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all gas and electricity customers*

To generators, shippers,
suppliers, network companies,
consumers and their
representatives, the sustainable
development community,
investors and other interested
parties

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Dear colleague

RIIO-T1: Initial Proposals for National Grid Electricity Transmission plc and National Grid Gas plc - Headlines

The next transmission price control (RIIO-T1) is the first price control¹ to be conducted under our new RIIO (Revenue = Incentives + Innovation + Outputs) model. The price control is due to run from 1 April 2013 to 31 March 2021. The objective of RIIO is to encourage network companies to play a full role in the delivery of a sustainable energy sector, and to do so in a way that delivers value for money for existing and future consumers.

This letter sets out the headlines of the Authority's decision on the Initial Proposals for National Grid Electricity Transmission plc (NGET) and National Grid Gas plc (NGGT). It provides a high-level summary of our assessment of the companies' business plans. Further detail on our proposals and our justification for those proposals will be set out in our Initial Proposals document which we will publish on 27 July. We will seek views from stakeholders at that point.

In the meantime, if you would like to discuss any aspect of this letter, please contact Grant McEachran on 0141 331 6008 or by e-mailing grant.mceachran@ofgem.gov.uk.

Background

Under the RIIO process, network companies are required to take into account the needs and views of stakeholders in order to submit to us well-justified business plans. In March 2011, we set out our Strategy Decision for RIIO-T1.² This set out decisions on the key aspects of the regulatory framework. It also set out what we expected to see in a well-justified business plan and the criteria against which we would assess such a plan. We used five broad criteria to assess the plans:

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

¹ We are also currently in the process of setting price controls for the gas distribution companies – RIIO-GD1.

² Decision on strategy for the next transmission price control: RIIO-T1 – Ofgem, 31 March 2011 Ref:46/11
<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decision.pdf>

We received the initial transmission owners' (TOs) RIIO-T1 business plans at the end of July 2011. Following our assessment of those plans we retained SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd (SHELTL) in the fast-tracking process.³ We published Initial Proposals for SPTL and SHELTL in February 2012 and Final Proposals in April 2012.

We decided not to retain NGET and NGGT in the fast-tracking process. Consequently, NGET and NGGT reverted to the non-fast-tracking process and submitted updated versions of their business plans on 2 March 2012. NGET's and NGGT's updated plans are available at the following links:

- NGET – <http://www.talkingnetworkstx.com/electricityplan/our-business-plan.aspx>
- NGGT – <http://www.talkingnetworkstx.com/gastransmissionplan/our-business-plan.aspx>

Assessment of updated business plans

This section summarises our updated assessment of each of NGET's and NGGT's revised business plans. This covers the five broad criteria we used in the initial assessment.

Our updated assessment is based on all of the information provided to us as part of this process. It is also informed by responses to our March business plan assessment⁴, views received from the Consumer Challenge Group (CCG)⁵ and information provided by other stakeholders.

NGET

NGET has followed a broadly robust process in developing its revised plan which is well informed by a further detailed round of stakeholder engagement.

NGET has largely addressed our outstanding issues with its proposed outputs and its business plan provides the basis for our Initial Proposals in these areas. NGET has also provided an improved coverage of innovation in its plan.

NGET's revised costs are broadly comparable to those set out in its initial business plan. Our analysis has highlighted that the proposed unit costs are high using comparisons with TPCR4, the Scottish TOs and our consultants' reviews. Further, we have identified some efficiency challenges in relation to maintenance, indirect and business support costs.

In relation to uncertainty, NGET provided good coverage of its risks. However, we retain concerns with the number and scope of some of its proposed uncertainty mechanisms and whether these adequately protect customers from risk. While we are proposing to accept NGET's proposals in a number of areas, we do not intend to include uncertainty mechanisms in all of the areas NGET has requested and in others we are proposing alternative approaches from that proposed by NGET.

NGET's financial proposals remained largely unchanged between business plans although it did provide further supporting material for its proposed financial package. However, we remain unconvinced by many of its arguments, including in relation to its proposed cost of equity, notional gearing, transitional arrangements and approach to totex capitalisation.

³ Where business plans are of sufficient quality, fast-tracking provides a process whereby we can reach early settlement of a company's price controls, ie their business plans may be "fast-tracked".

⁴ RIIO-T1: Publication of the revised business plans of NGET plc and NGG plc
<http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/NGET%20BP.pdf>

⁵ The CCG comprises consumer and environmental experts acting as a critical friend to Ofgem in the RIIO-T1 and RIIO-GD1 processes.

NGGT

NGGT has followed a similar process to NGET and undertaken further stakeholder engagement in a number of areas. However, from our own discussions with stakeholders it has become clear that, in a number of key areas of its plan, NGGT has discussed key issues with its stakeholders but not the detail of its proposals which it has subsequently set out in its business plan. This is not what we would expect of a 'well-justified business plan'.

NGGT presents an improved coverage of outputs in its updated business plan. However, in relation to availability NGGT has proposed some fundamental changes to its treatment of incremental capacity which require further consideration and development with industry and necessitate the introduction of an interim arrangement from the start of RIIO-T1. NGGT has provided improved coverage of innovation in its plan.

NGGT's revised costs are broadly comparable to those set out in its initial business plan. However, our analysis has highlighted some issues with NGGT's proposed baseline volumes, unit costs for compressors and other non-load-related capex. We also consider there is uncertainty on the timings and amounts of some expenditure proposed by NGGT. Finally, we have some queries on the efficiency of NGGT's operating costs reflecting TPCR4 comparisons and our consultants' reviews.

In relation to uncertainty, NGGT again provided good coverage of its risks. However, we retain some concerns with the number and scope of some of its proposed uncertainty mechanisms and whether these adequately protect customers from risk. While we are proposing to accept NGGT's proposals in a number of areas, we do not intend to include uncertainty mechanisms in all of the areas NGGT has requested and in others we are proposing alternative approaches from that proposed by NGGT.

NGGT's financial proposals remained largely unchanged between business plans although it did provide further supporting material for its proposed financial package. However, we remain unconvinced by many of its arguments, including in relation to its proposed cost of equity and notional gearing.

Summary of basis of NGET's and NGGT's Initial Proposals

We will publish the Initial Proposals for NGET and NGGT shortly. The key elements of those Proposals are summarised below. Further detail on the cost and financial components is set out in Annex 1 to this letter.

Table 1: Summary of overall cost parameters 2013-21 (£bn)

Expenditure 2009/10 prices (£bn)	NGET (T0)	NGET (SO)	NGGT (T0)	NGGT (SO)
Baseline capex	9.1	0.2	0.8	0.3
Capex (UMs)	2.6	-	2.6	-
Opex	2.2	0.6	1.5	0.3
Totals after IQI adjustment	13.9	0.8	4.9	0.6

Table 2: Summary of financial parameters

Financial parameters	NGET (T0)	NGET (SO)	NGGT (T0)	NGGT (SO)
Cost of equity (post-tax real)	7%		6.8%	
Notional gearing	60%		62.5%	
Cost of debt (pre-tax real)	10 year simple average index		10 year simple average index	
Asset life transition	8 years	Already 7 years	Already 45 years	Already 7 years
Totex capitalisation rate	Single rate 85%	31%	Base Totex 53%; Incremental Totex 90%	37%

Table 3: Summary of other key parameters

Area	NGET	NGGT
Outputs	<p>Complete range of RIIO outputs:</p> <ul style="list-style-type: none"> • Safety – provide a safe network in compliance with legal safety requirements • Reliability – minimise energy not supplied and optimise costs associated with network unavailability • Customer satisfaction - maintain a high level of customer and stakeholder satisfaction informed by a customer survey • Customer connections – encourage networks to connect in a timely and efficient way • Environmental – a range of measures – see below 	<p>Complete range of RIIO outputs:</p> <ul style="list-style-type: none"> • Safety – provide a safe network in compliance with legal safety requirements • Reliability – meet existing reliability obligations and existing times for providing new network capacity • Customer satisfaction - maintain a high level of customer and stakeholder satisfaction informed by a customer survey • Customer connections – encourage networks to connect in an efficient way • Environmental – a range of measures – see below
Environmental strategy	<p>A range of measures including:</p> <ul style="list-style-type: none"> • Financial incentive on reducing Sulphur hexafluoride (SF6) emissions • Reputational incentives on contribution to fewer losses and on Business Carbon Footprint • Initial expenditure cap of £100m to reduce the impact of existing infrastructure in designated areas⁶ • Environmental Discretionary Reward – to focus on aspects of TOs’ roles not captured in RIIO-T1 incentives 	<p>A range of measures including:</p> <ul style="list-style-type: none"> • Reputational incentives on Business Carbon Footprint • Change for compliance with the Industrial Emissions Directive (IED) in relation to compressor replacement • NGGT outlined measures to reduce venting through the development of innovative techniques to optimise maintenance scheduling, compressor operation and decompression techniques
Uncertainty mechanisms	<p>A range of mechanisms including, but not limited to:</p> <ul style="list-style-type: none"> • Volume drivers in relation to generation and demand connections and for boundary capability and non-boundary wider-works • Volume driver to mitigate the impacts of new infrastructure on visual amenity • Reopener for specific pre-defined and material events • Scope for a mid-period review to address specific areas of uncertainty if required 	<p>A range of mechanisms including, but not limited to:</p> <ul style="list-style-type: none"> • Requirement for further expenditure in relation to the Industrial Emissions Directive (IED) • Reopener for specific pre-defined and material events • Scope for a mid-period review to address specific areas of uncertainty if required
Efficiency incentive rate	48%	45%

⁶ Expenditure cap will ensure funding is available to deliver visual amenity outputs in designated areas at start of RIIO-T1. This will also give NGGT additional time to provide further justification for the level of the expenditure cap for the remainder of RIIO-T1.

Innovation

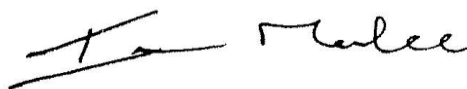
In our March strategy decision, we decided to set the maximum allowed funding for the gas distribution and transmission Network Innovation Competition (NIC) at £20m per annum. For the electricity transmission companies we set a maximum of £30m per annum. At Initial Proposals, we will consult on funding options for the gas NIC.⁷

We propose to allow NGET and NGGT a Network Innovation Allowance (NIA), designed to support small scale innovation projects, equal to 0.6% of revenues.

Next steps

We intend to publish our Initial Proposals for NGET and NGGT on 27 July 2012. We will provide an eight week consultation period and will require responses by 21 September. We intend to publish our Final Proposals in December 2012.

Yours faithfully



Ian Marlee
Senior Partner, Smarter Grids and Governance: Transmission

⁷ In our March strategy decision we stated that we would implement the equivalent funding model for NIC as for the Low Carbon Network Fund (LCNF) for the electricity distribution sector. However, as set out in our recent consultation decision, we require statutory change to introduce such a funding model. At Initial Proposals, we will consult on alternative funding options.

<http://www.ofgem.gov.uk/Networks/nic/Documents1/March%20decision%20document%20Final.pdf>

Annex 1 – Further detail on Initial Proposals

This annex sets out further detail on our Initial Proposals for National Grid Electricity Transmission plc (NGET) and National Grid Gas plc (NGGT).

In a number of areas this annex highlights the differences between the 'company submission' and our Initial Proposals. The company submission refers to the information provided by NGET and NGGT in their revised RIIO-T1 business plans in March 2012.

Cost proposals

Table 1 – Proposed capex and opex

2009/10 prices (£bn)	Total capex (best view ⁸)			Opex		
	Company submission	Ofgem Initial Proposals	% Diff	Company submission	Ofgem Initial Proposals	% Diff
NGET TO	13.3	11.7	-13%	2.6	2.2	-15%
NGGT TO	5.4	3.4	-38%	1.5	1.5	-3%
NGET SO	0.3	0.2	-35%	0.7	0.6	-21%
NGGT SO	0.4	0.3	-25%	0.3	0.3	-23%

Total capex comprises both baseline capex and capex provided through uncertainty mechanisms. The breakdown for NGET(TO) and NGGT(TO) is set out in Table 2.

Table 2 – Baseline capex vs. capex provided under uncertainty mechanisms

2009/10 prices (£bn)	NGET TO			NGGT TO		
	Baseline Capex	Uncertainty mechanisms	Total Capex	Baseline Capex	Uncertainty mechanisms	Total Capex
Company proposal	12.0	1.3	13.3	1.8	3.7	5.4
Initial Proposal	9.1	2.6	11.7	0.8	2.6	3.4

Reasons for reduction in costs

In total we have proposed reductions to the costs set out by NGET in its business plan of around £2bn for the TO and a further £0.25bn for the SO. This comprises:

- Capex efficiency challenges resulting in reductions in unit costs derived from comparisons to TPCR4, the Scottish TOs and consultants' evidence and including reductions to Real Price Effects (RPEs). This accounts for 60% of the reduction.
- Opex efficiency challenges account for around 20% of the reduction.
- Expenditure relating to the delivery of outputs in RIIO-T2. This account for around 20% of the reduction.
- In addition, we have moved around £1bn of expenditure which NGET had proposed in its baseline into uncertainty mechanisms. This is to reflect to uncertainties on timings and amounts associated with some projects.
- For the SO our proposed reduction reflects capex and opex efficiency challenges and a reduction in requested expenditure associated with the construction of a new data centre.

⁸ 'Best View' is the expenditure that we consider the licensees will need to deliver the outputs under their central scenario. It comprises 'baseline' and 'uncertainty mechanism' funding. 'Baseline' is the expenditure that is funded through ex ante allowances. 'Uncertainty Mechanism' funding is either provided automatically where outputs are delivered over the baseline level, or is triggered by events defined in the transmission licences, or is provided at certain times during the price control period after further assessment by Ofgem of needs case and costs.

In total we have proposed reductions to the costs set out by NGGT in its business plan of around £2.1bn for the TO and a further £0.14bn for the SO. This comprises:

- Changes from NGGT's incremental capex forecasts account for around 60% of the reduction.
- Reduced volumes and unit costs for compressors and other capex accounts for around 25% of the reduction.
- The combination of opex efficiency challenges and reductions in RPEs account for around 15% of the reduction.
- In addition, we have moved around £0.5bn of expenditure which NGGT had proposed in its baseline into uncertainty mechanisms. This is to reflect to uncertainties on timings and amounts associated with some projects.
- For the SO our proposed £0.14bn reduction reflects capex and opex efficiency challenges and a reduction in requested expenditure associated with the construction of a new data centre.

RAV values

Tables 3 and 4 set out the provisional RAV values for RIIO-T1 for NGET and NGGT respectively.

In addition, Transmission Investment in Renewable Generation (TIRG) expenditure for NGET and existing revenue drivers in gas transmission are remunerated outside the main RAV (ie in a 'shadow RAV') until the end of the incentive period. These are reflected separately for both NGET and NGGT in the tables below.

Table 3 – NGET TO & SO RAV values for RIIO-T1

2009-10 Prices £m	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Opening RAV	8,756							
Opening shadow RAV	96							
Closing RAV	9,691	10,748	11,665	12,670	13,344	13,997	14,334	14,402
Closing Shadow RAV	90	85	80	0	0	0	0	0

Table 4 – NGGT TO & SO RAV values for RIIO-T1

2009-10 Prices £m	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Opening RAV	4,125							
Opening shadow RAV	548							
Closing RAV	4,412	4,477	4,644	4,913	5,756	6,111	6,451	6,801
Closing Shadow RAV	312	330	392	484	72	22	1	0

Financial parameters

Tables 5a and 5b set out the proposed financial parameters for NGET and NGGT. For completeness the parameters are compared to the companies' own proposals. Our financeability tests seek to ensure that companies can achieve credit ratios consistent with a comfortable investment grade credit rating based on notional financial structures (ie 60% gearing for NGET and 62.5% gearing for NGGT).

Table 5a – NGET key financial parameters

Parameter	NGET (TO) Company proposal	NGET (TO) Our view	NGET (SO) Company proposal	NGET (SO) Our view
Cost of equity	7.5%	7%	7.5%	7%
Cost of debt	10 year simple average index	10 year simple average index	10 year simple average index	10 year simple average index
Notional gearing	55%	60%	55%	60%
Asset lives transition	16 years	8 years	Already 7 years	Already 7 years
Totex capitalisation	Base totex 86% Uncertainty Mechanism Totex 100%	Single rate 85%	31%	31%
Notional new equity	£2.5bn	£1.3bn	N/A	N/A

Table 5b – NGGT key financial parameters

Parameter	NGGT (TO) Company proposal	NGGT (TO) Our view	NGGT (SO) Company proposal	NGGT (SO) Our view
Cost of equity	7.5%	6.8%	7.5%	6.8%
Cost of debt	10 year simple average index	10 year simple average index	10 year simple average index	10 year simple average index
Notional gearing	55%	62.5%	55%	62.5%
Asset lives transition	Already 45 years	Already 45 years	Already 7 years	Already 7 years
Totex capitalisation	Base totex 57% Incremental Totex 90%	Base totex 53% Incremental Totex 90%	37%	37%
Notional new equity	£0.9bn	£0bn	N/A	N/A

Key points on the financial proposals

Cost of debt: Both NGET and NGGT have accepted our approach to annually updating the cost of debt assumption based on a 10-year simple trailing average index. For the purpose of modelling allowed revenue, we have used the same 3.03 per cent assumption as in the fast-track Final Proposals.

Cost of equity and notional gearing: In the Strategy Decision document we set out a range of 6.0-7.2 per cent for the cost of equity. We consider that this range remains appropriate for RIIO-T1. The RIIO principles dictate that the allowed return should reflect cash flow risk. Having assessed cash flow risk in our Initial Proposals package, we consider that NGGT faces notably lower cash flow risk than NGET, in part due to it having a lower investment rate (relative to RAV). Therefore, we consider the appropriate package for NGGT to assume 6.8 per cent cost of equity and 62.5 per cent notional gearing; and the appropriate package for NGET to assume 7 per cent cost of equity and 60 per cent notional gearing.

Asset lives and depreciation: NGET accepted our proposal to depreciate new assets over 45 years on a straight line basis, but sought 16 years transition from the current 20-year depreciation profile. We consider transition to be conditional on the financeability need and have identified 8 years transition as appropriate for NGET to achieve financeability given our Initial Proposals package.

Totex capitalisation: Both NGET and NGGT sought split capitalisation rates between base totex and incremental totex. We consider this appropriate in the case of NGGT, where incremental totex may result in significantly higher overall spend than the base level. For NGET, incremental totex is relatively small compared to the overall investment level. Therefore, we think that a single capitalisation rate would suffice.

Financeability: We have assessed our Initial Proposals against the criteria for attaining a 'comfortable investment grade' credit rating and have found them appropriate. We have stress-tested this and consider our Initial Proposals robust under a range of scenarios.

Allowed revenues

Table 6 sets out the allowed revenue profiles for NGET and NGGT for RIIO-T1.⁹

Table 6 – Allowed revenues (TO only)

2009-10 Prices £m Best View	2012-13 per Rollover								
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	
NGET	1,332	1,412	1,551	1,616	1,701	1,692	1,723	1,698	1,666
Yr on Yr Change	6.0%	9.8%	4.2%	5.2%	-0.5%	1.8%	-1.4%	-1.9%	
Cumulative Change	6.0%	16.4%	21.3%	27.7%	27.0%	29.4%	27.5%	25.1%	
NGGT	586	559	567	595	638	744	720	742	770
Yr on Yr Change	-4.5%	1.4%	5.1%	7.2%	16.6%	-3.2%	3.0%	3.7%	
Cumulative Change	-4.5%	-3.2%	1.7%	9.0%	27.0%	22.9%	26.7%	31.4%	

⁹ The step increase in NGGT revenues in 2017-18 in part results from the transfer of revenue driver expenditure from shadow RAV to full RAV. There is an offsetting fall in SO revenues in that year.