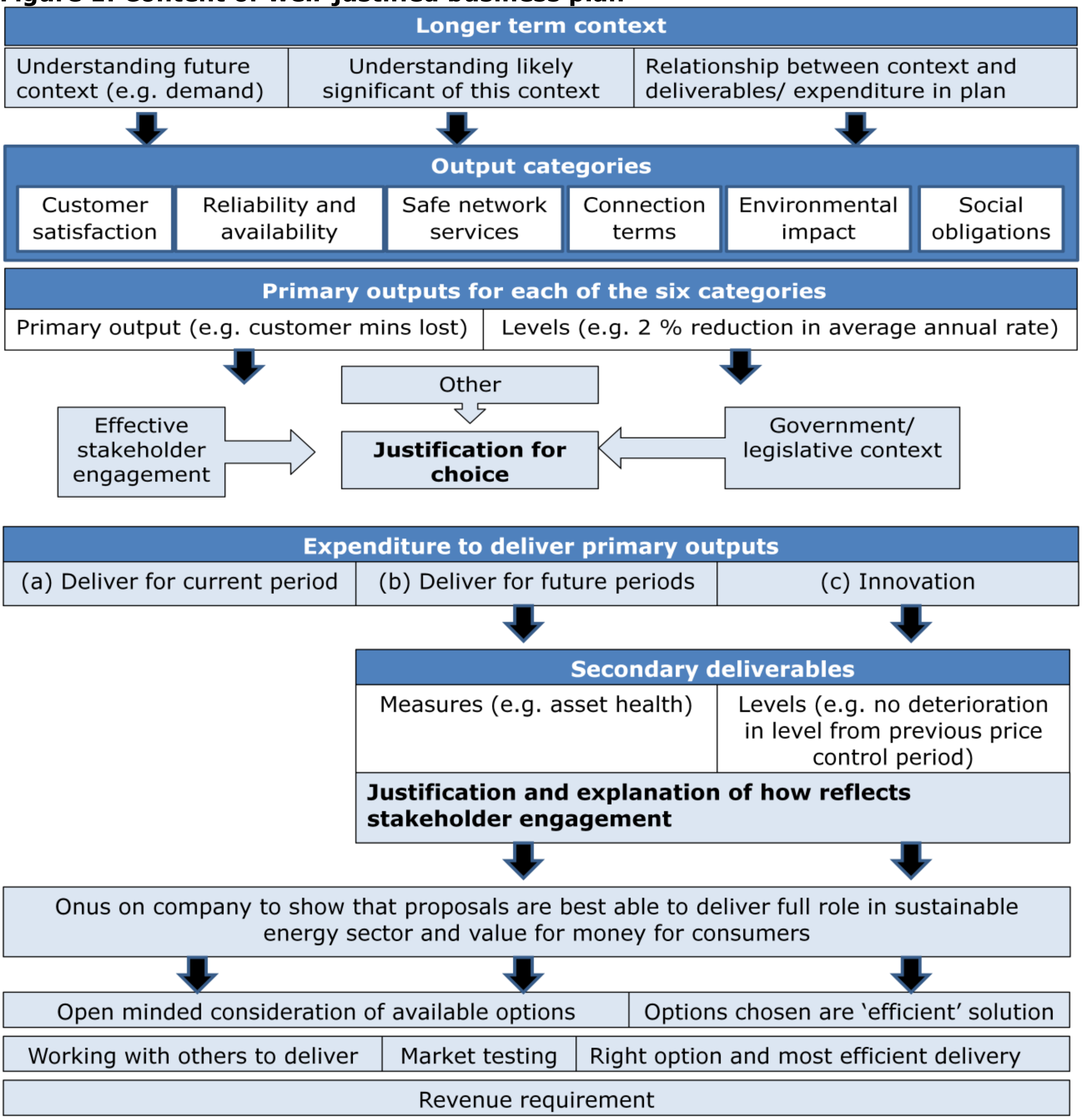
3. Initial guidance

Content

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

Figure 1: Content of well-justified business plan



Longer term context

3.2. As Figure 1 shows, the business plan needs to be set out in longer-term context both applicable to what is to be delivered and how (including the resulting expenditure). This is about network companies setting out their longer-term strategy for playing a full role in delivery of a sustainable energy sector and delivering long-term value for money, reflecting expectations of the nature and scale of future demand for network services.

3.3. The plan needs to set out the longer-term context of the company's plan – setting out what it does, what its operating environment looks like, what challenges and opportunities it faces over the long term, etc. – and the long-term strategy of the business, including how it would respond to changes in the context. This might include forecasts of volume/demand for network services. This is key to longer-term context/longer-term thinking and should be upfront to provide context for the rest of plan. It also needs to be informed by the company's view of different possible future scenarios and show how its plans are robust to these. For example, on the transmission side, the longer-term context would also need to consider developments in understanding the interactions between the System Operator (SO) regime, including SO external incentives, and the TPCR framework. Where applicable, the TO's business plans will need to reflect planned developments in this area, for example by including SO related developments.

3.4. There is no single definition of what 'longer-term' means in this context. It will be the task of the network company to consider the time horizon most relevant to particular delivery outputs and expenditure plans. However, the context of the environmental targets, e.g. the carbon reduction target for 2050, and the asset lives will be important influences. In some cases, or in relation to some aspects of a plan, e.g. asset management strategy, the justification is generally expected to include an understanding of whole life costing of the assets.

3.5. Essentially the different aspects will combine in a rolling longer-term context that will be updated over time but where updates are fully justified.

3.6. A well-justified business plan will need to set out the company's long-term strategy for delivery which should be informed by expectations of:

- demand;
- entry/exit;
- economy; and
- technological change.

3.7. Clearly, there will be uncertainty about aspects of the operating conditions that network companies expect to face over the price control period and over the longer-term. As part of their long-term business strategy we would expect them to demonstrate how they have taken account of the uncertainty when developing their proposed plan for delivering primary outputs and long-term value for money. As part of this, they would need to set out how they intend to manage uncertainty over the short- to medium-term, including for example keeping options open and trialling new ideas through innovation projects (either in the business plan or through the innovation stimulus package).

3.8. This means considering expenditure that they would need for the duration of the control but also the implications that this would have on required investment and associated efficiency beyond the control period. They would be expected to include expenditure for the price control period where this is needed to ensure long-term value for money delivery of primary outputs in future price control periods and/or is needed

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

3.9. We would also encourage network companies to include innovation projects in their core business plan, for example R&D activity, and explain how they are expected to have the potential to deliver long-term value for money. We would expect the network company to set out what the project is and how they intend to take account of, and potentially share, lessons learned from any projects that do not deliver expected benefits.

3.10. This long-term context will provide a starting point for discussion and assessment at future price control reviews. In reality circumstances will change. Where the actual context deviates significantly from the context given at the previous review, this materially affects the long-term context of what is being delivered, and expenditure plans for future control periods. We would expect companies to note and explain why strategies are changing and we would expect the impact of these changes for the future control period to be a key part of the assessment.

Primary outputs

3.11. We will set out the required level of primary outputs for each sector in our Strategy decision document (March 2011), reflecting work undertaken with network companies and input from key stakeholders.

3.12. The primary outputs are in six categories:

- customer satisfaction;
- reliability and availability of network services;
- safe network services;
- connection terms;
- environmental impact; and
- social obligations.

3.13. Within these categories, Ofgem and the network companies will work in the early stages of a price control review considering what should be included as a relevant methodology for assessing delivery in each of these categories. For each category, this may include a single quantitative measure, a combination of such measures or it might include measures and more qualitative indicators. The decision should, subject to proportionality (see below) be based on comprehensively reflecting what consumers and other stakeholders want the network companies to deliver. Where the decision in the business plan deviates from the views of stakeholders this should be clearly explained.

3.14. Ofgem will set out in its Strategy documents the primary outputs and a level of performance. A network company will need to set out in its well-justified plan how it intends to deliver that level, demonstrating that the proposed approach involves efficient delivery over the long-term.

3.15. The network company may also wish to set out an alternative level for one or more of the primary outputs – either higher or lower than the level specified in the Strategy documents. In these cases the network company would need to justify, with support from stakeholders where appropriate, why delivery of a different level would be consistent with playing a full role in delivery of a sustainable energy sector and delivery

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

Linking expected expenditure to delivery of primary outputs

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

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

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

3.18. Network companies should decompose their expenditure forecasts into:

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

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

Engagement with stakeholders and joint working

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

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

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

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

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

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

Secondary deliverables

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

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

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

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

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

Different types of evidence

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

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

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- comparative efficiency evidence including benchmarking and other activity based cost comparisons using both internal and external evidence such as wider industry comparisons or comparisons against other sectors; and
- market testing of a range of activities; we would expect network companies to explore and exploit potential opportunities by market testing proposed delivery solutions where this is expected to provide value for money. This might include evidence from the costs of a joint venture or running a competitive process to procure services to maintain assets from a third party.

- **demonstrate an open-minded consideration of available options:** the company would need to show that they had considered alternative ways to deliver outputs, where relevant, and provide evidence to support that their preferred approach is long-term value for money. For example, they would be expected to consider whether to pursue a capital investment solution or an operating cost solution. In some cases a full cost benefit analysis might be appropriate but this will depend on the scale of the activity following our proportionate approach (see below). They would also be expected to identify synergies across projects, where these can provide long-term value for money without jeopardising delivery of primary outputs.
- **show that its proposals are value for money**: the company should demonstrate how its proposed approach would ensure the delivery of value for money for consumers over the long term, having considered all of the other options available. This may involve seeking to keep options open for future development of the network where this would deliver value for money for existing and future consumers (see below).
- **consider keeping options open** where consistent with longer-term value for money e.g. where it allows information to be obtained that reduces uncertainty or enables synergies to be identified.

Environmental costs/benefits

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

Supporting evidence

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

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

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

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

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

Proportionate plans

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

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

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

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

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

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

Company views on key parameters

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

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

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- **risk and financing implications of package;** provide a view of the necessary financing costs required to attract and retain investors to support the activities in this plan, taking a view on the risks implied; and

- **licence conditions;** where licence conditions would need to be altered to reflect differences in the company's plan from the sectoral baseline outputs, it would be helpful for the company to include an indication of how this difference might be reflected and implemented in its licence.

Confidentiality and communication of plans

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

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

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

Next steps

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

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Annex D: Key milestones for GDPCR2

Date	Key Milestone
July 2010	Publication – Open letter consultation on the way forward for GDPCR2
July – Dec 2010	Meetings of outputs working groups
October 2010	1st Meeting of the Price Control Review Forum
Dec 2010	Publication - Initial strategy consultation document
February 2011	2nd Meeting of the Price Control Review Forum
March 2011	Publication – Strategy decision document (including business plan templates)
End July 2011	Submission of business plans
October 2011	3rd Meeting of the Price Control Review Forum
Dec 2011	Publication – Consultation on Authority fast tracking decision (if applicable)
January 2012	Revised business plan request sent out to non fast-tracked companies
January 2012	4th Meeting of the Price Control Review Forum
February 2012	Publication - Authority fast tracking decision (if applicable)
April 2012	Final business plan submissions (non fast-tracked companies)
May 2012	5th Meeting of the Price Control Review Forum
July 2012	Publication - Initial proposals (non fast-tracked companies)
October 2012	6th Meeting of the Price Control Review Forum
November 2012	Publication - Final proposals (non fast-tracked companies)
April 2013	Commencement of price control period

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