

Strategy consultation for the RIIO-ED1 electricity distribution price control

Overview

Consultation

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Overview:

This document provides an accessible overview of our proposed approach to the next electricity distribution price control (RIIO-ED1). The price control will set the outputs that the 14 electricity distribution companies (DNOs) need to deliver for their consumers and the associated revenues they are allowed to collect for the eight-year period from 1 April 2015 to 31 March 2023.

This will be the first electricity distribution price control to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model. RIIO is designed to drive real benefits for consumers. It will provide the companies with strong incentives to step up and meet the challenges of delivering a low carbon, sustainable energy sector at a better value for money 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 are required to develop well-justified business plans setting out their outputs and how they propose to deliver them. This document sets out, for consultation, the key elements of the regulatory framework that the DNOs will need to understand in order to develop their business plans.

Associated documents

Links to supplementary annexes

Strategy consultation for RIIO-ED1 - Outputs, incentives and innovation

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConOutputsIncentives.pdf>

Strategy consultation for RIIO-ED1 - Business plans and proportionate treatment

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConBusinessPlans.pdf>

Strategy consultation for RIIO-ED1 - Uncertainty mechanisms

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConUncertaintyMechanisms.pdf>

Strategy consultation for RIIO-ED1 - Financial issues

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConFinancialIssues.pdf>

Strategy consultation for RIIO-ED1 - Impact assessment

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConImpactAssessment.pdf>

Strategy consultation for RIIO-ED1 - Tools for cost assessment

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConCostAssessment.pdf>

Strategy consultation for RIIO-ED1 – Reliability and safety

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConReliabilitySafety.pdf>

RIIO-ED1 Glossary of terms

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1SConGlossary.pdf>

Links to other associated documents

Open letter consultation on the way forward for RIIO-ED1

<http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1LaunchOpenLetter.pdf>

Handbook for implementing the RIIO model

<http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/RIIO%20handbook.pdf>

Electricity Distribution Price Control Review 5 (DPCR5) Final Proposals

http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/DPCR5/Documents1/FP_1_Core%20document%20SS%20FINAL.pdf

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Executive Summary

Significant expenditure is needed in Britain's gas and electricity networks over the next decade. This investment is needed to ensure consumers continue to receive safe, reliable network services and to meet environmental challenges. It is therefore more important than ever that network companies can show consumers that they are getting value for money and that charges are contained.

The electricity distribution network operators (DNOs) have a key role to play. They will need to connect potentially significant volumes of local generation and low carbon demand (such as electric vehicles and heat pumps) in a timely and effective manner, without causing network problems. There is uncertainty about the location, timing and impact of this demand. The DNOs will need to manage this uncertainty, build in flexibility and use opportunities presented by new smart grids technologies and contractual arrangements with customers (ie demand side response) to find long-term efficient solutions. They will also need to consider the needs of their customers, especially with respect to vulnerable customers and the fuel poor.

To drive this change, in 2010 we announced a new regulatory framework. The 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. RIIO puts sustainability alongside consumers at the heart of what network companies do. It provides a transparent and predictable framework that rewards timely delivery.

In six months time we will conclude the first reviews conducted under RIIO: RIIO-T1 (in electricity and gas transmission) and RIIO-GD1 (in gas distribution). In these reviews we have seen a marked increase in the quality of company submissions and good evidence of stakeholder input. We are now undertaking the first electricity distribution price control review under RIIO: RIIO-ED1. This will set the outputs that the DNOs must deliver over the eight-year period (2015-2023) and the associated revenues they may collect from consumers. We expect the DNOs to learn from and build on the progress of the transmission and gas distribution companies.

We are committed to ensuring all stakeholders have appropriate opportunities to contribute. Our proposals reflect considerable stakeholder input, including consumer and environmental groups, industry and government, as well as the DNOs. We have also benefited from feedback from our Consumer Challenge Group, which comprises consumer and environmental experts acting as a critical friend to Ofgem.

Under the RIIO model the DNOs are responsible for developing and justifying a long-term strategy for delivering the network services that their customers value. To do this, they need to understand the key elements of the price control framework. This document therefore sets out, for consultation, the outputs we think the DNOs should deliver and our thinking on core elements of the framework.

The DNOs will need to deliver a range of outputs 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 expenditure and management of their networks
- to connect new generation and demand in a timely and efficient manner and efficiently accommodate demand increases from low carbon technologies.

We will attach incentives to the delivery of outputs, the strength of which will reflect the value consumers attach to delivery and DNOs' degree of control. We will put in place mechanisms to ensure efficient risk sharing between DNOs and consumers.

Innovation will play a key part in the DNOs delivering at efficient cost and dealing with uncertainty. In the current price control (DPCR5) we established the Low Carbon Network (LCN) Fund, which provides up to £500m for DNOs to test innovative ways to address the low carbon future. We expect to see the learning from these trials in the DNOs' business plans. We have already committed to replacing the LCN Fund with a competition to fund innovation across electricity transmission and distribution. Whilst we are not in a position to set the total amount available over RIIO-ED1, we are consulting on a value of up to £180m for the first two years of RIIO-ED1.

In the interests of consumers, we are committed to ensuring that efficient companies are able to raise timely finance and are remunerated appropriately; and that we have a fair balance of costs between current and future consumers. The RIIO framework sets out the principles by which we will set the various financial elements of the price control settlement. We have already set out decisions to index the cost of debt assumption based on a long-term trailing average of interest rates and move to the use of economic asset lives for depreciation, which for electricity distribution we determined to be 45 years (from 20 years currently).¹ Whilst we do not intend to revisit these decisions in RIIO-ED1, we will consider representations from the DNOs regarding the need for tailored or transitional arrangements.

In this consultation we have set out an indicative cost of equity range of 6.0-7.2 per cent (post-tax real) based on the expected future risk profile of the DNOs. It is for the DNOs 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 DNOs 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 proportionate regulatory process, with potential for a fast-track settlement that concludes up to nine months ahead of the standard timetable.

We invite views on any aspect of our proposals. In February 2013, we intend to publish our decision on the strategy for RIIO-ED1. This will reflect the responses to this consultation and views provided through various stakeholder fora.

¹ Following a review of economic asset lives, on 31 March 2012 we published our 'Decision letter on the regulatory asset lives for electricity distribution assets'
<http://www.ofgem.gov.uk/Networks/Policy/Documents1/assetlivedecision.pdf>

1. Introduction

Chapter Summary

This chapter sets out the purpose of this overview document and explains the relationship between this document and the supplementary annexes. It also sets out our high-level strategy for RIIO-ED1.

Purpose of this document

1.1. The existing price control period for the 14 DNOs (DPCR5) ends on 31 March 2015. This document summarises our proposals for the regulatory framework for the next electricity distribution price control, RIIO-ED1. In RIIO-ED1 we will set allowed revenues for the DNOs for the eight-year period (1 April 2015 to 31 March 2023) and the associated outputs they will be required to deliver.

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 supplementary annexes published alongside this overview document. (See Figure 1.1 at the end of this chapter.)

The RIIO framework

1.3. The next decade will be a critical period for the networks as they ensure continued security of supply whilst meeting the environmental challenges. In 2010 we announced a change in the way we regulate in order to drive network companies to address these challenges. 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 expenditure in the networks.

1.4. RIIO-ED1 is the first price control in electricity distribution to use the RIIO model. The proposals that we are consulting on in this paper are designed to:

- encourage DNOs 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.

1.5. We are committed to ensuring that all stakeholders have appropriate opportunities to engage in the price control reviews. The proposals set out in this consultation reflect the input we have received from a wide variety of stakeholders

since we launched the review in February 2012. We provide more detail on this in Chapter 3. We appreciate the considerable time and effort that a wide range of parties have provided in the process so far.

High-level strategy

1.6. One of the principal 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. The DNOs will set out these strategies in their well-justified business plans which they will submit in July 2013. Therefore this document consults on the aspects of the control that DNOs need to understand in order to be able to create their strategies and business plans.

1.7. Those DNOs that rise to the challenge of providing us with well-justified business plans will benefit under our proportionate regulatory approach.

1.8. To guide the DNOs we are publishing, as part of this consultation, further guidance on what is required in a well-justified business plan. We also set out our proposed approach for deciding whether a DNO should be fast-tracked or should receive proportionate treatment. We have also set out how we have incorporated the lessons learned from the ongoing RIIO-T1 and GD1 reviews. This is discussed briefly in Chapter 4 and in more detail in the 'Supplementary annex - Business plans and proportionate treatment'.

1.9. The process for RIIO-ED1 differs significantly from that of previous electricity distribution reviews. We have built on the process being used for RIIO-T1 and GD1. We set out a draft timetable for the RIIO-ED1 review in the February open letter and in Chapter 4 we set out proposed changes to this timetable, in particular reflecting learning from the RIIO-T1 fast-track experience.

Structure of this document and associated documents

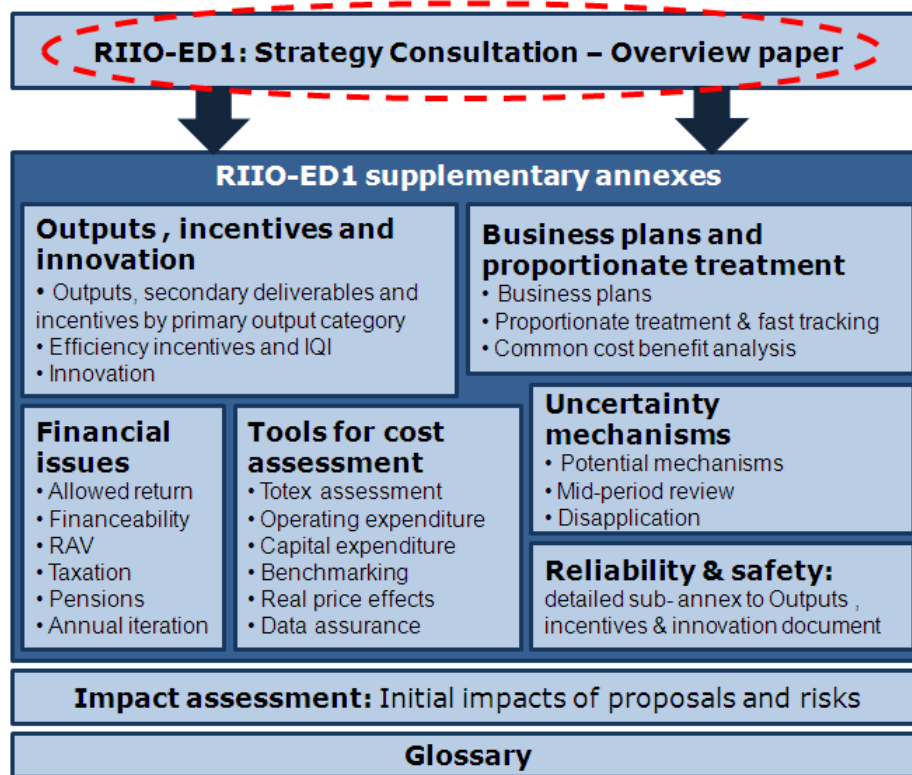
1.10. This document is structured as follows:

- Chapter 2 provides a summary of the electricity distribution sector, the current price control and the key challenges facing the sector.
- 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 presents the proposed form and structure of the review, as well as potential implications on the volatility of charges.
- Chapter 5 sets out the proposed outputs that we expect DNOs to deliver over the ED1 period, and associated incentive mechanisms to ensure efficient delivery.
- Chapter 6 discusses the criteria we propose to use to assess companies' business plans and our proposed approach to cost assessment.
- Chapter 7 describes our proposed approach to innovation.
- Chapter 8 sets out our proposed approach to dealing with uncertainty, and how risks should be shared between customers and the DNOs.

- Chapter 9 discusses our approach to financial issues, including efficient debt and equity financing costs, optimal gearing, capitalisation and depreciation policies.
- Chapter 10 sets out the next steps in this review.

1.11. We provide further detail on all of these issues in the supplementary annexes published alongside this document. Figure 1.1 below sets out a map of all the RIIO-ED1 documents we have published today. Links to these annexes as well as other associated documents are set out in the 'Associated Documents' section in at the front of this paper.

Figure 1.1: Map of RIIO-ED1 Strategy Consultation documents



Links to these documents can be found in the 'Associated documents' section of this document

2. Context

Chapter Summary

This chapter provides an overview of the electricity distribution sector, the current price control, and recent DNO performance. We then discuss the key challenges facing the sector, and how we propose to address them in RIIO-ED1.

What is electricity distribution?

2.1. Electricity distribution networks carry electricity from the high voltage transmission network to industrial, commercial and domestic users. Some generators (generally smaller scale) are connected directly to the distribution network. The distribution networks are owned and operated by privately owned companies (DNOs) who have territorial monopolies. Consequently, we regulate the revenues DNOs can recover from consumers and incentivise them to innovate and find new ways to improve their efficiency and quality of service – using the price control process. The DNOs' duties and obligations are set out in licences and legislation.

2.2. As illustrated in Figure 2.1 there are 14 DNOs within six ownership groups. Distribution costs account for about 18 per cent of electricity bills.² The current cost per average household is approximately £85 per annum. In return, DNOs are expected to deliver a safe and reliable supply and to respond effectively to requests for new connections, complaints and queries.

The current price control – DPCR5

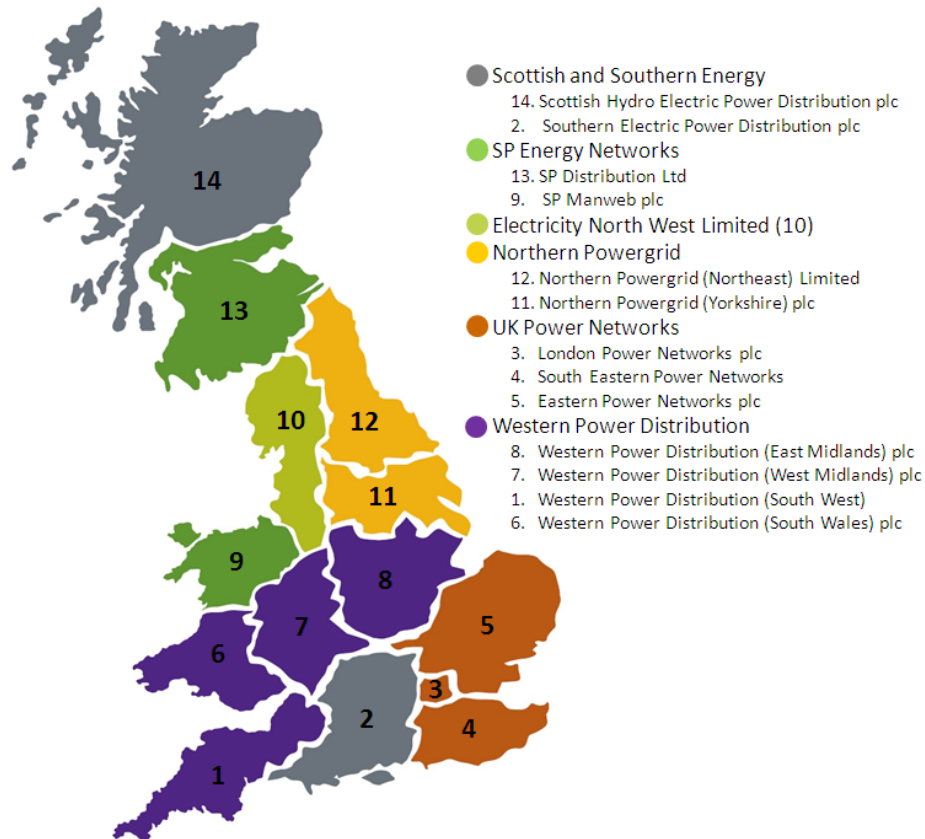
2.3. The current, fifth electricity Distribution Price Control (DPCR5) set allowed revenues for the period from 1 April 2010 to 31 March 2015. The price control takes the form of a revenue cap which determines the maximum revenue a DNO can collect from its consumers. The price control formula allows for the allowed revenues to be updated annually for the change in the retail price index (RPI). It also allows for 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 DNOs' performance in managing interruptions, losses and customer service.

2.4. In DPCR5 we set total allowed revenues for the sector at around £16bn for the five-year period. Network investment constitutes the DNOs' major expenditure item at £7.6bn. Other major expenditure categories include operating expenditure (£3.0bn) and support costs (£5.2bn) (all 2011-12 prices).

² <http://www.ofgem.gov.uk/Media/FactSheets/Documents1/household-bills.pdf>

2.5. DPCR5 was a significant step towards the RII0 framework. It had an increased focus on outputs and looked at the role DNOs would need to play to facilitate the transition to a low carbon economy. Therefore, where components of DPCR5 are working well and satisfy the RII0 principles (such as the interruptions incentive and the DNOs' reporting of their carbon footprint), we are looking to maintain them as part of RII0-ED1.

Figure 2.1: DNO location and ownership



2.6. We require the DNOs to report financial and performance data to us on an annual basis to allow us to monitor their performance against the regulatory settlement. As set out in the Electricity Distribution Annual Report for 2010-11³ DNOs are generally showing improved performance against reliability and availability measures and are engaging well in the environmental arena.

3

http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/DPCR5/Documents1/Electricity_Distribution_Annual_Report_for_2010_11.pdf

Key challenges and issues for RIIO-ED1

2.7. The electricity networks face a number of important challenges which we have taken into account in developing our proposals for RIIO-ED1. These key challenges include ensuring that the networks can connect and manage the new low carbon technologies and generation required for GB to meet its carbon targets; the need for the DNOs to manage their environmental impact and social issues, notably the need to address fuel poverty and the treatment of vulnerable customers. In this section, we discuss each issue in turn, and describe how our proposals for RIIO-ED1 address these challenges.

Managing the transition to a low carbon energy sector

2.8. Respondents to our February open letter agreed with our identification of the key issues for RIIO-ED1 being the network challenges presented by the transition to a low carbon future. We highlighted that the DNOs will need to be able to accommodate potentially significant volumes of local generation (such as solar photovoltaic, pV, and wind) and low carbon demand (such as electric vehicles, EVs, and heat pumps). However, distribution networks are not designed to accommodate these loads (ie the increase in domestic demand and the variability of renewable generation) and we expect this to be a key driver of future investment needs. Adding to the challenge is the considerable uncertainty around the take-up of these technologies, in terms of volumes and location as well as the impact on the network.

2.9. The DNOs need to consider their future role. They will need to create a network that allows them to connect new customers without delays or undue costs, but avoids investing in assets that may be redundant. Similarly they need to ensure that the network can accommodate the increasing loads from domestic EVs, heat pumps and pVs without overloading the network and causing interruptions and without inefficient reinforcement. To do this they may need to move away from traditional investment to the newer, more flexible solutions offered by smart grids technologies and contractual arrangements with demand and generation customers.

2.10. We see our role in this as three-fold.

1. To help industry and stakeholders understand DNOs' future role, and regulatory and policy implications.
2. To help facilitate an industry-wide understanding of the costs and benefits of smart grids solutions, potential barriers to their implementation and how to resolve them.
3. To create a package of outputs, incentives and financing for RIIO-ED1 that incentivises DNOs to accommodate these new loads efficiently.

Future role

2.11. We have had many discussions with DNOs and other stakeholders about what networks will need to look like in the future and the impact of this on the regulatory framework for RIIO-ED1. Both have raised questions about the future structure of

the industry and the regulatory framework. As DNOs actively manage the local levels of demand, whilst at the same time accommodating varying amounts of generation onto the network, they will start to behave like system operators (ie locally balancing demand and supply on their networks). This raises questions about whether the regulatory and commercial framework facilitates this, and how they would interact with the overall system operator, National Grid.

2.12. There are also questions over the potential use of demand side response (DSR) since many different entities (such as suppliers, transmission operators, DNOs and the system operator) may want to use it, causing potential conflicts. There are also questions around what cost signals customers would need to see in their contracts or bills to drive the desired response and the cost benefit of the overall approach.

2.13. There is insufficient information to answer these questions now. RIIO-ED1 should facilitate these questions being addressed in the medium term.

Smart grids solutions

2.14. In 2011 we established the Smart Grid Forum (SGF) with the Department of Energy and Climate Change (DECC). The SGF is aimed at understanding what drives the value of smarter solutions and addressing barriers to their adoption. More information on the SGF is provided in Appendix 2. We also established the LCN Fund in DPCR5 which is funding trials to assess the potential operation and benefits of smart technologies (including storage) and DSR, amongst other things.

2.15. As part of the SGF, DECC have created four scenarios on the potential take-up of low carbon technologies. All scenarios meet the 2030 4th Carbon Budget⁴ but involve different relative contributions from the electrification of heat and transport and the use of carbon credits to offset emissions. These scenarios indicate that, other than pV, the take-up of technologies is unlikely to be significant until the latter half of RIIO-ED1. However, the take-up will vary geographically, and DNOs are currently translating the scenarios to reflect their areas.

2.16. The SGF has looked at whether there might be benefits from rolling out smart grids solutions en masse in RIIO-ED1. Initial cost benefit assessments, combined with the fact that we currently do not fully understand smart grids and the uncertainty around low carbon technology take-up, appear to indicate that a more organic approach would be appropriate during RIIO-ED1.

2.17. One of the SGF workstreams has also looked at the commercial and regulatory barriers to smart grid solutions. In its report⁵ it concludes that there are some

⁴ http://www.decc.gov.uk/en/content/cms/emissions/carbon_budgets/carbon_budgets.aspx

⁵ SGF Workstream 6 Report – August 2012:
http://sharepoint/Networks/ElecDistrib/Elec_Distrib_Lib/Smart%20Grids/SG%20Forum/Commercial%20and%20Regulatory%20Issues%20WS/July%20report/WS6%20report%20Aug12.docx

barriers, but that these can be addressed by the DNOs and industry (eg through changes to engineering recommendations). Further work is required to understand what may be needed to facilitate efficient and effective commercial arrangements in the market – including where DNOs use third parties to help provide services such as storage or energy efficiency. We consider that the existing regulatory framework should not act as a barrier to these activities, and that therefore we do not need to resolve these issues in setting the price control for RIIO-ED1. We will continue to explore these issues with the SGF and other parties as a separate, ongoing workstream.

2.18. During RIIO-ED1 DNOs will need to prepare for RIIO-ED2 and beyond. Assets installed in RIIO-ED1 will last 40 years or more, meaning that they need to be fit for purpose in the long term. DNOs will need to consider the following:

- what their networks will need to look like when low carbon technologies are commonplace, and their strategy for getting there
- how their customers will adopt and use the new technologies
- how to design a strategy for RIIO-ED1 such that it can efficiently accommodate any of the DECC scenarios
- a variety of network solutions, comparing whole life/long term costs and benefits
- whether solutions need to provide flexibility – for example using DSR to delay an investment until the understanding of future demand is clearer
- whether there are benefits from upfront investment – ie in RIIO-ED1.

Smart meters

2.19. Smart meters will play a key role in the DNOs' smart grids solutions. The majority of the government's mandated installation of smart meters in domestic and small non-domestic premises will take place well before the end of RIIO-ED1. DNOs need to maximise the benefits they can obtain from these meters – such as providing better outage and usage data which the DNOs can use to operate the networks in a smarter way. There will be costs to the DNOs associated with both the smart meter roll-out and the use of the data. We have set out proposals in the 'Driving sustainable networks' chapter of the 'Supplementary annex - Outputs, incentives and innovation' to make sure these costs are efficient.

Heat

2.20. The government's Strategic Framework for Low Carbon Heat in the UK⁶ suggests a significant roll out of heat pumps in rural areas and heat networks in urban areas. Earlier in this section we have considered how the DNOs will need to facilitate the uptake of heat pumps. With respect to heat networks the DNOs' role is less clear. One DNO is currently undertaking an innovation trial exploring the benefits to the electricity network from working collaboratively with a heat network. We expect the learning from this project to be shared with the other DNOs. DNOs will need to consider how their role will evolve as the electrification of heat increases.

⁶ http://www.decc.gov.uk/en/content/cms/meeting_energy/heat_strategy/heat_strategy.aspx

RIIO-ED1 package

2.21. As stated above, DNOs will need to be able to connect the new low carbon loads in an appropriate time, at appropriate cost, without causing network problems and without incurring excessive costs. We believe this behaviour will be driven by a coherent and balanced package of outputs and incentives, alongside a combination of ex ante assessment and appropriate uncertainty mechanisms. We set out in Chapter 5 how we think our package of connections, customer service, reliability and efficiency outputs and incentives will provide this. In Chapters 5 and 6 we describe how we expect the DNOs to set out, in their business plans, a strategy which combines an appropriate balance of ex ante funding and uncertainty mechanisms to flex to achieve the different scenarios of low carbon technologies at efficient cost. We set out in Chapter 7 how our innovation proposals will encourage the DNOs to further innovate and trial solutions to better accommodate the take-up of low carbon technologies and the connection of generation, particularly using smart grids solutions and customer response.

Environmental impact, customer and social issues

2.22. As well as facilitating the transition to a low carbon future, DNOs also need to reduce their own carbon footprint. The biggest contributor to their footprint is electrical losses over the networks – and significant problems have arisen with the data used to calculate the current losses incentive.⁷ In Chapter 5 we set out our proposals for new mechanisms to encourage the DNOs to manage losses, as well as other emissions.

2.23. Consumers are dependent upon the DNOs to provide them with a reliable supply of electricity and to provide an efficient service to those seeking to connect to the network. With the number of people reliant upon electricity as their primary source of energy expected to increase, and with the emergence of new types of customers (such as DG) requiring a connection, the service DNOs provide becomes ever more critical. DNOs need to understand the changing requirements of consumers and ensure that any aspect of their service that falls below their expectations is rectified. Historically, we have found that in the absence of regulatory incentives DNOs can be sluggish in responding to customer requirements.

2.24. A key part of this consideration of customer requirements is ensuring that vulnerable customers are treated appropriately. This includes considering the specific requirements of the fuel poor. There are many agencies working in this field, and the DNOs will need to take a strategic approach, with emphasis on joint working with a range of stakeholders to ensure that in responding to social issues, the right actions are undertaken by the most appropriate agency.

⁷ <http://www.ofgem.gov.uk/Networks/ElecDist/Policy/losses-incentive-mechanism/Pages/index.aspx>

3. Incorporating stakeholders' views

Chapter Summary

This chapter outlines the role of stakeholder engagement and sets out the stakeholder engagement process in more detail.

Question 1: Do you have any comments on our stakeholder engagement approach?

Question 2: Do you have any views on how our engagement process or that of the DNOs could be made more effective?

Role of stakeholders in the price control review

3.1. The RIIO-ED1 review will impact a wide range of parties. Under RIIO, stakeholders have greater opportunity to influence our and network companies' decisions. We expect DNOs to engage proactively with consumers on an ongoing basis. We are also working with stakeholders through a variety of different forums, recognising that it is important that different types of stakeholders get to engage on the issues that matter to them. Both the companies' and our approach to engagement are discussed below.

Company-led engagement

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

3.3. This year we trialled the stakeholder engagement element of the Broad Measure of Customer Satisfaction (BMCS) introduced in DPCR5. This mechanism involves the assessment of DNOs' stakeholder engagement activities by an independent panel, chaired by Ofgem. Feedback from this trial should enable the DNOs to improve their approach to stakeholder engagement.

Ofgem-led engagement

3.4. The objectives of our stakeholder engagement for RIIO-ED1 are to:

- ensure that stakeholders are familiar with policy developments so that they are able to contribute effectively as the price control review progresses
- ensure that the views of consumers are fully reflected in the process.

3.5. We have adopted a multi-layered process to ensure that all affected parties have appropriate opportunities to engage in the review. We have set out more information on the ways in which we have engaged stakeholders in Appendix 3. A high-level summary of the issues raised by respondents to our February open letter is provided in Appendix 4.

3.6. We have also conducted research into customers' views to help us understand consumer priorities for the DNOs over the next 10-15 years, including views of how future scenarios may impact on the network.

Appealing against price control decisions

3.7. As part of our RIIO decision⁸ we published guidance on how third parties could challenge a price control decision by requesting the Authority to exercise its powers to make a modification reference to the Competition Commission. It also covered modification references arising as a result of a licensee's rejection of our price control final proposals.

3.8. In 2011 DECC, as part of the implementation of the EU Third Package, introduced a new process for licence modification decisions by the Authority. This means that this aspect of our RIIO guidance is no longer valid. Modification references to the Competition Commission no longer exist and so the Authority cannot refer a matter to the Competition Commission at the request of a third party.

3.9. The Authority can now modify a licence irrespective of whether the licensee consents to the modification. However, the licensee, other electricity licensees who may be affected, and certain other specified bodies representing licensees or consumers have the right to appeal the licence modification decision to the Competition Commission if they are dissatisfied.

3.10. As part of RIIO-T1 and GD1 we are proposing to make provision in the licences for a 'light-touch' process for modifications to the financial instruments in the licence that are unlikely to have a significant impact. Where a modification proposal was found to have a significant impact, the Authority would need to apply the statutory licence modification process, so that licensees and others (as outlined above) would have the right to appeal the modification to the Competition Commission if they objected to the change.

3.11. In addition, we are proposing that certain key elements of the price control package that sit under the licence, such as the Financial Model and the Financial Handbook, should have the status of licence conditions.

3.12. We propose to adopt the same principles for RIIO-ED1.

⁸ 'RIIO: A new way to regulate energy networks. Final Decision' 128/10 October 2010
<http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf>

4. Form and structure of the price control

Chapter Summary

This chapter sets out the form and structure of the RIIO-ED1 price control including our decision on the length of the control period. It also sets out the timetable for RIIO-ED1, highlighting key changes.

Question 1: Do you have comments on the form or structure of the price control?

Question 2: Do you agree with our proposed changes to the RIIO-ED1 timetable?

Question 3: Do you have a view on the materiality of potential changes in allowed revenues/charges between price controls? Do you have proposals to address this?

Length of the price control

4.1. Under RIIO we have lengthened the default price control period from five years to eight. This was specifically to enhance companies' ability to manage more effectively the uncertainties they face in the move to a low carbon economy.

4.2. However, using an eight-year control for RIIO-ED1 means that the process for RIIO-ED2 will overlap with those for RIIO-T2 and GD2. This has both pros and cons.

4.3. In our February open letter, we consulted on whether the RIIO-ED1 period should be eight or nine years. Most respondents did not express a strong opinion⁹ and views were evenly split. However, many respondents raised concerns over increased uncertainty under a nine-year control due to the increase in low carbon technologies over the RIIO-ED1 period and perceived an associated increase in risk. One stakeholder proposed a five-year control to reduce uncertainty, and another proposed a one year roll-over (which was explicitly rejected by a different stakeholder).

4.4. **We have decided to adopt the default eight-year period for RIIO-ED1.** We believe there are synergies from overlapping the price controls by a year. Neither Ofgem nor the companies with transmission/gas distribution and electricity distribution licensees consider resourcing to be a problem.

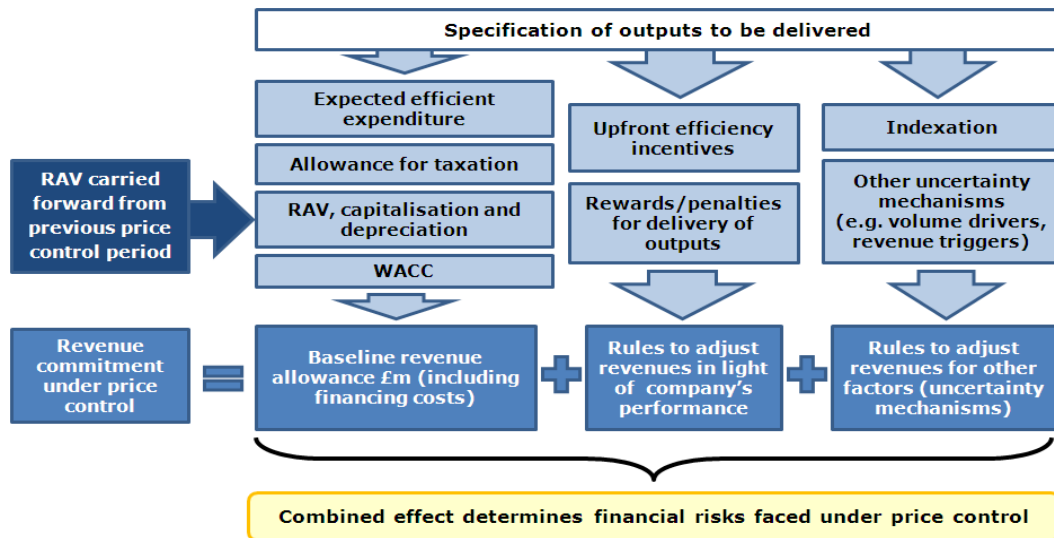
Form of the price control

4.5. Under the RIIO model, we set the outputs that DNOs need to deliver and the revenues they are able to collect from consumers for delivery. The allowed revenues will be set using a building block approach, the core elements of which are illustrated

⁹ Appendix 4 summarises responses to the open letter.

in Figure 4.1 below. The way we set each of the building blocks is discussed in the remaining chapters of this document and the associated supplementary annexes.

Figure 4.1: Price control building blocks



4.6. We will adjust the revenue cap annually for changes in RPI. In 'Supplementary Annex – Uncertainty mechanisms' we consult on our proposal to remove the lag present in the historical methodology.

4.7. We are aware of the current consultation by the Office for National Statistics' Consumer Prices Advisory Committee (CPAC) on the RPI methodology. We will consider whether there is any need to make any changes to our RPI methodology when the outcome of the consultation is known in early 2013.

4.8. Other adjustments to revenue relate to output incentives, efficiency incentives and uncertainty mechanisms. More details on these elements are provided in Chapters 5, 6 and 8 respectively and the related supporting annexes.

Scope of the price control

4.9. The RIIO-ED1 price control review will apply to all 14 DNOs and culminate in licence conditions for each licensee to take effect on 1 April 2015. We will set allowed revenues to cover all aspects of a DNO's business except for excluded services and de minimis¹⁰ activities.

¹⁰ De minimis activities are any business conducted by a DNO (or affiliate or related business), other than its regular business, and any other business or activity to which the Authority has given its consent under standard condition 29 of the licence.

4.10. Excluded services are services where the revenues earned by DNOs are not subject to a price control. However, in setting the price control we will forecast expected revenues and costs from providing these services. If DNOs are able to sell additional excluded services, then the revenues they receive should cover the additional costs incurred and any surplus revenues will not be counted as allowed regulated revenues, subject to the companies only earning a reasonable return.

4.11. We set out in the 'Supplementary annex - Financial issues' how we propose to clarify the arrangements for excluded services in order that DNOs can keep the margin they earn on these services. This will ensure that there is a reasonable incentive for DNOs to work with others (eg broadband) to maximise the use of their assets, and that customers benefit from the contribution that the excluded services customers make to the costs of the assets and operational costs.

Price control process

4.12. The key elements of the RIIO-ED1 process are set out below.

- Effective stakeholder engagement will inform the process throughout.
- The beginning of the process focuses on the development of outputs and the overall strategy for the review. This is to provide enough information about our price control framework for DNOs to develop their well-justified business plans.
- Following submission of the business plans in July 2013 we will assess the plans and consult on whether any warrant proportionate treatment or fast-tracking.
- For any DNO that is fast-tracked we will conclude their review nine months ahead of the other DNOs and a year ahead of the implementation of ED1.
- We will begin the process of developing licence conditions after the publication of the February strategy decision to help align the legal drafting with the policy development.

4.13. We are proposing a change to the process used for RIIO-T1 and GD1. When we fast-tracked the two Scottish transmission operators (TOs) for RIIO-T1 we noted that it was the first time that companies had had to produce business plans under the RIIO framework. We stated that we had therefore provided for greater iteration between the first business plan submission and our fast-track decision than we intended to do in the future. We expect the DNOs to have learned from the RIIO-T1 and GD1 process what is expected from them under RIIO. We therefore propose not to provide DNOs the opportunity to revise elements of their plans once submitted.

4.14. This will be reflected in a streamlined business plan assessment process. In RIIO-T1 and GD1 we had a two part process. We published an initial assessment¹¹ stating that the Scottish TOs had the potential to be fast-tracked, followed three months later with our decision to fast-track the two companies¹² alongside their

¹¹ <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/busplanletter.pdf>

¹² <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Further%20assessment%20of%20RIIO-T1%20business%20plans.pdf>

initial proposals. For RIIO-ED1 we propose to publish a single assessment which sets out which DNOs are being considered for fast-track, alongside their Initial Proposals.

4.15. Also learning from RIIO-T1 and GD1 we want to make it clear that the RIIO framework front-loads the majority of decisions on policy. Therefore in Initial Proposals for fast-tracked on non-fast-tracked companies we should be setting out our draft position for consultation. Unlike pre-RIIO price controls, we would only expect to make changes between Initial and Final Proposals where we have made an error or there is material new information that could not have reasonably been provided earlier in the process.

4.16. We think that using the pre-RIIO document names of Initial and Final Proposals confuses this message. We therefore propose to change the names of the two publications – from Initial and Final Proposals to Draft and Final Determination.

4.17. Our RIIO-ED1 timetable is set out in Appendix 5. This shows two significant changes from the timetable we published in our February open letter.

- Since we have reduced the initial business plan assessment from a two stage process to a single stage, we have reduced the time this assessment will take. We have therefore delayed the date for the DNOs to submit their business plans.
- We have also reduced the time between the non-fast-tracked Draft and Final Determinations by one month. This will provide us with more time to analyse the non-fast-tracked business plans and will still enable us to consult for eight weeks.

Revenue profiling and charging volatility

4.18. In RIIO-T1 and GD1, stakeholders voiced concerns about the volatility of network charges arising from the price control settlement. Some suppliers indicated that they include a risk premium in their fixed contracts in order to protect themselves against unforeseen changes in network charges. It was also noted that charging volatility could act as a barrier to small suppliers who may be less able to absorb any unexpected changes.

4.19. We therefore consulted on options to improve the predictability of charges and reduce their volatility.¹³ Our consultation proposed changes to both the price control framework and the setting of network charges, in order to improve the predictability of revenue changes, and thus charges. This was based on the premise that if suppliers understand how charges will evolve, they can incorporate such changes in the contracts they offer customers. This should reduce any risk premium included in suppliers' contract offers. Whilst we have yet to publish our decision on charging volatility, we intend to reflect that decision in the design of the RIIO-ED1 framework.

¹³ Mitigating network charging volatility arising from the price control settlement Ref:52/12 13/4/2012 available at http://www.ofgem.gov.uk/Networks/Policy/Documents1/Charging_Volatility_Cons.pdf

4.20. Stakeholders have also raised concerns about the potential step change in allowed revenues, and therefore charges, from one price control to the next, and the lack of prior notice of this change. This was not covered in our consultation. Some suppliers have suggested that we increase visibility of final network revenue changes by fixing allowed revenues for the first year of the price control earlier in the review process. Any difference between the allowed revenue fixed in advance and allowed revenues provided for in Final Determination would be collected/refunded over the remaining years of the price control.

4.21. We consider that the front-loaded nature of the RIIO framework, where business plans are submitted nearly two years before the start of the new period, should provide more visibility of the materiality of any changes. However, we welcome stakeholders' views on the materiality of this issue and proposals for additional improvements.

4.22. We will also consider whether we require any additional profiling or smoothing mechanism once we have received DNOs' business plans. We will then have a better understanding of the volatility of cost requirements. If reprofiling is considered, we propose to use the weighted average cost of capital as the discount rate to ensure that DNOs are neither penalised nor rewarded for any revenue re-profiling.

5. Ensuring output delivery

Chapter Summary

This chapter 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 - Outputs, incentives and innovation'.

Question 1: Do you consider that the proposed outputs and associated incentive mechanisms, taken together with other elements 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 (eg do we have too many or too few)?

Question 3: Do you have any views on the proposed outputs and incentives?

Introduction

5.1. 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. 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.

5.2. 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 companies:

- play a full role in the delivery of a sustainable energy sector
- deliver long-term value for money for existing and future consumers.

5.3. 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. In planning this investment companies will have to show consumers that they are getting value for money over the longer term, setting out clearly what alternative (particularly smart) options they have considered, 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.

5.4. The RIIO model identifies six primary output categories – key areas of delivery for network companies. These are: safety, environmental impact, customer satisfaction, connections, social obligations, and reliability and availability. We have

identified a number of specific behaviours that we are seeking to encourage in each of these categories.

- Safety: ensuring the provision of a safe network in compliance with Health and Safety Executive (HSE) safety standards.
- 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, visual amenity and pollution.
- Customer satisfaction: maintaining high-levels of customer satisfaction, and improving the service 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 different customers' specific needs, whilst facilitating competition.
- Social obligations: encouraging the DNOs to take a strategic approach, adopting a coordinating and partnership role with other networks, suppliers and agencies to share data and knowledge and establish best practice.
- Reliability and availability: promoting a network capable of giving long-term reliability and minimising the number and duration of interruptions experienced over the price control period, and ensuring adaptation to climate change.

5.5. The outputs framework comprises both primary outputs and secondary deliverables. Primary outputs 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' in order to ensure long term delivery and value for money.

5.6. In identifying primary outputs, we have drawn on the principles set out in the RIIO Handbook. These include ensuring they are controllable by the network companies (or where we have concerns about controllability, we consider carefully the applicability of financial incentives), measurable, auditable and comparable.

5.7. We have been assisted in the identification and design of the proposed outputs and incentives by a collection of stakeholder working groups. These groups are focussed on each of the primary output categories and include the DNOs and other stakeholders, including environmental, social and customer representative groups. Our proposals reflect the working group discussions as well as views expressed at other stakeholder forums.

5.8. We expect the DNOs to include the costs of delivering outputs in their business plans. We also expect them to include 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)

5.9. For many of the outputs we plan to set the level (or baseline) to be delivered, taking into account stakeholder views. However for some outputs and secondary deliverables (such as the asset health and loading indices), DNOs will need to set out their proposed level of output delivery in their business plans. This level should be justified in terms of the costs and benefits to network users and should be informed by their stakeholder engagement.

Incentive mechanisms

5.10. For each output category, we have considered a range of incentive mechanisms to encourage DNOs 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.

5.11. 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.

Monitoring delivery of outputs

5.12. During the price control period it is important that we have a clear understanding of the DNOs' performance on output delivery. We will use the regulatory instructions and guidance (RIGs) and the electricity distribution Annual Report for this purpose. To facilitate a meaningful comparison of DNO performance we use a balanced scorecard approach which provides a clear and simple way to convey and compare information. In line with the RIIO recommendations, the scorecard takes the form of a 'traffic light' system with companies' performance judged on whether their delivery is low (red), medium (amber) or green (high).

5.13. In order to monitor effectively and evaluate the DNOs' performance we need the companies to report data of an appropriate quality. As part of RIIO-T1 and GD1 we are developing a data assurance process, by which companies demonstrate the risks associated with different data elements and the assurance mechanisms they have in place. The DNOs are involved in the development, and we propose to implement the same process across all three sectors.

Outputs and incentives proposals

5.14. 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.

Safety

5.15. The HSE is the health and safety regulator for the electricity networks in Great Britain. As with RIIO-T1 and GD1, we propose an output for the DNOs to meet HSE obligations but are not proposing any financial incentives. Absolute standards are in place and the HSE is able to take enforcement action in the event of non-compliance. We therefore do not consider that it is reasonable or necessary for us to impose an additional penalty or to reward companies for out performing.

Customer satisfaction

5.16. Although customer satisfaction is a separate output category, our proposals across a range of outputs are intended to deliver benefits to consumers. For instance, in our proposals for network reliability we set out how we will incentivise DNOs to minimise the number of customers who experience a supply interruption (and the length of the interruption). Elsewhere we will strengthen incentives on DNOs to provide customers with good service, in particular those connecting to the network. Finally we recognise that some consumers may be in position of vulnerability and require additional forms of support; here we look to encourage DNOs to understand and address these issues by working collaboratively with others.

5.17. In DPCR5 we introduced a new mechanism, the BMCS, which was switched on in April of this year. It comprises various elements which each have a separate financial incentive: an independent panel assessment of the company's ongoing stakeholder engagement; the ability of the DNOs to resolve complaints; and a survey of customer satisfaction that incorporates the views of customers who have made a general enquiry, experienced an interruption or required a connection.

5.18. Since the BMCS has only just been introduced we are not proposing significant changes. We are looking to increase the overall size of the incentive to reflect our enhanced understanding of the effectiveness of the mechanism in delivering benefits to consumers (increased from +/- 1 per cent to +1.5 per cent to -2 per cent of allowed revenues). The level of penalty exposure will depend on how much competition there is for connections work in each DNO's region. We also want to ensure that the views of customers requiring larger connections are sufficiently represented. Finally, we propose to review the scope of the survey so that customers who interact with the DNO by web-based technologies are included alongside telephone based contacts.

Environment

5.19. Our proposals aim to ensure DNOs play their role in achieving broader environmental objectives and reduce their own carbon footprint. This is part of our overall objective to create an enabling regulatory environment to ensure that companies play their role in delivering a low carbon energy sector. In particular we need to ensure that DNOs facilitate the connection of the new low carbon technologies, such as heat pumps and EVs, which will be required to achieve the government's carbon targets.

5.20. There are many elements of our proposed regulatory framework that contribute to this objective, including:

- Connections and customer satisfaction, which encourage DNOs to provide timely and efficient service to those wishing to connect, including distributed generation.
- Network reliability, where we will retain the current interruptions incentive to ensure that the DNOs anticipate how the network can accommodate the increasing use of low carbon technologies without causing outages.
- Innovation stimulus, which will provide funding for research and trialling of the impact of low carbon technologies on the network and different ways (including smart grids solutions) for accommodating them.

5.21. The DNOs should set out in their business plans how they will deliver these elements at long-term efficient cost. The proposed efficiency incentive also maintains an incentive on cost efficiency throughout the price control.

5.22. Whilst we currently have an incentive mechanism to encourage the DNOs to connect uncertain volumes of distributed generation (DG) at efficient cost, we think this mechanism is no longer required given the package of measures set out above. This package will encourage appropriate behaviour, such as information provision, customer service, and speed and cost of connection across both low carbon technologies and DG. We discuss this further in the Connections chapter of the 'Supplementary annex - Outputs, incentives and innovation'.

5.23. We also propose specific environmental outputs to incentivise the DNOs to reduce their own emissions and consider their impact on the broader environment.

Losses

5.24. Losses are the largest component of the DNOs' carbon footprint, and comprise 1.5 per cent of GB greenhouse gas emissions. They are an inevitable consequence of transferring electricity across the distribution networks, but can be reduced through various actions by the DNOs and other stakeholders.

5.25. Unfortunately we have experienced significant problems with the DPCR5 losses output and incentive due to major fluctuations in the relevant data. We have consulted on switching the DPCR5 mechanism off due to the problems associated with attaching a financial reward/penalty to this unreliable data. We consider that the data problems will continue during RIIO-ED1 as the roll-out of smart meters uncovers unknown problems with meter readings.

5.26. Until smart meters are rolled out, there is no way to assess objectively consumption, and therefore to measure the losses on the network. Instead of an output measure we therefore propose to place a licence obligation on the DNOs to reduce losses, combined with a common cost-benefit analysis which will enable the DNOs to justify expenditures on the basis of carbon reduction. The DNOs will be required to publish their plans for reducing losses, and then set out what they have achieved.

5.27. We are considering establishing a discretionary reward of up to £32m over the RIIO-ED1 period, assessed by an independent panel of experts, for efficient and innovative loss reduction initiatives. We are also setting out separate proposals to encourage a joined-up approach between suppliers and DNOs to reduce electricity theft.

5.28. We propose to review the losses mechanism at RIIO-ED2 at which point we will be able to assess whether smart meters and other smart grids technologies are providing a reliable measure of losses.

Other environmental impacts

5.29. We propose to retain the DPCR5 requirement on DNOs to report their business carbon footprint (BCF) annually, and the publication of an annual league table of percentage change as a reputational incentive. We will enhance the league table by publishing the actions DNOs have undertaken to reduce their BCF. We also propose to improve the consistency of reporting between the DNOs to ensure that they are all making the same assumptions and categorising emissions in the same way.

5.30. The DPCR5 allowance for undergrounding of overhead lines in Areas of Outstanding Natural Beauty and National Parks, with activities prioritised by local groups, has strong stakeholder support and we intend to retain it with few changes.

5.31. We are also consulting on whether the discretionary reward for loss reduction activities proposed above could apply to broader activities a DNO can undertake to facilitate the transition to the low carbon economy. We are asking stakeholders whether they think our proposed package of outputs and incentives will already drive the appropriate behaviour, making a reward potentially duplicative.

Conditions for connections

5.32. A set of statutory guaranteed standards of performance for connections requires DNOs to deliver various elements of the connections process within a specified period of time. However, there is no single standard associated with the overall time to connect and ultimately this is determined by the DNO. We therefore propose to introduce a new Average Time to Connect output and incentive. This is to encourage DNOs to move beyond the guaranteed standards and consider how they can plan and process connections more effectively to reduce the overall time taken.

5.33. We also plan to improve the connections elements of the BMCS by creating separate surveys for large and small customers. This is to recognise stakeholder concerns that different sized customers have different requirements.

5.34. In DPCR5 we established mechanisms to encourage competition in the connections market. Therefore we will only implement connection incentives in those parts of the market deemed uncompetitive, to ensure that we are only regulating

where we need to. The connections guaranteed standards of performance will still apply to all connections, providing a minimum threshold of service.

5.35. We propose that performance under both the satisfaction survey for connections customers and the average time to connect incentive will be subject to financial rewards and penalties for smaller connection customers. For large connection customers in segments of the market that are seen to be competitive, these incentives will apply on a penalty only basis. The level of penalty exposure will depend on the extent to which a DNO is able to demonstrate that effective competition exists in their area.

5.36. We also propose to enhance the BMCS to encourage DNOs to provide more information upfront which enables customers (including DG) to make cost effective decisions. We also propose to retain the existing requirement for the DNOs to maintain a common user-friendly DG connection guide.

Social obligations

5.37. We want DNOs to address those social issues that are associated with their activities. We have highlighted in our new Consumer Vulnerability Strategy the need for network companies to help deliver solutions for vulnerable and fuel poor customers. We consider DNOs should adopt a strategic approach, with emphasis on joint working with a range of stakeholders across industry (including GDNs and suppliers), government and other agencies to address key issues around fuel poverty and other forms of consumer vulnerability.

5.38. The depth and quality of information DNOs hold on consumers is key to ensuring vulnerable consumers are identified and their needs met. One method of identification is through the Priority Services Register (PSR).¹⁴ As part of our work under the consumer vulnerability strategy we will be reviewing supplier and distributor approaches to PSRs. We see the co-ordinated sharing of information about consumers on industry PSRs, and other information, as key to targeting support. We therefore want DNOs to outline in their business plans how they intend to improve their understanding of consumer vulnerability and how they will work in partnership with others (eg suppliers, other distributors, local authorities and devolved administrations and other utility providers such as water) to share and use their information more strategically during RIIO-ED1.

5.39. We are continuing to look at what specific DNO activity might arise as a result of the above and whether this might require funding. Similarly, we are also considering what outputs might be delivered through these activities and whether we can set a financial incentive for their delivery. We are seeking views on whether there are specific activities in this area and whether we should introduce a mechanism to enable funding during the course of the price control.

¹⁴ DNOs have a licence obligation to maintain a PSR capturing information on any customers attached to their network that are vulnerable to supply interruptions.

5.40. We also propose to increase the financial incentive associated with the stakeholder engagement element of the BMCS. This will provide a mechanism to reward specific efforts by DNOs to work in association with others in developing and using the information they hold on consumer vulnerability.

Reliability and availability

5.41. We plan to retain the existing interruptions incentive scheme (IIS). Under the IIS a DNO's performance on the number of customer minutes lost and the number of customer interruptions is incentivised against a DNO specific target created from benchmarking historical industry performance.

5.42. In DPCR5 we introduced secondary deliverables for reliability – the health index and load index. The health index is a DNO specific composite measure of age, asset condition and fault history amongst other things. The load index is a DNO specific measure of comparative loading. We propose to retain these for RIIO-ED1 but ensure a more consistent methodology for assessment across the DNOs. As for RIIO-T1 and GD1, we are proposing to enhance the health index to take into account how critical the asset is to the DNOs' operations. We expect DNOs to continue to work to significantly improve both the completeness and robustness of their asset data and include measurements of asset criticality and risk.

5.43. We plan to continue a mechanism to address customers deemed to be 'worst served' in terms of reliability. We are considering whether a financial incentive in this area is suitable or whether to retain the DPCR5 'use it or lose it' allowance.

5.44. Statutory regulations set out guaranteed standards of performance on reliability, under which a customer is entitled to a fixed payment from the DNO if their supply has been interrupted for a period of 18 hours or more. Following willingness to pay analysis and further stakeholder feedback we are proposing to reduce this period to 12 hours.¹⁵ We have already consulted on removing the exemption to the guaranteed standards for SSE's Scottish Highlands and Islands area. This would mean that these customers receive payments for being off supply in line with other customers.

5.45. In DPCR5 we recognised the risk of flooding and the potential impact on supply. We therefore provided DNOs with funding to mitigate this risk in certain areas. We propose to continue to fund this mitigation, and are consulting on whether to place an incentivised output metric on flood resilience.

¹⁵ The guaranteed standard penalties are paid by the DNOs. Therefore any increase in penalties arising from this change in standard will not affect customers.

6. Assessing efficient costs

Chapter Summary

This chapter sets out our process for assessing efficient costs in RIIO-ED1. This includes our proportionate approach to assessing the price control package and the conditions under which we will consider fast-tracking a DNO. It also sets out how we will assess the costs and incentives in place for efficient forecasting and delivery.

More details on the issues in this chapter are set out in the 'Business plans and proportionate treatment' and 'Tools for cost assessment' supplementary annexes.

Question 1: Is our proposed approach to cost assessment appropriate?

Question 2: Do you have views on our proposed use of proportionate treatment?

Question 3: Do you have any views on the criteria for assessing business plans?

RIIO model for assessing efficient costs

6.1. Under RIIO 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 DNOs to develop well-justified business plans which show an understanding of their assets and 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.

6.2. As with RIIO-T1 and GD1, in RIIO-ED1 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 DNOs that submit high quality, well-justified business plans the opportunity for a proportionate regulatory approach. We may offer some DNOs a fast-track settlement where we agree the terms of their price control up to a year earlier than for the other DNOs. 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 DNOs that do so.

6.3. This chapter sets out an overview of how business plans, cost assessment and proportionate treatment fit into the RIIO-ED1 process.

Well-justified business plans

6.4. A core part of RIIO is the companies' development of well-justified business plans. Each DNO is 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 transition to a low carbon economy. DNOs will also be required to demonstrate that their proposals take account of the various risks and uncertainties and provide a strategy to deal with these efficiently and maintain delivery.

6.5. We set out business plan guidance in various RIIO-T1 and GD1 documents and DNOs have seen the feedback we gave the transmission and gas distribution companies on their business plans. We therefore consider that the DNOs should have a good understanding of what comprises a well-justified plan.

6.6. Following stakeholder feedback in RIIO-T1 and GD1 we are providing additional guidance in the 'Supplementary annex - Business plans and proportionate treatment' on how the DNOs should structure their plans in order to make them more accessible and comparable without influencing the companies' proposals. We have also set out a common cost benefit analysis methodology that the DNOs should use to justify their proposals, based on that developed as part of RIIO-GD1. The model being developed by the Smart Grid Forum provides a useful basis for assessing smart grid solutions together with our cost benefit analysis guidance.

6.7. We expect all business plans to contain the following key elements.

- Justification of the DNO's proposed strategy for delivering their output baselines against a thorough understanding of the long-term trends (and risks and uncertainties) they face. In addition, a demonstration that they understand their role, and are looking to be proactive, in contributing to the UK's carbon targets.
- Clear links between expenditures, outputs and secondary deliverables
- Demonstration that the DNO has 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
- A holistic view of the package the DNO believes to be appropriate, ie the company's view on financeability metrics (with evidence), against their view on expenditure and outputs.

Proportionate treatment

6.8. 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 our attention where it is likely to produce greatest value.

6.9. In cases where a DNO produces a particularly high quality business plan which reflects its track record, we will consider whether it is appropriate to conclude that company's price control process early, ie we fast-track the DNO. This is discussed in further detail below.

Incentives associated with proportionate treatment

6.10. The scope for proportionate treatment and, to a greater degree, fast-tracking, provides DNOs with incentives to step up to the challenge of submitting realistic and well-justified business plans. This is because these approaches will allow DNOs to:

- get on with business as usual without focussing 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.

6.11. We are consulting on whether the decision to fast-track a DNO should be recognised in the way we set its information quality incentive (IQI). The IQI is designed to encourage DNOs to provide business plans that reflect best available information about future efficient expenditure requirements. It may therefore be appropriate for it to recognise any company that has supplied information of such a high standard that it can be fast-tracked. The IQI is explained below.

6.12. The scope for proportionate treatment provides strong incentives for DNOs to perform better over time and to submit better quality business plans. It may also provide incentives for companies to reveal information that would not be available otherwise that might assist with the assessment of other companies.

6.13. In Appendix 6 we set out our proposed process and criteria for proportionate treatment.

Fast-tracking

6.14. 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. The key features of fast-tracking are:

- DNO's price control will be finalised approximately nine months ahead of non fast-tracked companies although implementation will still be on the same date for all companies – 1 April 2015
- we will consult on whether any company should be fast-tracked before taking a final decision
- we will ensure that a company that is fast-tracked does not secure a settlement that means they were worse off than had they remained in the process.

Cost assessment

6.15. 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 plan to use benchmarking of historical and forecast data as a means of informing our assessment of the DNOs' forecasts rather than as a mechanistic means of setting allowances.

6.16. We propose to develop a toolkit approach to cost assessment, based on the approach we are using for RIIO-T1 and GD1. The toolkit will comprise both total expenditure (totex) analysis and the use of disaggregated approaches, ie 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. The DNOs are currently developing proposals for totex and disaggregated modelling which they are sharing with us.

Efficiency incentives and IQI

6.17. We want to ensure that DNOs face strong financial incentives to control costs and seek out and implement delivery approaches that provide better value for money for existing and future consumers. We therefore propose to continue to use an efficiency incentive and the IQI, similar to that used in DPCR5 and RIIO-T1 and GD1.

6.18. The efficiency incentive is a fixed and symmetric incentive for each DNO which gives the DNOs a clear and strong financial stake in restraining and, where possible, reducing, the costs of delivering outputs over the price control period.

6.19. The efficiency incentive shares risk. Investors and consumers share the benefits when the company delivers outputs for less money than we envisaged when setting the price control. Similarly, investors and consumers 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 DNO delivering at higher cost than expected and the more they stand to gain if the DNO can deliver at lower cost.

6.20. We are proposing two changes to the way that the efficiency incentive rate is implemented, compared to the efficiency incentive in DPCR5:

- the efficiency incentive rate will 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 total expenditure (totex) is adjusted in light of a given over-spend or under-spend.

6.21. 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.

6.22. 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. 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.

6.23. The application of efficiency incentives and IQI are discussed in detail in the 'Supplementary annex - Outputs, incentives and innovation'.

7. Innovation

Chapter Summary

This chapter considers the role of innovation in achieving the RIIO objectives and specifically the adoption of a time-limited innovation stimulus that builds on, and replaces, the LCN Fund. Further details can be found in the 'Supplementary annex - Outputs, incentives and innovation'.

Question 1: Do you have any views on the role of innovation in RIIO-EDI?

Question 2: What should the funding threshold for the Network Innovation Competition (NIC) be? Do you agree with our proposal to review it after two years to reflect learning from the LCN Fund?

7.1. The DNOs are likely to need to innovate if they are to ensure the delivery of a sustainable electricity sector and that their services represent long-term value for money for existing and future consumers. In DPCR5 we introduced the LCN Fund to encourage the DNOs to sponsor projects which trial innovative technological, operating and commercial arrangements to facilitate the transition to a low carbon future. It is widely considered to have significantly improved the DNOs' attitude to innovation, knowledge sharing and collaborative working with third parties. We expect to see the results of learning from LCN Fund projects in DNOs' business plans.

7.2. The RIIO model has a number of elements that are designed to drive innovation, including the longer price control period, the outputs focus and strong efficiency incentives. Companies may also 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 DNOs to set out the longer-term business case for the innovation and to commit to outputs relating to this expenditure.

7.3. We will also take account of the level of past and future innovation funding provided to the DNOs in setting the efficiency frontier for the period (ie we would expect the innovation to drive more efficient costs).

7.4. However, where the commercial benefit of innovation is unclear, network companies may not have a strong motivation to pursue innovation in a timely way. The RIIO model therefore includes a time-limited innovation stimulus package that builds on the LCN Fund, to supplement the incentives inherent in the framework.

Time-limited innovation stimulus

7.5. In RIIO-T1 and GD1 we are introducing a time-limited innovation stimulus package consisting of an annual competition (NIC), a limited funding allowance (NIA) and a mechanism to fund the roll-out of successful innovation trials. A key requirement of these mechanisms is that the projects funded generate learning for

all the companies, and that this learning is shared. We propose to introduce the same stimulus for RIIO-ED1. Projects will be part-funded, with the DNOs and partners providing at least 10 per cent of the funding.

Network innovation competition (NIC)

7.6. We have already signalled that the LCN Fund will cease at the end of DPCR5¹⁶ and that there will be a single annual competition in the electricity sector (the NIC) covering distribution and transmission. As part of the RIIO-T1 and GD1 reviews we have worked with a variety of stakeholders (including DNOs) to develop the NIC, and have consulted on key elements in separately from the main RIIO process.¹⁷

7.7. The NIC is an annual competition for funding larger-scale innovative projects that have the potential to deliver low carbon or environmental benefits to consumers. It adopts many of the principles established in the LCN Fund, such as partnership working and shared learning. It will also be open to other network licensees¹⁸ to apply for project funding.

7.8. The electricity NIC will start in April 2013 with the commencement of the transmission price control period, RIIO-T1. In RIIO-T1 we set out the amount available (based on only transmission companies competing) as up to £27m per annum.

7.9. The DNOs will join the NIC at the start of RIIO-ED1. We have already stated that the total funding from that point will be reviewed as part of RIIO-ED1. We are consulting on the total amount in the combined electricity NIC from 1 April 2015 that will be available to fund projects proposed by electricity transmission and distribution licensees. Given that the majority of LCN Fund projects are still being implemented, it is difficult to say whether the annual LCN Fund funding limit of £64m is a suitable reference. We are therefore consulting on a maximum funding threshold for the NIC between £60m and £90m per annum for the first two years of RIIO-ED1. This includes the £27m already set for the duration of RIIO-T1. The top end of this range assumes an additional amount similar to that available under the LCN Fund. The lower end assumes an additional amount equivalent to the amount set in RIIO-T1.

7.10. We plan to conduct a review of the LCN Fund in 2016 once sufficient projects have been completed to undertake a comprehensive review of value for money. This will enable us to set a revised level for the NIC from 2017-18 onwards. This revised amount, which could be profiled, will be at least £27m (the amount set in RIIO-T1). Importantly, any of this funding would only be disbursed through the NIC if there are projects of sufficient quality and consumer benefit.

¹⁶ The last LCN Fund competition will be run in 2014, with project funding from 1 April 2015.

¹⁷ <http://www.ofgem.gov.uk/Networks/nic/Pages/nic.aspx>

¹⁸ Offshore transmission operators from 2013 and independent network operators, IDNOs, from 2015.

Network innovation allowance (NIA)

7.11. As in RIIO-T1 and GD1, we are also proposing to fund a limited amount of innovation (the NIA) within DNOs' revenue allowance on a use-it-or-lose-it basis. 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, for the NIA we will also require DNOs to set out an innovation strategy as part of their business plans. We propose to set the NIA for each DNO at between 0.5 and 1 per cent of allowed revenue, depending on the quality of their strategy. The 'Encouraging innovation' chapter of 'Supplementary annex – Outputs, incentives and innovation' sets out more detail on what the information strategy should contain.

Innovation Roll-out Mechanism (IRM)

7.12. We consider that there are strong incentives for DNOs to roll-out successful innovation projects. They can base their ex ante funding request in their business plans on utilising innovative approaches and techniques. Within the price control period, where innovation projects prove that a new technique or practice can lower costs or help the DNO better meet its outputs, the DNO will be incentivised to realise those savings through the efficiency incentive which allows the DNO to share the benefits with consumers.

7.13. However, in RIIO-T1 and GD1 we recognised that there may be occasions where successful innovation does not provide sufficient benefits for the company to fund its roll-out, but where it would provide wider environmental or social benefits. We therefore designed the Innovation Rollout Mechanism (IRM) to enable companies to apply for additional funding within the price control to roll-out a proven innovation where the innovation meets defined environmental criteria. We consider that the same mechanism is appropriate for RIIO-ED1.

7.14. We propose that DNOs will be able to apply for funding in two windows during the price control period. Projects will need to demonstrate low carbon or environmental benefits and long term value for money. They will also need to be material and contain outputs or other end products against which the roll-out will be assessed.

8. 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-ED1 control. It also sets out the scope of the mid-period review.

Question 1: Do you have any views on the uncertainty mechanisms identified?

Question 2: Are there any additional uncertainty mechanisms required?

Question 3: Are there any mechanisms that we have included that are not necessary and why?

Uncertainty in setting price controls

8.1. 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. These risks are arguably greater under an eight-year price control than under a five-year one. 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.

8.2. 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.

8.3. The efficiency incentive, which shares any variations between actual and forecast expenditure between the DNOs and consumers, also helps to reduce the impact of uncertainty. (For further information see Chapter 6.)

What are uncertainty mechanisms?

8.4. 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 - which link revenue allowances to a significant change in volumes
- revenue drivers - which link revenue allowances to specific measurable events which are considered to influence costs
- specific re-openers - provisions to re-set the revenue allowances (or the parameters that give rise to revenue allowances) at a specific date and/or upon crossing a specified threshold

- pass-through items - elements where any changes in costs are recovered fully from customers
- 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

8.5. 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.

8.6. 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.

8.7. 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

8.8. Our 'Supplementary annex - Uncertainty mechanisms' sets out a detailed explanation of the mechanisms that we propose to include in RIIO-ED1. Many are retained from DPCR5, since we judge that the particular uncertainty still exists and the mechanisms are still appropriate. The proposed mechanisms for RIIO-ED1 are set out in Table 8.1 below.

8.9. We are proposing to introduce five new mechanisms, three of which will match mechanisms in RIIO-T1 and GD1. The remaining mechanisms are to cover any unanticipated DNO costs of the smart meter roll-out, and a revenue driver to cover the uncertain cost of connecting low carbon technologies. We are proposing that three of the mechanisms in DPCR5 will not continue in RIIO-ED1.

Table 8.1: Summary of proposed uncertainty mechanisms for RIIO-ED1

type	area covered
Indexation	Inflation Cost of debt [new]
Pass through	Business rates Licence fees
Volume driver	High-volume low-cost connections Volume driver for low carbon connections [new] Smart meter additional call-out costs [new]
Reopener	Street works Critical national infrastructure Load related expenditure (general reinforcement and low-volume high-cost connections) High-value projects Innovation Roll-out Mechanism [new]
	Pension deficit repair [new]
Trigger	Tax legislation

8.10. The DNOs 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

8.11. 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.

8.12. 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.¹⁹ This document provides greater transparency and clarity on the types of circumstances under which we will reopen a price control and the associated process. We are not proposing any changes to these arrangements for RIIO-ED1.

¹⁹ 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](http://www.ofgem.gov.uk/Networks/Policy/Documents1/GUIDANCE%20DOC%20(DECISION%20DOC)%20-%20FINAL.pdf)

Mid-period review of outputs

8.13. Recognising the scope for significant changes in outputs during an eight-year price control period, the RIIO framework sets out a 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 to restrict the scope for the mid-period review 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. This is the same scope that we adopted for RIIO-T1 and GD1.

8.14. 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.

8.15. For RIIO-ED1 we propose that the mid-period review will take place in 2018, with any changes being implemented from 1 April 2019.

Process for the mid-period review

8.16. 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 a change to outputs, the review process will take up to 12 months. This includes:

- three months to consult and decide whether to progress the review
- six months to develop policy (Ofgem and the DNOs)
- three months to consult on proposals and make any amendments.

8.17. Once we have published our decision on the proposed changes, if any, to output requirements, the DNOs 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.

8.18. We provide further details on the proposed process for the mid-period review in the 'Supplementary annex - Uncertainty mechanisms'.

9. Financing efficient delivery

Chapter Summary

This chapter sets out the main financial issues affecting RIIO-ED1. 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 assessing the cost of equity and the associated range of 6.0-7.2 per cent (real post-tax)?

Question 3: Do you have any views on the other elements of our financeability proposals?

Financeability under RIIO

9.1. 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 aimed at ensuring that the network expenditure required in the next ten years can be effectively financed:

- 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.

9.2. The 'Supplementary annex - 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

9.3. In the RIIO framework, we stated that we would add a fixed proportion of costs to the RAV in order to ensure companies face 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 in total costs, to ensure that current and future consumers bear a fair share of costs.

9.4. This policy is already in place for DPCR5. However, not all costs are subject to this capitalisation. For RIIO-ED1 we propose to remove any outstanding boundary issues and include all costs in the capitalisation process. DNOs will need to set out what they think the appropriate capitalisation proportion is in their business plans.

Asset life and depreciation

9.5. 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. During RIIO-T1 we commissioned a review of economic asset lives, and consulted on appropriate periods for all sectors, including electricity distribution. On March 2011 we published our decision²⁰ that we will use an average expected economic asset life of 45 years for new assets, with straight-line depreciation.

9.6. We stated that the new asset life will only apply to new expenditure from the commencement of RIIO-ED1 on 1 April 2015 and that existing assets will continue to use the existing 20-year asset life.

9.7. We also recognised that, even with the policy of applying the change in asset lives to new assets only, transitional arrangements may be required and that these may need to be over more than one price control period. Therefore DNOs will have the opportunity to demonstrate, in their business plans at RIIO-ED1, the transitional arrangements that they believe are necessary to ensure financeability.

The allowed return

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

9.9. Under the RIIO model we continue to use a notional gearing assumption. This will be based on an assessment of the risk of DNOs' cash flows. We will not be able to determine the appropriate level of notional gearing until we have seen and

²⁰ Following a review of economic asset lives, on 31 March 2012 we published our 'Decision letter on the regulatory asset lives for electricity distribution assets'
<http://www.ofgem.gov.uk/Networks/Policy/Documents1/assetlivedecision.pdf>

assessed DNOs' business plans. Indeed, the DNOs themselves will need to set out what they think the appropriate level of gearing is in their business plans.

9.10. At this point we are therefore focussing on setting out the approach we propose to use to determine appropriate notional gearing. This approach is set out in more detail in the 'Supplementary annex – Financial issues'.

Cost of debt

9.11. Under the RIIO model, the cost of debt assumption included in the allowed return is based on the trailing average of a cost of debt index, with revenues updated annually to reflect changes in the index. As for RIIO-T1 and GD1 we propose to introduce an uncertainty mechanism to enable the cost of debt to be adjusted each year based on the iBoxx non-financials 10+ maturity series for a range of broad 'A' and broad 'BBB' credit ratings. Further details of the index are set out in the 'Supplementary annex – Financial issues'.

Cost of equity

9.12. 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.

9.13. We are consulting on a cost of equity range of 6.0 - 7.2 per cent (post-tax real). This is the same range that we set out in the RIIO-T1 and GD1 Strategy Decision. Ahead of the RIIO-T1 and GD1 Initial Proposals our consultants reviewed the cost of equity range and suggested that this range remains appropriate taking into consideration economic developments since the Strategy Decision. We therefore consider that it also remains appropriate for RIIO-ED1 at this time. DNOs will need to set out in their business plans what they think is an appropriate cost of equity consistent with the cash flow risks.

Other financial issues

9.14. For other financial issues (including pensions, tax and RAV) we propose to largely follow established policies and procedures which are set out in full detail in the 'Supplementary annex - Financial issues'.

10. Next steps

10.1. 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 23 November 2012.

10.2. Between October 2012 and January 2013 there will be a number of stakeholder events. These include:

- the next meeting of the Price Control Review Forum (PCRF)
- further meetings of the policy working groups to develop further thinking on the output measures and their associated incentives
- an opportunity for the DNOs to meet with the Authority Committee for RIIO-ED1.

10.3. We expect that the DNOs will also continue their stakeholder engagement during this period.

10.4. We intend to publish our Strategy decision in February 2013 confirming the Authority's decision on the strategy for RIIO-EDI. This will reflect the responses to this consultation and views provided through other stakeholder interactions.

10.5. Our February strategy decision will provide the information required for the DNOs to develop their well-justified business plans. The companies will be required to submit their business plans in July 2013.

Appendices

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Appendix 1 - Consultation response and questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

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 23 November 2012 and should be sent to:

- Anna Rossington
- RIIO-ED1
- 9 Millbank, London, SW1P 3GE
- 0207 901 7401
- RIIO.ED1@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 our Strategy Decision in February 2013. Any questions on this document should, in the first instance, be directed to Anna Rossington, as set out above.

CHAPTER: Three

Question 1: Do you have any comments on our stakeholder engagement approach?

Question 2: Do you have any views on how our engagement process or that of the DNOs could be made more effective?

CHAPTER: Four

Question 1: Do you have comments on the form or structure of the price control?

Question 2: Do you agree with our proposed changes to the RIIO-ED1 timetable?

Question 3: Do you have a view on the materiality of potential changes in allowed revenues/charges between price controls? Do you have proposals to address this?

CHAPTER: Five

Question 1: Do you consider that the proposed outputs and associated incentive mechanisms, taken together with other elements 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 (eg do we have too many or too few)?

Question 3: Do you have any views on the proposed outputs and incentives?

CHAPTER: Six

Question 1: Is our proposed approach to cost assessment appropriate?

Question 2: Do you have views on our proposed use of proportionate treatment?

Question 3: Do you have any views on the criteria for assessing business plans?

CHAPTER: Seven

Question 1: Do you have any views on the role of innovation in RIIO-EDI?

Question 2: What should the funding threshold for the NIC be? Do you agree with our proposal to review it after two years to reflect learning from the LCN Fund?

CHAPTER: Eight

Question 1: Do you have any views on the uncertainty mechanisms identified?

Question 2: Are there any additional uncertainty mechanisms required?

Question 3: Are there any mechanisms that we have included that are not necessary and why?

CHAPTER: Nine

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 assessing the cost of equity and the associated range of 6.0-7.2 per cent (real post-tax)?

Question 3: Do you have any views on the other elements of our financeability proposals?

Appendix 2 – Smart Grid Forum

1.1. In conjunction with DECC, we established the SGF to look at the policy and regulatory implications of smart grids. The SGF aims to:

- identify future challenges for electricity networks and system balancing, including current and potential barriers to efficient deployment of smart grids
- guide the actions that DECC and Ofgem are taking to address future challenges, remove barriers and aid efficient deployment
- identify actions that DECC and Ofgem, the industry or other parties could be taking to facilitate the deployment of smart grids
- facilitate the exchange of information and knowledge between key parties, including those outside the energy sector
- help all stakeholders better understand future developments in the industry that they need to be preparing for
- track smart grid developments and their drivers
- track smart grid initiatives in Europe and elsewhere.

1.2. The SGF work was divided into six work streams. Its recent work has been specifically design to inform RIIO-ED1. We have provided further details on the key work streams relating to RIIO-ED1 below.

- **WS1** – Assumptions and scenarios – DECC has led work on developing four national scenarios around the potential take up of low carbon technologies, which the DNOs are translating into scenarios for their network areas.
- **WS3** – Developing Networks for Low Carbon – the DNOs are leading this work to model the network impacts of the assumptions and scenarios from WS1 and assess the costs and benefits of different smart grids solutions. Given the input from a variety of respected smart grids experts, we expect the DNOs to use this model when justifying smart grids expenditure in their business plans. First indications are that investing in some level of smart grids is likely to be justified irrespective of the volume take up of low carbon technologies, but that it is worth waiting until we have more future certainty (ie RIIO-ED2) before embarking on a wholesale roll-out.
- **WS6** - Commercial and Regulatory. This work stream brings together stakeholders to investigate the commercial and regulatory challenges of implementing the smart grid solutions (including demand side response). The work stream published a report in August 2012. We have used it to inform the RIIO-ED1 policy development. Two key issues this group looked at were whether the network reinforcement costs of demand increases caused by low carbon technologies should be socialised, and whether there are any regulatory barriers to DNOs evolving into system operators (ie balancing generation and demand on their networks) over the RIIO-ED1 period.

1.3. Further information and reports can be found on the Ofgem website at:
<http://www.ofgem.gov.uk/Networks/SGF/Pages/SGF.aspx>

Appendix 3 – Stakeholder engagement

engagement process	description
Consultation documents	Throughout the price control process we will publish consultation documents to allow stakeholders to comment on our current thinking. These will be available on the RIIO-ED1 page of the Ofgem website, and we will use the daily email alert to notify stakeholders of publication.
Stakeholder events	Large open event(s) such as the 'Introduction to RIIO-ED1' (60+ people) used to summarise broad aspects of policy (eg consultation documents) to a wide range of stakeholders. Provides information about key policy areas we have and are considering.
Price Control Review Forum (PCRF)	A high level stakeholder group which provides input to Ofgem and the DNOs about a range of aspects of the price control on an advisory basis. Comprises over 40 representative stakeholders. The forum provides the opportunity for DNOs and their stakeholders to feed directly into the price control review process either on specific issues or across a wide range of issues.
Working groups ²¹	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. The working groups are: <ul style="list-style-type: none"> • Connections Working Group • Cost Assessment Working Group • Customer and Social Issues Working Group • Environmental Issues Working Group • Losses Working Group • Innovation Working Group • Flexibility and Capacity Working Group • Reliability and Safety Working Group.
Bilateral meetings	Over the review we have had numerous bilateral meeting with interested stakeholders and groups and these will continue through the review.
Ofgem commissioned research	Under RIIO the onus is on DNOs 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, for example using our Consumer First Panel of domestic customers.
Ofgem's website	We will post relevant information on the RIIO-ED1 page of the Ofgem website in an open and timely fashion.

We also have a Consumer Challenge Group (CCG) which is a small group of consumer experts which act as a "critical friend" to Ofgem in ensuring that the views of consumers are considered fully in the review.

²¹ Full details of all RIIO-ED1 workings groups, including minutes and slide packs can be found on our website: <http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrls/riio-ed1/working-groups/Pages/index.aspx>

Appendix 4 – Summary of responses to February open letter

1.4. We received 27 responses our 'February open letter'.²² Responses were received from six DNOs, three suppliers, two generators, an IDNO, a Gas Distribution Network operator, DECC, two consumer groups, four trade associations and seven other stakeholders. Not all respondents answered each of the questions set out in the RIIO ED1 open letter. Non confidential responses are published as associated documents to the open letter.²³

1.5. We have summarised the views of respondents and how we have taken them into account, against each of the questions set out in the letter.

Do you agree that ensuring that DNOs accommodate low carbon technologies in a timely and cost effective way should be a key objective of RIIO-ED1? Do you have any thoughts on how we could address this?

1.6. Twenty of the twenty-three respondents agreed that the accommodation of low carbon technologies should be a key objective of RIIO-ED1. Many respondents highlighted that there is a level of uncertainty around low carbon technologies in the RIIO-ED1 period and therefore network flexibility is required including through smart grids and system integration. Many emphasised that DNOs must take a long-term view, through anticipatory investment and ensuring assets and investments are future-proof. There was some agreement that innovation funding will be important in determining how to achieve the objective.

Next steps/our response:

1.7. We have worked with stakeholders in the Flexibility and Capacity Working Group and have also utilised the outputs of the Smart Grid Forum to address this challenge. We have set out our thoughts and proposals on this in Chapter 3 of 'Supplementary annex – Outputs, incentives and innovation'.

Which of the DPCR5 outputs and incentives do you consider to be fit for purpose, or require minimal amendment, for RIIO-ED1?

1.8. A wide range of DPCR5 outputs and incentives were mentioned as requiring minimal or no amendment. Those most frequently cited by respondents were the

²² The open letter can be found at <http://www.ofgem.gov.uk/Networks/ElecDist/PriceCtrls/riio-ed1/consultations/Documents1/RIIOED1LaunchOpenLetter.pdf> with the non confidential responses published as associated documents.

²³ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=1&refer=Networks/ElecDist/PriceCtrls/riio-ed1/consultations>

Interruption Incentive Scheme (IIS), innovation funding, the undergrounding incentive and Business Carbon Footprint (BCF). Many respondents mentioned that the losses incentive was not fit for purpose and should be revisited.

Next steps/our response:

1.9. We agree with the respondents and have only proposed minor modifications to the DPCR5 IIS, BCF, undergrounding arrangements and the RIIO-T1 and GD1 innovation stimulus package. We have revisited the DPCR5 losses incentive mechanism and have set out our new proposals in Chapter 5 of the 'Supplementary annex – Outputs, incentives and innovation' published as part of this consultation.

1.10. After two years of development the BMCS came into effect on 1st April 2012. With only a limited period in which to assess its impact we are not proposing any significant changes to this incentive.

We welcome respondents' views on how we can improve the cost assessment, particularly with respect to the expenditures that will be proposed in RIIO-ED1.

1.11. Some respondents praised aspects of cost assessment in DPCR5 while others highlighted where there is room for improvement. A number agreed that high level regression analysis should not be used for cost assessment. The flexible toolkit approach and totex analysis were endorsed by many respondents, and transparency around benchmarking was also considered important. Some respondents believed that the assessment of efficient costs should be based solely on outputs rather than inputs and should consider the long term benefits of investment. Two respondents highlighted the need to properly include DSR solutions in any cost assessment. A number were supportive of a working group to consider these issues.

Next steps/our response:

1.12. We have taken these views into account when developing the proposals on cost assessment set out in the Supplementary annex - Tools for cost assessment' published as part of this consultation. We have made significant use of the Cost Assessment Working Group in the development of these proposals.

We would be interested to hear stakeholders' views on potential outputs, for example what might be included in the social obligation category, and whether it would be useful to set outputs related, for example, to the role DNOs might play in Local Authorities' integrated energy schemes.

1.13. On the broad question of potential outputs, a range of suggestions were made. One licensee suggested an output to support network flexibility and capacity. Another licensee was supportive of all DPCR5 outputs with the exception of GSOPs for connections as they are too complex, and the losses incentive. Another licensee suggested a broad measure of corporate social responsibility and a measure of

health of the supply chain and employees as outputs. One non-licensee supported outputs for innovation and customer satisfaction.

1.14. On the specific question of social outputs, one licensee raised the concern that at present while there are some areas of social responsibility where DNOs have a clear role there are others where DNOs are less well placed to deliver outputs. Another licensee highlighted that the role of the DNO should end at the meter to avoid confusion with the role of the supplier. Three respondents agreed that DNOs should become involved in Local Authorities' integrated energy systems.

Next steps/our response:

1.15. We have taken the suggestions into account when developing the proposals on outputs set out in the 'Supplementary annex – Outputs, incentives and innovation' published as part of this consultation. These proposals have been developed with the input of DNOs and a range of different stakeholders

Do you think the ED1 price control period should last for eight or nine years?

1.16. The majority of respondents did not have a strong view on the exact length of the price control. However, many respondents raised concerns of the increased uncertainty over the RIIO-ED1 period and the associated increase in risk. One licensee suggested that the price control should last for five years to reduce the uncertainty. Some respondents supported the period length that would create the least resourcing burden on Ofgem. One licensee suggested a one year roll over at the start of the period, but another licensee said they could not support this approach as stakeholders are keen to move to the RIIO framework. In total, three respondents supported nine year periods and four supported eight-year periods. One licensee highlighted the need for the limits of the mid-period review to be clearly specified to avoid a full scale review, regardless of the length of the period.

Next steps/our response:

1.17. We have taken these views into account when developing our conclusion to keep the RIIO-ED1 price control period at eight years. The reasons for this decision are set out in Chapter 4 of this document.

We welcome feedback on the business plans and proportionate treatment process for RIIO-T1 and GD1 and any improvements we can make for RIIO-ED1.

1.18. A variety of concerns were raised by respondents. Many were concerned that the process for fast track assessment is unclear or flawed. Another concern was that the process is not adequately transparent and the criteria are not clear. One licensee noted that for RIIO-GD1 there was not enough transparency in the business plans

and therefore there were difficulties producing comparative analysis. To solve these issues, they urged Ofgem to produce a strawman business plan.

Next steps/our response:

1.19. We have held a stakeholder workshop to gather more detailed views on the business plans and have also received valuable input from the Consumer Challenge Group. We have used this input to develop the revised business plan guidance set out in the 'Supplementary annex – Business plans and proportionate treatment' published as part of this consultation.

We welcome feedback on the company stakeholder engagement processes used in RIIO-T1 and GD1, and also welcome any feedback on the consultations being initiated by the DNOs.

1.20. The majority of respondents felt that stakeholder engagement should be a main feature of RIIO-ED1 and that there needs to be continued engagement as part of ongoing business as usual. However, one licensee responded that there is no obvious decision-making process for opinions from stakeholders to be fed into and form part of business plans.

Next steps/our response:

1.21. Our assessment of business plans will take into account how each DNO enabled the views of a range of different stakeholders to feed into the development of their plans.

Have these stakeholder engagement groups been useful in RIIO-T1 and GD1? Are there any improvements that we could make for RIIO-ED1?

1.22. The majority of respondents found stakeholder engagement groups useful. Many suggested improvements for RIIO-ED1. One licensee suggested that Ofgem should provide guidance on relative priorities to help DNOs weigh up conflicting stakeholder needs. One non-licensee stakeholder said that stakeholder engagement groups need clear terms of reference and prioritisation. Another non-licensee stakeholder noted that Ofgem's Consumer Challenge Group is a better way of gaining informed engagement.

Next steps/our response:

1.23. In preparing their business plan each DNO needs to take responsibility for the stakeholder engagement activities that underpin their submission. We expect DNOs to engage with a wide range of different stakeholders but we do not believe it is appropriate for us to identify these groups for the DNOs. In presenting their business plan, DNOs should be able to clearly articulate what they see as their priorities and how they have balanced the competing views of different stakeholder groups.

Appendix 5 – RIIO-ED1 timetable

phase	year	month	milestone
Strategy Development	2012	February	Open letter consultation published (8 weeks consultation)
		September	Strategy Consultation published (8 weeks consultation)
Initial Business Plan Assessment and fast-track decision	2013	February	Strategy Decision published
		July	DNOs submit & publish business plans Invitation for comments (4 weeks)
	October	Initial Assessment and fast-track Draft Determination published (8 weeks consultation)	
Draft and Final Determination and launch	2014	February	Fast-track Final Determination published
		March	Non-fast-track DNOs resubmit & publish business plans Invitation for comments (4 weeks)
		July	Non-fast-track Draft Determination published (8 weeks consultation)
		November	Non-fast-track Final Determination published
	December	Statutory Consultation (28 days) on licence modifications	
	2015	April	Wednesday 1 st - new price control (RIIO-ED1) commences

Appendix 6 – Process and criteria for proportionate treatment

Process

1.24. We propose three key stages to the process for assessing whether a DNO receives proportionate treatment or potentially fast-tracking:

- Stage 1 – In July 2013 DNOs submit their business plans, informed by our February 2013 Strategy Decision and their stakeholder engagement. We will undertake an initial assessment of the plans and consider their overall quality. We will assess whether there are any candidates for proportionate treatment or fast-tracking and publish our recommendations in October 2013. These recommendations will set out our Draft Determination for the settlement for any DNO we consider could be fast-tracked and our initial assessment of the other business plan submissions.
- Stage 2 – We will assess the responses to the fast-tracking and proportionate treatment recommendations and publish our decision in February 2014. For fast-tracked DNOs, that decision will constitute the Final Determination.
- Stage 3 – We will develop and publish Draft and Final Determinations for non fast-tracked DNOs in July 2014 and November 2014 respectively. The price controls for all DNOs will come into effect on 1 April 2015.

1.25. More detail on each of these stages is set out in our 'Supplementary annex - Business plans and proportionate treatment'.

Assessment criteria

1.26. The initial assessment of the business plans will be informed by three different sources of evidence:

- the quality of the DNO'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 DNOs - including benchmarking data
- our assessment of performance during the previous price control period.

1.27. 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) reflection of strategy in the plan. These reflect the RIIO recommendations and align with the business plan guidance set out in our

RIIO-T1 and GD1 documents. These criteria are set out and discussed in detail in our 'Supplementary annex - Business plans and proportionate treatment'.

1.28. We are not assessing the DNOs' historical performance ahead of their business plan submissions, but expect them to set out how they will address areas of relative inefficiency and concerns over DPCR5 delivery in their business plans.

1.29. It is possible for all, some or no companies to qualify for fast-tracking or proportionate treatment. 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

1.30. A key principle of fast-tracking is to ensure that a DNO that is fast-tracked is no worse off than if they had remained in the process, in order that there is no disincentive for companies to aim for fast-tracking.

1.31. There are a number of reasons why we do not consider it likely that a fast-tracked DNO would receive a worse settlement. We would expect fast-tracked DNOs 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 DNOs should be set less exacting efficiency goals or more generous financial settlement. These reasons are:

- in order to be considered high quality, well-justified and suitable for fast-tracking a DNO's business plan will need to be well informed about potential longer-term trends, ie it would be more likely to anticipate future changes and have built in mechanisms for dealing with these
- those not being fast-tracked are likely to be subject to heavier regulatory scrutiny, 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.

Appendix 7 - 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:

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