



Making a positive difference
for energy consumers

To: Electricity and Gas Distribution companies, Electricity and Gas transmission companies, consumer groups', investors, users of Regulatory accounts and other interested parties

Direct Dial: 020 3263 9945
Email: sanjay.vadhera@ofgem.gov.uk

Date: 24 June 2015

Dear All,

Open letter consultation on our proposals to develop and introduce RIIO accounts

Introduction

This is an open letter to invite interested parties to engage with us over the next few months during a consultation on a proposed new form of regulatory reporting. The new form of accounts will apply to the network operators (NWOs) that are regulated under our RIIO framework. NWOs' licences currently require them to prepare Regulatory accounts, but stakeholders have explained to us, and we agree, that the current form of those accounts can make it difficult to interpret the regulatory position and performance of the NWOs. We intend that the new accounts, which we expect to call RIIO accounts, will improve transparency.

We also invite interested parties to give us their initial views on:

- **the content of the proposed RIIO accounts**
- **our proposed engagement timetable**
- **our draft principles of corporate governance, in Appendix 1**

About RIIO accounts

We have carried out some initial work on potential RIIO accounts. We have identified that the Price Control Financial Models (PCFMs) for each sector, which we update annually in our RIIO annual iteration process, would provide an authoritative foundation for NWOs to report on their regulatory financial position and performance. We expect RIIO accounts will include primary accounting statements on the NWO's regulatory financial position and regulatory financial performance. These statements would reflect the regulatory accounting and incentive mechanisms in RIIO and in particular the economic value implicit in the Regulatory Asset Value for each NWO. They would adopt high standards of accounting discipline and be prepared to the end of each regulatory financial year of the 31 March.

Consistent with our requirements for Regulatory accounts, we expect RIIO accounts would also include a statement on regulatory corporate governance.

These statements would be accompanied by further disclosure notes as necessary to assist readers in understanding and interpreting the information.

We expect that NWOs will publish RIIO accounts within four months of the end of the regulatory financial year, as they currently do with Regulatory accounts.

During the course of this programme of dialogue and consultation, we propose to develop the format and contents of RIIO accounts, a Regulatory Financial Reporting Standard (RFRS) for their preparation and the basis on which auditors express an opinion on them. We anticipate that auditors will express an opinion on whether or not the RIIO accounts present fairly the regulatory financial position and performance of the respective NWO in accordance with the RFRS.

Benefits of RIIO accounts

In our preliminary discussions, many in the industry, the investor community and consumer groups have expressed support for accounts that reflect the RIIO position and performance of NWOs. One NWO has already taken the initiative of separately reporting its 2013-14 RIIO results¹ to investors. This indicates to us that audited accounts under an Ofgem-designed framework would improve the transparency of information available to investors and other stakeholders.

Our design criteria would be for RIIO accounts to present information that helps current and potential investors (shareholders and lenders), rating agencies, consumers and other stakeholders to understand whether or not NWOs are creating value under our incentive-based regulatory regime.

The aim of the RIIO regime is to encourage NWOs to create value for consumers. The regime's incentive mechanisms operate by harnessing the interest of investors towards this aim. We believe RIIO accounts should therefore be primarily addressed to shareholders.

The principles of corporate governance set out in the UK Corporate Governance Code should encourage NWOs to report to their shareholders on how creating value for consumers underpins value-creation for investors, how boards satisfy themselves that NWOs comply with their regulatory obligations and how investors can be confident of long term financial viability.. In Appendix 1, there is a draft statement of principles that expand on the principles in the UK Corporate Governance Code for the specific circumstances of a regulated company. We invite interested parties to comment on this.

Taking these reforms to regulatory accounting and corporate governance reporting together, we believe RIIO accounts should help improve the quality of information available to all stakeholders, not just shareholders. Giving stakeholders better information to judge how NWOs are performing should amplify the effectiveness of our incentive-based regime in encouraging good performance. This will benefit both consumers and investors.

The wider context of regulatory reporting

RIIO accounts will need to be designed to build on other improvements in the way we and NWOs communicate performance under RIIO; including more published information on the company website about network company performance against outputs and efficient expenditure targets as in the annual reports on RIIO performance that we recently published.

Aside from this consultation on regulatory reporting reforms, we will also soon be seeking stakeholders' views on how best to report on overall company performance within the context of the new RIIO-ED1 price control. We are keen to ensure that information reported

¹ National Grid published its [RIIO Baseline Databook](#) to reflect its outlook for RIIO following the November 2014 Annual Iteration Process, which updated the 8 year financial model for RIIO-T1 with 2013-14 actual expenditure.

by Ofgem and the Distribution Network Operators (DNOs) is appropriately targeted and meets the needs of a wide range of stakeholders. Any lessons we learn from this project will help inform the way NWOs in other sectors report on overall performance.

Responding to this consultation and next steps

It is important that we receive views from a wide range of stakeholders. This letter starts the initial consultation process. We seek your views on the issues raised in this paper and your responses to the questions in Appendix 2. In particular, we would like to assess any impact that the replacement of Regulatory accounts with the proposed RIIO accounts will have on the regulatory burden and we invite your views on this.

Further consultation will follow this, incorporating all your responses and further developments in all the workstreams involved. We hope to include draft statements to RIIO accounts in this further consultation, as well as draft RFRS principles mentioned in this letter.

Subject to the responses to this open letter, RIIO accounts will be further developed for implementation by March 2016.

Appendix 3 consists of a proposed timeline of activities going forward. Workshops will continue to be held with NWOs, audit community and investor groups to engage them on the process as we proceed.

Please submit your completed feedback questionnaire (Appendix 2) to Sanjay.Vadhera@ofgem.gov.uk by 5 August 2015. Word document of the feedback questionnaire is attached separately. Unless your response is clearly marked as confidential we will publish it on our website.

If you would like to discuss the contents of this letter please call Sanjay Vadhera on 0203 263 9945.

Yours faithfully

Ian Rowson
Associate partner, Regulatory Finance and Compliance

Annex 1- Background and further information on RIIO accounts

Existing regime and reasons for reform

The current reporting requirements are in standard special licence conditions A30 on Regulatory accounts for Gas Distribution and Transmission, standard condition B1 on Regulatory accounts for Electricity Transmission and standard condition 44 on Regulatory accounts for Electricity Distribution. If the Regulatory accounts were to be replaced, these licence conditions will need to be modified to reflect the introduction of RIIO accounts.

We currently require NWOs to prepare Regulatory accounts for each year to 31 March on an historical cost accounting basis, consistent with their statutory accounts. However, it is now widely acknowledged that a statutory accounting basis cannot present a fair view of a regulated company's regulatory performance and position, a view that is of increasing importance to the investor community and other stakeholders.

Our preliminary discussions with a wide range of stakeholders indicate that accounts presented in RIIO terms, provided they are subject to audit and prepared in accordance with appropriately designed regulatory financial reporting standards, would be more meaningful and useful.

We propose that RIIO accounts would present assets, liabilities, equity, revenues and returns within a RIIO regulatory context. For example, the Regulatory Asset Value (RAV) will be shown in the statement of regulatory financial position and allowed revenues will be shown in the statement of regulatory financial performance. The type of information that stakeholders normally request will become **transparent** on the face of the accounts.

RIIO accounts, if it's introduced would be in line with the shift in global reporting to acknowledge the corporate social responsibility of companies to their stakeholders by providing more meaningful information through reports. We expect that they will help different stakeholders to hold the NWOs' boards of directors to account for their performance.

Our development of RIIO accounts will be informed by the International Accounting Standards Board (IASB)'s emerging thinking and ongoing work on reporting the Financial Effects of Rate Regulation².

RIIO accounts will be designed to achieve **consistency** in how financial information on networks is presented. This will make it easier to compare performance in absolute and relative terms. We aim to facilitate this by developing a support module to the existing PCFM that will be available to the NWOs to automate the regulatory asset and inflation accounting for the statements of regulatory financial position and regulatory financial performance. Other inputs into the statements will be provided as adjustments by the networks using Ofgem's prescribed principles in the Regulatory Financial Reporting Standard (RFRS) we plan to develop.

A number of network operators we have engaged with are keen to report performance that is in line with the RIIO regime. This reflects the efforts some of the transmission and gas distribution businesses have already made to develop performance information for their stakeholders that reflects the RIIO economic environment in which they operate.

² For example, see <http://www.ifrs.org/Current-Projects/IASB-Projects/Rate-regulated-activities/Discussion-Paper-September-2014/Documents/Discussion-Paper-Reporting-Financial-Effects-Rate-Regulation-September-2014.pdf>

Contents of the RIIO accounts

We expect RIIO accounts will consist of a statement of regulatory financial position, a statement of regulatory financial performance and a statement of regulatory corporate governance.

Preparation of RIIO accounts will be significantly simplified by a support module to the PCFM. This will handle the more complex RAV accounting and inflation calculations for the NWOs and generate the core input values for RIIO accounts.

Statement of Regulatory Financial Position

The statement of regulatory financial position would include disclosure of the network's assets and liabilities in RIIO terms; for instance Regulatory Asset Value (RAV), other regulatory balances (such as accrued output incentives and accrued under or over-recovery of revenue), net financing balances and working capital.

Importantly, RFRS would require NWOs to make adjustments to regulatory balances to ensure they represent fair or enduring value to investors.

We would expect RIIO accounts will not only provide improved transparency in economic performance of the NWOs, but will also help improve understanding of Ofgem's regulatory processes.

Statement of Regulatory Financial Performance

We envisage this statement would disclose the network's turnover and costs in RIIO terms. It will present two perspectives. The first will show revenue and deductions for non-capitalised expenditure, regulatory depreciation, inflation-adjusted interest and tax resulting in the real³ equity return for the NWO. The second would present reconciliation between the real equity return and allowances for the cost of equity showing how the NWO has created positive or negative value from incentives etc.

Statement of Regulatory Corporate Governance

We also anticipate that a third primary statement will draw from the now familiar reporting of UK listed companies on their corporate governance. The NWOs are not listed companies, but we will specify in the licence conditions, that they should nonetheless report on their regulatory corporate governance as if they were listed, in other words in accordance with the UK Corporate Governance Code (UK Code) (which is periodically updated by the Financial Reporting Council).

We have developed draft corporate governance principles for price controlled networks, included as Appendix 1, that apply the principles set out in the UK Code (intended to be an interpretation of the UK Code in a regulatory context not an attempt to extend it). We present these principles in this open letter with a view to informing and capturing the investor community's expectations on how NWO boards should report on their governance. If we are successful in establishing an investor expectation of fuller reporting, we hope to minimise the need for specific further governance reporting requirements.

We believe there are a number of features of UK corporate governance reporting that would help stakeholders understand how NWOs generate value for their shareholders by generating value for wider stakeholders in an incentive-based regime. Some examples follow.

³ Inflation-adjusted

- i. The UK Code acknowledges that the interests of other stakeholders can be relevant to the long-term success of a company, and we wish to build on this so that NWOs report on how the value they are creating for consumers relates to and supports the value they are creating for investors and how their business strategy aligns with the longer term interest of consumers.
- ii. One of the principles in the UK Code is that the board should ensure that its obligations to its shareholders and others are understood and met. As regulated entities, NWOs have material obligations under their licences. We envisage boards reporting on how they satisfy themselves that they comply with their licence obligations.
- iii. The 2014 update of the UK Code focused on the provision by companies of information about the risks which affect longer term viability. This would allow NWOs to describe how price control and our ring-fence protections help secure longer term financial viability.

Audit opinions and regulatory financial reporting standards

We have held preliminary discussions with representatives of the NWOs' auditors. They have shown interest in working collaboratively with us on developing the RIIO accounts proposals and that there is a broader public interest in doing so. We will aim, through this dialogue to develop a basis for an audit opinion that provides assurance that the RIIO accounts fairly represents the regulatory financial position and regulatory financial performance of the NWOs. The audit opinion would need to consider the board's judgement on matters such as accrued incentives and the need to make provision for non-delivered outputs.

We envision that one of the deliverables of this project will be the RFRS. The RFRS will specify the accounting principles necessary for RIIO accounts to present fairly the NWOs' regulatory financial position and performance. Where possible, the RFRS will be principles-based rather than rules-based and draw from existing accounting concepts, including IFRS 15 and the IASB's continuing work on reporting the financial effects of rate regulation. The RFRS will document the principles behind the support module to the PCFM we plan to develop.

APPENDIX 1- Draft principles of regulatory corporate governance

Introduction

These principles expand on the principles of corporate governance set out in the UK Corporate Governance Code (UK Code) to help boards of directors and users of accounts interpret the UK Code's application to licensed operators of energy networks, subject to price control under RIIO. They may also be relevant to the governance of groups that contain licensee companies.

These principles are not a rigid set of rules and an alternative to following them may be justified in particular circumstances if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders in the company's annual RIIO accounts.

The main focus of these principles remains the relationship between the company and its shareholders. In light of their regulated status, companies are encouraged to recognise the role of other stake holders and to confirm the board's interest in listening to their views and understanding their interests insofar as these are relevant to the licensee company's overall approach to governance.

While governance of a licensee company is the responsibility of that company's board, these principles recognise that some aspects of a licensee company's governance may be shared with companies within a group. It would be for the company's board of directors to be satisfied that the company's governance, taking all aspects together, operates in the licensee company's interest and meets appropriate standards.

Leadership

RA1 When setting the licensee company's values and standards and ensuring that its obligations to its shareholders and others are understood and met, the board is encouraged to recognise the obligations the company has under its licence. The board is also encouraged to recognise that the longer term success of the company as a licensee depends on effective engagement with, and maintaining the shared interest of a wide range of other stake holders - including consumers and the regulator.

Effectiveness

RB1 When identifying in the annual report each non-executive director it considers to be independent, if relevant, the board should refer to the licensee company's licence requirement to have two Sufficiently Independent Directors, explain the roles played by those directors, and explain the governance relationships between any wider group and the licensee company.

Accountability

RC1 These principles are relevant to the annual RIIO accounts of a licensee company that is required to prepare them and should be considered by the board in presenting its statement of regulatory corporate governance.

RC2 In exercising its responsibility to present a fair, balanced and understandable assessment of the licensee company's position and prospects, the board should take account of the company's regulated business model and the wider range of stake holders who have an interest in and an ability to influence its future.

RC3 The directors' explanation of the basis on which the licensee company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company should refer to the regulatory incentive regime the company operates under, and the shared interests of consumers and investors in the company's success.

RC4 Reflecting the benefit-sharing nature of the licensee company's regulatory regime and that demonstrating benefits for consumers helps maintain the perceived legitimacy of the regime, the board should explain how consumers have benefited from performance alongside the benefits for shareholders.

RC5 In confirming their robust assessment of the principal risks facing the licensee company, the directors should describe how the principal risks affecting consumers, both in terms of tariff and service levels and in the shorter and longer term, are being managed or mitigated.

RC6 The board's report on its review of the licensee company's risk management and internal control systems should cover its controls over compliance with its licence obligations.

RC7 The board should satisfy itself that the terms of reference for the main role and responsibilities of the audit committee that the board relies on for oversight of the licensee company's risk management and internal control systems, which may be a committee of the holding company's board, covers the company's controls over compliance with its licence obligations.

APPENDIX 2 - FEEDBACK QUESTIONNAIRE (an editable version of this questionnaire is separately attached as a word document)

Thank you for taking the time to respond to our questions
We hope all the questions are understandable, If you have any difficulties please email Sanjay.Vadhera@ofgem.gov.uk

Once the questionnaire has been completed, please send it back to us using the email address above. Please return the completed questionnaire by 5 August 2015.

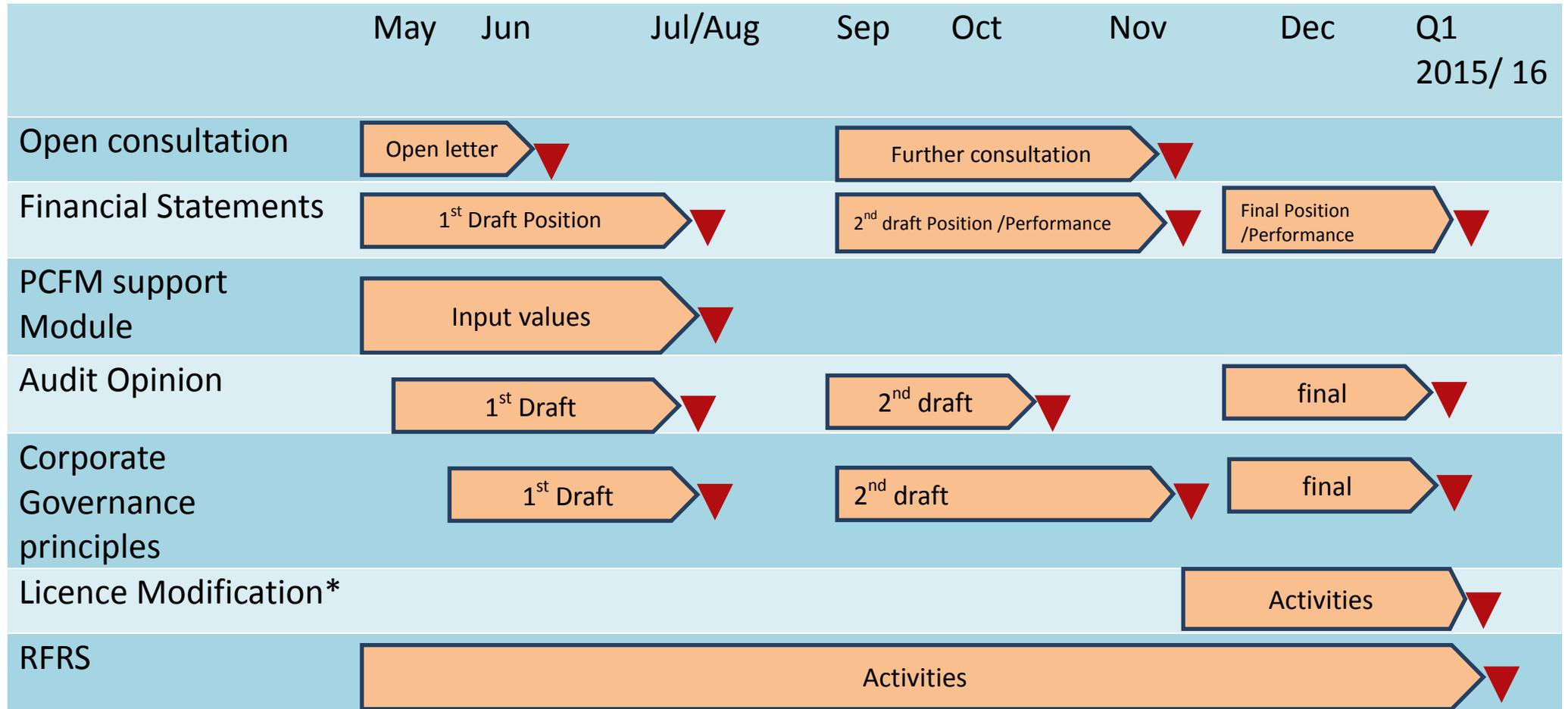
Section 1 - About you	
Question	Response
What is your name	
What is your job title	
What is your contact detail	
What is your company name	
What is the name of your group(applicable only if you are representing a user group)	

Section 2 – RIIO accounts	
Questions	Response
1. Do you have any comments on the withdrawal of the current regulatory accounts as specified in standard special licence conditions A30 on Regulatory accounts for Gas Distribution and Transmission, standard condition B1 on Regulatory accounts for Electricity Transmission and standard condition 44 on Regulatory accounts for Electricity Distribution?	
2. Do you agree with the use of RFRS principles as a basis for the preparation of RIIO accounts? If not, please give further information why.	

<p>3. Do you agree that the new framework for reporting on Network's financial position and performance would be more beneficial to users and stake holders? If you don't please explain.</p>	
<p>4. Do you have any comments on the principles stated in the statement of regulatory corporate governance contained in Appendix 1 of this letter and do you support the development of such principles?</p>	
<p>5. Do you have any comments on the proposed time line in Appendix 3?</p>	
<p>6. Do you have any comments on our proposal to develop an audit opinion that provides assurance on the proposed RIIO accounts on a 'fairly presents' basis?</p>	
<p>7. What are your expectations on how NWO boards should report on their governance (comments from investors are particularly welcome)?</p>	
<p>8. Please use this section to let us know of any other thoughts you might have on the introduction of RIIO accounts.</p>	

APPENDIX 3 – PROPOSED TIMELINE FOR DELIVERY OF RIIO ACCOUNTS

▼ = milestone delivery



* This includes changes that will take effect not less than 56 days after publication of the modification notice

APPENDIX 4 - GLOSSARY

Regulatory Asset Value (RAV)

This is the value of capital investment in networks used to calculate the price control allowances in the RIIO price control.

RIIO

This is an acronym for the current price control of the NWOs. It represents Revenue = innovation + incentives + outputs

Fast money

This is the portion of allowed expenditure for a network licensee which does not pass into RAV and is effectively included in the licensee's revenue allowance for the year of expenditure.

Regulatory accounts

These are the set of accounts that the Network operators are required to produce each regulatory financial year of the 31 March as required by their licence conditions.

Price Control Financial Model (PCFM)

A model that has been developed to calculate the appropriate changes to each licensee's base revenue through an annual iteration process