ofgem Promoting choice and value
for all gas and electricity customers

RIIO GD1

Consultation on strategy for the next gas distribution price control - RIIO-GD1 Overview paper

Document type: Consultation

Ref: Insert reference: 160/10

Date of publication: 17 December 2010

Deadline for response: 4 February 2011

Target audience: Consumers and their representatives, transmission companies, distribution network companies, generators, offshore gas producers/importers, suppliers, shippers, debt and equity investors, environmental organisations, government policy makers, independent gas transporters (IGTs) and other interested parties

Overview:

This paper aims to provide an accessible overview of our proposed approach to the next gas distribution price control (RIIO-GD1). The price control will set the outputs that the eight GDNs need to deliver for their consumers and the associated revenues they are allowed to collect for the eight-year period from 1 April 2013 to 31 March 2021.

This will be the first gas distribution price control to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model. RIIO is designed to drive real benefits for consumers; providing network companies with strong incentives to step up and meet the challenges of delivering a low carbon, sustainable energy sector at a lower cost than would have been the case under our previous approach. RIIO puts sustainability alongside consumers at the heart of what network companies do. It also provides a transparent and predictable framework, with appropriate rewards to promote timely investment in the networks.

Under the RIIO model, network companies will be required to develop well-justified business plans setting out their outputs and how they propose to deliver these. This document sets out, for consultation, the key elements that the network companies will need to understand in order to develop their business plans.

Contact name and details: Rachel Fletcher, Partner, Distribution

Tel: 020 7901 7194

Email: RIIO.GD1@ofgem.gov.uk

Team: RIIO-GD1

Links to supplementary annexes

- Consultation on strategy for the next gas distribution price control - RIIO-GD1 Outputs and incentives
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1%20outputs%20and%20incent.pdf
- Consultation on strategy for the next gas distribution price control - RIIO-GD1 tools for cost assessment
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1%20costs%20assess.pdf
- Consultation on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Business plans, innovation and efficiency incentives
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/T1%20and%20GD1%20BP%20prop.pdf
- Consultation on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Uncertainty mechanisms
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/T1%20and%20GD1%20uncert.pdf
- Consultation on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Financial issues
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/T1%20and%20GD1%20finance.pdf
- Consultation on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Impact Assessment
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/T1%20and%20GD1%20IA.pdf

Links to other associated documents

- Consultation on strategy for the next transmission price control - RIIO-T1 Overview paper
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIOT1%20overview.pdf
- Website section setting out stakeholder engagement to date and relevant papers.
http://www.ofgem.gov.uk/Networks/PriceControls/Pages/PriceControls.aspx
- Handbook for implementing the RIIO model - Ofgem, October 2010
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf
- RIIO: A new way to regulate energy networks: Final decision
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf
- The Economic Lives of Energy Network Assets - Report by CEPA/SKM/GL on behalf of Ofgem
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/CEPA%20Econ%20Lives.pdf

- The Weighted Average Cost of Capital for Ofgem's Future Price Control – Report by Europe Economics on behalf of Ofgem
  http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Europe%20Economics%20Final%20Report%20-%20011210.pdf
- Establishment of pension deficit funding rate of return - Report by Ernst & Young on behalf of Ofgem
  http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/EY%20pension%20deficit%20funding.pdf

A full glossary of terms used in this and the other RIIO-T1 and GD1 documents can be found on our website:

- 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

Table of Contents

Summary

Significant investment is needed in Britain's gas and electricity networks over the next decade. This investment is needed to develop smarter networks to ensure continued security of supply and to meet environmental challenges. It is not just a matter of doing more. The way networks are designed, operated and priced is likely to need to change. The scale of this investment means higher energy bills are almost certain. Against this backdrop, it is more important than ever that network companies can show consumers that they are getting value for money and that prices are contained.

Meeting these challenges will require companies to manage uncertainty around what needs to be built, how and when. It will also require them to think longer term, understand what their customers' value, innovate and work with others.

To support and encourage network companies to meet these challenges, we recently announced a change in the way we regulate. Our new RIIO model (Revenue = Incentives + Innovation + Outputs) is designed to drive real benefits for consumers; providing companies with strong incentives to meet the challenges of delivering a sustainable energy sector at a lower cost than under our previous approach. RIIO puts sustainability alongside consumers at the heart of what network companies do. It provides a transparent and predictable framework that rewards timely delivery.

The transmission and gas distribution price controls (RIIO-T1 and RIIO-GD1) are the first price controls under the RIIO model. RIIO-GD1 will set the outputs that the gas network owners (GDNs) must deliver over the eight-year period 2013-2021 and the associated revenues they may collect from consumers. RIIO-T1 will do the same for gas and electricity transmission.

We are committed to ensuring all stakeholders have appropriate opportunities to voice their views. Our proposals reflect considerable input from a wide variety of stakeholders. These include consumer and environmental groups, industry, government, unions and special interest groups, as well as the network companies. We have also benefited from feedback from the Consumer Challenge Group, which comprises consumer and environmental experts acting as a critical friend to Ofgem.

The proposals we set out here for consultation are aimed at encouraging the GDNs to deliver safe, reliable and sustainable network services at long-term value for money to consumers; enabling them to finance required investment in a timely and efficient way; and rewarding them according to their delivery for consumers.

An important part of the RIIO model is to look to the companies to take responsibility for developing and justifying a long-term strategy for delivering the network services that their customers' value. To do this, companies need to understand the key elements of the regulatory framework. This document therefore sets out, for consultation, the outputs we think the GDNs should deliver and our thinking on core elements of the framework.

The outputs we propose to hold GDNs to delivering are designed to encourage them:

- to work with the wider industry to facilitate the move to a low carbon energy sector, as well as manage their own carbon footprint

- to provide safe, secure and reliable services based on efficient asset management
- to connect new bio-methane plants to the network in a timely and efficient manner, and provide timely and accessible information to potential connectees
- to step up their efforts to improve customer service and in the role they play in addressing fuel poverty and carbon monoxide poisoning.

We will attach incentives to the delivery of agreed outputs, minimising bias towards any particular delivery method. The strength of the incentives will reflect the value consumers attach to delivery and GDNs' degree of control. We will implement mechanisms to ensure efficient risk sharing between companies and consumers.

In the interests of consumers, we are committed to ensuring efficient companies are able to raise timely finance and are remunerated appropriately; and we have a fair balance of costs between current and future consumers. We are setting out our proposals on our approach to the financial elements of the regulatory package.

In particular, we are consulting on front end loading the depreciation profile to reflect the uncertainty over the economic life of gas distribution networks. We are also proposing to increase the rate of mains replacement expenditure that is capitalised, to bring it in line with the rate used for other cost categories. This may have a significant impact on cash flow for the GDNs. Where this is the case, we will consider appropriate transition arrangements. We are also consulting on the indexation mechanism for remunerating the cost of debt and our methodology for determining both notional gearing and the assumed cost of equity. We set out an indicative cost of equity range of 4%-7.2% (post tax real) based on the expected future risk profile of the GDNs. However, it is for the GDNs to set out in their business plans their proposals for notional gearing and where we should land within this cost of equity range, based on detailed evidence of their cash flow risk. It is only when we have received this information that we will be in a position to establish an appropriate range for the allowed return for the price control settlement.

We recognise that RIIO marks a considerable change for network companies in the way we approach the price control. Those companies that rise to the challenge and provide well-justified business plans will benefit from a lighter-touch regulatory process, with potential for a fast-track settlement that concludes up to a year ahead of the standard timetable. We feel that this proportionate approach is important in encouraging companies to step up to the challenges they face, and has real value to those companies that do so. We are consulting on the criteria for assessing business plans, analysing costs and the approach we take to proportionate treatment. We also recognise that companies may need to make changes to how they run their business in the transition to a sustainable energy sector. We are consulting on the type of projects that should be funded and propose funding of up to £400m for gas distribution and transmission.

We invite views on any aspect of our proposals. In March 2011, we intend to confirm the Authority's decision on the strategy for RIIO-GDI. This will reflect the responses to this consultation and views provided through our wider stakeholder events.

1. Introduction

Chapter Summary
This chapter sets out the purpose of this document, and explains how the document and the supplementary annexes are organised. It also sets out our high level strategy to this price control review, adopting the approach set out in the RIIO framework.

Question 1: Do you have any comments on the proposed process and timetable for the review?

Purpose of this document

1.1. The existing price control that currently applies to GDNs will expire on the 31 March 2013. This paper summarises our initial proposals for the regulatory framework for the next gas distribution price control (RIIO-GD1). RIIO-GD1 will set allowed revenues for the 8 GDNs for an 8 year period, 1 April 2013 to March 31 2021.

1.2. This document provides a high-level overview of our proposed price control framework. It is written with a view to giving a wide range of interested parties an opportunity to respond to the key elements of our proposals. We provide a more detailed description of our proposals in supporting supplementary annexes published along with this overview. (See Figure 1.1. below.)

1.3. The gas distribution price control review is being undertaken at the same time as the transmission price control (RIIO-T1), which will set the allowed revenues for the electricity and gas transmission companies for an 8 year period, 1 April 2013 to 31 March 2021.

Introducing RIIO

1.4. We estimate that network companies will need to invest significantly over the next ten years in developing smarter networks to ensure continued security of supply and to meet the environmental challenges.

1.5. While the low carbon transition is centred around the electricity sector, there are important implications for gas networks. There are questions about the long term role of gas in our energy mix, and this uncertainty needs to be taken into account in decisions being made today. Bio-methane could potentially play a significant role in meeting our carbon emission targets and network companies will need to meet the needs of this new customer group.

1.6. Meeting these challenges will require companies to manage the uncertainty around what needs to be built on their networks, how and when. It will also require them to think longer term, to understand what their customers' value, to innovate at a level unprecedented in the last 50 years or more of the industry's history, and to work with others to find whole industry solutions.

1.7. To support and encourage network companies in meeting these challenges, earlier this year we announced a change in the way we will regulate. Our new model, the RIIO model, is specifically designed to drive real benefits for consumers; providing network companies with strong incentives to step up and meet the challenges of delivering a low carbon, sustainable energy sector at a lower cost than would have been the case under our previous approach. RIIO puts sustainability alongside consumers at the heart of what network companies do. It also provides a transparent and predictable framework, with appropriate rewards to promote timely investment in the networks.

1.8. RIIO-T1 and RIIO-GD1 are the first price controls to be undertaken under the RIIO model. The proposals that we are consulting on in this paper are designed to:

- encourage the GDNs to deliver safe, reliable and sustainable network services at long-term value for money to consumers
- enable them to finance the required investment in a timely and efficient way
- remunerate them according to their delivery for consumers.

1.9. We are committed to ensuring that all stakeholders have appropriate opportunities to engage in the price control reviews. As set out in Chapter 3, the proposals set out here reflect the input we have received from a wide variety of stakeholders since we launched the reviews in July 2010. We appreciate the considerable time and effort that a wide range of parties have provided in the process so far.

1.10. This document sets out, for consultation, the outputs that we think the GDNs should deliver for consumers over the next price control period as well as our thinking on core elements of the regulatory package.

1.11. Below we discuss the high level strategy we are adopting for the review and the key changes in company behaviour we are looking to incentivise through the package of proposals we have developed.

High level strategy

1.12. One of the principle aims of the RIIO model is to encourage network companies to take responsibility for developing and justifying a long-term strategy for delivering the network services that their customers value. In July next year, we will be asking network companies to submit to us well-justified business plans which describe their long-term strategies.

1.13. This document sets out, for consultation, our views on the aspects of the control that network companies need to understand in order to be able to put together their business plans. We will take into consideration responses to this document and issues raised through our wider stakeholder engagement processes before setting out our decision on these issues in March 2011.

1.14. In particular, we are setting out here for consultation:

- the proposed outputs that we expect GDNs to deliver and the associated incentive mechanisms that we are considering, to ensure efficient delivery
- the criteria we propose to use to assess the companies' business plans and our proposed approach to cost assessment
- how we will apply the principles of proportionate treatment which will potentially allow companies who meet our assessment criteria a quicker and/or lighter scrutiny
- our proposed approach to dealing with uncertainty and to encouraging innovation
- our proposed approach to financial issues.

1.15. We are doing this so that the companies can develop business and financial plans with a clear understanding of Ofgem's expectations. This signals a departure from previous price control reviews where network companies have submitted their cost proposals without linking them clearly to what they expect to deliver – and where the discussion on business plans has been divorced from those on risk and financeability.

1.16. We are hoping that this leads to a more effective review process, with the companies:

- making their own judgement (based on their understanding of their assets and of what their stakeholders want and are willing to pay for) about the level they should target for each output, linking this clearly to their view of cost requirements, and setting out this rationale in their business plans
- developing their own strategies for handling future uncertainties, for example on where renewable generation will look to connect, or what will happen to gas demand, while meeting the RIIO objectives
- bringing forward their own financial plans and justifying where they believe the allowed return should be set.

1.17. We recognise that RIIO marks a considerable change for network companies in the way that we approach price control reviews. Those companies that rise to the challenge of providing us with well-justified business plans in July 2011 will benefit from a proportionate regulatory approach, with the potential for us to offer them either a 'fast-track' regulatory settlement (that concludes up to a year ahead of the standard timetable); or a 'lighter-touch' process which involves less intensive scrutiny of their plans. We feel that the possibility of this proportionate approach is an important part of encouraging companies to step up to the challenges they face, and that it has real value to those network companies that do so.

1.18. To guide companies, we are publishing as part of this package of papers, further guidance on what is required in a business plan. We also set out in more detail, the proposed approach for deciding whether a company should be 'fast-tracked' or should receive a 'light-touch' approach, and how we will apply proportionate treatment to the assessment of all business plans. This is discussed briefly in chapter 5 and in more detail in the supplementary annex entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives'.

1.19. At this stage, and as we have not received any formal business plan submissions from the companies, we are not making any statements about the efficiency or otherwise of the gas distribution companies' projected costs. However, as part of this package of papers we have set out a comparative analysis of companies' cost performance, and we expect companies to set out how they will address areas of relative inefficiency in their business plans.

Process and timetable

1.20. The process for RIIO-GD1 differs significantly from that for previous reviews. The key differences are as follows:

- effective stakeholder engagement, both by us and by the companies, will inform each stage of the process
- the beginning of the process focuses on the development of outputs and the overall strategy for the review. This reflects the need to provide enough information about

our price control framework for companies to develop their well-justified business plans
- from August we will undertake an 'initial sweep' of companies' business plans and consult on whether some companies' plans should be 'fast-tracked'. This initial sweep will identify the areas we need to focus on in each company's business plan and help us to take a proportionate approach to those companies that are not 'fast-tracked'
- any companies that are fast-tracked will receive their final proposals approximately nine months ahead of the other companies and a year ahead of the implementation of the controls
- to facilitate fast-tracking, we will develop licence conditions at an earlier stage in the process. This should also help align the policy development with development of legal drafting for the licences.

1.21. These process differences will mean that the timetable for RIIO-GD1 is significantly different from that of previous reviews. We published a draft timetable in our July open letter. A more detailed version of this timetable is set out in Appendix 2.

Structure of this document and associated documents

1.22. This document aims to provide an accessible overview of our proposed strategy for RIIO-GD1 aimed at a wide range of interested parties.

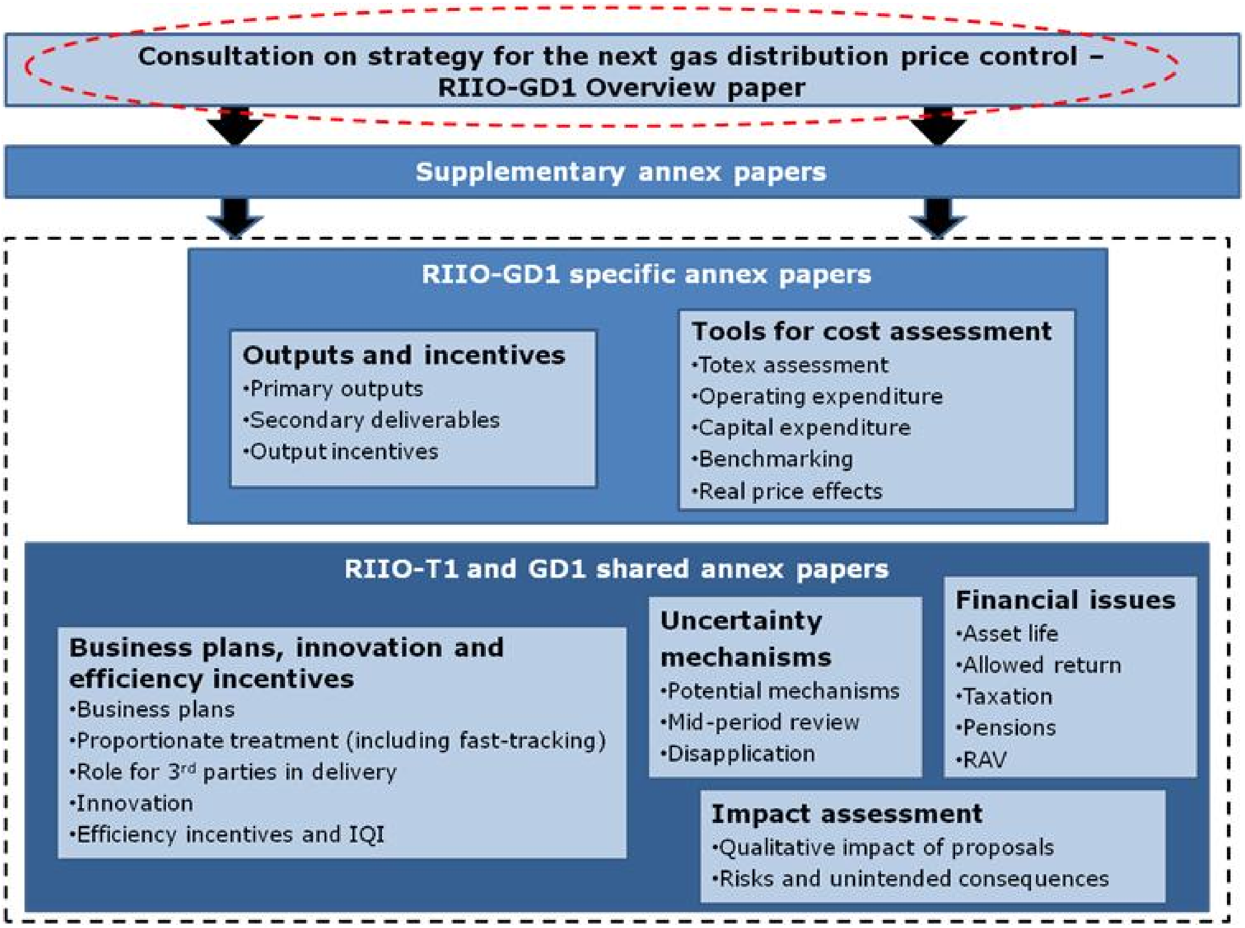
1.23. The document is structured as follows:

- Chapter 2 provides a summary of the gas distribution sector, the current price control, and GDNs recent financial performance. We also set out the key challenges facing the gas distribution and wider energy sector, and how we propose to address these challenges in our proposals.
- Chapter 3 sets out the stakeholder engagement that we have undertaken to date, and how stakeholders' views have been reflected in our proposals.
- Chapter 4 discusses the proposed outputs that we expect GDNs to deliver over the RIIO-GD1 review period, and the associated incentive mechanisms to ensure efficient delivery.
- Chapter 5 discusses the criteria we propose to use to assess companies' business plans and our proposed approach to cost assessment. We set out further details on how we will apply the principles of proportionate treatment and our proposals for fast-tracking.
- Chapter 6 describes our proposed approach to innovation and competition.
- Chapter 7 sets out our proposed approach to dealing with uncertainty, and how risks should be shared between customers and the GDNs.
- Chapter 8 discusses our approach to financial issues, including our views on efficient debt and equity financing costs, optimal gearing, and capitalisation and depreciation policies.
- Chapter 9 sets out next steps in this review.

1.24. We provide further detail on all of these issues in our supplementary annexes. These are entitled: 'RIIO-GD1 Outputs and incentives', 'RIIO-T1 and GD1 Business plans, proportionate treatment and efficiency incentives', 'RIIO-GD1 Tools for cost assessment', 'RIIO-T1 and GD1 Uncertainty mechanisms' and 'RIIO-T1 and GD1 Financial issues'. Links to these as well as other associated documents were set out in the 'Associated Documents' section in this paper.

1.25. Figure 1.1 below provides a map of the RIIO-GD1 documents and indicates clearly where these are common with those for RIIO-T1.

Figure 1.1 - RIIO-GD1 Supplementary appendix document map



*Document links can be found in the 'Associated documents' section of this paper.

2. Context

Chapter Summary
This chapter provides an overview of the gas distribution sector, the current price control, and the recent financial performance of the GDNs. We then discuss the key challenges facing the gas distribution sector, and how we propose to address them at RIIO-GD1.

Question 1: Do you agree that we have identified the key challenges facing the gas sector, and our approach to accommodating these challenges within the price review?

Introduction

2.1. In this chapter, we first provide a brief overview of the gas distribution sector, the current revenue cap, and GDNs' financial performance under the current controls. We then discuss the key challenges facing the gas distribution sector, and how our proposals for RIIO-GD1 address these challenges.

Overview of the gas distribution sector

2.2. Natural gas is supplied from the gas fields in the North Sea and Norway, via pipelines linking Great Britain with continental Europe, and from liquefied natural gas (LNG) terminals. The national transmission system (NTS) is a network of pipelines that takes gas from where it is brought onshore and transports it at high pressures across Great Britain. The GDNs are linked to the NTS at various points called offtakes. The GDNs transport gas at lower pressures from the offtakes to the homes and businesses of gas customers.

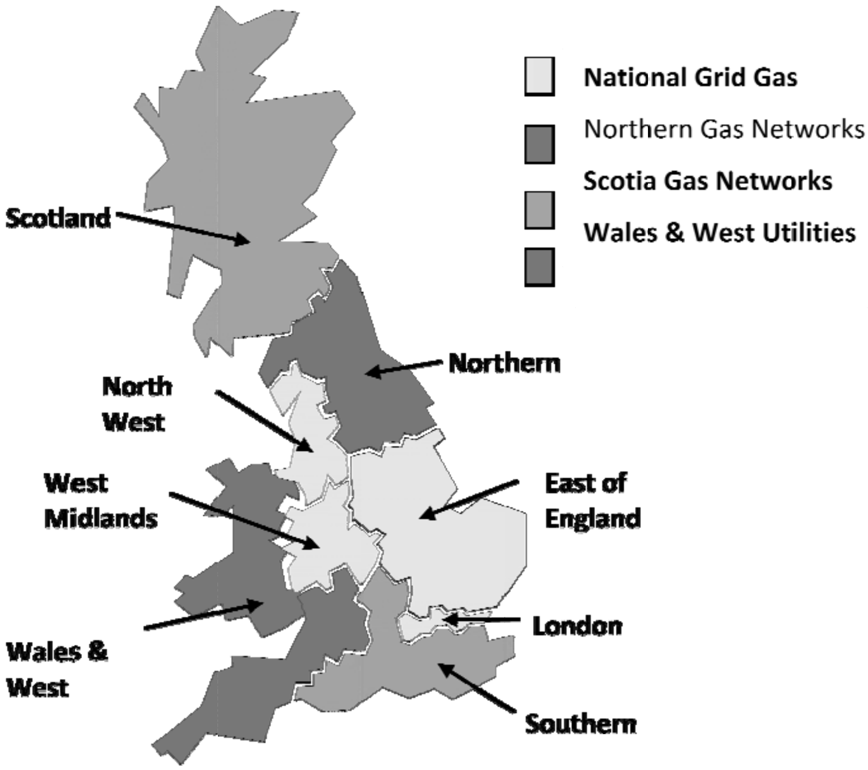
2.3. National Grid Gas (NGG) own and operate the NTS throughout Great Britain. We are resetting gas transmission charges in April 2013 as part of the concurrent RIIO-T1 price review.

2.4. Customers rely on the GDNs to ensure there is a reliable pipeline service through the operation, maintenance, repair and renewal of the low pressure networks. GDNs also provide emergency service personnel to potential and actual gas emergencies (for example if a customer smells gas) and provide gas connections to customers within their network area. GDNs do not purchase gas.[1] The gas commodity is purchased by the customer's chosen energy supplier. Suppliers book capacity (through "gas shippers") on the GDN network in order to meet their customers' demand for gas. GDNs bill the shipper for the gas transported.

2.5. There are eight gas distribution networks in Great Britain: East of England, London, North West, West Midlands, Northern, Scotland, Southern and Wales & West. They are owned by four companies: National Grid Gas, Northern Gas Networks, Scotia Gas Networks and Wales & West Utilities. (See Figure 2.1)

[1] With the exception of natural gas the GDNs purchase to replace gas lost through transportation, theft, and own-use gas.

Figure 2.1: Gas Distribution Networks



The current price control – GDPCR1

2.6. The current Gas Distribution Price Control (GDPCR1) set allowed revenues for the period from 1 April 2008 to 31 March 2013. The price control takes the form of a revenue cap which determines the maximum revenue the company can earn. The price control formula allows for the allowed revenues to be updated annually for the change in the retail price index (RPI), and for a number of other specific items. These items include the level of mains and service replacement undertaken by GDNs, changes in specific cost or revenue items that we were unable to forecast with certainty at the price review, and adjustments for rewards and penalties in relation to companies' performance in reducing gas lost on the transport network.[2]

2.7. In 2009/10, total allowed revenues for the industry as a whole were around £2.8 billion. The iron mains replacement expenditure (or repex) constitutes the GDNs major expenditure item at £0.8bn. The other major expenditure categories include operating expenditure (£0.7n), and capital expenditure (£0.4bn).

2.8. In terms of final customer bills, gas distribution network charges comprise around 15% of the average household bill.[3] The major component of the household bill reflects energy supply costs, which include the gas commodity cost and the supplier margin.

[2] The revenue formula is set out in the companies' Licence. See Special Conditions Applicable to the Licensee (DN): Part E.
[3] Source: http://www.ofgem.gov.uk/MEDIA/FACTSHEETS/Documents1/updatedhouseholdbills09.pdf

GDN financial performance (2008-2010)

2.9. We require the GDNs to report to us financial and standards of performance data on an annual basis to allow us to monitor their performance against the regulatory settlement. We then publish these data in our annual cost and performance report.[4]

2.10. One of the key financial performance indicators we publish is the return on regulated equity (RORE), a measure of the return earned by companies' shareholders through the regulatory settlement. Figure 2.2 shows our preliminary analysis of companies' RORE for the period 2008-2010. The Figure compares actual company financial performance to the allowed return on regulated equity (or "baseline") set at the price review of 7.25%.[5] At this point in time, we only have figures for the first two years of the current price control period. The Figure shows that the GDNs have earned a total RORE of around 7-11% in these years.

2.11. The Figure also provides information on the source of the companies' outperformance. Data is provided in relation to the cost of finance, the operation of an incentive mechanism to reward (or penalise) GDNs for gas lost on the transport network[6] and to cost allowances. The gap between the red and the blue lines shows that companies have outperformed our assumptions on financing costs and the incentive mechanisms in relation to gas losses. The Figure also shows that in most cases companies have outperformed on the cost allowances set at the last review for the individual expenditure categories (as indicated by the difference between the red line and the purple line).

2.12. Our RORE analysis only covers the first two-years of the price review, and earnings to GDNs over the full price control period may vary considerably from the figures presented here. These calculations are also based upon initial regulatory reporting submissions and are subject to change. We will publish final RORE figures for the period 2008-10 in March 2011.

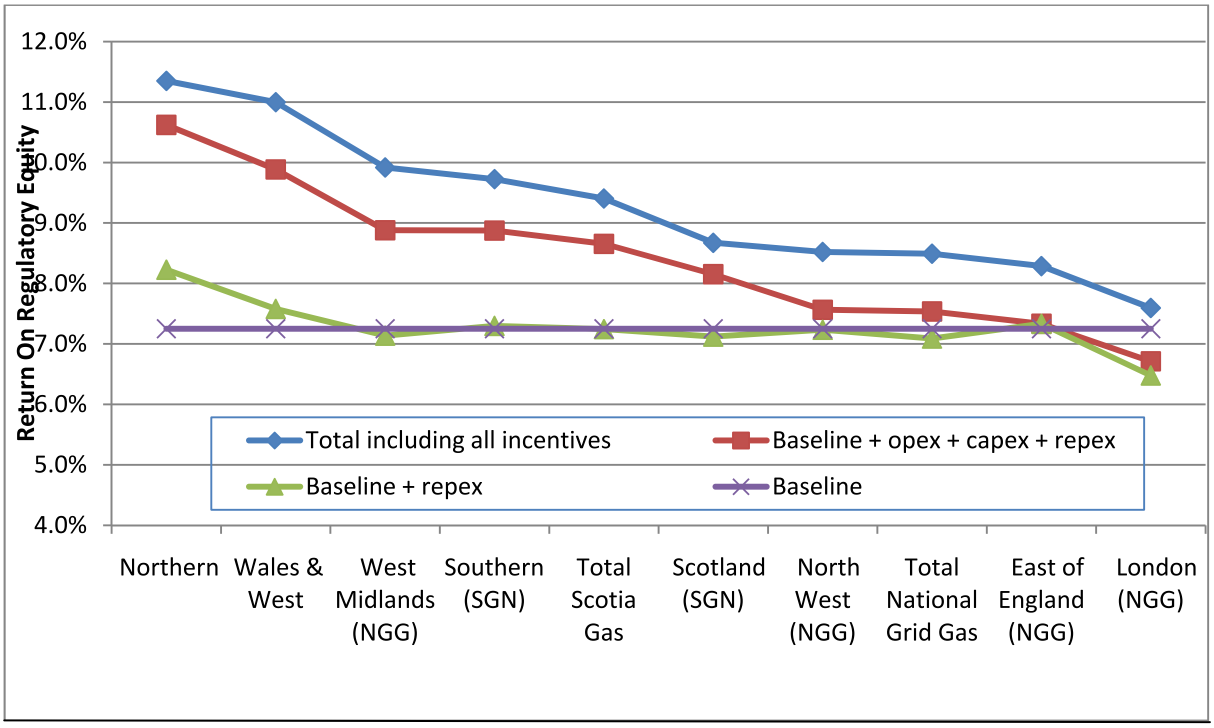
---

[4] See for example: Ofgem (March 2009) Gas Distribution Annual Report 2007/08 http://www.ofgem.gov.uk/NETWORKS/GASDISTR/GDPCR7-13/Documents1/Gas%20Distribution%20Annual%20Report%202007_8.pdf

[5] This is a real post-tax figure. See Ofgem (December 2007) Gas Distribution Price Control Final Proposals Consultation Document, p.105. http://www.ofgem.gov.uk/Networks/GasDistr/GDPCR7-13/Documents1/final%20proposals.pdf

[6] Under the shrinkage allowance mechanism and Environmental Emissions Incentive (EEI) GDNs face rewards or penalties according to their performance on gas lost through on the transport network (referred to as "shrinkage"). We explain how the mechanism works in detail in the "Supplementary Annex - RIIO-GD1 Outputs and incentives"

Figure 2.2[7] Preliminary RORE analysis for the period 2008-2010



Key challenges for RIIO-GD1

2.13. The gas networks face a number of important challenges which we have taken into account in developing our proposals for RIIO-GD1. These key challenges include: the uncertainty around the future role of gas networks as we decarbonise our energy use; the need for the gas sector to play its role in promoting low-carbon flows on the gas network; social issues, notably the need to address fuel poverty and to reduce the number of carbon monoxide poisoning incidents; and, the requirement to improve asset management to ensure least-cost service provision. In this section, we discuss each issue in turn, including how our proposals for RIIO-GD1 accommodate these challenges.

Uncertainty future role of gas networks

2.14. The challenge to reduce carbon emissions in the energy sector means that there is significant uncertainty surrounding the way that gas will be consumed and transported in the UK. The potential to meet domestic heat and hot water energy needs through renewable electricity could lead to a reduction in the use of natural gas and in the utilisation of gas distribution networks. Equally, there are also future scenarios where natural gas, as well as biogas, could continue to play a major ongoing role in the UK energy mix. Recent studies by the government[8], industry[9], and by Ofgem[10] all point towards uncertain future gas network use.

[7] Notes to Figure: (1) Baseline = allowed return on regulated equity (of 7.25% real post-tax); "baseline + repex" shows companies' RORE in relation to repex performance only; "baseline + opex + capex+ repex" shows companies' implied RORE in relation to outperformance on opex, capex and repex; "total" shows companies' RORE taking into account their performance for all expenditure categories, including debt financing costs and rewards/penalties associated with shrinkage and EEI incentive mechanisms.
[8] See for example: DECC (July 2010) 2050 Pathways Analysis
[9] See for example: Redpoint (October 2010) Gas Future Scenarios Project – Final report.
[10] Ofgem (February 2010) Project Discovery – Options for delivering secure and sustainable energy supplies. http://www.ofgem.gov.uk/markets/whlmkts/discovery/Documents1/Project_Discovery_FebConDoc_FINAL.pdf

2.15. For example, a recent report commissioned by the industry outlined a set of four plausible but diverse scenarios with very different implications for the future use of gas networks.[11] Under their "green gas" scenario, characterised by the commercialisation of carbon capture and storage technologies (CCS) but the absence of commercially successful electricity and heat storage technologies, the report suggests that annual gas flows on the gas distribution networks will be approximately constant over the period from 2010 to 2050.[12] By contrast, under the "electrical revolution" scenario, characterised by the slow development of CCS but the emergence of electricity heat and storage technologies, the report suggests that annual gas flows would fall to zero by 2050.

2.16. We have considered changes to our asset depreciation policies to address the uncertainty with regard to future network use, and we explain our proposals in Section 8. We have also set out proposed changes to the way GDNs meet future capacity requirements on their networks to reflect the uncertainty, as we explain in a supplementary annex.[13] The scenarios highlight the need for gas distribution networks to develop strategies to address future uncertainty with regard to asset utilisation, and we have set this out as an important criterion in assessing companies' business plans.[14]

The GDNs' contribution to the low carbon transition

2.17. The gas distribution companies have an important role in promoting low-carbon flows on the gas network, and need to reduce their own carbon footprint. As part of their business plan submissions, we expect companies to demonstrate how they will meet the broader environmental challenges, and set out how they will reduce their own emissions. This will be one of the key criteria in assessing companies' plans.

2.18. The Government has announced its intention to introduce the Renewables Heat Incentive (RHI), which will provide a subsidy to renewable heat technologies to bridge the financial gap between conventional heating and renewable heating sources.[15] In the gas sector, there is the prospect of substituting natural gas used for heating purposes with bio-methane, a renewable source of gas produced from waste matter. We are committed to ensuring that GDNs facilitate the potential growth of bio-methane.[16]

2.19. As set out below, we are consulting on proposals to create a regulatory environment which enables the timely and efficient connection of bio-methane. We have set out proposals to introduce connection standards for bio-methane to reflect the specific needs of this customer group. Our proposed customer service incentives (or broad measure) will also provide financial incentives for companies to be responsive to customers' needs, by incentivising them to perform well in customer satisfaction surveys, to deal with complaints effectively, and to engage with stakeholders, including bio-methane producers. We are also inviting stakeholders' views on whether there are any wider network or other benefits from bio-methane that should be reflected in the current connection and use of system charging arrangements. Along with our proposals

[11] See footnote 9.
[12] Redpoint (October 2010) Gas Future Scenarios Project – Final report, p. 8 and 29. The "green gas" scenario shows annual flows on the gas distribution networks of around 600 TWh over the modelling period, 2010-2050..
[13] See Supplementary annex: RIIO-GD1 Outputs and incentives. See Associated Documents for link.
[14] See Supplementary annex: RIIO-T1 and GD1 Business plans, innovation and efficiency incentives. See Associated Documents for link.
[15] DECC (February 2010) Renewable Heat Incentive, Consultation on the proposed RHI financial support scheme.
[16] Biogas can be produced through a process of anaerobic digestion using manures, slurries from agriculture, food waste and sewage sludge as feedstock. Biogas can then be scrubbed to produce bio-methane, which can be injected into gas networks.

set out for the price control review, we are also working with the industry on addressing technical (e.g. gas quality) issues with regard to the connection of distributed gas.[17,18]

2.20. We propose to require companies to report on the capacity of bio-methane connected to the network. At this time we are not proposing to apply any financial rewards or penalties in respect of their performance given that the development of bio-methane will be influenced by factors outside of companies' control (e.g. financial support made available through the RHI).

2.21. We also set out for consultation measures that directly contribute to reducing companies' own carbon footprint. For example, we are proposing the continuation of an incentive mechanism which will provide powerful incentives for network companies to reduce gas lost on the transport network ("shrinkage"), the major component of companies' business carbon footprint and a material element of the UK's overall greenhouse gas emissions. We expect companies to set out in their business plans schemes to reduce their other carbon emissions, and we will fund schemes that are justified in cost-benefit terms.

Customer and social issues

2.22. Efficient service delivery is not only about least-cost provision but also ensuring companies are responsive to customers' needs. We propose to introduce a "broad measure" of customer satisfaction, which will provide incentives for companies to improve customer satisfaction levels, manage complaints more effectively, and understand the needs of their stakeholders on an on-going basis.

2.23. We will also require GDNs to play a direct role in addressing fuel poverty by extending networks to those households in fuel-poverty who are not grid connected, and who rely on more expensive forms of energy for water and space heating. There are uncertainties about what impact the RHI and other interventions might have on the relative cost of different energy solutions in years to come. We are looking to keep track of these developments and will explore whether the GDNs could facilitate a non-gas solution to fuel poor customers where this is least cost. Another important social issue of relevance to this review is carbon monoxide (CO) poisoning. We expect the network companies to commence trials to understand the cost and benefits of the different roles that the GDNs could play, including the installation of CO alarms to vulnerable customers. We expect to have results from the trials by the end of 2011, to allow us to develop our view on the role of GDNs in CO awareness, and the associated revenue allowances for the RIIO-GD1 period.

Improving asset management

2.24. Investment in the gas pipelines and other expenditure to keep them safe and reliable is a key component of what customers pay for. An important objective for RIIO-GD1 is to ensure long term value for money. This will mean satisfying ourselves that there are clear outputs associated with network expenditure and that the companies

[17] For example, Ofgem held a workshop with DECC, the GDNs, and environmental/bio-methane representative organisations to discuss technical issues with regard to connecting bio-methane plant to the networks in August 2010. See: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=235&refer=Networks/GasDistr/GasDistrPol

[18] Distributed gas includes both renewable (e.g. bio-methane) and non-renewable forms of gas connected to the distribution network.

have used appropriate asset management techniques to arrive at a plan that represents long term value for money.

2.25. The GDNs' investment programme is largely driven by the iron mains replacement programme, which requires gas network companies to replace all iron mains within 30 metres of buildings over a 30-year period. [19] The repex programme constitutes the largest single expenditure item for the GDNs. At GDPCR1, we allowed funding of £3.9 for repex, equal to around 70 per cent of GDNs' total capital expenditure baseline and around one-quarter of the total GDN revenue requirement.[20]

2.26. The iron mains programme was developed as a response to societal concern about the potential consequences of mains failures. It recognised failures were happening and getting worse, but that it was not possible to remove all risk immediately. The programme was developed in discussion with industry. It prioritises the replacement of higher risk mains based on a detailed risk model of GDNs' iron mains assets, taking into account both the risk and consequences of fractures. It appears that the replacement programme has removed much risk from the mains network. HSE and Ofgem now agree that we need to review the programme to make sure we look across the whole system to ensure that risk is managed in a targeted and proportionate manner.

2.27. The HSE is currently undertaking a review of the repex programme, which we are co-sponsoring. The HSE expect their consultants to report to them in March 2011 after which the HSE will consider what further actions are appropriate. Decisions on the future of the current mains replacement programme reside, rightly with the HSE. HSE will review the evidence gathered by the review and the implications for the current programme. If the review indicates fine tuning only of the programme is justified these changes will be adopted quickly. However, if a more fundamental change of approach or changes to legislation are needed, clearly these will take some time to implement and such changes may also be dependent on how long it takes the companies to collect the asset data required for any alternative approach.

2.28. The focus on the repex programme has ensured GDNs have developed a good understanding of the condition of the mains. By contrast, the GDNs' understanding of the risk associated with their other asset classes (e.g. above ground installations, governors, steel mains and services) is more limited. We are concerned that this will prevent the GDNs from developing an investment programme for RIIO-GD1 which delivers a safe and reliable network at least cost. We are also concerned that the GDNs do not currently take a broader view of the risk associated with all their assets, i.e. taking into account the risk associated with other asset classes in determining the size and scope of their investment programme.

2.29. We are therefore in discussions with HSE about the introduction of a holistic, risk model for assessing the appropriate levels of network investment. We would like to encourage a fundamental change in the way that GDNs manage their assets. Our overall objective is to encourage GDNs to develop a risk-based approach to asset management, where they optimise investment across their entire asset base based on a detailed understanding of the asset health and condition, the consequence of asset failure and the associated cost of removing risk. The HSE are supportive of this approach.

[19] HSE (undated) A guide to regulation 13A of the Pipelines Safety Regulations 1996, para. 2.
[20] This is based on 2009/10 revenues: total regulated revenues were £2.8bn, of which £0.7 bn was repex.

2.30. We have already written to GDNs to encourage them to begin collecting the data and developing the systems they will need to implement this holistic approach. We will take a hard line on companies that propose investment programmes where the investment driver is condition/integrity of the asset, but where the planned investment is not justified with appropriate asset health and criticality information.

2.31. In our tools for cost assessment supplementary annex, we discuss the potential implications for the RIIO-GD1 process of the HSE's decision on the future iron mains programme, and how we will accommodate any future change during and beyond the review period.

3. Making sure stakeholders' views are heard

Chapter Summary

This chapter outlines the process and timetable for RIIO-GD1. It highlights that the process is very different from previous controls reflecting the introduction of an outputs-led framework, the introduction of proportionate treatment and the role of stakeholder engagement.

This chapter also sets out the stakeholder engagement process in more detail. It provides an outline of the mechanisms for engagement as well as the key issues highlighted by stakeholders.

Question 1: Do you have any comments of the overall approach to stakeholder engagement?
Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?

Role of stakeholders in the price control review

3.1. The network price controls will impact on a wide range of parties. Under RIIO, stakeholders have greater opportunity to influence our and network companies' decisions. We expect network companies to engage proactively with consumers on an ongoing basis. Our approach to enhanced engagement will be developed for each price control review but it will be particularly important that different types of stakeholders get to engage on the issues that matter to them. Both the company and our approach to engagement are discussed below.

Company led engagement

3.2. Under the RIIO model, we expect network companies to engage with their consumers and wider stakeholders on an ongoing basis. While we do not want to be prescriptive about how network companies engage with their stakeholders, effective engagement must have informed their well-justified business plans. Our guidance for network company business plans provides an indication of our expectations of network company engagement with their customers. It is not a 'box ticking' exercise but about seeking to understand and, where appropriate, act on the information that is gathered.

3.3. The network companies have already initiated their stakeholder engagement programmes. We expect this engagement will increase as they start to develop their business plans.

Ofgem-led engagement

3.4. Since the start of the RIIO-GD1 review we have adopted a multi-layered process to ensure that all affected parties have appropriate opportunities to engage in the review. When we have engaged with stakeholders we have sought to adhere to our principles for effective enhanced engagement set out in the RIIO handbook.[21]

[21] See page 13, Box 2 of the handbook:
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf

3.5. The objectives of our stakeholder engagement for RIIO-GD1 to date have broadly been to:

- introduce the RIIO model and set out how it works
- ensure that the views of consumers are fully reflected in the process
- consider stakeholders' broad views of the output categories
- develop further thinking on output measures
- ensure that stakeholders are familiar with policy developments so that they are able to contribute effectively as the price control review progresses.

3.6. Appendix 4 summarises the different ways we have engaged stakeholders, the issues addressed, and the stakeholders involved. A high level summary of the issues raised by respondents to our July 2010 open letter on RIIO-GD1 is provided in Appendix 5. [22]

Third party modification requests

3.7. As part of our RIIO decision document we published guidance on how third parties, and network companies, could make representations about a price control settlement and could request the Authority to exercise its power to make a modification reference to the Competition Commission.[23] The guidance was developed to provide parties with a clear route to challenging the merits of our price control decisions should they feel they may operate against the public interest. This is an important part of the RIIO model, with its over-riding objective being to facilitate increased and more effective stakeholder engagement by us and network companies.

3.8. As part of the implementation of the EU Third Package, DECC are looking to introduce (by March 2011) a new process for appealing licence modifications and have published a consultation on the process.[24] We will provide an update on any developments in this area in our March 2011 Strategy Decision document and when the new process has been settled we will make any required changes to our guidance document.

[22] Open letter consultation on Gas Distribution Price Control Review 2 (GDPCR2) – the way forward - July 2010 http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Pages/ConRes.aspx
[23] A Guide to Price Control Modification References to the Competition Commission - Licensee and Third Party Triggered Reference
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/final%20mod%20guidance.pdf
[24] http://www.decc.gov.uk/en/content/cms/consultations/imp_eu_third/imp_eu_third.aspx

4. Outputs and Incentives

Chapter Summary
This Section sets out our views on the type of outputs the companies should deliver over the next price control period, and the mechanisms by which we propose to incentivise or require the companies to deliver.
We provide more details in the supplementary annex 'RIIO-GD1 Outputs and incentives'.

Question 1: Do you consider that the proposed outputs and associated incentive mechanisms, taken together with other element of the price control, will ensure that companies deliver value-for-money for consumers, and play their role in delivering a sustainable energy sector?
Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate (e.g. do we have too many or too few)?
Question 3: Do you have any views on the proposed outputs or incentive mechanisms?

Introduction

4.1. A core component of the RIIO framework is the development of an outputs-based regulatory framework. This chapter summarises our proposals for the output measures and associated incentive mechanisms for RIIO-GD1 for consultation.

4.2. Outputs-based regulation is an effective way of promoting efficiency. By defining what network companies are required to deliver, companies face powerful incentives to innovate and seek least-cost solutions to delivering the services required by customers. The adoption of an output based framework also makes it easier for stakeholders to express views about what they want from the network companies and hence for them to engage with the price control review process. This should result in the delivery of services that are valued by customers.

4.3. Under the RIIO model, we are committed to setting out clear and comprehensive outputs that the network companies will be held to account for delivering. These outputs, taken together, need to ensure the companies deliver the high level RIIO objectives. These are:

- to ensure that network companies play a full role in the delivery of a sustainable energy sector
- deliver long-term value for money in the services they provide for existing and future consumers.

4.4. These objectives are interrelated. To meet the demands of moving to a low carbon economy there will need to be significant investment in the networks. The scale of the required investment means that higher energy bills are almost certain. In making that investment companies will have to show consumers that they are getting value for money over the longer term, setting out clearly what is being delivered and at what cost. Further, companies will be expected to innovate to identify which technologies will prove most effective in delivering the low carbon economy while providing best value for consumers.

4.5. The RIIO model identifies six key output categories – or key areas of delivery for network companies. These are: environmental impact; customer satisfaction; safety;

reliability; conditions for connection; environmental impact; and, social obligations. For each of these output groups, we have identified a number of specific behaviours that we are seeking to encourage in each of the key service delivery areas:

- Environment: encouraging companies to play their role in the achievement of broader environmental objectives, namely the reduction in carbon emissions, as well as minimising the "narrow" environmental impact of the company's activities by managing their own carbon footprint.

- Customer satisfaction: maintaining high-levels of customer satisfaction, and improving the service levels provided where required. We also seek to encourage companies to undertake effective engagement with their stakeholders, and reflect stakeholders' views in the day-to-day operation of their business.

- Connections: encouraging networks to connect customers in a timely and efficient way, including responding to the specific needs of distributed gas, including bio-methane, customers.

- Social objectives: extending the gas network to communities who are fuel-poor where it is efficient to do so (and where it is not, working with other parts of the energy industry to meet the needs of the fuel poor). Introducing measures to address incidents of carbon monoxide (CO) poisoning.

- Safety: ensuring the provision of a safe network in compliance with Health and Safety Executive safety standards, and improving their asset knowledge to ensure companies develop well-justified investment plans.

- Reliability and availability: promoting a network capable of giving long term reliability as well as minimising the number and duration of interruptions experienced over the price control period, and ensuring adaptation to climate change.

4.6. We established working groups in July to identify outputs and incentive mechanisms for each of the six output categories. The working groups included the network companies, as well as other stakeholders, including environmental, social, and customer representative groups, as well as the HSE. Our recommendations reflect the working group discussions as well as views expressed at other stakeholder forums.

4.7. The outputs framework comprises both primary outputs and secondary deliverables. Primary outputs are the ones that will make a material contribution to the outcomes we are seeking. Secondary deliverables have an important role in helping us to monitor companies' performance, and often provide "leading indicators" of performance in order Ito ensure long term delivery and value for money.

4.8. n identifying primary outputs, we have drawn on the principles set out in the RIIO Handbook.[25] This includes, inter alia, ensuring they are controllable by the network companies (or where we have concerns about controllability, we consider carefully the applicability of financial rewards/penalties); measurable; auditable; and comparable.

[25] See Ofgem (4 October 2010) *Handbook for implementing the RIIO model,* p. 35.

4.9. We expect network companies to include in their business plans the costs required to deliver primary outputs in future price control periods. To ensure consumers do not pay unnecessarily high prices, companies will be expected to set out the rationale for expenditure in the context of a long-term strategy for delivery.

Setting future performance levels (or baselines)

4.10. Our work has focussed on how the outputs for each category are defined and measured. For most output measures, we do not propose to prescribe output levels (or baselines). Instead, companies will need to set out the required level of outputs in their business plans, justifying the proposed level in terms of the costs and benefits to network users, and informed by their stakeholder engagement. The exceptions include health and safety related output measures – where network owners need to comply with HSE specified outputs – and output levels covered by the Guaranteed Standards of Performance (GSOP).

Incentive mechanisms

4.11. For each output category, we have also considered a range of incentive mechanisms to encourage network companies to deliver the primary outputs and secondary deliverables. Where we seek to contain the financial risk or reward to companies, we have also proposed caps and collars on the size of the reward and penalty payments.

4.12. We have not proposed financial incentive mechanisms for all output measures. For example, we have not proposed any financial incentives for the set of safety related outputs where absolute standards are in place and HSE is able to take enforcement action in the event of non-compliance. We do not consider that it is reasonable or necessary for us to impose an additional penalty. Equally, we do not think it is appropriate to reward companies for outperforming safety requirements.

Monitoring delivery of outputs

4.13. The RIIO model proposes a balanced scorecard approach to assessing companies' performance on output delivery. The purpose of the scorecard is to provide a clear and simple way to convey information about network company performance and to facilitate a meaningful comparison of performance.

4.14. The development of the scorecard is relevant to delivering the other parts of the RIIO framework, including facilitating discussion during enhanced engagement; supporting our approach to proportionate assessment; and providing scope to attach financial incentives to overall performance.

4.15. We propose that the scorecard focuses on the delivery of primary outputs with secondary deliverables used only where they are particularly useful in illustrating network company performance. In line with the RIIO recommendations, we propose that the score card takes the form of a 'traffic light' system with companies' performance judged on whether their delivery is low (red), medium (amber) or green (high). We set out further detail on the approach to developing the balanced score card in the supplementary annex entitled 'RIIO-GD1 Outputs and incentives'.

Quality of reporting data

4.16. The proposed outputs package places greater emphasis on the quality of reporting by companies to ensure that we can monitor and evaluate their performance against the regulatory settlement. Consequently, we are also consulting on ways to ensure the quality of information provision, including whether companies should appoint independent auditors (or 'reporters') to verify their output and cost data. We will be considering this further and intend to set out proposals in our March strategy decision document.

Proposals for RIIO-GD1: Output Measures and Incentive Mechanisms

4.17. Our key proposals in each output category are set out below. We seek feedback on the detail of these proposals as well as any general observations on the balance between the different output categories and the proportionality of the approach we have developed so far. Companies can also set out alternative or additional output measures within their business plans, e.g. a training output measure to support expenditure on staff development.

Environment

4.18. We have out proposals to ensure companies play their role in achieving broader environmental objectives, and reduce their own carbon footprint. Our overall approach is to create an enabling regulatory environment to ensure that companies play their role in delivering a low carbon energy sector. There are many elements of our proposed regulatory framework that contribute to this objective, including:

- connection standards, which we propose to extend to bio-methane and other distributed gas customers; we will require companies to develop strategies for providing these customers with the information they need when they are seeking to connect the gas networks
- network reliability, where we will improve the current incentive arrangements for companies to engage in demand-side management (or “interruptible contracts”) to meet new load requirements
- customer service and stakeholder engagement incentives, where we will encourage companies to be more consumer focused, and where we will reward companies that demonstrate that they effectively engage with and understand their stakeholders’ needs, including the needs of new bio-methane stakeholders
- innovation stimulus, which will provide financing for trialling of technologies relating to the delivery of a low carbon future.

4.19. We also propose to require GDNs to report the capacity of bio-methane connected. However, we do not propose any associated financial rewards or penalties associated with the connection of bio-methane, because the industry is in its infancy (there are currently only 2 bio-methane plants injecting into the grid in the UK), and because the companies have only limited control over the connection of bio-methane. The primary determinant will be the government’s decision on support available under the RHI.

4.20. We have also set out specific environmental output measures to incentivise companies to reduce their own-emissions. The largest source of company emissions is gas lost through transportation ("shrinkage") which accounts for more than 0.75% of UK's greenhouse gas (GHG) emissions.[26] We propose to maintain the financial incentive to minimise shrinkage which were established in GDPCR1. However we propose to adopt a higher carbon value and therefore a stronger incentive reflecting the latest government approach to valuing carbon abatement.

4.21. We also propose to require companies to report their wider business carbon footprint (BCF), and we will publish a league table of companies' BCF to provide reputational incentives to reduce emissions.

Customer satisfaction

4.22. We have undertaken research with customers supported by other stakeholder engagement in order to identify the aspects of network services important to customers, and we have drawn on this to construct a composite or "broad measure" of customer satisfaction. The broad measure will comprise results from a customer satisfaction survey; a complaints handling measure; and, an incentive on the network companies to incorporate an understanding of stakeholders' views and needs in the ongoing development of business plans and strategies.

4.23. We have proposed a financial incentive mechanism in relation to the broad measure of customer satisfaction, ensuring that companies continue to maintain and improve where necessary the services they provide to customers and their engagement with stakeholders. At this stage, we propose to set a penalty/reward for the broad measure (i.e. comprising all three elements) of +/-1% of total revenues. This is equivalent to the financial incentive associated with the broad measure for electricity distribution companies at DCPR5, which we consider provides a reasonable financial incentive for companies to continue to improve performance (and an appropriate penalty where they fail).

4.24. The GDNs also provide gas balancing and settlement services to shippers through a contract with xoserve. In our responses to our stakeholder engagement, network users have expressed a level of dissatisfaction with the level of service provided by xoserve. We propose to undertake a review of xoserve early next year, which will examine both the overall revenue requirement and associated outputs, as well as consider alternative governance and ownership arrangements.

Conditions for connections

4.25. Ensuring timely connection to the gas grid contributes to the wider environmental objectives, as well as addressing a key issue for customers and producers. There are Guaranteed Standards in place relating to connections service and generally these standards, and the overall licence conditions on the GDNs in respect of connections service, appear to work well.

[26] Source: This is calculated using the government's reported statistics on total greenhouse gas emissions: http://www.decc.gov.uk/assets/decc/statistics/climate_change/1_20100325084241_e_@@_ghgnationalstatsrelease.pdf and the volume of shrinkage which GDNs reported in 2008/9.

4.26. We seek views on whether we need to introduce any new standards, as well as whether we should review the response times and penalties associated with the standards, for example, to bring them into line with those in electricity.[27]

4.27. We are also proposing the extension of existing standards to distributed gas, including bio-methane producers, as part of our package of measures to ensure this new category of customers receives a good service when seeking a connection.

Social obligations

4.28. We have been working with GDNs and other stakeholders to consider how they can promote gas safety and address fuel poverty. During the current review period, network companies have embarked upon a number of trials to understand the cost and benefits of different schemes to address carbon monoxide (CO) incidents, including the installation of CO alarms to vulnerable customers. We expect to have some results from the trials by the end of 2011.

4.29. We also propose a continuation of the current scheme to provide network extensions for the fuel poor. We propose arrangements that will require the companies to document the costs and benefits of the scheme, and we propose to draw on this information to keep under review whether network extensions represent the least cost way to address fuel poverty (e.g. in the light of the RHI, which will introduce funding mechanisms for renewable forms of heat energy). We also invite views on how the GDNs can work with other parts of the energy industry to help the fuel-poor.

Safety outputs

4.30. The HSE is the health and safety regulator for the gas networks in Great Britain, and we have set out proposals for safety outputs measures that are consistent with the HSE obligations. The mains replacement programme is driven by the HSE requirement to reduce the level of risk arising from gas mains in close proximity to properties. We are proposing changes to the existing revenue mechanism in relation to iron mains. The existing mechanism rewards companies according to the length and diameter of mains and service pipes replaced. We are considering replacing this with a mechanism that incentivises companies to seek the least cost way to reduce iron mains risk (e.g. through spray lining rather than decommissioning).

4.31. Companies also provide an emergency service in relation to gas escapes on their network and downstream of the meter. Our proposed primary output measures for the GDNs emergency service reflect current performance standards. The other output measures for other safety output sub-categories (“Repairs” and “Major Accident Hazard Prevention”) are based on compliance with the HSE “safety case”.

Reliability

4.32. There are two key issues associated with the reliability of the gas distribution networks: the condition of the network and associated loss of supply; and the level of capacity that is provided.

[27] See Supplementary Annex - RIIO-GD1 Outputs and incentives

4.33. With regard to loss of supply, we propose the number and duration of supply interruptions as our primary output measure. This is currently incentivised through the Guaranteed Standard scheme which requires the GDNs to compensate customers directly if their supply is interrupted beyond a specified period of time. We are consulting on whether we should change the level of compensation available to customers under the Guaranteed Standard scheme.

4.34. With regard to loss of supply, we are also proposing a secondary deliverable: a risk metric capturing asset health and condition, and the consequences of asset failure. These measures are required to enable us to monitor the effect of GDNs' network investment programmes in both the short and longer-term. We will require companies to justify their investment plans in terms of the expected improvement in asset health indices. Throughout the price control period we will review their performance against the expected improvements. If, at the end of the period they have not met the expected improvements we will either make a revenue adjustment to ensure the company does not benefit from any deferral of expenditure or, require the company to make up the difference at their own cost in the subsequent price control period.

4.35. With regard to providing network capacity, we are developing proposals to identify a primary measure around achieving security of supply (based on the 1 in 20 winter peak design standard), which will provide incentives for GDNS to deliver capacity increments at least cost (including through non-network solutions such as contracting for interruptible services). We are also proposing to change the incentive framework so that GDNs have an incentive to choose the least cost solution between investing in their own network, booking National Transmission System (NTS) exit capacity or agreeing interruptible contracts with large users (demand-side response). We also propose to require GDNs to consider introducing a real option value into the interruptible contract price, to ensure they consider the uncertainty surrounding network asset lives – arising from changing energy patterns – in choosing between whether to invest in their network or engage in an interruptible contract.

5. Assessing efficient costs

Chapter Summary

This chapter sets out the process for assessing efficient costs in RIIO-GD1. There are a number of elements. We intend to adopt a proportionate approach to assessing the price control package with the intensity of the assessment reflecting the quality of a company's business plan and its record of delivery. Under this approach a number of companies' business plans may be subject to lower scrutiny. Strong performing companies who submit sufficiently well-justified business plans may be "fast-tracked" through the price control process. This chapter also considers the role for the facilitation of a greater role for third parties in delivery.

More details on the issues discussed in this chapter are set out in the supplementary annexes entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives' and 'RIIO-GD1 Tools for cost assessment'.

Question 1: Is our proposed approach to cost assessment appropriate?
Question 2: Do you have any views on our proposed process for proportionate treatment?
Question 3: Do you have any views on the criteria for assessing business plans? Are any of the criteria highlighted inappropriate? Are there any additional criteria that should be added?
Question 4: Do you have any views on the proposed role for competition in third party delivery?

RIIO model for assessing efficient costs

5.1. The RIIO framework introduces some important new principles to guide the price control process. Under the RIIO model the onus is on the network companies to determine how best to deliver outputs over time, reflecting on the results of their stakeholder engagement. We expect the companies to develop well-justified business plans which show an understanding of their assets and which reflect feedback from their stakeholders. We will use companies' plans as well as other available information, including past performance, to form a view of the expected efficient costs of delivering outputs and long-term value for money.

5.2. We will adopt a proportionate approach to assessing business plans. We will focus attention and effort where it is expected to generate most value. In doing so we will provide those companies that step up to the challenge of providing well-justified business plans the opportunity for a lighter-touch regulatory approach, potentially offering some companies a 'fast-track' settlement, (i.e. we will agree the terms of their price control up to a year earlier than for other network companies). We feel that the proportionate approach is an important part of encouraging companies to step up to the challenges they face, and has real value to those network companies that do so.

5.3. This chapter sets out an overview of how business plans, cost assessment and proportionate treatment fit into the RIIO-GD1 process. It also notes the facilitation of a greater role for third parties in delivery.

Well-justified business plans

5.4. Under RIIO, the onus is on network companies to develop well-justified business plans. Each company will be required to demonstrate that its plan will deliver in the interests of both current and future customers and how it will meet the challenges associated with facilitating the move to a low carbon economy. Companies will also be required to demonstrate that their proposals take account of the various risks and uncertainties and, given these, provide a strategy to deal with these efficiently and maintain delivery.

5.5. We set out initial draft business plan guidance in our July open letters.[28] This was welcomed by stakeholders. It has helped companies start to understand what we are expecting of them.

5.6. Key points of our business plan guidance to emphasise are:

- companies need to justify their proposed strategy for delivering their output baselines against a thorough understanding of the long-term trends (and risks and uncertainties) that they face. They also need to show that they understand their role, and are looking to be proactive in, contributing to the UK's carbon reduction targets
- we expect the companies to demonstrate that, in drawing up their business plans, they have considered the views of stakeholders, and the opportunities to use innovative technologies, techniques or commercial arrangements to deliver their outputs at long-term value for money
- the plan should present a holistic view of the package the company believes to be appropriate, i.e. for the first time the company's view on financeability metrics will be included alongside views on expenditure and outputs with the former justified against their plan and backed up by other evidence.

Proportionate treatment

5.7. The RIIO model envisages a proportionate approach to assessing the price control package. Under this approach the intensity and timescale of the assessment will reflect the quality of a company's business plan and the company's record for efficient output delivery. This approach is consistent with better regulation principles as it allows us to focus greatest regulatory scrutiny where it is likely to produce greatest value.

[28] Ofgem, open letter consultation on the gas distribution price control review 2 (GDPCR2), the way forward. http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Pages/ConRes.aspx

5.8. Where a company produces a high quality business plan we propose to focus less resource on them such that there business plans are subject to a lower level of scrutiny. In some cases where a company produces a particularly high quality business plan we would consider whether it would be appropriate to conclude that company's price control process early, i.e. the company would be fast-tracked. This is discussed in further detail below.

Incentives associated with proportionate treatment

5.9. The scope for lighter-touch scrutiny and, to a greater degree, fast-tracking provides network companies with incentives to step up to the challenge of submitting realistic and well-justified business plans. This is because these approaches will allow companies to:

- get on with business as usual without focusing as much resource on the price control process
- plan with greater certainty earlier in the process
- be a significant driver of its own review outcome
- gain positive reputational advantage associated with the kudos of achieving a fast-tracked settlement or having lower-proportionate scrutiny.

5.10. The scope for proportionate treatment will provide strong incentives for network companies to perform better overtime and to submit better quality business plans. It may also provide incentives for companies to reveal information that would not be available otherwise which might assist with the assessment of other companies.

Fast-tracking

5.11. As noted above, fast-tracking describes a process whereby the price control for a company that develops a well-justified business plan may be concluded early.

5.12. We propose that the key features of fast-tracking will be:

- a company's price control will be finalised approximately 12 months ahead of non fast-tracked companies although implementation will still be on the same date for all companies - 1 April 2013
- a company's licence conditions as a whole will be finalised at the time of the fast-tracking decision
- we will consult on whether any company should be fast-tracked before taking a final decision
- we will ensure that a company who is fast-tracked does not secure a settlement that means they were worse off than had they remained in the process.

Process and criteria for proportionate treatment

Process

5.13. There will be four key stages to the process for assessing whether a company receives 'lighter-touch' scrutiny or potentially fast-tracking:

- Stage 1 – In July 2011 the network companies will submit complete business plans informed by our March 2011 strategy decision document and their stakeholder engagement. Between July and October we will undertake an 'initial sweep' of this information. This will consider the overall quality of the companies' plans. At this point we will take a view on whether it might be possible to fast-track any of the companies on the basis of their business plan submissions. We will inform companies of the outcome of this assessment and highlight areas where their business plans require further development.
- Stage 2 – We will undertake further analysis on candidates for 'lighter-touch' scrutiny and fast-tracking and publish recommendations in December 2011. Recommendations will set out our initial proposals for the settlement for any company we consider could be fast-tracked and our initial assessment of the other business plan submissions.
- Stage 3 – We will assess the responses to the fast-tracking and 'lighter-touch' recommendations and publish our decisions in February 2012. For fast-tracked companies, that decision will constitute final proposals for those companies.
- Stage 4 – We will develop and publish initial and final proposals for non fast-tracked parties in July 2012 and December 2012 respectively. The price controls for all parties will come into effect on 1 April 2013.

5.14. More detail on each of these stages is set out in our supplementary annex entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives'.

Assessment criteria

5.15. The initial sweep will be informed by three different sources of evidence:

- the quality of the company's business plan (including accompanying data, evidence of stakeholder engagement and the financial model)
- use of any available comparative evidence both our own and additional information provided by the companies including benchmarking data
- our assessment of performance during the previous regulatory control based on pre-established principles.

5.16. There are a range of criteria we propose to use in assessing the quality of the business plans. These criteria are divided into three categories: (1) the approach to process; (2) strategy; and (3) refection of strategy in the plan. These reflect the RIIO recommendations and align with the business plan guidance set out in our July open letter. These criteria are set out and discussed in detail in our supplementary annex entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives'.

5.17. It is possible for all, some or no companies to qualify for fast-tracking or a lighter-touch approach. We will base our decision on the absolute quality of individual business plans against the criteria.

Ensuring that no fast-tracked company is worse-off

5.18. A key issue for fast-tracking is to ensure that a company that is fast-tracked is no worse off than a company that is not fast-tracked. This is important to provide incentives to network companies to aim for fast-tracking.

5.19. There are a number of reasons why we do not consider it likely that a fast-tracked company would receive a worse settlement. We would expect fast-tracked companies to be able to demonstrate they are operating at the frontier of efficiency. We would also expect these companies to set the benchmark on financial issues. It is unlikely that we will be presented with subsequent evidence to suggest that other companies should be set less exacting efficiency goals or more generous financial settlement. These reasons are:

- in order to be considered a high quality well-justified plan and suitable for fast-tracking a company's business plan will need to be well informed about potential longer-term trends, i.e. it would be more likely to anticipate future changes and have built in mechanisms for dealing with these
- those not being fast-tracked are going to be subject to heavier regulatory scrutiny so which is likely to put pressure on their requested allowed revenues
- cost of debt assumptions will update automatically and therefore fast-tracked companies would have the same protection against changes in credit markets.

5.20. We are considering the need for further protections for fast-tracked companies. The options we are seeking views on are:

- whether there are any aspects of the settlement where adjustments might need to be guaranteed to the 'fast-tracked' company to ensure it is not disadvantaged against the others
- providing rewards to any 'fast-tracked' GDN to reflect the rewards that would have been available through our upper quartile benchmarking approach, to the most efficient company - we are not proposing this in transmission as there are fewer and more diverse companies and therefore less scope for meaningful comparison
- whether a more explicit reopener would be required for 'fast-tracked' companies.

5.21. It is likely that we will invite fast-tracked companies to identify aspects of their settlement which may need to be reconsidered in the light of the settlement agreed for non fast-tracked companies.

Cost assessment

5.22. Under the RIIO framework the onus is on companies to demonstrate the cost-efficiency and long-term value for money of their business plans. We intend to place our focus on the companies' forecasts and the use of benchmarking as a means of informing our assessment of the companies' forecasts rather than as a mechanistic means of setting allowances. We will place much more emphasis on the benchmarking of forecasts (as opposed to historic costs) as these are likely to be more relevant in the context of our sustainable development duties and the introduction of new output measures.

5.23. As part of RIIO-GD1, we propose to develop a toolkit approach to cost assessment. The toolkit will comprise both total expenditure (totex) analysis and the use of disaggregated approaches, i.e. separate reviews of operating and capital expenditure. Totex analysis captures the key trade-offs between different areas of costs in establishing the overall levels of efficiency of network operators. But, as this is the first time we are making full use of the totex techniques, we consider the use of more disaggregated approaches is important in providing a crosscheck to ensure our approach is robust.

Efficiency incentives and the Information Quality Incentive (IQI)

5.24. We want to ensure that network companies face strong financial incentives to control their costs and to seek out and implement delivery approaches that provide better value for money for existing and future consumers. The RIIO model proposed a fixed and symmetric 'efficiency incentive rate' for each company. This will give companies a clear and strong financial stake in restraining, and where possible reducing, the costs of delivering outputs over the price control period.

5.25. The efficiency incentives are about risk-sharing. Investors and consumers will share the benefits when the company delivers outputs for less money than we envisaged when setting the price control. Similarly, investors and consumers will share the additional costs if the company spends more money than envisaged. The higher the efficiency incentive rate, the more investors are exposed to the network company delivering at higher cost than expected and the more they stand to gain if the network company can deliver at lower cost.

5.26. We are proposing two changes to the way that the efficiency incentive rate is implemented, compared to efficiency incentives in previous price controls:

- the efficiency incentive rate would be implemented through revenue adjustments made annually during the price control period
- the level of the efficiency incentive rate will determine the extent to which the RAV is adjusted in light of a given over-spend or under-spend. This means that the RAV will not track actual (capital) expenditure.

5.27. The aim of the IQI is to encourage companies to submit more accurate expenditure forecasts to Ofgem. A necessary feature of the IQI is that the efficiency incentive rate for each company depends on the difference between its expenditure forecast and Ofgem's assessment of its (efficient) expenditure requirements. We propose that the exact efficiency incentive rate for each company is set as part of the IQI, within a range of 40% to 60%.

5.28. We want companies to find the lowest cost way of delivering outputs over the longer-term, considering a variety of potential delivery approaches. The same efficiency incentive rate will apply to operating expenditure and capital expenditure. This will reduce the risk that expenditure decisions may be distorted in favour of capital expenditure solutions. At the price control review, our cost assessment will look across all areas of costs. We will seek to avoid an approach to cost assessment that could skew companies' plans, and their subsequent delivery approaches, towards certain categories of expenditure.

5.29. The application of efficiency incentives and IQI are discussed in detail in the supplementary annex entitled 'RIIO-T1 and GD1 Business plans, innovation and efficiency incentives'.

Role for third parties in delivery

5.30. Providing scope for competition in delivery, ownership and operation of network assets in defined circumstances is an important element of RIIO. The option to require the competitive provision of network services is expected to impose discipline on existing network companies to encourage them to strive for timely delivery, be more innovative and seek out lower long-term cost delivery solutions.

5.31. The RIIO model outlined three key ways in which we could use competition to realise benefits for the consumer. The first two, detailed below, define the information we expect from licensees as part of their well-justified business plans, and are included in the business plan guidance for the first RIIO price control:

- companies will be expected to provide, as part of a well-justified business plan, evidence of efficient procurement; and
- where we feel a network company has failed to provide robust evidence to support its business plan they may be asked to supply more evidence, including (potentially) market testing evidence.

5.32. Under the third approach, we would have the option to grant a third party licensee funding for ownership and potentially delivery of selected projects. We would only consider initiating steps to explore the potential to give licensed third parties a greater role in delivery where the project meets certain criteria which indicate that this is likely to deliver long term benefits to consumers.

5.33. We set out the factors we would consider in determining whether to use this approach in the supplementary annex, 'RIIO-GD1 Business plans, innovation and efficiency incentives'. For gas distribution, more generally, we are also considering whether we should make use of third-party tendering given the role of Independent Gas Transporters (IGTs).

6. Managing uncertainty

Chapter Summary

Reflecting the principles outlined in the RIIO framework, this chapter outlines the specific mechanisms that we propose to include in the RIIO-GD1 control. This chapter also sets out the intention to have a mid-period review and sets out the scope of that proposed review.

Question 1: Do you have any views on the uncertainty mechanisms identified?
Question 2: Are there any additional uncertainty mechanisms required that we have not identified?
Question 3: Are there any mechanisms that we have included that are not necessary and why?

Uncertainty in setting price controls

6.1. There are always uncertainties about what will happen during the course of a price control period. During the control period factors will change which can impact a company's outputs and expenditure requirements. Under RIIO, risks should be borne by the party best able to manage them efficiently. In some cases this will be the network company. In other cases it may be that risks are best borne by the consumer or shared.

6.2. These risks are arguably greater under an eight-year price control than under a five-year one. We have taken this into account in setting out our proposed approach to dealing with uncertainty in RIIO-GD1.

6.3. The RIIO framework includes a number of elements to help deal with uncertainty. The elements, which are discussed in this chapter, are:

- uncertainty mechanisms
- the potential for disapplication of the price control
- a tightly-defined mid-period review of output requirements.

6.4. The mechanism for sharing any variations between actual and forecast expenditure between the companies and consumers also helps to reduce the impact of uncertainty for network companies (referred to as the IQI). (See Section 5.)

Uncertainty mechanisms

What are uncertainty mechanisms?

6.5. We use the term "uncertainty mechanisms" to cover a range of mechanisms which allow changes to the revenues a network company is allowed to collect in light of what happens during the price control period. These include:

- volume drivers - a means of linking revenue allowances to a significant change in volumes during a price control period
- revenue drivers - a means of linking revenue allowances under a price control to specific measurable events which are considered to influence costs
- specific re-openers - specific provisions to re-set the revenue allowances (or the parameters that give rise to revenue allowances) under a price control
- pass-through items - elements where any changes in costs are recovered fully from customers via pass-through arrangements
- indexation - the adjustment of an economic variable so that the variable rises or falls in accordance with the rate of inflation
- logging-up - a provision under which a company will be compensated for all, or part, of its actual expenditure on a particular activity or area, through the revenue allowance set at the next price control review
- rolling average - an average of a specified number of data points which is updated continuously to reflect the most recent data.

Uncertainty mechanisms under RIIO

6.6. The use of uncertainty mechanisms may benefit consumers in a number of different ways. For example, contributing to a lower cost of capital and reducing consumers' exposure to forecasting uncertainty at the price control review. However, they may also bring downsides, such as undermining efficiency incentives, complexity and risks of unintended consequences, as well as price-volatility for network users and consumers.

6.7. The overarching principle for uncertainty mechanisms under the RIIO model is that we expect network companies to manage the uncertainty they face. The regulatory regime should not protect network companies against all forms of uncertainty. The use of uncertainty mechanisms should be limited to instances in which they will deliver value for money for existing and future consumers while also protecting the ability of networks to finance efficient delivery.

6.8. The RIIO framework calls for:

- a clear justification of the need for each uncertainty mechanism
- design of each mechanism to mitigate the potential downsides
- a coherent approach across uncertainty mechanisms.

Proposed uncertainty mechanisms

6.9. Our supplementary annex entitled 'RIIO-T1 and GD1 Uncertainty mechanisms' sets out a detailed explanation of the mechanisms that we propose are included in RIIO-GD1. These mechanisms include:

- A revenue driver in relation to the iron mains replacement programme, to protect companies from volume risk. We are also consulting on changes to this revenue driver to provide incentives for companies to seek alternative ways to decommissioning to reduce risk on their networks.

- a specific reopener to account for any change to the HSE's iron mains replacement programme during the review period.
- a range of financial uncertainty mechanisms protecting network company and consumers against variations in the market-wide cost of debt over the price control period, allowing for the resetting of revenues to reflect companies' triennial valuations of the pension deficits; and protecting network company and consumers against variations in the tax regime over the price control period, including potential changes to the tax treatment of repex.

6.10. Companies will have an opportunity, as part of their business plans, to set out which uncertainty mechanisms they would find valuable in managing risk. We expect companies to justify why any additional mechanisms would be appropriate and the benefits these would bring for consumers.

Disapplication of the price control

6.11. During a price control review we seek to provide a licensee with a revenue stream that is expected to be sufficient to enable it to finance efficient delivery of its obligations. This is in the interests of consumers. If circumstances arise during the control period which means that the revenue allowance set at the price control review is insufficient to enable an efficiently managed company to finance its regulated activities, then we will consider requests from that company for amendments to its price control. This process is a way of managing the impact of highly significant, but unpredictable, events which could occur during the price control period. We expect the use of this mechanism to be rare.

6.12. We issued a guidance document in October 2009 setting out the arrangements for responding in the event that a network company experiences deteriorating financial health.[29] This document provides greater transparency and clarity on the types of circumstances under which we will reopen a price control and the associated process. These circumstances include situations in which:

- it can be demonstrated that adequate provision is not provided by the existing price control settlement
- the cause of financial distress was beyond the company's control
- re-opening the settlement could reasonably be expected to relieve the financial distress in a timely manner.

6.13. We are not proposing any changes to the disapplication licence condition or our guidance for responding to financial distress of a network company for RIIO-GD1.

[29]Arrangements for responding in the event that an energy network company experiences deteriorating financial health - Decision document, Ofgem - October 2009 http://www.ofgem.gov.uk/Networks/Policy/Documents1/GUIDANCE%20DOC%20(DECISION%20DOC)%20-%20FINAL.pdf

Mid-period review of outputs to be delivered

6.14. Recognising the scope for significant changes in outputs during an eight-year price control period, the RIIO framework proposed provision for a mid-period review of output requirements. In setting a mid-period review there is a risk that it could undermine the purpose of setting a longer control period. Consequently, we propose the scope for a mid-period review is restricted to changes to outputs that can be justified by clear changes in government policy and the introduction of new outputs that are needed to meet the needs of consumers and other network users.

6.15. We propose a qualitative materiality test to decide whether there is a material change that requires a mid-period adjustment to outputs. We do not think it is possible to capture the consumer interest within a quantitative threshold. In taking decisions on a mid-period review, we will consider the risks and downsides of potential changes, for example instability of the outputs, reducing incentives to improve output performance and administrative costs.

6.16. For RIIO-GD1 the mid-period review will take place in 2016, with any changes being implemented in March 2017.

Process for the mid-period review

6.17. If we decide that a material change is needed at the mid-period review of output requirements we will initiate the review and will consult on our proposed actions. Where there is a need for change to outputs, the review process will take up to 12 months. This includes:

- 3 months to consult, understand the issues and decide whether to progress the review
- 6 months to develop policy (Ofgem and the network companies)
- 3 months to consult on proposals and make any amendments.

6.18. Once we have published our decision on the proposed changes, if any, to output requirements, networks will need to provide notice of changes to their charges such that they can start to recover any changes to their allowed revenue at the start of the following year.

We provide further details on the proposed process for the mid-period review in supplementary annex entitled 'RIIO-T1 and GD1 Uncertainty mechanisms'.

7. Innovation

Chapter Summary

This chapter considers the role of innovation in achieving the RIIO objectives and specifically the development of a time-limited innovation stimulus that builds on the Low Carbon Network Fund (LCN Fund).

Question 1: Do you have any views on the role of innovation in RIIO-TI?
Question 2: Do you have any views on the time limited innovation stimulus?

Innovation

7.1. The network companies are likely to require significant innovation to ensure the delivery of a sustainable energy sector and that their services represent long-term value for money for existing and future consumers.

7.2. The RIIO model has a number of elements that are designed to drive such innovation, including the longer price control period, the outputs focus and strong efficiency incentives. Another important aspect of our approach is to allow companies to highlight in their business plans where they propose to roll out innovative technology, techniques or commercial strategies but which pose higher costs in the price control period than the "business as usual" approach. In these cases we would expect companies to put forward the longer term business case for the innovation and to commit to outputs relating to this expenditure.

7.3. However, where the commercial benefit of innovation is not clear, network companies may not have a strong motivation to pursue innovation in a timely way. The RIIO model includes a time-limited innovation stimulus package to supplement the incentives inherent in the RIIO price control framework.

Time limited innovation stimulus

7.4. As set out in our RIIO decision, we will introduce an innovation stimulus for electricity networks and a separate stimulus for gas networks. The gas stimulus will be available for transmission and distribution projects. Since there is already the LCN Fund in place which incentivises innovation in electricity distribution, the electricity innovation stimulus will initially only be available for projects related to electricity transmission. We have committed to retaining the LCN Fund until 2015 when the DPCR5 period ends. From that point onwards, we expect that funding arrangements to encourage innovation in the electricity distribution sector to be incorporated into the broader electricity innovation stimulus. Both the gas innovation stimulus and the electricity innovation stimulus will allow third parties to apply for project funding.

7.5. The stimulus will take the form of regular open competitions for project funding. The package design will seek to adopt many of the principles established in the LCN Fund for electricity distribution and this type of funding will be extended to other parts of the energy networks. Further details on the stimulus are set out in our supplementary annex entitled 'RIIO-GD1 Business plans, proportionate treatment, and efficiency incentives'.

7.6. We are also proposing to fund a limited amount of innovation (an innovation allowance) within companies' revenue allowance. This is similar in principle to the current Innovation Funding Incentive (IFI) and First Tier funding available under the LCN Fund, which provide innovation funding for small projects with companies self-certifying against published criteria. However unlike these mechanisms, we will require companies to set out an innovation strategy as part of their business plan, containing defined outputs which the innovation allowance will fund. We are considering whether to set the allowance as a fixed percentage of allowed revenue, or whether to allow a variable level (up to a fixed ceiling) depending on the quality of the company's innovation strategy.

7.7. The innovation stimulus package is being developed in parallel to the price controls. We recently published a consultation on this subject.[30] There are three key elements that will inform the network operators in developing their business plans:

- *Amount of funding available under each innovation stimulus.* We consider there is greater scope for the application of innovation in distribution than in transmission, and greater scope in electricity than in gas. We are inviting views on our proposal that £25m-£35m per year should be available for electricity transmission, around half that currently provided for electricity distribution (£64m), bringing total funding in electricity to between £90m and £100m a year. We are considering setting the level of funding for the gas innovation stimulus at £45m-£50m per year, available to both gas distribution and transmission. During the RPI-X@20 review we commissioned consultants KEMA to take forward a report looking at the potential for technological innovation on the GB energy networks.[31]
- *Scope for what can be funded.* The innovation stimulus in both electricity and in gas should be focussed on projects that will inform the low carbon future. We recognise that for the gas sector there may be an argument for a broader objective of contribution to long-term network sustainability and we are keen to get views on this option. We are currently consulting more widely on what types of projects the stimulus might fund.
- *Partial funding of projects*. We propose to set a maximum level of project funding from the stimulus of 80 per cent. We consider this provides an appropriate level of risk for companies to be exposed to, although we note that under the LCN Fund companies can apply to have 90 per cent of the project funded.

[30] Open letter consultation on the development of gas and electricity innovation stimuli, October 2010 http://www.ofgem.gov.uk/Networks/Policy/Documents1/Innovation%20Stimuli%20%2012102010%20Open%20Letterpdf.pdf

[31] RPI-X@20: Technological change in electricity and gas networks - KEMA report http://www.ofgem.gov.uk/Networks/rpix20/ConsultReports/Documents1/KEMA%20Technology%20changes%20Final%20Report.pdf

8. Finance Issues

Chapter Summary

This chapter sets out the main financial issues affecting RIIO-GD1. These are the basis for using economic asset lives to set depreciation allowances, the approaches for calculating the cost of debt, the cost of equity and for setting the allowed return.

Question 1: Do you consider that our proposed package of financial measures will enable required network expenditure to be effectively financed?
Question 2: Do you have any views on our proposed approach to capitalisation and depreciation policies?
Question 3: Do you have any views on our proposed approach to implementing any transitional arrangements required to address cash-flow affects from a change in our repex capitalisation policy?
Question 4: Do you have any views on our preferred approach to assessing the cost of debt?
Question 5: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 4.0-7.2 per cent (real post-tax)?
Question 6: Do you have any views on the other elements of our financeability proposals?

Financeability under RIIO

8.1. We are committed to ensuring that efficient companies are able to finance themselves (both through debt and equity). The RIIO decision document sets out a number of principles to establish a sustainable longer term package of financeability parameters which would support the considerable investment required by the network companies over the next few years, including:

- a capitalisation policy based on equalising incentives and more closely aligned with the actual split between operating and capital expenditure
- asset lives based on the average expected economic life of the assets in question
- the use of the capital asset pricing model (CAPM) supported by other approaches to determine the cost of equity
- cost of debt based on the long-term trailing average
- gearing based on a company's risk exposure
- the onus on companies to manage short term requirements within their overall corporate structure and to provide equity as necessary.

8.2. This package of measures is aimed at ensuring that the network expenditure required by 2020 can be effectively financed.

8.3. The supplementary annex 'RIIO-T1 and GD1 Financial issues', published alongside this document provides more details on our proposals on these issues and the financial methodologies including tax, pensions and the regulatory asset value (RAV).

Capitalisation Policy

8.4. In the RIIO framework, we stated that we would add a fixed proportion of costs to the RAV in order to ensure companies faced equal incentives in choosing between operating and capital solutions. We also stated that the percentage of costs capitalised would reflect the expected share of companies' capital expenditure over total costs, in order to ensure that current and future consumers bear their fair share of costs.

8.5. Under the current price control, only 50 percent of repex is added to the RAV; the other 50 percent is expensed in the year in which it is incurred. Our view is that replacement expenditure should be treated as an investment in longer life assets and capitalised at 100 per cent (instead of the current approach where only 50 percent is capitalised). Given the size of the repex programme this change in capitalisation approach could have a material impact on GDNs' cash-flows. We discuss our approach to dealing with this issue in the section below ("transitional arrangements").

Asset life and depreciation

8.6. In the RIIO decision document we stated that we would use economic asset lives to set depreciation allowances. The economic life takes into consideration both the technical life of the assets and the estimated period over which the assets will be usefully employed. We have engaged consultants to undertake a full review for us and their report is published today.[32] We have largely accepted their recommendations as a basis for our consultation.

8.7. Our consultants have highlighted that, although the technical life of gas distribution assets supports the use of the current regulatory asset life of 45 years, there is uncertainty over the long-term use of the assets. In part, this uncertainty relates to the Government's target to significantly decarbonise the energy sector by 2050.

8.8. In undertaking their analysis our consultants have considered scenarios through to 2050. These imply a range of outcomes for gas. In some scenarios the peak day demand is at a similar level to today. In other scenarios the level of gas usage is at significantly reduced levels. Some of the factors affecting the level of gas use include the development of CCS, the use of bio-methane and the high cost of providing electricity to meet peak heating requirements. We agree with the consultants that at present there is sufficient potential for gas to be useful into 2050 and we do not need to make any adjustments to the current regulatory asset life of 45 years at this time. We believe the future pathway for gas will be much clearer at the end of RIIO-GD1.

8.9. We are however concerned that if by the end of the RIIO-GD1 period the use of gas starts to decline, there will be too few customers to absorb the increased

[32] http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/WorkingGroups/Pages/WG.aspx

depreciation charges that would arise. We therefore also asked our consultants to consider whether such considerations should influence the depreciation profile. Their recommendation is that either a straight line or front-end loaded profile would be appropriate for gas distribution. We are consulting on our preference to apply a front-end loaded profile.

Transitional arrangements

8.10. In RIIO we said that where the application of the RIIO financeability principles in a single step would cause an efficient company financing difficulties, we will implement transitional arrangements.

8.11. With regard to gas distribution, we might need to consider transitional arrangements in relation to our proposal to change the capitalisation treatment of repex, if making the change in one-step gives rise to financeability concerns. We will also take into consideration changes to the depreciation profile in our assessment (where our consideration of front-loading of the depreciation profile might provide an off-setting effect).

8.12. Our current preference is to implement any transitional arrangements over one price control period if possible. However, this will depend on the business plans we receive next summer and in the first instance it will be for the companies to include proposals for transitional arrangements in their business plans reflecting their own particular circumstances.

8.13. A key input into the assessment of transition arrangements will be maintenance of credit rating ratios and consideration of equity metrics. However, as with any business that is undertaking a significant investment programme we will expect equity injection to play its role in ensuring that appropriate credit metrics are achieved.

The allowed return

8.14. We are taking a fundamentally different approach to setting the allowed return under RIIO.

8.15. We are introducing indexation of the cost of debt and will set the notional gearing on an assessment of the volatility of the cashflows faced by each business. We will need to balance a number of items in coming to a view on the appropriate notional gearing including the riskiness of the cashflows, equity and credit metrics, transitional arrangements and the cost of equity. These are described further below.

Notional gearing

8.16. We will continue to use a notional gearing assumption under the RIIO model. This will be based on an assessment of the risk of companies' cash flows.

Consequently, the level of gearing could vary across sectors and, in some circumstances, between companies within a sector. We will not be able to determine the appropriate level of notional gearing until we have seen and assessed companies' business plans. Indeed, the companies themselves will need to set out what they think the appropriate level of gearing is in their business plans next summer.

8.17. At this point we are therefore focussing on setting out the approach we will use to determining appropriate notional gearing. This approach is set out in more detail in the supporting paper.

Cost of debt

8.18. Under the RIIO model, the cost of debt assumption included in the allowed return will be based on the trailing average of a cost of debt index, with revenues updated annually to reflect changes in the index. We have evaluated a number of alternative indexes. Our preferred approach is to use a 10-year trailing average of BBB and A rated bonds. We are seeking views on this approach. Using our preferred index currently results in a cost of debt of 3.1 per cent real. We will consider developments such as Basel 3 to ensure that the index is robust to potential regulatory changes.

8.19. Further detail of the index and implementation issues are set out in the supplementary annex entitled 'RIIO-T1 and GD1 Financial issues'.

Cost of equity

8.20. As highlighted above, in the RIIO model we need to ensure that there is consistency and balance between the cash flow risk faced by companies, the level of notional gearing and the cost of equity. At this stage in the process our cost of equity assessment considers only the market factors and the risk generally experienced in the recent past by regulated businesses.

8.21. We have reviewed the cost of equity and recent precedents including the Competition Commission's Bristol Water case.[33]

8.22. We recognise the companies have made arguments that lengthening the time over which capital is remunerated could raise the riskiness of cash flows and therefore the cost of equity. Our consultants have reviewed these arguments. They have considered the theoretical arguments and sought to find empirical evidence in support of this claim. They have not found any supporting evidence and conclude that the theoretical arguments are not compelling. Nevertheless, we retain an open mind on this issue and would be pleased to consider further evidence in support of (or indeed which counters) the companies' claims.

[33] Bristol Water plc - A reference under section 12(3)(a) of the Water Industry Act 1991 - Report http://www.competition-commission.org.uk/rep_pub/reports/2010/fulltext/558_final_report.pdf

8.23. We are consulting on a cost of equity range of 4.0-7.2 per cent (post-tax real). This is based on financing assumptions and compares to the range used by the Competition Commission in Bristol Water of 3.6-6.6 per cent and a figure of 7-7.25 per cent used in the previous transmission and gas distribution controls respectively.

Other financial issues

8.24. A key issue for the gas distribution companies is the tax treatment of repex. Upcoming changes to accounting standards could result in a change in the tax treatment of repex, and lead to a significant increase in GDNs' tax liability during the review period. We propose to address this uncertainty by means of a tax trigger, which will allow companies to recover these additional costs, above the dead band, through allowed revenues if the tax treatment of repex changes.

8.25. For other financial issues (namely pensions, and other tax issues) we are largely following established policies and procedures which are set out in full detail in the supporting paper.

9. Next steps

Chapter Summary

This chapter sets out the next steps for RIIO-GD1.

There are no specific questions in this chapter.

Next steps

9.1. We welcome the views of interested parties in relation to any of the issues set out in this document. Responses should be provided no later than **4 February 2011**.

9.2. During January and February there will be a number of stakeholder events. These include:

- the next meeting of the Price Control Review Forum (PCRF) on 24 January 2011;
- further meetings of the working groups to develop further thinking on the output measures and their associated incentives
- two meetings of the financial issues working group
- the GDNs will have the opportunity to meet with our Committee of the Authority
- a City event in mid-January 2011.

9.3. We expect that the GDNs will also continue their stakeholder engagement during this period.

9.4. We intend to publish a document in late March 2011 confirming the Authority's decision on the strategy for RIIO-GDI. This will reflect the responses to this consultation and views provided through our wider stakeholder events.

9.5. Our strategy decision document will provide the information required for the GDNs to develop their well-justified business plans. The companies will be required to submit their business plans by end-July 2011.

Appendices

Index

Appendix 1 - Consultation Response and Questions

1.1. We would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from consumers and their representatives, gas and electricity transmission and distribution companies, generators and offshore gas producers/importers, suppliers, shippers, debt and equity investors, those with sustainable development interests, academics and other interested parties.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 4 February 2011 and should be sent to:

- RIIO.GD1@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish a document in late March 2011 confirming the Authority's decision on the strategy for the RIIO-GDI review. Any questions on this document should, in the first instance, be directed to:

James Grayburn
Head of RIIO-GD1
9 Millbank, London SW1P 3GE
0207 901 7483
RIIO.GD1@ofgem.gov.uk

Summary of Questions

CHAPTER: One

Question 1: Do you have any comments on the proposed process and timetable for the review?

CHAPTER: Two

Question 1: Do you agree that we have identified the key challenges facing the gas sector, and our approach to accommodating these challenges within the price review?

CHAPTER: Three

Question 1: Do you have any comments of the overall approach to stakeholder engagement?
Question 2: Do you have any views on how our engagement process and that of the network companies could be made more effective?

CHAPTER: Four

Question 1: Do you consider that the proposed outputs and associated incentive mechanisms, taken together with other element of the price control, will ensure that companies deliver value-for-money for consumers, and play their role in delivering a sustainable energy sector?
Question 2: Do you consider that the proposed outputs and incentive arrangements are proportionate (e.g. do we have too many or too few)?
Question 3: Do you have any views on the proposed outputs or incentive mechanisms?

CHAPTER: Five

Question 1: Is our proposed approach to cost assessment appropriate?
Question 2: Do you have any views on our proposed process for proportionate treatment?
Question 3: Do you have any views on the criteria for assessing business plans? Are any of the criteria highlighted inappropriate? Are there any additional criteria that should be added?
Question 4: Do you have any views on the proposed role for competition in third party delivery?

CHAPTER: Six

Question 1: Do you have any views on the uncertainty mechanisms identified?
Question 2: Are there any additional uncertainty mechanisms required that we have not identified?
Question 3: Are there any mechanisms that we have included that are not necessary and why?

CHAPTER: Seven

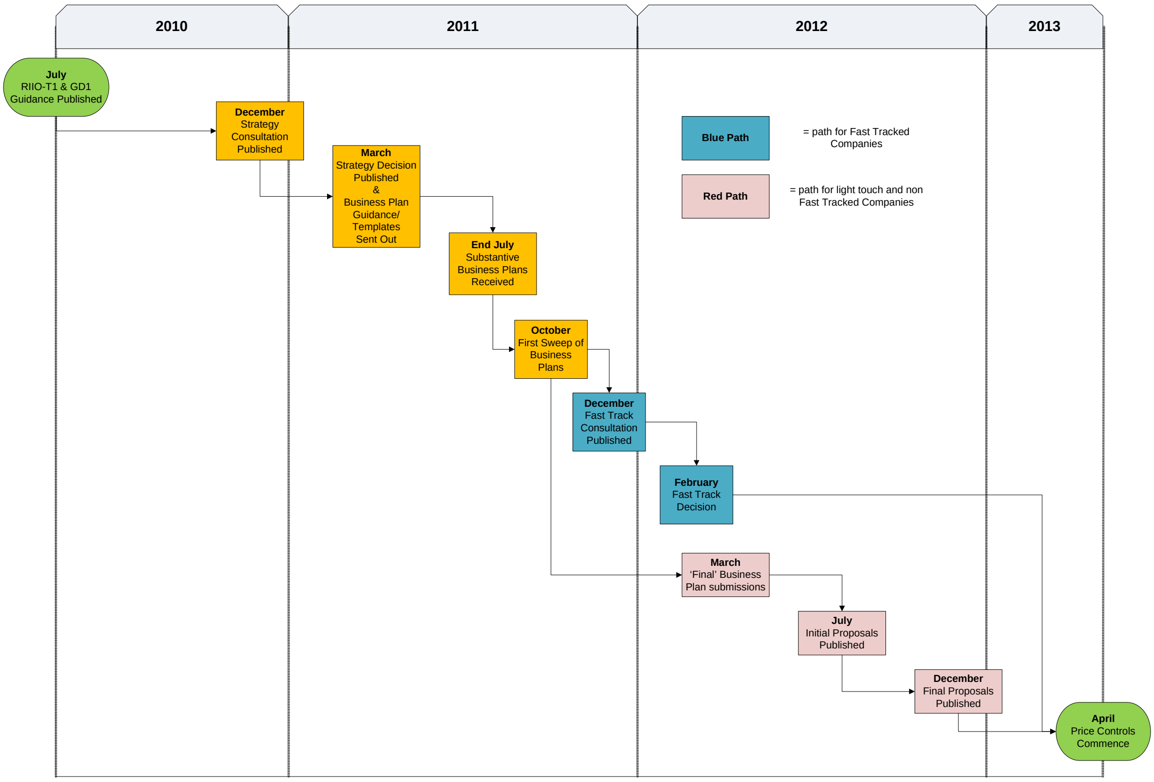
Question 1: Do you have any views on the role of innovation in RIIO-TI?
Question 2: Do you have any views on the time limited innovation stimulus?

CHAPTER: Eight

Question 1: Do you consider that our proposed package of financial measures will enable required network expenditure to be effectively financed?
Question 2: Do you have any views on our proposed approach to capitalisation and depreciation policies?
Question 3: Do you have any views on our proposed approach to implementing any transitional arrangements required to address cash-flow affects from a change in our repex capitalisation policy?
Question 4: Do you have any views on our preferred approach to assessing the cost of debt?
Question 5: Do you have any views on our proposed approach to assessing the cost of equity and the associated range of 4.0-7.2 per cent (real post-tax)?

Question 6: Do you have any views on the other elements of our financeability proposals?

Appendix 2 – RIIO-GD1 Timetable



Appendix 3 - Stakeholder Engagement Process

Engagement Process	Description of Process	Areas discussed to date	Stakeholders involved
Consultation documents	Throughout the price control process we will publish consultation documents to allow stakeholders to comment on our current thinking.	Open letter consultation published 30 July 2010 focused on the key issues for the review and its process. We received 14 responses to the RIIO-GD1 consultation.	RIIO-GD1: Network companies, environmental groups, suppliers, shippers; gas safety groups, and HSE.
Stakeholder event	Large open event (90+ people) used to summarise broad aspects of policy (e.g. consultation documents) to a wide range of stakeholders. Provides information about key policy areas we have and are considering.	Price control launch and engagement event held 7 October 2010. Presented key issues for review and gave stakeholders opportunities to discuss issues related to the output categories.	Wide range inc.: network companies, suppliers, Govt., consumer reps, the City, unions, generators, shippers, consultants and environmental groups.
Working groups	Focus on specific policy areas - testing ideas and looking at design details. Groups contain a mixture of around 15 to 20 stakeholders. Membership is open to any interested party.	Working Groups to date have looked at each of the output categories & incentives (summaries of discussions are on our website34) There was a separate workshop on financeability on 24 November.	Includes representatives from network companies, members from interested third parties e.g. environmental, safety, the City, and consumer and business groups.
Bilateral meetings	Over the review we have had numerous bilateral meeting with interested stakeholders and groups.	Discussions have been driven by the needs of particular stakeholder groups. So far in the process they have generally focused on setting out the RIIO model and key issues for	Includes: Scottish Environmental Protection Agency, Consumer Focus, network companies, regulators, LUG, SMUG, DECC and the HSE.

34 For RIIO-T1: http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/WorkingGroups/Pages/WG.aspx
For RIIO-GD1: http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/WorkingGroups/Pages/WG.aspx

		their review.	
Ofgem commissioned research	Under RIIO the onus is on network companies and stakeholders to conduct their own research to inform business plans. But, there are occasions where we need to commission our own research to elicit stakeholders' views.	We commissioned two pieces of qualitative research looking at what outputs are important for network companies to deliver from domestic and business consumers' perspectives35. Further details of the outcome from this is summarised below.	Domestic consumers and businesses
Ofgem's Website	We have sought to post relevant information in an open and timely fashion.	Summaries of the working groups, stakeholder event and the PCRF have been posted on our website and flagged to stakeholders.	

Price Control Review Forum (PCRF)

1.1. The PCRF is a new engagement tool introduced as part of the RIIO model. It provides an opportunity for network companies and stakeholders to feed into the price control review process. Its aims are to:

- allow us and network companies to hear first-hand the views of interested parties
- provide an opportunity to bring together all aspects of stakeholder engagement being undertaken by us, network companies and interested third parties
- provide an opportunity to discuss different outputs (across all the categories) and consider their interactions as a package of measures to meet the objectives of the RIIO model.

1.2. PCRF membership brings together a broad range of stakeholders including: network operators; several consumer and business representatives; unions, supplier representatives (including one for small energy suppliers); several environmental groups; and Government. A full membership list is published on our website.[36]

1.3. The first PCRF meeting was held on 4 November and largely focused on questions and discussions around our initial thinking on output measures for each of the output categories. A full summary of the proceedings, along with all the material discussed on the day can be found on our website.[37] The next PCRF is scheduled for 24 January 2011.

35 Domestic customers: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=39&refer=Sustainability/Cp/CF
Business customers:http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=41&refer=Sustainability/Cp/CF

36 http://www.ofgem.gov.uk/NETWORKS/PRICECONTROLS/PCRF/Documents1/PCRF%20final%20terms%20of%20reference.pdf

37 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=2&refer=NETWORKS/PRICECONTROLS/PCRF

Consumer Challenge Group

1.1. The Consumer Challenge Group (CCG) was first used using DPCR5 to trial a more intensive form of engagement with consumer advisors. The CCG has a critical role in ensuring that consumers' views are fully considered as part of the price control process.

1.2. A single CCG has been formed for RIIO-T1 and RIIO-GD1 comprising eight members appointed by Ofgem on the basis of their expertise in the interests of existing and future consumers and energy sector knowledge. The members are appointed in an individual capacity and not as representatives of any organisational interest. Their role in the price control review process is to provide Ofgem with advice on consumer priorities for the price control and approaches to protecting existing and future consumer interests. To help achieve this the group seeks to identify the main questions which the price control raises for consumers and how these should be addressed in the various documents published by Ofgem in the price review process.

1.3. The key areas the CCG have considered so far include:

- the potential for an environmental output measure which reflects the extent to which network companies' are actively contribution to facilitating a low carbon future network
- in terms of the way the network companies deal with their consumers, how output incentives output incentives could as far as possible mirror a competitive situation in terms of, for example, the financial impact of loss of market share resulting from poor practice
- the balance between the current focus on capex to more opex solutions – including potential for stronger consideration of commercial and operational approaches to network challenges and the potential for non network solutions (such as demand management)
- the importance of considering network companies business plans for the full eight years – looking at innovation, their abilities to plan for uncertainty, and the needs of future consumers
- how network companies could be judged on the quality of understanding of the consumers they serve rather than just the efficacy of their processes of stakeholder engagement
- striking the right balance in terms of the number of uncertainty mechanisms, recognising the impact of risk on network companies and consumers
- recognition that fast-tracking could be difficult to achieve but that proportionate treatment in itself, reflected in more tailored scrutiny, was a key incentive for companies to develop good quality business plans
- the emphasis on fuel poverty and the interests of vulnerable households
- viewing gas safety issues from a wider perspective than the HSE's iron mains replacement programme.

1.4. There have been two meetings of the CCG to date. The next meeting in January 2011 will discuss policy issues arising from the publication of this document.

Key issues highlighted by our stakeholder engagement

Process

- In general, stakeholders support our approach to the RIIO-GD1 review, and the key issues we propose to address. Some respondents raised concerns about the tight timeline of the review.

Outputs

- Stakeholders have been generally supportive of the development of primary outputs and believe the categories are broadly right. A number of stakeholders have proposed additional outputs measures including: an output in relation to minimising the volatility of network charges; an output measure in relation to incentivising the accuracy of off-take meter readings; and the need for a specific output measure in relation to vulnerable customers.
- Some stakeholders have expressed concern that there are not sufficient financial incentives being proposed to encourage network companies to play a role in delivering a low carbon economy.

Financial

- RIIO's financeability proposals remain a contentious area for network companies although, no significant new issues (since those flagged as part of the RIIO consultation) have been raised by any stakeholders.

Uncertainty mechanisms

- There has been general support for our proposed approach to setting uncertainty mechanisms including the role and scope of the mid-period review.
- The network companies have proposed additional uncertainty mechanisms, which we have set out in our detailed supplementary paper: "Supplementary appendix - RIIO-T1 and GD1 Uncertainty mechanisms".
- By contrast, suppliers are keen to see the limited use of uncertainty mechanisms to minimise the volatility of charges.
- Our discussions with other stakeholders (namely CCG) also highlighted the need to limit the number of uncertainty mechanisms.

Business plans and proportionate treatment

- In general respondents have welcomed the draft business plan guidance we published as part of the July open letter.
- Stakeholders strongly support proportionate treatment. However, network companies have expressed a number of reservations, in particular, the potential for a frontier (i.e. least-cost) GDN to receive a worse-deal under fast-tracking rather than the standard process (because of the way we set cost allowances), as well as the implications of fast-tracking for the review process.

Innovation

- Stakeholders are generally supportive of our proposals on innovation.

Appendix 4 – Responses to our July Open Letter

1.1. We received seventeen responses to our July Open Letter.[38] These included responses from the four GDN ownership groups, suppliers/shippers, trade bodies, HSE, as well as safety and environmental groups. We set out some of the key themes, and respondents' views arising from this consultation.

General

1.2. In general, the respondents believed that the Open Letter correctly identified the key issues for RIIO-GD1 (with most responses focussing on repex, outputs-based approach and financeability issues). The respondents did not identify any material issues not identified in our Open Letter.

1.3. With regard to process, a number of respondents expressed concern about our ability to keep to the timetable, particularly, given the need to accommodate the conclusions of the HSE review, develop output measures, and ensure constructive engagement with stakeholders.

Our response/ steps taken

1.4. We note the concerns about the tight nature of the timetable for RIIO-GD1. We recognise that the timetable is tighter in the early stages of the review than in previous controls to enable us to introduce the potential for fast-tracking companies that submit well-justified business plans. We have conducted extensive stakeholder consultations as part of the December Initial Strategy Consultation, and our stakeholder engagement process will continue through the review process, i.e. beyond the Strategy Consultations.

Repex

1.5. Almost all respondents highlighted repex as a priority issue for the review. The GDNs (as well as SBGI) emphasised the importance of the programme with regard to public safety, and the legal constraints on changing the programme. GDNs also emphasised environmental benefits of programme.

1.6. Other respondents' expressed concern about the costs and benefits of the programme, and Centrica has commissioned a consultancy to undertake a cost benefit study. Centrica also argue that all repex should be capitalised, consistent with RIIO principles.

Our response/ steps taken

1.7. We continue to engage constructively with the HSE regarding their review of the repex programme. In order to accommodate uncertainty with respect to the outcome of their review, we have set out our proposals for a repex trigger which will enable us to re-consider the repex programme within the price review if the HSE changes its current policy. We have also started to work with the network companies on an overall risk-

[38] Gas Distribution Price Control 2 (GDPCR2) – the way forward.
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Pages/ConRes.aspx

based approach to asset management, which we consider is an integral part of ensuring value-for-money for consumers. We have also held discussions with the HSE with regard to our proposed risk-based approach.

1.8. With regard to capitalisation of repex, we propose to fully-capitalise repex, consistent with RIIO principles.

Environmental issues (leakage)

1.9. There was broad support for the retention of the leakage model developed at GDPCR1 to address network owners' greenhouse gas emissions (GHG).

1.10. The GDNs and Centrica discussed whether a model could be developed based on actual (as opposed to modelled) leakage. One GDN suggested that it might be appropriate to base the shrinkage model on actual losses post-2020 (i.e. smart meter roll-out) when robust settlement data will be available.

Our response/ steps taken

1.11. We have set out proposals for continuation of the shrinkage allowance mechanism and EEI developed for GDPCR1, with a few modifications (e.g. changes to the approach to the valuation of carbon abatement). We have also set out proposals for the development of an incentive framework based on actual shrinkage when such data become available.

Bio-methane

1.12. Some GDNs stated that Ofgem should go beyond eliminating barriers to bio-methane development towards more active support. For example, some GDNs consider that charging arrangements will need to be reviewed if bio-methane is to become a viable option, including adopting a policy similar to the incentives provided to DNOs to connect DG.

Our response/ steps taken

1.13. We have set out detailed proposals to ensure there are no regulatory barriers to the development of bio-methane. This include consulting on whether we should extend current standards of connection to entry-customers, and the provision of technical information to bio-methane producers. We also invite respondents' views on potential changes to the connection and use of system (UoS) charging arrangements, as well as recovering the costs of bio-methane plant within general network charges.

CO poisoning

The responses were supportive of GDNs undertaking measures to address CO poisoning events. In our proposals, we note that the GDNs are undertaking a number of trials, and we expect to provide revenues and develop associated output measures for the roll-out of successful trials for RIIO-GD1.

xoserve

1.14. There was broad support for our proposed review of xoserve's governance and funding arrangements, although respondents' expressed opposing views regarding the quality of service provided by Xoserve. A number of shippers consider that the service offered by xoserve is poor (and comparatively poor to Elexon.) ICoSS note that one of its members has raised a UNC review proposal (0334) to examine the funding and governance arrangements of Xoserve to feed into the price review process. By contrast, xoserve state that they consistently perform well in surveys of customer satisfaction.

Our response/ steps taken

1.15. We have set out proposals for a review of xoserve which we expect to undertake early in 2011. Our review will consider both the allowed revenues and associated outputs, as well as alternative governance and ownership models. In developing our policy recommendations, we will also draw on the UNC review of the industry.

Capacity outputs

1.16. National Grid welcomed our proposal to investigate GDNs incentives with regard to booking NTS capacity to meet load growth. They consider that we should take the opportunity of the two reviews to align the GDNs and NTS incentives to provide capacity.

Our response/ steps taken

We have established a capacity outputs working groups which comprises NGG, GDNs, and other stakeholders to development of the framework for providing flex and firm capacity on the NTS, as well as other issues in relation improving the incentive framework with regard to providing incremental capacity on GDNs networks.

Financeability

1.17. The network operators continued to raise concerns about the RIIO financeability proposals, and in particular, the impact of changes to depreciation and capitalisation policies on cash-flows. On the other hand, Centrica welcomed the proposals to align depreciation profiles with economic lives, and the prospect for lower customer bills.

Our response/ steps taken

1.18. We note that our financeability proposals are an important part of the overall RIIO model and we have sought to provide greater clarity to stakeholders as part of this consultation to address their concerns. For example, we have set out how we propose to index the cost of debt as well our approach to measuring asset lives and our depreciation policy.

1.19. As part our consultation we are setting out our approach for the development of transitional arrangements to ensure that the cash flows of the network companies are not unduly impacted by the move to these arrangements.

1.20. We recently held a finance working group to discuss and understand key areas of concerns with our proposals. We continue to believe that our approach to financeability, rather than deterring investors will encourage investment, through the provision of a commitment to a set of transparent principles.

Appendix 5 - The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008 and 2010) as well as arising from directly effective European Community legislation.

1.3. References to the Gas Act and the Electricity Act in this appendix are to Part 1 of those Acts.[39] Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This appendix must be read accordingly.[40]

1.4. The Authority's principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

1.5. The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with,

- the shipping, transportation or supply of gas conveyed through pipes
- the generation, transmission, distribution or supply of electricity
- the provision or use of electricity interconnectors.

1.6. Before deciding to carry out its functions in a particular manner with a view to promoting competition, the Authority will have to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner (whether or not it would promote competition) in which the Authority could carry out those functions which would better protect those interests.

1.7. In performing these duties, the Authority must have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met
- the need to secure that all reasonable demands for electricity are met

[39] Entitled "Gas Supply" and "Electricity Supply" respectively.
[40] However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them[41]
- the need to contribute to the achievement of sustainable development.

1.8. In performing these duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[42]

1.9. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed[43] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems; protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and secure a diverse and viable long-term energy supply, and shall, in carrying out those functions, have regard to the effect on the environment.

1.10. In carrying out these functions the Authority must also have regard to:

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.11. The Authority may, in carrying out a function under the Gas Act and the Electricity Act, have regard to any interests of consumers in relation to communications services and electronic communications apparatus or to water or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

1.12. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[44] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

[41] Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Acts in the case of Electricity Act functions.
[42] The Authority may have regard to other descriptions of consumers.
[43] Or persons authorised by exemptions to carry on any activity.
[44] Council Regulation (EC) 1/2003.

Appendix 6 - 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