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To network companies,
generators, suppliers, consumers
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other interested parties.

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Dear colleague

Assessment of RIIO-ED1 business plans and fast-tracking

This letter summarises our assessment of the 14 distribution network operators' (DNOs) business plans for the next price control period, RIIO-ED1.[1] We consider that only Western Power Distribution's (WPD) plans for its four licensees are consistently high quality across the board. We believe that these plans represent good value for current and future customers and should therefore be finalised early (termed 'fast-tracking') subject to the outcome of this consultation and the consultation on the methodology for assessing equity market returns described below.

The potential to be fast-tracked has driven all DNOs to raise their game in terms of delivering more for less. Plans show efficiency savings of more than £2 billion versus their previous forecasts. However we set a high hurdle for fast-tracking, which only WPD has met. The other DNOs' plans show areas of strength, but we consider that all have scope for improvement. We have therefore decided that the remaining ten DNOs must resubmit their plans. We expect the revised plans to show improved value for customers.

We provide more detail on our assessment in a supplementary annex entitled 'Assessment of the RIIO-ED1 business plans'.[2] We have also published our Draft Determination for WPD which consults on the details of their price control settlement.[3] We will consider views as part of our fast-track decision which we will publish at the end of February 2014. Our decision at that point will be either to fast-track WPD or take it through the slow-track process. Please submit any written comments to this letter and Draft Determination to RIIO.ED1@ofgem.gov.uk by **22 January 2014**. Unless clearly marked as confidential, responses will be published on our web site.

Background

RIIO-ED1 will set the outputs the 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

[1] The eight year RIIO-ED1 period starts on 1 April 2015 and ends 31 March 2023.
[2] https://www.ofgem.gov.uk/publications-and-updates/riio-ed1-draft-determinations-fast-tracked-distribution-network-operators
[3] https://www.ofgem.gov.uk/network-regulation-%E2%80%93-riio-model/riio-ed1-price-control

to 31 March 2023. It is the first price control review in the electricity distribution sector to be conducted under our new RIIO model (Revenue = Incentives + Innovation + Outputs).[4]

A core part of RIIO is the network companies' well-justified business plans. Each DNO was required to submit a detailed plan which demonstrates how they will deliver in the interests of both existing and future consumers and how they will meet the challenges associated with the transition to a low carbon energy sector. These plans should take into account the needs and views of the company's stakeholders.

Under RIIO we apply proportionate treatment to companies' plans, where the level of our regulatory scrutiny varies according to the quality of the plans. This encourages companies to submit their best view upfront. We have stated that DNOs that submit very high quality plans would be offered the option of agreeing their price control early – termed fast-tracking.

In March 2013 we published our Strategy Decision[5] on the key elements of the regulatory framework for RIIO-ED1. This included the outputs DNOs are required to deliver, incentives and financial parameters. It also provided business plan guidance and described the tools we would use for assessing the DNOs' plans. The DNOs submitted their plans to us on 1 July 2013, and published them on their websites.[6] We published an open letter on the same day, seeking views. We have published responses on our website[7] and summarised them in an appendix in the 'Assessment of the RIIO-ED1 business plans' supplementary annex.

Consultation on our methodology for assessing equity market returns

The Competition Commission (CC) published its provisional determination for Northern Ireland Electricity on 12 November 2013.[8] The CC, or its successor the Competition and Markets Authority, is the appeal body for the RIIO-ED1 settlements. We have identified a difference between the position adopted by the CC in this provisional determination and the methodology we have generally adopted, and signalled in our Strategy decision, for assessing equity market returns. We use an assessment of equity market returns to set the cost of equity for the companies, which, in conjunction with the cost of debt, is used to set the return a DNO can earn.

We consider it is necessary for us to consult before we can reach a considered evaluation of the methodology we use to assess equity market returns. We will conduct the methodology consultation early in December 2013, with a view to making a decision in advance of our decision on fast-tracking at the end of February 2014. Should we conclude it is appropriate for us to adopt the CC's position for estimating equity market returns, we would need to take this into account in our fast-tracking decision. This means that we would provide WPD with the opportunity to accept an adjusted cost of equity as part of its fast-track settlement. We would calibrate this adjustment to reflect only the change in policy.

We explain the issues and the process in more detail in the Assessment of the RIIO-ED1 business plans supplementary annex.

Our assessment of RIIO-ED1 business plans

The business plans submitted by the DNOs show a marked improvement over previous price control submissions and demonstrate that they have responded positively to the RIIO

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[4] More information on the RIIO model can be found at https://www.ofgem.gov.uk/network-regulation-%E2%80%93-riio-model
[5] See Ofgem (4 March 2013, ref: 26/13) Strategy decision for the RIIO-ED1 electricity distribution price control https://www.ofgem.gov.uk/ofgem-publications/47067/riioed1decoverview.pdf
[6] The RIIO-ED1 page on our website provides links to all the plans https://www.ofgem.gov.uk/network-regulation-%E2%80%93-riio-model/riio-ed1-price-control
[7] https://www.ofgem.gov.uk/publications-and-updates/open-letter-consultation-riio-ed1-business-plans
[8] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2013/northern-ireland-electricity-price-determination/131112_main_report.pdf

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framework. The DNOs have clearly learned from the RIIO-T1 and GD1 price control reviews in transmission and gas distribution. All have engaged with stakeholders in developing their plans and reflect consideration of stakeholders' views. All have also made strides towards developing plans that are outputs-led and demonstrate how they have taken account of a wider range of issues. This included their role in helping vulnerable customers, contributing to delivering a sustainable energy sector and the risk and uncertainties associated with delivering their plans. The DNOs have all published significantly more information than they have in previous price controls.

The DNOs' financial proposals generally comply with our policies. All DNOs accepted the indexation of the allowed return on debt, proposed notional gearing of 65 per cent and proposed an allowed return on equity of 6.7 per cent (6.8 for ENWL). In light of downside uncertainty surrounding the cost of equity, we assess that these proposals would only be satisfactory for a company that commits itself to especially tough cost efficiency assumptions. Our assessment is that only WPD's plans will deliver the cost efficiencies that we consider are consistent with their financial proposals.

We have undertaken an assessment of the business plans against the five assessment criteria set out in our Strategy Decision. Our assessment is summarised in Table 1 and set out in more detail in the supplementary annex to this letter. WPD is the only DNO group to score green across all five criteria. We therefore conclude that only WPD's plans contain strong outputs at good value for money. We propose to accept its plans and fast-track the settlement for its four licensees, subject to consultation.

In the first year of RIIO-ED1, WPD forecasts an average reduction in distribution charges for domestic customers of between 7 and 22 per cent (in real terms) across its four licensees.[9] Over the remaining seven years of RIIO-ED1, WPD forecasts these charges to rise by one per cent per annum (in real terms). WPD has historically been at the frontier of customer service and reliability, and, since the take-over of the two network companies previously owned by E-On has demonstrated its ability to turn-around the service of these companies while driving out costs.

No plan will be perfect and it may be possible for some stakeholders to identify specific elements which they would like improved. However, we have assessed the four WPD DNOs as providing clear value for consumers, with the most efficient costs against deliverables that stakeholders value, and that these are the only plans to be sufficiently justified on all five criteria to merit fast-tracking.

Our assessment against each of the criteria is summarised in Table 1 as follows:

- green denotes aspects of companies' plans that are broadly acceptable to us
- amber denotes areas where we consider some work will be required to produce acceptable proposals in the business plan submitted at slow-track
- red denotes areas where we consider a lot of work will be required to produce acceptable proposals in the business plan submitted at slow-track.

[9] WMID: 7 per cent reduction; EMID: 7 per cent reduction; SWALES: 22 per cent reduction; SWEST: 15 per cent reduction

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Table 1: Summary of assessment of DNOs' business plans

DNO Group	licensee[10]	Process	Outputs	Resources – efficient costs	Resources – efficient finance	Uncertainty and risk
Western Power Distribution	WMID					
	EMID					
	SWALES					
	SWEST					
Electricity North West Ltd	ENWL					
Northern Powergrid	NPgN					
	NPgY					
UK Power Networks	LPN					
	SPN					
	EPN					
SSE Power Distribution	SSEH					
	SSES					
SP Energy Networks	SPD					
	SPMW					

Western Power Distribution: West Midlands, East Midlands, South Wales, South West (WMID, EMID, SWALES, SWEST)

WPD's plans are clear and reasonably easy to navigate. WPD demonstrates a robust approach to stakeholder engagement which has clearly informed the plan. It plans to build on its strong historical performance in outputs, especially with respect to customer service and reliability. It also sets out more challenging and binding reliability targets than those specified by Ofgem.[11] It also has a comprehensive social strategy. We note that we expect WPD to review and strengthen its losses and innovation strategies, at the earliest opportunity.

WPD sets out reasonable benefits from smart grids solutions, and, in our assessment, it has proposed a challenging cost package which is the most cost efficient of all the DNOs. It provides reasonable explanations around its approach to uncertainty and risk.

<u>On this basis we propose to fast-track WMID, EMID, SWALES, SWEST.</u>

Electricity North West Ltd (ENWL)

ENWL's plan is clearly written and relatively easy to navigate. It provides clear evidence of stakeholder engagement, and a strategy for long term delivery. It has ambitious output objectives particularly versus its current performance on customer satisfaction and connections.

ENWL provides good justification for its choice of uncertainty mechanisms, and forecast of low carbon technology take-up. While it does not explicitly set out how it would use smart grids, ENWL does appear to have included significant smart grids benefits in its plan.

ENWL proposed a higher cost of equity than the other DNOs without a compelling justification, and we have factored this into the cost efficiency benchmark. At this stage, we are not convinced that its proposed expenditure allowances are efficient.

<u>On this basis we have decided not to fast-track ENWL.</u>

[10] The licensee names are spelled out in the text following the table

[11] We have not assessed these new targets as part of the outputs assessment, as the reliability targets proposed by Ofgem are deemed acceptable. However we have factored the value of these additional outputs into the expenditure assessment.

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Northern Powergrid (NPg): Northeast and Yorkshire (NPgN and NPgY)

NPg submitted very well written plans which were praised by stakeholders for their clarity and readability. It is clear that stakeholder feedback has significantly informed the plan. NPg's proposals for outputs are strong, particularly its very comprehensive social strategy. It provides reasonable explanations around its approach to uncertainty and risk.

NPg's plans include a good strategy for using smart grids solutions, and anticipate reasonable benefits from doing so. However, at this stage, we are not convinced that NPg's proposed expenditure allowances are efficient, particularly their assumptions for real price effects and overall efficiency on asset replacement.

<u>On this basis we have decided not to fast-track NPgN and NPgY.</u>

UK Power Networks (UKPN): London Power Networks, South East Power Networks and Eastern Power Networks (LPN, SPN and EPN)

UKPN's plans are clear and well-written, and show significant evidence of how they have been informed by a good stakeholder engagement process. It has ambitious output objectives, particularly versus its current performance on customer satisfaction and connections. It has a comprehensive social strategy. However, we consider its proposals on asset health, asset loading and resilience are lacking for LPN and SPN. It provides reasonable explanations around its approach to uncertainty and risk.

UKPN's plans include a very good strategy for using smart grids solutions, and anticipate reasonable benefits from doing so. However, at this stage, we are not convinced that the expenditures they contain are efficient, particularly on load-related expenditure and asset replacement for EPN and LPN.

<u>On this basis we have decided not to fast-track LPN, SPN and EPN.</u>

Scottish and Southern Energy Power Distribution (SSEPD): Hydro and Southern Electric (SSEH, SSES)

SSEPD's plans are generally acceptable in terms of presentation and clarity, and provide some information on how they have been informed by stakeholder engagement. It has good outputs for customer service and connections but we have concerns over its assumptions on losses reductions, with high associated costs. While it has historically performed well on reliability, we have concerns about the reliability of its asset health and criticality data and its information on asset loading. Its social commitments are narrow.

It does not provide a clear picture of the cost savings from using smart grid solutions, and we are not currently convinced that its proposed expenditure is efficient. We consider that SSEPD has significantly de-risked its plan (the cost of which passes to consumers) by amending some of the uncertainty mechanisms we set out in the Strategy decision, and adding a significant new one.[12] It provides little justification for this, and we note that no other DNO deems these added protections necessary.

<u>On this basis we have decided not to fast-track SSEH and SSES.</u>

SP Energy Networks (SPEN): Distribution and Manweb (SPD, SPMW)

SPEN's plans are generally acceptable in terms of presentation and clarity. However, in an answer to a clarification question it provided information that gave us concerns about the accuracy of its asset data. It has ambitious output objectives particularly versus its current performance on customer satisfaction. It does not set out how it proposes to reduce losses,

[12] SSEPN also proposed an uncertainty mechanism for the diversion costs of National Rail's electrification programme. We consider that this mechanism is appropriate.

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despite including costs to do so. We also consider its proposals on asset health, asset loading and resilience are weak, and its social commitments are narrow.

SPEN's financing proposals are relatively well justified. It accepts the uncertainty mechanisms set out in the Strategy Decision, but provides little consideration of risk or transition between different scenarios for the take-up of low carbon technologies.

SPEN's strategy for using smart grids solutions could be clearer, although it anticipates reasonable benefits from doing so. However, SPEN is an outlier in our assessment of efficient costs – especially SPMW – which is largely due to very high network investment.

<u>On this basis we have decided not to fast-track SPD and SPMW.</u>

Next steps

Alongside this letter we have published WPD's Draft Determination for consultation. We will consider responses and will publish our decision on whether to fast-track WPD in February 2014. If WPD is fast-tracked, we will publish its Final Determination at the same time. If it is not fast-tracked, WPD will return to the slow-track process.

As stated earlier, we will also consult in parallel on the methodology for assessing equity market returns. We aim to publish the decision on the methodology in February 2014, in advance of our fast-tracking decision. Should we conclude it is appropriate for us to adopt the CC's position, we will offer WPD the opportunity to accept an adjusted cost of equity as part of its fast-track settlement.

For those DNOs that have not met the standard to be fast-tracked, we will provide further feedback on their plans on a bilateral basis. This will focus on areas they need to address before resubmitting their plans for the slow-track process in March 2014. We expect the DNOs to improve their plans as part of the slow-track process, while retaining the commitments set out in their original plans.

Yours sincerely

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