

To electricity distribution companies, distributed generators, suppliers, customer groups, environmental groups and other interested parties

Promoting choice and value for all gas and electricity customers

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Dear colleague,

Open letter consultation on the way forward for the next electricity distribution price control review – RIIO-ED1

The next electricity distribution price control (ED1) is due to start on 1 April 2015. This letter consults on how we plan to run the price control review (RIIO-ED1), the key issues for the review, and sets out how stakeholders can get involved. We welcome views on any of the issues set out in this letter, and responses should be emailed to RIIO.ED1@ofgem.gov.uk by 2 April 2012.

Introduction

The cost of distributing electricity from the transmission system to users is around 20 per cent of an average domestic customer's bill. Ofgem regulates the 14 distribution network operators (DNOs). We set the total revenues that they can collect from customers, the outputs they must deliver in return and incentivise them to improve their efficiency and overall quality of service.

In October 2010 we published our decision to implement a new regulatory framework, known as the RIIO model (Revenue = Incentives + Innovation + Outputs).¹ RIIO is designed to encourage network companies to play a full role in the delivery of a sustainable energy sector, and to do so in a way that delivers a reliable supply and value for money for existing and future consumers. We are currently implementing the RIIO model in the price control reviews for electricity and gas transmission (RIIO-T1) and gas distribution (RIIO-GD1). These reviews are progressing well. We have recently announced that the business plans of two of the transmission operators are of sufficient quality to be considered for "fast tracking".² We will use the RIIO framework in RIIO-ED1. We will follow the same overall process that we have used for RIIO-T1 and GD1, making minor adjustments to the process to incorporate lessons learned from the ongoing reviews.

Low carbon technologies and smart grids

During the ED1 period we are likely to see significant take up of low carbon technologies such as heat pumps, photovoltaics and smaller scale, distribution connected wind farms driven by incentives such as the feed-in tariff and renewable heat incentive, local planning

¹ RIIO: a new way to regulate energy networks. Final decision

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

² Companies that submit very high quality plans are offered the option of agreeing the price control early – "fast-tracking". Our decision - RIIO-T1: Decision on fast-tracking for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd is set out at <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/Further%20assessment%20of%20RIIO-T1%20business%20plans.pdf>

rules, technological developments and reductions in technology cost. These locally connected low carbon technologies could make an important contribution to meeting the UK's greenhouse gas emissions targets.³ A key objective of RIIO-ED1 will therefore be to ensure that DNOs accommodate these low carbon technologies in a timely and cost effective way.

Distribution networks are not designed to accommodate large volumes of these technologies and we expect their take up to be an important driver of investment needs over the ED1 period. However there is uncertainty over how fast and where the take up of low carbon technologies will be. One challenge for RIIO-ED1 will be to strike a balance between ensuring that network capacity is in place to accommodate low carbon technologies and ensuring that customers do not pay for redundant assets.

Smart grid technology and associated contractual arrangements with customers and generators may offer a more cost effective way of providing the flexible network required. At the last review (DPCR5) we created the Low Carbon Networks (LCN) Fund which is funding trials of both smart technology and demand side response. We have also established the Smart Grids Forum (SGF)⁴ with DECC which is aimed at understanding what drives the value of smarter solutions and addressing barriers to their adoption.

As part of the RIIO-ED1 review, and in order to ensure the timely and cost effective connection of low carbon technologies, we may need to consider the following issues:

- the approach the DNOs use in developing their business plans – particularly the timeframe, scenario analysis and methodology to evaluate different investment strategies⁵
- the outputs we will require the DNOs to deliver, particularly relating to connections, network reliability and environmental objectives and whether it is appropriate to establish output targets for dates beyond the end of the ED1 period
- barriers to the DNOs adopting commercial arrangements to manage demand and generation output (demand side response) and
- incentives and uncertainty mechanisms.

The connection of low carbon technologies spans several of the six primary output categories in the RIIO framework (as set out in Annex 1). We therefore plan to have an overarching "flexibility and capacity" working group to focus on this issue, which will start in advance of work on the related primary outputs. This working group will inform the development of the associated outputs and ensure coordination between them.

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?

Review of DPCR5 mechanisms

In the fifth price control review, DPCR5, we set the allowed revenues, outputs and incentives for the DNOs for the period from 1 April 2010 to 31 March 2015.⁶ DPCR5 was a significant step towards the RIIO framework. It had an increased focus on outputs and looked at the role networks would need to play to facilitate the transition to a low carbon economy. Our initial thought is that where components of DPCR5 are working well, we should not look to revisit them as part of RIIO-ED1. Some mechanisms, such as business

³ Legally binding targets to reduce the UK's greenhouse gas emissions by at least 34 percent below base year levels in 2020 and at least 80 percent below base year levels by 2050.

⁴ More information on the SGF is provided on our website at <http://www.ofgem.gov.uk/Networks/SGF/Pages/SGF.aspx>

⁵ This should be assisted by the SGF work streams which will produce national demand scenarios and work that will assist the development of a methodology to evaluate long term smarter investments.

⁶ Electricity Distribution Price Control Review - Final Proposals Ref: 144/09 was published on 7 December 2009, and is available at http://www.ofgem.gov.uk/Networks/ElecDist/PriceCntrs/DPCR5/Documents1/FP_1_Core%20document%20FINAL.pdf

carbon footprint and undergrounding in areas of natural beauty could remain largely unchanged. Others such as the interruption incentive scheme may only need revised targets and incentive rates. The broad measure of customer satisfaction has been in development for a number of years and will be implemented for the first time from April 2012. We therefore consider that it should only need minor amendments for RIIO-ED1.

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

We have already made certain financial decisions that will apply for RIIO-ED1. The decision to index the cost of debt allowance based on a long-term trailing average of forward interest rates was made as part of the RIIO Final Decision. As part of the RIIO-T1 review we undertook a review of asset lives for both electricity transmission and distribution and concluded that we should base depreciation allowances on economic asset lives of 45 years for both sectors instead of the current regulatory asset life of 20 years.⁷ We therefore will not be revisiting these decisions, but will focus on whether transitional arrangements are justified. It should also be noted that reviews of pensions are now undertaken separately to the price control reviews although there will be a pensions review during 2014 which will form the basis of allowances for the start of RIIO-ED1.

Assessing efficient costs

We will be looking to adopt a toolkit approach for assessing efficient costs in the companies' business plans. This will be similar to the approach used for RIIO-T1 and will involve a range of different levels of analysis. There are a number of key issues that we will need to address, such as developing totex analysis (ie comparable analysis of high level costs), the assessment of innovative solutions or the avoidance of investment, determining appropriate cost drivers, regional factors and the treatment of insourcing versus outsourcing.

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.

Smart meters

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 ED1. Smart meters should bring benefits to the networks, by potentially providing better outage and usage data which the DNOs can use to operate the networks in a smarter way.

The roll-out is likely to impact the DNOs. Whilst suppliers will be responsible for procuring and installing the smart meters, we expect that the DNOs will incur costs from additional call-outs as operational issues for which they are responsible are uncovered during installation. We are working with the DNOs and the Department of Energy and Climate Change to ensure that these additional costs are appropriately borne between the competitive supplier mechanisms and the price controlled DNOs.

We also expect that the meter replacement will uncover issues affecting the accuracy of the data used for balancing and settlement. We will need to consider how this affects the losses incentive which uses settlements data as an input. However we expect that once smart meters are rolled out there will be a significant improvement in the measurement of losses.

Timetable and outputs

The high level timetable for the review is set out in Annex 2. We have increased the total time for the review versus that of RIIO-T1 and GD1 in order to provide more time to develop the RIIO-ED1 policy framework and strategy ahead of the DNOs submitting their business plans in May 2013.

⁷ Our decision, dated 31 March 2011, can be found at
<http://www.ofgem.gov.uk/Networks/Policy/Documents1/assetlivedecision.pdf>

A key element of the RIIO model is the focus on the delivery of outputs. We plan to use the RIIO primary output categories, as set out in Annex 1. We do not want to create unnecessary new outputs. We therefore plan to concentrate on the most material elements in each category. For example, within the safety category there may be existing safety metrics that the companies report to the Health and Safety Executive. ***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.***

Length of price control

We set out in the RIIO Decision that the default length of price control periods is eight years. However we also stated that it would be a matter for individual controls as to whether an eight year price control was appropriate in each case. It may be worth running ED1 as a nine year price control, since this would offset the timing of RIIO-ED2 from RIIO-T2 and GD2. However we are very aware of the changes expected in the electricity sector over the next eight or nine years and recognise that respondents may consider that a longer control is inappropriate.

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

Business plans and proportionate treatment

As for RIIO-T1 and GD1, companies will be required to develop well-justified business plans setting out their long term view of what they intend to deliver, how they intend to deliver it and their view on the cost of delivery. The business plans should be informed by enhanced stakeholder engagement and reflect Ofgem's strategy decision.

We will adopt a transparent and proportionate approach to assessing the business plans, with the intensity and timescale of assessment reflecting the quality of the individual business plan and the company's record for efficient output and customer service delivery. Companies considered for "fast tracking" will need to have submitted a plan to us in May 2013 that is acceptable with limited further revision.

We set out guidance for well-justified business plans in the RIIO-T1 and GD1 Strategy Decisions⁸ published in March 2010. We plan to use this guidance as the basis for our guidance for RIIO-ED1, but consider that there is scope for further development particularly with respect to a common methodology for justifying investment that is likely to provide longer term benefits. We will also look at making the plans more consistent (eg terminology, presentation) to make them easier to navigate and compare. DNOs should be informed by our views on the business plans submitted in RIIO-T1 and GD1.⁹ Our guidance will also set out the level of disclosure we expect from the companies, again to allow stakeholders to understand and compare companies' plans.

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.

Enhanced stakeholder engagement

As part of the RIIO model, stakeholder engagement features more prominently across all stages of the price control process. The key responsibility lies with the network companies

⁸ The business plan guidance can be found in the Decision on strategy for the next transmission and gas distribution price controls - RIIO-T1 and GD1 Business plans, innovation and efficiency incentives at <http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1decisionbusplan.pdf>

⁹ The initial assessment of RIIO-T1 business plans and proportionate treatment is available at <http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/busplanletter.pdf>. The initial assessment for gas distribution will be published on 1 March 2012.

to make effective use of engagement in developing their business plans. The companies will need to consider how best to engage stakeholders (for example which stakeholders to involve at different stages of the business plan development) and the most effective methods of engaging them (which may vary by stakeholder type).

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.

For the Ofgem-led elements we propose to use the multi-layered approach we are using in RIIO-T1 and GD1.

- *Price Control Review Forum (PCRF)*: This is a high level stakeholder group which will provide input to Ofgem and the DNOs about a range of aspects of the price control. Draft terms of reference are set out in Annex 3. We will invite representative stakeholders to be part of this group. We also welcome expressions of interest from parties who consider they can provide a representative view.
- *Consumer Challenge Group (CCG)*: This 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.
- *Working groups*: We will establish a range of working groups where Ofgem, the DNOs and other stakeholders can discuss specific issues in depth. These working groups will assist us to develop the strategy that we will consult on in September 2012. Our proposed list of working groups is set out in Annex 4.

We will be undertaking research to establish customers' views on a range of issues, with particular emphasis on the low carbon future. We will continue to meet stakeholder representatives throughout the review.

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

We invite any parties with an interest in being involved in the PCRF or any of the working groups to contact us at the email address below by 27 February 2012 and explain what they believe they could contribute.¹⁰

We will be holding a launch event in March for PCRF and working group members, and will provide further details to members at the end of February.

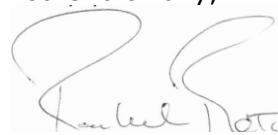
Views invited

We welcome views on any of the issues set out in this letter, but particularly in relation to:

- how we should structure the price control to deliver the timely and cost effective connection of low carbon technologies
- which DPCR5 outputs and incentives can be retained
- how we can improve the cost assessment for RIIO-ED1 expenditures
- whether the ED1 price control period should last eight or nine years and
- stakeholder engagement mechanisms used by the companies and by Ofgem.

We welcome responses to this letter by 2 April. Unless clearly marked as confidential, we will publish responses on our website. Please email responses to RIIO.ED1@ofgem.gov.uk.

Yours faithfully,



Rachel Fletcher,
Acting Senior Partner, Distribution

¹⁰ Further information on what we would like the expressions of interest for the PCRF to contain are set out in the PCRF draft terms of reference in Annex 3.

Annex 1: Primary output categories for RIIO-ED1

The following table sets out our initial views on primary output categories for RIIO-ED1.

Output category	Description
Environment	<p>Help to minimise the environmental impact of DNO operations and of users on the network by:</p> <ul style="list-style-type: none">• ensuring low carbon technologies can connect at a reasonable cost and in a timely manner• managing losses• minimising business carbon footprint• minimising material non carbon emissions• using a stakeholder based approach to visual amenity in areas of outstanding natural beauty or national parks• potentially encouraging any role the DNOs might play in Local Authorities' integrated energy schemes.
Reliability	<p>Maintain operational performance for existing and future customers by improving existing health and loading indices and expanding these output measures to include network risk and criticality.</p> <p>Incentivise reliability using the interruptions incentive scheme and guaranteed standards, and have regard to worst served customers.</p>
Connections	Connect users and suppliers of energy in a timely and cost effective manner and provide high quality information, in a transparent way, on the conditions of connection. Incorporate the societal costs of delays to connection in the output baseline and/or incentive mechanisms.
Customer satisfaction	Maintain levels of customer satisfaction through the broad measure of customer satisfaction.
Safety	Maintain compliance with Health and Safety Executive requirements.
Social obligations	To be discussed. Could include issues such as initiatives to target the fuel poor.

Annex 2: Key milestones for RIIO-ED1

Milestone	Comments	Provisional timing
Publication of open letter consultation	Set out timetable, identify key issues and invite stakeholder participation.	February 2012
Working group meetings		March – August 2012
Publication of strategy consultation	Set out the detail of all elements that will influence the companies' creation of their business plans.	September 2012
Publication of strategy decision (including business plan templates)	Our decision on the strategy elements. We will also set out how we will assess the companies for fast track and proportionate treatment.	February 2013
DNOs submit business plans		May 2013
Publication of initial business plan assessment	Our initial view on the business plans and whether any companies could be fast tracked.	September 2013
Publication of Fast Track consultation	Set out the companies, if any, that we propose to fast track or give proportionate treatment.	November 2013
Publication of Fast Track decision	Decision on fast tracking and proportionate treatment.	March 2014
Publication of Initial Proposals	For non fast tracked companies, consultation on the proposals for the price control package.	June 2014
Publication of Final Proposals	Decision on the price control package for the non fast tracked companies.	November 2014
Issue statutory consultation on new licence conditions	Consultation on the licence conditions implementing the price control package.	December 2014
New price control period starts		1 April 2015

Annex 3: Draft terms of reference for the Price Control Review Forum (PCRF)

Note: this may be subject to change following the consultation.

Purpose

The functions of the price control review forum (PCRF) include:

- to provide the opportunity for stakeholders to feed directly into the price control review process either on specific issues or across a wide range of issues
- to allow Ofgem and network companies to hear firsthand the views of interested parties
- to provide an opportunity to bring together all aspects of stakeholder engagement being undertaken by Ofgem, network companies and interested parties
- to allow Ofgem to evaluate its outputs and incentives proposals and for the DNOs to evaluate their business plans (although much of this will be the responsibility of network companies in their own engagement) and
- allow stakeholders to contribute to debates on how to optimise cost, supply quality, customer service and environmental objectives.

The forum's role is advisory and while Ofgem will consider the views raised in the PCRF there is no obligation for Ofgem to accept the views raised by the group.

Representatives on the group are also encouraged to make separate responses to Ofgem's price control consultations.

Scope

- The PCRF will meet at key points in the price control review process.
- Members will be able to learn about and comment on research done by network companies and Ofgem.
- The PCRF will provide an opportunity for members to table papers for discussion.
- Members will get updates from Ofgem on emerging thinking and will have the opportunity to discuss and influence our thinking.
- The PCRF will enable network companies to give presentations e.g. on their business plans.

Objectives of the PCRF

For PCRF

- Review Ofgem's and DNOs' research findings.
- Provide feedback on Ofgem's emerging thinking.

For Ofgem

- Opportunity for Ofgem to explain how our proposals are being shaped by industry and stakeholder views.

For network operators

- DNOs present the feedback they are getting from their own stakeholder engagement.
- Provide information on how they run their businesses to facilitate better understanding among the stakeholders to enable them to effectively engage.

- Provide their views on Ofgem's proposals.

Membership and structure

The chair and secretariat functions of the PCRF will be carried out by Ofgem. We intend to develop the agenda and papers for the PCRF and will circulate a draft agenda two weeks before a PCRF meeting seeking views from attendees about any other issues they would like to raise or present at the meeting. We will circulate a final agenda and the papers one week before the meeting. We will take notes of the meeting and aim to circulate a summary of discussions to members two weeks after the meeting for comment. We will then publish the summary on our website.

Expectations of PCRF members

We would expect PCRF members to play a role in canvassing the views of other organisations active in the area they represent (not just their own organisation) to feed into Forum discussions.

- We will help to facilitate this by circulating reading material and questions for discussion at least one week before the PCRF meeting.
- In addition, where appropriate, we will forward questions from other stakeholders to the PCRF representative active in their area.

We would expect PCRF members to play a role in reporting back key messages from the PCRF to other groups active in the areas they represent.

As an example, a supplier representative would report back to all suppliers and represent all supplier views on the group and not just their own company interests.

Dates of meetings

We consider that it would be worth holding the PCRF meetings in advance of the price control documents (May/June 2012, January 2013, August 2013, October 2013, April 2014, May 2014, October 2014) and may convene additional meetings if appropriate.

Nominations

As set out in the covering letter, we welcome stakeholders expressing an interest in being on the PCRF. After considering expressions of interest, Ofgem will approach representatives to join the group.

In their expressions of interest stakeholders should include information on:

- who they represent
- what their interest in the price control review is
- how they will co-ordinate the comments they receive from the stakeholders they represent and how they will feedback the discussion from the PCRF meetings
- whether they have experience of undertaking a similar role before and
- what they can bring to the group.

Expressions of interest should be emailed to RIO.ED1@ofgem.gov.uk by 27 February 2012.

Annex 4: Potential working groups for RIIO-ED1

The following table sets out our initial views on potential working groups for RIIO-ED1. In the majority of cases these are aligned with the primary output categories.

Working group	Issues to be addressed	Indicative start
Flexibility and capacity	Overarching issues associated with the connection of low carbon demand and generation.	February
Environment	Environmental outputs relating to the DNOs' environmental impact.	March
Innovation	Innovation stimulus package. This will be a continuation of the working group created for RIIO-T1 and GD1.	ongoing
Reliability and safety	Reliability and safety outputs. This will encompass the DPCR5 review of network outputs as well as their further development for RIIO-ED1.	February /March
Connections	Connections outputs.	March
Customer and social issues	Customer satisfaction and social obligations outputs. This will encompass the finalisation of the DPCR5 broad measure of customer satisfaction.	March
Finance	Financial issues.	May
Cost assessment	Creating the toolkit of methods to assess efficient costs in the business plans.	Late March