

RIIO - (Revenue = Incentives + Innovation + Outputs)

RIIO UPDATE

ISSUE **01**
AUGUST 2011

Features in this issue include...

Key progress so far and a future timetable

An update on the "broad environmental measure"

A look at the work of the Price Control Review Forum and the Consumer Challenge Group

Welcome to the first issue of an occasional newsletter giving updates on Ofgem's implementation of RIIO – our new performance-based model for network regulation.

Strong stakeholder engagement is integral to the success of RIIO. This newsletter aims to keep you up-to-date with developments on the road to April 2013, when the first price controls using the RIIO model start. These are for the high voltage electricity and high pressure gas transmission networks (RIIO-T1) and the local gas distribution networks (RIIO-GD1).

Households and businesses depend on these network companies to deliver secure energy supplies. Power generators rely on them to get their electricity into the grid effectively and there are many new renewable generators waiting to get connected. The gas networks play a big role in safely delivering gas to heat homes, power businesses and fuel many electricity generators. These networks are a critical part of Britain's energy systems so it is crucial that we get the regulation right.

About RIIO

Britain's energy networks face significant new challenges, not least meeting the need for an estimated £30 billion of investment in the next decade. As the sector's economic regulator, Ofgem must ensure that this investment – vital for secure and sustainable energy supplies – is delivered to time and at a fair price for consumers.

To help achieve this, Ofgem developed RIIO (Revenue=Incentives+Innovation+Outputs) – a new performance based model for setting the network companies' price controls. RIIO is designed to:

- » encourage network companies to play a full role in delivering a low carbon economy and wider environmental objectives
- » invest efficiently to ensure continued safe and reliable services
- » innovate to reduce network costs for current and future consumers.

Where are we now?

At the end of March we hit the first key RIIO milestone when we announced strategy decisions that set out the key elements of RIIO-T1 and RIIO-GD1.

In case you missed it, here are some of our key proposals

INCENTIVES

A strong financial package that will allow efficient companies to finance their activities. This includes an indicative range for **cost of equity** (the return on an investment required by shareholders) of 6.0 - 7.2 per cent and an indexed cost of debt that better reflects market conditions. All companies will be given incentives to outperform baselines significantly if they demonstrably deliver for consumers.

INNOVATION

A £400 million **Network Innovation Competition** to drive innovation that enables networks to deliver a more environmentally friendly energy sector faster and/or cheaper. This builds on the successful Low Carbon Networks Fund already in place for electricity distribution networks.

OUTPUTS

Measures for safety, reliability, environment, customer satisfaction and stakeholder engagement; with strong financial and reputational incentives for efficient delivery. Examples for gas distribution companies include measures to encourage them to make timely and efficient network connections for biomethane plants and to aid them to step up efforts to reassess and improve the role they play in addressing fuel poverty and carbon monoxide poisoning.

Business plans

The four transmission companies (TOs) have now submitted their business plans, using the framework we set out in our March strategy documents.

Well justified business plans are an essential element of RIIO. They will encourage companies to take responsibility for developing and justifying a long-term strategy for delivering the network services that their customers value.

In their business plans, companies must set out and justify:

- » the services and outputs they will deliver to customers during the price review period, taking account of their own stakeholder engagement
- » the revenue they require to deliver these outputs, including evidence that their proposed operating and capital expenditure requirements are efficient in the long term
- » their financing requirements (the required return on equity, cost of debt and any transitional arrangements.)
- » how they will address risk and uncertainty in formulating the plan.

We are very keen for stakeholders to review the business plans and send us their feedback.

You can read more about what we want to know and how you can respond in our open letter of 10 August at <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/Pages/RIIO-T1.aspx>. This letter includes links to the four TO's business plans.

Ofgem will review these plans to determine what levels of proportionate treatment - that is the level of scrutiny - we will apply. Where a plan is of particularly high quality we will also determine if any of the TO's new price controls can be agreed early - or *fast-tracked* - by February 2012

The deadline for the **eight gas distribution companies** to submit their business plans for RIIO-GD1 has been extended until 30 November 2011 so they can take account of significant changes to the iron mains replacement programme recently announced by the Health and Safety Executive (HSE). The HSE wants gas distribution networks (GDNs) to remove the riskiest iron mains first and decide on the management of the remainder of their iron mains on a similar basis to the way they manage other assets.

Due to this extended timetable it is now unfeasible for us to reach a decision on proportionate treatment and potential fast-tracking for the GDNs by February 2012, as we said in our original timetable. However, it may still be possible to settle price controls for GDNs who submit well-justified business plans around the Initial Proposals stage.



Hannah Nixon is Ofgem's Partner for Smarter Grids and Governance who has been a key player in developing RIIO. Here she outlines the new model's revolutionary potential

In many ways RIIO is an evolution of our previous regulatory regime; retaining the best bits, evolving others and bringing new things.

But it has the potential to drive a revolution in terms of the way network companies deliver for consumers. It will not be possible to assess fully the impact of RIIO for some time, but the early signs are good. The language we hear from the network companies and from the wider industry is much more customer focussed, outputs focussed and proactive.

There's much greater engagement with stakeholders, and we're seeing groups that historically have tended not to engage in price controls actively participate. We've also been told by several network companies that RIIO has fundamentally changed the debate on price controls at their boards, from a cost-return based one to a customer-outputs focussed one.

Stakeholders matter

We want to optimise stakeholders' opportunities to engage in RIIO-T1 and RIIO-GD1, so we have established a range of media to help and encourage debate and involvement. Read about two of the most important below:

The **Price Control Review Forum** (PCRF) meets at key points during the price control review process, to bring together all aspects of stakeholder engagement being undertaken by Ofgem, network companies and interested third parties. It aims to:

- » provide opportunities for network companies and their stakeholders to feed *directly* into the price control review process
- » allow Ofgem and network companies to hear interested parties' views first hand.

As well as Ofgem and the network companies, membership of the PCRF also includes representatives from suppliers, generators, government, environmental groups, energy users, consumer groups and unions.

Feedback from meetings has been very positive. At the most recent, network companies gave presentations on their business plans, including what they had gleaned from their own stakeholder engagement. Some emerging issues include that:

- » suppliers want transparency and predictability in network charges and GDNs will feed this into their business plan. One GDN said they intended to propose a specific measure to help suppliers in this respect
- » customers have been positive about the RIIO proposal that GDNs play a role in reducing the risk of carbon monoxide poisoning
- » GDNs were very positive about the role increased stakeholder engagement was playing in developing their business plans and one noted that the RIIO process has helped get "customers" talked about

within their company more than ever before

- » TOs flagged up the challenge of maintaining current levels of security of supply given the need for massive investment, specifically planning and keeping stakeholders informed
- » customers of transmission networks expected charges to increase but believed that keeping charges down is very important.

We intend to hold the next PCRF meeting towards the end of this year and will post the details on our website.

The **Consumer Challenge Group** is a panel of experts, appointed by Ofgem, who meet regularly to give us consumer insight into some of the more complex issues that we are unable to address through market research.

At their latest meeting the group gave feedback on the RIIO strategy decisions and their views on proposals for a broad environmental measure, visual amenity and customer satisfaction. In particular, they examined the possibility of a qualitative measure to the broad environmental measure using a 'balanced scorecard' to assess companies' behaviour to help facilitate low carbon flows on the networks.

The Consumer Challenge Group will meet with Ofgem and the TOs in early autumn to give their input to Ofgem's assessment of the companies' business plans.

Members of the Group are: Solitaire Townsend, (Co-Founder Futerra), Tony Grayling (Head of Climate change and Sustainable Development, Environment Agency), Simon Roberts (Chief Executive, Centre for Sustainable Energy), Trisha McAuley (Deputy Senior Director at Consumer Focus Scotland), Sharon Darcy (non-executive Director at Consumer Focus), Bob Spears (Chairman – Utility Consumers Consortium), Jeremy Nicholson (Director, Energy Intensive Users Group), Gill Owen (Chair, Public Utilities Access forum and Senior Research Fellow Warwick Business School).

Update on Broad Environmental Measure

In our March RIIO-T1 strategy we said we would consult on applying financial incentives for electricity TOs against the **broad environmental measure** of contributing to a low carbon economy.

It is important that any financial incentives for electricity TOs in relation to the broad environmental measures deliver positive environmental outcomes and complement the wider policy and delivery landscape. Therefore, we propose to consult on potential financial incentives after we have reviewed the companies' business plans and had time to consider the implications of the government's Electricity Market Review.

Get involved in RIIO

Access this webpage to see the latest RIIO documents and get news of upcoming stakeholder engagement events, including the Price Control Review Forum:
<http://www.ofgem.gov.uk/Networks/PriceControls/Pages/PriceControls.aspx>

You can also view or join our growing RIIO Web Forum – an opportunity for interested parties to submit analysis and papers that contribute to the reviews.

RIIO schedule

RIIO-T1

RIIO-GD1

2011	Timetable
31 July	TOs submitted business plans to Ofgem
August	TOs publish business plans on their websites and Ofgem invites interested parties to send their views to the regulator
October	Ofgem publishes initial views on TO Business Plans including views on potential proportionate treatment and fast tracking eligibility
30 November	GDNs to submit business plans to Ofgem (see previous note on deadline extension)
December	Ofgem to consult on TO fast-tracking
2012	
February	TO Fast Track Final Decision published
March	Feedback on GDN business plans published
July/August	TO and GDN Initial Proposals published
November/December	TO and GDN Final Proposals published
2013	
1 April	RIIO-T1 and RIIO-GD1 begin



Your feedback

We hope that stakeholders have found the first RIIO Update useful. If you would like to send any feedback to help us make the next RIIO Update even better, please email:
alison.wright@ofgem.gov.uk

