Promoting choice and value
for all gas and electricity customers

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

Initial Proposals – Overview Document

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Overview:

This document sets out our Initial Proposals for the transmission price controls for National Grid Electricity Transmission (NGET) and National Grid Gas (NGGT) from 1 April 2013 to 31 March 2021.

This is the first transmission price control to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model. Under RIIO we are adopting a very different process for setting price controls. Companies are required to develop and submit well-justified business plans, supported by the views of stakeholders, setting out what they will deliver. Those plans inform the setting of the price control components.

The document sets out: what NGET and NGGT will be required to deliver during the next price control period; the incentives that would be placed around that delivery; the costs the companies would be able to recover and the arrangements for addressing risk and uncertainty around those costs; and the basis of the financial package for determining the companies' allowed revenues.

We are seeking respondents' views on the package of proposals put forward for each company.

Associated documents

Supporting Documents

RIIO-T1: Initial Proposals for NGGT and NGET – Outputs, incentives and innovation

RIIO-T1: Initial Proposals for NGET and NGGT – Cost assessment and uncertainty

RIIO-T1: Initial Proposals for NGGT and NGET – Finance

Associated Documents

RIIO-T1/GD1: Initial Proposals – Real price effects and ongoing efficiency appendix

RIIO-T1: Initial Proposals for NGGT and NGET – Impact Assessment

RIIO–T1/GD1: Financial model

RIIO-T1 Stage 4 - National Grid System Operator Electricity and Gas Capex and Opex Initial Assessment – Summary Report

RIIO-T1 SUMMARY REPORT – GAS A report to the Office of Gas and Electricity Markets July 2012

RIIO-T1 Stage 4 NGET Final Assessment – A report for Ofgem

Cost of capital study for RIIO –T1 and GD1

Licence consultation documents

RIIO-T1 and RIIO-GD1: Draft licence conditions – First informal licence drafting consultation

Supporting Document 1: Draft RIIO-T1 Electricity Transmission licence changes

Supporting Document 2: Draft RIIO-T1 Gas Transmission licence changes

Supporting Document 4: Response template for RIIO-T1 & GD1-First licence drafting consultation

RIIO ET1 Price Control Financial Handbook

RIIO GT1 Price Control Financial Handbook

Other documents

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

Glossary for all the RIIO-T1 and RIIO-GD1 documents

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Executive Summary

Britain's gas and electricity network companies face unprecedented challenges. They will need to invest over £30 billion over the next decade to secure energy supplies, to develop smarter networks and to meet environmental challenges. Against this backdrop, it is more important than ever that network companies can show consumers they are getting value for money.

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

In this document we set out our Initial Proposals for National Grid Electricity Transmission (NGET) and National Grid Gas (NGGT). We are not putting forward Initial Proposals for SP Transmission Ltd (SPTL) and Scottish Hydro Electric Transmission Ltd (SHETL) as we settled those companies' price controls in April 2012 as part of the RIIO "fast-track"[1] process.[2] However, in relation to a number of the RIIO outputs we are providing an update on areas of work that are also relevant for both SPTL and SHETL.

Overview of our proposals

In a number of areas our Initial Proposals directly reflect the RIIO-T1 business plans put forward by NGET and NGGT. In areas where we did not consider the companies' proposals were fully justified we are putting forward alternative proposals.

The Initial Proposals put forward in this document comprise:

- a comprehensive set of outputs that reflect the interests of NGET's and NGGT's customers now and in the future and strong incentives to deliver those outputs over the RIIO-T1 period
- a package of measures to encourage NGET and NGGT to innovate to drive improved outcomes for consumers
- total funding of £20.2bn in 2009/10 prices of which around £15bn represents investment in the electricity and gas transmission networks comprising both upfront funding and funding to be brought forward during the RIIO-T1 period
- a package of mechanisms for addressing risk and uncertainty over the 8 year period of the price control
- a financial package which provides an appropriate level of financial reward to the companies for their activities and also provides value for money to consumers.

[1] Where business plans are of sufficient quality, fast-tracking provides a process whereby we can reach early settlement of a company's price controls, ie their business plans may be "fast-tracked".
[2] Subject to statutory consultation on implementing the licence conditions: see RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd – Overview document http://www.ofgem.gov.uk/NETWORKS/TRANS/PRICECONTROLS/RIIO-T1/CONRES/Documents1/SPTSHETLFP.pdf

Impact on consumer bills

Overall, our proposals result in an increase in allowed revenues for NGET by around 25 per cent and for NGGT by around 31 per cent over the RIIO-T1 period relative to the last year of the current control (2012/13).

In terms of customer bills, the increase in revenues translates into approximately a £4 increase in the average annual household electricity bill and a £2 increase in the average annual household gas bill. Taking into account the parallel RIIO-GD1 price control then the average gas bill will increase by £7 per year in total under the proposals being published today.

Next steps

We are putting forward these Initial Proposals for consultation. We welcome respondents' views on these proposals. We will consider respondents' views and will put forward Final Proposals in December 2012.

1. Introduction

Chapter Summary

This chapter explains the structure and purpose of this document and sets out the context of the Initial Proposals.

Purpose of this document

1.1. This document sets out, for consultation, our Initial Proposals for National Grid Electricity Transmission (NGET) and for National Grid Gas (NGGT) for the next transmission price control, RIIO-T1.[3] NGET owns and maintains the electricity transmission network assets across England and Wales. NGGT owns and maintains the gas transmission network assets across Great Britain (GB). This price control will cover the eight-year period from 1 April 2013 to 31 March 2021.[4]

1.2. This document aims to provide an accessible overview of the Initial Proposals for NGET and NGGT. Alongside this document we have published three documents (the Supporting Documents):

- RIIO-TI: Initial Proposals for NGET and NGGT – Outputs, incentives and innovation[5]
- RIIO-TI: Initial Proposals for NGET and NGGT – Cost assessment and uncertainty[6]
- RIIO-T1: Initial Proposals for NGET and NGGT – Finance.[7]

1.3. The Supporting Documents are aimed primarily at network companies, investors and those who require a more in-depth understanding of the proposals.

1.4. These Initial Proposals are different from those we have set out in previous price control processes. This is for two reasons:

[3] We note that National Grid has recently undertaken an internal reorganisation. Whilst this may affect which cost categories expenditure falls under in the future, we do not consider it will impact the total costs outlined in this document. We have therefore continued to base our cost categorisation on NGET's and NGGT's business plans.
[4] All monetary values in this document are in 2009-10 prices unless otherwise stated.
[5] RIIO-T1: Initial Proposals for NGET and NGGT – Outputs, incentives and innovation http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIO%20T1%20NGGT%20and%20NGET%20Outputs%20and%20incentives.pdf
[6] RIIO-T1: Initial Proposals for NGET and NGGT – Cost assessment and uncertainty http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIO%20T1%20NGGT%20and%20NGET%20Cost%20assessment%20and%20uncertainty.pdf
[7] RIIO-T1: Initial Proposals for NGET and NGGT – Financial issues http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIO%20T1I%20NGGT%20and%20NGET%20Finance.pdf

(1) At an early stage in the RIIO process we consulted, and then published decisions, on the regulatory framework for RIIO-T1 – our March 2011 Strategy document[8] (Strategy Document). That document set out the regulatory framework for the RIIO-T1 price control.

(2) Under RIIO, companies are required to put forward well-justified business plans setting out what they will deliver, supported by the views of stakeholders. Companies that submit high-quality plans will be offered the option of settling their price controls early ie "fast-tracking". Although the plans put forward by NGET and NGGT have not been fast-tracked, there are a number of aspects of these Initial Proposals that are based directly, or partially, on the updated RIIO-T1 business plans developed by NGET and NGGT. These plans are available at the following link: http://www.talkingnetworkstx.com/our-business-plans.aspx.

1.5. In a number of areas of this document we reference our Strategy Document, the Supporting Documents and the companies' plans where further detail is set out to support these Initial Proposals.

RIIO

1.6. In October 2010[9], we announced a change in the way we will regulate the GB onshore network companies. We introduced the RIIO (Revenue = Incentives + Innovation + Outputs) model. The overriding objective of the RIIO model is to drive real benefits for consumers by providing energy network companies with strong incentives to meet the challenges of delivering a low carbon economy and a sustainable energy sector at a lower cost than would have been the case under the previous approach.

1.7. The price control process under RIIO is different to previous controls. In particular, under RIIO the onus is on network companies to develop well-justified business plans. Each network company is required to develop detailed plans which demonstrate how they will deliver against those plans in the interests of both existing and future consumers and how they will meet the challenges associated with facilitating the move to a low carbon economy.

1.8. We published a timetable for RIIO-T1 in our Final Proposals for SP Transmission Ltd (SPTL) and Scottish Hydro Electric Transmission Ltd (SHETL). We set out an updated timetable in Appendix 2.

[8] Decision on strategy for the next transmission price control: RIIO-T1 – March 2011 http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/T1decision.pdf
[9] RIIO: A new way to regulate energy networks: Final decision – October 2010 http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf

Role of this document in the RIIO-T1 process

1.9. Our Strategy Document set out the key elements of the regulatory framework that the transmission companies would need to understand in order to develop their business plans. We received the transmission companies' initial RIIO-T1 business plans at the end of July 2011. We assessed those plans against the criteria that we had set out in our Strategy Document.

1.10. In October 2011 we published our initial assessment of the RIIO-T1 business plans.[10] This set out our assessment of the quality of the plans and indicated those areas that may be suitable for proportionate treatment.

1.11. Our initial assessment concluded that none of the TOs business plans was suitable for fast-tracking in their existing format but that the scale of the outstanding issues for SPTL and SHETL may allow them to resolve these in a timeframe consistent with fast-tracking. On this basis we retained SPTL and SHETL in the fast-tracking process. Following consultation on Initial Proposals in February 2012[11], we published our fast-track Final Proposals[12] for both SPTL and SHETL in April 2012.

1.12. In the case of NGET and NGGT we concluded that the scale of the work required to address the outstanding issues in their plans was too great to enable these to be resolved in a timetable consistent with fast-tracking. However, we did identify a number of areas of those plans that were suitable for proportionate treatment.

1.13. In line with the RIIO-T1 process, both companies were required to submit updated business plans by 5 March 2012. Both NGET and NGGT submitted their updated plans on 2 March 2012 (updated business plans). In March 2012 we published a consultation on NGET's and NGGT's plans.[13]

1.14. The purpose of this document is to set out the basis of the Initial Proposals for NGET and NGGT reflecting the proposals set out in their updated business plans. The document sets out our proposals on: what those network companies will be required to deliver during the next price control period; the incentives that would be placed around that delivery; the costs the companies would be able to recover and the arrangements for addressing risk and uncertainty around those costs; and the basis of the financial package for determining NGET's and NGGT's allowed revenues.

[10] Initial assessment of RIIO-T1 business plans and proportionate treatment – October 2011 http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/busplanletter.pdf

[11] RIIO-T1: Initial Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd – February 2012 http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/SPT_SHETL_IP.pdf

[12] RIIO-T1: Final Proposals for SP Transmission Ltd and Scottish Hydro Electric Transmission Ltd – Overview document – April 2012 http://www.ofgem.gov.uk/NETWORKS/TRANS/PRICECONTROLS/RIIO-T1/CONRES/Documents1/SPTSHETLFP.pdf

[13] RIIO-T1: Publication of the revised business plans of National Grid Electricity Transmission plc and National Grid Gas plc – March 2012 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=170&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes

Stakeholder engagement

1.15. The RIIO framework places considerable emphasis on stakeholder engagement, both by the network companies and by Ofgem. The requirement on TOs to undertake detailed stakeholder engagement and to demonstrate how this has been reflected in their plans is a key component of the RIIO process.

1.16. Both NGET and NGGT have undertaken additional stakeholder engagement to inform their updated business plans. For the most part their performance in this area has been impressive and this has been recognised by their stakeholders. However, from our own discussions with stakeholders and echoed by respondents to our March 2012 consultation letter, it has become clear that, in a few specific areas of its plan, NGGT has discussed the issues and options with its stakeholders but not the detail of the proposals which it has subsequently set out in its business plan. The two key areas are in respect of the treatment of incremental capacity and constraint management. This is not what we would expect of a 'well-justified business plan'.

1.17. We expect NGET and NGGT to keep developing their approaches to stakeholder engagement and to seek continually to improve throughout RIIO-T1. We will continue to monitor the companies' progress in this area.

Our engagement

1.18. Since the start of RIIO-T1, we have adopted a multi-layered process to ensure that all affected parties have effective opportunities to engage in the review. When we have engaged with stakeholders, we have sought to adhere to our principles for effective enhanced engagement set out in the RIIO handbook.[14]

1.19. The key elements of our recent process have been:

- March Consultation 2012 on our assessment of the updated business plans to which we received 5 responses.[15] These are summarised in Appendix 3. We have taken these views into consideration in developing these Initial Proposals. We previously sought respondents' views in a consultation letter in August 2011[16] in response to the submission of the initial business plans in July 2011. Where views were expressed in relation to that process were relevant to the setting of controls for NGET and NGGT we have also taken these into consideration in developing these Initial Proposals.

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[14] Handbook for implementing the RIIO model
http://www.ofgem.gov.uk/networks/rpix20/consultdocs/Documents1/RIIO%20handbook.pdf

[15] RIIO-T1: Publication of the updated business plans of National Grid Electricity Transmission and National Grid Gas
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/NGET%20BP.pdf

[16] RIIO-T1: Transmission companies' business plans - publication and next steps
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIOT1busplans.pdf

- A further meeting of the Price Control Review Forum (PCRF)[17] to discuss our assessment of the plans.
- A range of bilateral meetings with both the transmission companies and other interested stakeholders.

1.20. We are publishing these Initial Proposals for consultation and will continue to engage with all interested parties throughout the RIIO-T1 process. This will include a further meeting of the PCRF.

Consumer Challenge Group (CCG)

1.21. Separate from our stakeholder engagement processes, we have benefited from feedback from the CCG, which comprises consumer and environmental experts acting as a critical friend to Ofgem.

1.22. The CCG has an important role in ensuring that consumers' views are fully considered as part of the price control process. We have formed a single CCG for RIIO-T1 and the concurrent gas distribution price control review (RIIO-GD1). The group comprises eight members appointed by us on the basis of their expertise in the interests of existing and future consumers and energy sector knowledge.

1.23. We met with the CCG on 27 March 2012 and 17 May 2012. The key points raised were:

- both updated business plans were an improvement on the initial business plans submitted in July 2011 in terms of structure and coverage
- the CCG considered National Grid has demonstrated a genuine commitment to embed engagement in its ongoing business practices
- it welcomed the further progress to develop stakeholder surveys and a network access policy in electricity transmission
- it considered charging volatility would be a significant issue for consumers
- the group considered the plans should have provided a clearer view on innovation strategy with a stronger demonstration of how projects would be targeted and prioritised.

[17] Further information on the PCRF is set out on our website at: http://www.ofgem.gov.uk/Networks/PriceControls/PCRF/Pages/PCRF.aspx

Impact assessment

1.24. Alongside this document, we are also publishing an impact assessment (IA).[18] This is based on the IA we published for RIIO-T1 in December 2010.[19] We consider that the benefits and impacts outlined in the December IA remain applicable in most part to the updated proposals outlined in this document but we have updated this document where necessary.

Interaction with other policy areas

SO incentives

1.25. In parallel with our work on RIIO-T1, we are working to set external system operator[20] (SO) incentives for the period from 1 April 2013. Alongside this document we have published our Initial Proposals in this area.[21] We note that we will work with the SOs to finalise, for each output and cost incentive scheme, the appropriate scheme length.

1.26. The interaction between RIIO-T1 and the setting of SO incentives is considered in more detail in the Outputs, incentives and innovation Supporting Document.

Broad environmental incentive

1.27. In our Strategy Document we noted our intention to include a reputational incentive on promoting low carbon energy flows. We further noted that, subject to consultation, we may introduce an incentivised financial reward which would future proof the output framework for new opportunities arising over RIIO-T1.

1.28. In February 2012, alongside our Initial Proposals for SPTL and SHETL, we published a consultation on the form of an Environmental Discretionary Reward (EDR) to complement the existing RIIO-T1 price control package.[22] We noted that the purpose of the EDR would be to facilitate the role of electricity transmission in the transition to a low carbon energy sector.

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[18] RIIO-T1: Initial proposals for NGGT and NGET for RIIO-T1 – Impact Assessment
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/RIIO%20T1%20NGGT%20and%20NGET%20Impact%20Assessment.pdf

[19] Consultation on strategy - RIIO-T1 and GD1 Impact assessment – December 2010
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIOT1/ConRes/Documents1/T1%20and%20GD1%20IA.pdf

[20] The SO has responsibility for day-to-day system operation, including balancing of the system and constraint management. NGET is the electricity SO. NGGT is the gas SO.

[21] System Operator incentive schemes from 2013: Initial Proposals
http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Documents1/IP%SO%2013.pdf

[22] Environmental discretionary reward under the RIIO-T1 price control – February 2012
http://www.ofgem.gov.uk/Networks/Trans/PriceControls/RIIO-T1/ConRes/Documents1/EDR_consult.pdf

1.29. Consultation responses indicated comprehensive support for our broad concept for the implementation of the EDR. As well as providing useful feedback on the elements of the EDR, which will assist us in the development of the scheme, a majority of the respondents noted that key areas of performance in the proposed scorecard involve the electricity system operator. Following this consultation, we have made the decision on the concept for the implementation of the EDR, which will now incorporate the electricity system operator, as we set out in our July 2012 EDR decision letter.[23] This is consistent with views expressed in the consultation. We will finalise the detail of the EDR in the autumn, in line with RIIO-T1 timescales.

Transmission Investment Incentives/ Strategic Wider Works

1.30. We introduced the Transmission Investment Incentives (TII) framework in 2010 to supplement capital allowances and deep revenue drivers set within the previous price control review (TPCR4) by providing project-specific, interim funding (up to the end of the price control period) to facilitate the timely delivery of critical electricity transmission infrastructure projects. The TII framework has been extended to the rollover year 2012/13.

1.31. For RIIO-T1, some of the projects funded under TII will be included in the TOs' baseline and we are introducing arrangements to enable TOs to request Ofgem to determine the efficient forecast costs of delivering further wider works outputs and to adjust the TOs' wider works outputs and associated revenues during the price control period (ie within period determination). These arrangements, which include volume drivers and the Strategic Wider Works (SWW) mechanism, will replace the TII arrangements introduced during TPCR4.

1.32. SWW is discussed in more detail in the Outputs, incentives and Innovation Supporting Document and the Cost assessment and uncertainty Supporting Document.

Innovation

1.33. Incentives for innovation are embedded in the RIIO model. Companies are incentivised to innovate to meet outputs in the most efficient way and the longer price control strengthens these incentives. We set out our innovation framework for RIIO-T1 in our Strategy Document.

1.34. The RIIO model has a number of elements that encourage innovation, including the longer price control period, the outputs focus and strong efficiency incentives. In addition, we set out the three elements of an innovation stimulus package which the companies have considered in developing their business plans:

[23] Decision on the concept for the implementation of the Environmental Discretionary Reward for the electricity transmission owners and system operator http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=210&refer=Networks/Trans/PriceControls/RIIO-T1/ConRes

- **Network Innovation Allowance (NIA)** - The NIA is a set allowance that each of the RIIO network licensees will receive to fund small-scale innovative projects as part of their price control settlement.

- **Network Innovation Competition (NIC)** - The NIC is an annual competition for funding larger, more complex networks projects. The NIC will comprise of two competitions - one for gas and one for electricity.

- **Innovation Roll-out Mechanism (IRM)** - A Revenue Adjustment Mechanism that enables companies to apply for additional funding within the price control period for the rollout of initiatives with demonstrable and cost effective low-carbon or environmental benefits.

1.35. The innovation stimulus will be introduced as part of the RIIO-T1 and RIIO-GD1 price controls on 1 April 2013. In order to implement the innovation stimulus we will develop licence conditions and set the legal framework for the governance arrangements. The governance arrangements will provide detailed assessment criteria, guidance on obligations and requirements for the NIC, as well as criteria and obligations attached to the utilisation of the NIA.

1.36. In our Strategy Document, we decided to set the maximum allowed funding for the gas distribution and transmission NIC at £20m per year. For the electricity transmission companies we set a maximum of £30m per year. We are developing the governance arrangement through the course of 2012. An innovation working group (IWG) has been established to support this process. We intend to hold the first electricity NIC in 2013, with the winning projects receiving funding from 1 April 2014. In gas our view is that, as drafted, the Gas Act 1986 does not allow us to implement the NIC in the gas sector using our preferred funding mechanism. Our approach to dealing with this issue is being consulted on through these Initial Proposals and is set out in further detail in the Outputs, incentives and innovation Supporting Document.

1.37. Both NGG and NGET considered that innovation funding should be available to the SOs, as it is to the TOs, through the new mechanisms introduced by RIIO-T1. They therefore consider that the SOs should be able to participate in the NIA and NIC as part of NGET and NGGT. It is our proposal that the SOs should also be able to access the TOs innovation funding.

Implementing competition in onshore electricity transmission

1.38. As part of RIIO, we are developing a potential framework to enable third parties to bid to build, own and operate parts of the onshore electricity transmission system. We anticipate that, where appropriate, the framework would build on the principles set out within the offshore regime.

1.39. In continuing to develop this framework we are prioritising further work on identifying what benefits such competition could bring. This will inform any subsequent development of the detailed framework.

1.40. For the avoidance of doubt, projects treated as SWW in our RIIO Final Proposals could be subject to this competitive process and therefore potentially delivered by a third party TO. While the detailed arrangements for the competitive process are still being developed, TOs should be aware that they could be required to make relevant pre-construction outputs available to third parties as part of a selection process, and eventually such assets might be transferrable to the party selected to construct the assets.

Charging volatility

1.41. In our Strategy Document we noted concerns raised by stakeholders that volatility in the price control settlement has an adverse impact on consumers. This issue cuts across all the network companies. We published a consultation on this issue in April 2012 which has now closed.[24] Our consultation identified a number of options aimed at mitigating network charging volatility created by the price control settlement, or its effects.

1.42. We received 23 responses to our consultation. We are currently in the process of reviewing these. We intend to publish our decision in the autumn, and we will reflect any implications of our decision on charging volatility for RIIO-GD1 for Final Proposals.

DECC consultation on providing redress to consumers

1.43. The Department of Energy and Climate Change (DECC) has recently consulted on a new power for Ofgem to compel regulated energy businesses to provide redress to consumers.[25]

1.44. The power would only be applicable if National Grid breached its licence. Under the existing arrangements, Ofgem has the power to fine National Grid for licence breaches of an amount up to 10 per cent of its total annual turnover. The measures proposed by DECC would give us the power to mandate paying compensation in appropriate circumstances. They do not increase the level of uncertainty around the magnitude of any potential fine. Further, we note that under the proposed arrangements, National Grid could potentially gain if it were adversely affected by the actions of another regulated energy business. Therefore, we do not consider these measures materially impact National Grid's level of risk.

[24] Mitigating network charging volatility arising from the price control settlement: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=368&refer=Networks/Policy

[25] Consultation on a proposed new power for Ofgem to compel regulated energy businesses to provide redress to consumers
http://www.decc.gov.uk/assets/decc/11/consultation/4975-consultation-on-a-proposed-new-power-for-ofgem-to-.pdf

Gas Distribution price control (RIIO-GD1)

1.45. Alongside our RIIO-T1 Initial Proposals, we are publishing Initial Proposals for the Gas Distribution Networks (GDNs) for the next transmission price control, RIIO-GD1.[26] The GDNs maintain and operate the local gas networks that transport gas from the national transmission system (NTS) to homes and businesses throughout GB. The RIIO-GD1 price control will also cover the eight-year period from 1 April 2013 to 31 March 2021.

1.46. In developing our proposals for RIIO-T1, we have taken into account the interactions with RIIO-GD1.

Structure of this document

1.47. The remainder of this document provides an overall summary of the Initial Proposals for NGET and NGGT. It is structured as follows:

- Chapter 2 sets out a summary of the package of Initial Proposals for NGET.
- Chapter 3 sets out a summary of the package of Initial Proposals for NGGT.
- Chapter 4 sets our next steps for RIIO-T1.

1.48. Alongside this document we have published the Supporting Documents. These provide further information on each of the individual areas of the price control packages for NGET and NGGT.

1.49. We have also published a consultation on initial licence drafting for all transmission companies including SPTL and SHETL.

1.50. Figure 1.1 provides a map of the RIIO-T1 documents we are publishing today and indicates clearly where these are common with those for RIIO-GD1.

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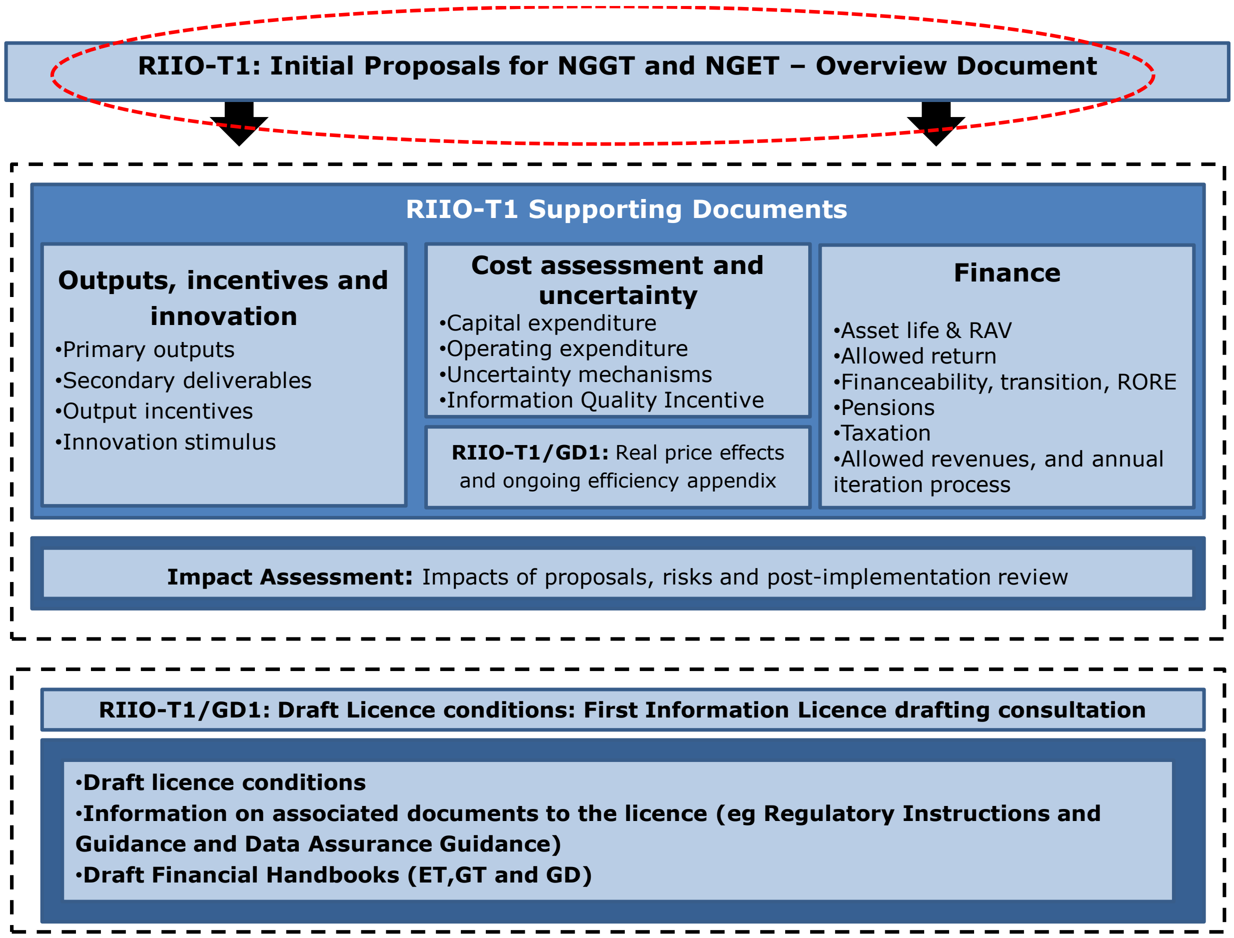
[26] RIIO-GD1: Initial Proposals – Overview
http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/GD1%20Outputs%20and%20Incentives%20Initial%20proposals%20270712.pdf

Figure 1.1 - RIIO-T1 Supplementary appendix document map



***Document links can be found in the 'Associated documents' section of this paper.**

2. Summary of Initial Proposals for NGET

Chapter Summary: This chapter summarises the Initial Proposals for NGET.

Question 1: Do you have any comments on the overall package of proposals for NGET?

Introduction

2.1. This chapter summarises the key components of NGET's Initial Proposals in its role as TO and also in relation to its internal SO costs. We have developed these proposals based on the information set out in NGET's updated RIIO-T1 business plan.

2.2. Further detail on each of the areas set out below is provided in our Supporting Documents which we have published alongside this document.

Outputs and incentives

2.3. RIIO is an outputs-led framework. It is important that throughout the RIIO-T1 period, the TOs understand what they are expected to deliver and are held to account for delivery.

2.4. Table 2.1 summarises the outputs that NGET will be expected to deliver, during RIIO-T1. These closely reflect the overall package of outputs that, following consultation, we set out for all TOs in our Strategy Document. We published Final Proposals for SPTL and SHETL in April 2012. However, in relation to customer satisfaction, network availability and visual amenity we are providing updates that are also relevant for both SPTL and SHETL. These are discussed in further detail in the Outputs, incentives and innovation Supporting Document.

2.5. We note that a number of the incentives are linked to the percentage of allowed revenue. To maintain strong output incentives and appropriate revenue allowances for specific activities it is important that the caps and collars on these do not just reflect the opening base revenue allowance but also adjust in response to ongoing, but uncertain, changes in revenue in order to better reflect the true change in network total expenditure (totex) and other in-period adjustments over the price control period. References to 'percentage of allowed revenue' therefore reflect a combination of the opening base revenue allowance plus within period adjustments captured through the annual iteration of the financial model. This is discussed in further detail in the Outputs, incentives and innovation Supporting Document.

2.6. We will generally consider a TO's performance against its outputs on an annual basis. We will set out information requirements and monitoring arrangements in our Regulatory Instructions and Guidance (RIGs). We intend to publish RIGs by the end of 2012.

Table 2.1 – Proposed output and incentive parameters for NGET in RIIO-T1

Category	Output	Incentive
Safety	Compliance with safety obligations set by the Health and Safety Executive (HSE). Supported by measures of asset health, condition and criticality	Statutory requirements. No financial incentive.
Reliability	Primary output based on Energy Not Supplied (ENS).	Incentive rate of £16,000/MWh[27] which is based on an estimate of the value of lost load (VoLL).[28] A collar on financial penalties limiting the maximum penalty to 3% of allowed revenues. A licence condition on minimum performance standard.
Availability	Prepare and maintain a Network Access Policy.[29]	Reputational incentive.
Customer Satisfaction	Develop customer satisfaction survey.	Up to +/-1% of allowed revenue.
	Effective stakeholder engagement.	Up to 0.5% of allowed revenue via a discretionary reward scheme.
Connections	To meet existing legal requirements.	Downside only penalty of up to 0.5% of allowed revenue.
Environmental	SF_6 – Baseline target calculated annually with best practice 0.5% leakage rate for new assets installed.	Differences to baseline subject to a reward/penalty based on the non-traded carbon price for carbon equivalent emissions.
	Losses – Publish overall strategy for transmission losses and annual progress in implementation and impact on transmission losses.	Reputational incentive.
	Business Carbon Footprint (BCF) – Publish BCF accounts at business level annually over RIIO-T1.	Reputational incentive.
	Facilitating broad environmental objectives and improving business sustainability	Positive reward available from EDR Scheme if achieve excellent performance.

[27] The actual incentive rate is effectively halved consistent with the application of the sharing factor, and will be further adjusted for inflation.
[28] VoLL represents the value that gas users attribute to security of gas supply and the estimates could be used to provide a price signal about the adequate level of security of supply.
[29] We also note that, reflecting the coverage of the document, all parties have agreed that the policy should now more accurately be referred to as the Network Access Policy rather than 'Availability' Policy.

Category	Output	Incentive
	Visual amenity – to efficiently meet planning requirements for new infrastructure and deliver visual amenity outputs by mitigating impacts of existing infrastructure when it is located in designated areas.	Baseline funding for additional cost of mitigation technologies required for development consent. Initial expenditure cap of £100m to reduce the impact of existing infrastructure in designated areas. Discussed further below.
Wider works (new investment)	Baseline wider works outputs of 28,600MW of additional transmission transfer capacity funded through volume driver subject to meeting Network Development Policy criteria. Best view wider works outputs to be funded through a volume driver and SWW arrangements (potentially an additional 22,000MW of transmission capacity on the main integrated transmission system).	NGET's scheduled baseline and SWW outputs will be subject to timely delivery standards.

Context for proposed outputs – visual amenity

Existing infrastructure in designated areas

2.7. For the most part NGET's proposed outputs reflect the proposals outlined in its business plan which, in turn, were consistent with the position in our Strategy Document. One area where we are proposing a variation to NGET's proposal is in relation to the setting of an expenditure cap to reduce the impact of existing infrastructure in designated areas.

2.8. In our Strategy Document we proposed to set an expenditure cap, on a use-it-or-lose it basis, for TOs to mitigate the impacts of existing assets on the visual amenity of National Parks and Areas of Outstanding Natural Beauty (AONB). We said the cap should be informed by consumer willingness to pay (WTP) analysis. Although only NGET has undertaken the analysis, we proposed that the expenditure cap would apply to all three TOs. SPTL and SHETL have noted that it would have limited relevance in their areas.

2.9. NGET has recently completed analysis[30] on consumer WTP. As a result of this analysis, NGET proposes to set the cap using a WTP value of £6.40/year[31] giving a total expenditure cap of £1.1 billion (2009/10 prices) for the RIIO-T1 period.

2.10. Based on our assessment of NGET's analysis we consider that there is not enough information on the modelled WTP estimates at this time to robustly set an expenditure cap for the entire RIIO-T1 period. On this basis, we are consulting in Initial Proposals on a proposal to set an initial expenditure cap of £100m for the start of the price control.

2.11. Our proposed approach will ensure funding is available to start delivery of visual amenity outputs in designated areas at the start of RIIO-T1. It will also give NGET additional time to provide further justification for the level of the expenditure cap for the remainder of RIIO-T1. We will re-consider the level of the expenditure cap in our Final Proposals if further information is provided in time, otherwise we retain the option to review the level of the cap at a later stage.

2.12. This issue is discussed in further detail in the Outputs, incentives and innovation Supporting Document.

New infrastructure

2.13. We propose to adopt NGET's proposition for a baseline allowance to deploy undergrounding technologies that is equivalent 10 per cent of the new transmission lines proposed for delivery in RIIO-T1. We recognise that this baseline amount could be too large or too little and is a working assumption only for the purpose of setting the price control. Therefore, we also propose to include a volume driver to adjust NGET's revenues for the level of mitigation technologies that is actually needed over the course of the price control to obtain development consent.

2.14. This issue is discussed in further detail in the Outputs, incentives and innovation Supporting Document.

[30] The consumer research consisted of a qualitative phase (10 focus groups across GB) followed by a quantitative phase (1,002 national representative telephone interviews). NGET's consultants (Accent) conducted a stated preference choice exercise to derive consumers' WTP.

[31] NGET's modelled results gave point estimates of average consumer WTP for different mitigation options. WTP ranged from 52p to £15 per year for eight years. Figures were highest for respondents stated preferred mitigation technologies, areas of greatest landscape sensitivity and for mitigation options that covered longer distances. The £6.40/year figure is derived using the lowest average estimate of consumer WTP for consumers' preferred mitigation options – undergrounding and tree screening.

Innovation

2.15. There are a number of components of the innovation stimulus package. These were summarised in Chapter 1. In their business plan NGET set out a consideration of innovation through its plan as well as providing a specific innovation strategy.

2.16. NGET highlighted an improved coverage of innovation in its updated business plan and addressed a number of the areas we previously highlighted as requiring improvements. It has clearly set out the challenges that it will seek to innovate around and the processes it would use to seek to continually capture and prioritise innovation opportunities. NGET also set out how it will collaborate with third parties in developing innovations. However, there is a lack of specificity in the stakeholder engagement it has used to support the development of its innovation strategy and priorities. Also, it has not delineated between innovations that it will take forward as part of business as usual versus that which will be funded through the specific NIA.

2.17. NGET has requested an annual innovation allowance of 1 per cent of allowed revenue. We do not consider NGET has provided sufficient justification to merit this level of allowance. However, it has met the basic requirements set out in our Strategy Document and exceeded these in some areas. On this basis, we propose to provide NGET an allowance of 0.6 per cent.

Cost efficiency

2.18. There are various costs that NGET incurs as a TO and for which it seeks to recover revenue in its price control. The main costs areas are:

- Load-related capex – the investment required to connect new generators and customers to the network, to upgrade the existing network and to cater for growth in demand.
- Non load-related capex – the expenditure required to replace existing assets on the network, but also including expenditure relating to network resilience, flooding and physical security.
- Operating costs (Opex) – the ongoing costs of running the business, including asset maintenance and support services.

2.19. Table 2.2 sets out the cost parameters we propose to specify for NGET as both TO and SO in our Initial Proposals to deliver its business plan.

Table 2.2 – RIIO-T1 total cost parameters proposed for NGET (TO and SO)[32]

Parameter	**NGET (TO)**	**NGET (SO)**
	(2009/10 prices) (£/bn)	(2009/10 prices) (£/bn)
Load-related capex	6.7	0.2
Non load-related capex	4.4	
Customer contributions[33]	-0.2	-
Total capex (Best View)[34]	**11.0**	**0.2**
Total opex (controllable and non-controllable)[35]	**2.2**	**0.6**
Real Price Effects (RPEs)[36]	0.5	0.0
Totex before IQI adjustment	**13.7**	**0.8**
IQI adjustment[37]	0.2	0.0
Totex after IQI adjustment	**13.9**	**0.8**

Context for proposed cost parameters

2.20. In a number of areas our cost parameters differ from those requested by NGET in its business plan. The context for our cost proposals is as follows:

- *NGET (TO) capex* – NGET requested total capex of £13.3bn comprising £12.0bn baseline capex and £1.3bn through uncertainty mechanisms. We have reduced the proposed capex for NGET reflecting capex efficiency challenges resulting in reductions in unit costs derived from comparisons to TPCR4, the Scottish TOs and evidence from our engineering consultants, Pöyry. These include reductions to Real Price Effects (RPEs). This accounts for reductions of around £1.3bn. We have also disallowed expenditure relating to the delivery of outputs in RIIO-T2 (which would expect to be remunerated on delivery of those outputs in RIIO-T2). This accounts for around £0.4bn of the reduction.

- *NGET (TO) opex* – NGET requested total opex of £2.6bn. We have reduced the requested amount reflecting TPCR4 comparisons, our engineering consultants' reviews and reductions in RPEs. This accounts for a reduction of around £0.4bn.

[32] Totals may appear different to the sum of individual numbers due to rounding.
[33] Payments that customers make for specific connection assets for their sole use.
[34] 'Best View' is the expenditure that we consider the licensees will need to deliver the outputs under their central scenario. It comprises 'baseline' and 'uncertainty mechanism' funding.
[35] Controllable costs are those costs that are broadly in the company's control. Non-controllable costs are outside the company's control which they cannot determine eg licence fees or business rates. Non–controllable costs for NGET are around £0.6bn.
[36] The TOs are also provided with an allowance for RPEs which represent the expected change in input prices relative to economy wide inflation.
[37] As part of the IQI mechanism to ensure incentive compatability we set totex allowances using an interpolation approach, whereby allowances equal 75% of our view of the efficient level of costs and 25% of the company's view of appropriate costs (as adjusted for volumes or outputs to be on a consistent basis).

- NGET (SO) – NGET requested total SO costs of around £1bn comprising £0.3bn capex and £0.7bn opex. We have reduced the SO's allowances reflecting capex and opex efficiency challenges by £0.2bn and a reduction in requested expenditure associated with the construction of a new data centre.

- We have moved some expenditure which NGET had proposed in its baseline into uncertainty mechanisms. This comprises two elements:

    - We have reduced NGET's proposed baseline by £0.6bn to reflect the greater downside risk that new generation capacity will be less than that on which the Gone Green scenario is based. However, our "best view" of expenditure is based on the Gone Green scenario with the extra funding being delivered via volume drivers.
    - Since the publication of its business plan, NGET has indicated that a reinforcement work is likely to cost more than £0.5bn. Given that, we moved the £0.5bn into the SWW funding mechanism. NGET will be able to bring forward a request for funding for this project when it has confirmed a needs case.

- In total we have reduced NGET requested costs by around £2.0bn for the TO and a further £0.25bn for the internal SO. We have also moved £1.1bn from NGET's baseline into uncertainty mechanisms.

2.21. Further details on our cost proposals for NGET are outlined in our Cost assessment and uncertainty Supporting Document.

Financial proposals

2.22. The financial package comprises a number of elements. These elements combine to determine the total allowed revenue that NGET will be able to recover over RIIO-T1. Table 2.3 sets out the key financial parameters in the Initial Proposals for NGET as TO and SO. Table 2.4 sets out the allowed revenues.

Table 2.3 – Key financial parameters proposed for NGET (TO and SO)

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

Table 2.4 – Allowed revenues

2009-10 Prices £m Best View	2012/13 per Rollover	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
	1332	1412	1551	1616	1701	1692	1723	1698	1666
Yr on Yr change		6.0%	9.8%	4.2%	5.2%	-0.5%	1.8%	-1.4%	-1.9%
Cumulative change		6.0%	16.4%	21.3%	27.7%	27.0%	29.4%	27.5%	25.1%

Context for proposed financial parameters

2.23. In a number of areas our financial proposals differ from those requested by NGET in its business plan. The context for our proposals is as follows:

- *Cost of equity and notional gearing* – NGET proposed a cost of equity of 7.5 per cent and 55 per cent notional gearing. In our Strategy Document we set out a range of 6.0-7.2 per cent for the cost of equity. We consider that this range remains appropriate for RIIO-T1. The RIIO principles dictate that the allowed return should reflect cash flow risk. Having assessed cash flow risk in our Initial Proposals package, we consider that NGET faces a higher risk than NGGT but slightly lower cash flow volatility compared to SPTL and SHETL. On that basis, we consider the appropriate package for NGET comprises a 7 per cent cost of equity and 60 per cent notional gearing.

- *Cost of debt* – NGET accepted our approach to annually updating the cost of debt assumption based on a 10-year simple trailing average index. For the purpose of modelling allowed revenue, we have used the same 3.03 per cent assumption as in the fast-track Final Proposals. We will update this value ahead of Final Proposals.

- *Asset lives and depreciation* – NGET accepted our proposal to depreciate new assets over 45 years on a straight line basis rather than the current 20-year profile. However, it proposed to do so over 16 years. We consider transition to be conditional on the financeability need and have identified 8 years transition as appropriate for NGET to achieve financeability given our Initial Proposals package.

- *Totex capitalisation* – NGET sought a split capitalisation rate between base totex and incremental totex. We only consider such an approach appropriate where incremental totex may result in significantly higher overall spend than the base level. For NGET, incremental totex is relatively small compared to the overall investment level. Therefore, we consider that a single capitalisation rate is appropriate.

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

2.24. Further details on our financial proposals for NGET are outlined in our Finance Supporting Document.

Uncertainty mechanisms

2.25. NGET has proposed a range of mechanisms in the RIIO-T1 control to help it manage the potential uncertainty it has identified during the eight-year price control period.

2.26. One key uncertainty mechanism is the efficiency incentive rate which determines the percentage of underspend/overspend against expenditure allowed at the price control review that is kept by the company responsible. The remaining savings/losses are passed through to consumers. The efficiency incentive rate is calculated by the application of the Information Quality Incentive (IQI) mechanism using the companies' updated business plans adjusted for output changes. When calculated for NGET it gives an incentive rate of 48 per cent.

2.27. Table 2.5 sets out an overview of the other uncertainty mechanisms that we propose to provide for NGET in its roles as TO and SO.

Table 2.5 – Proposed uncertainty mechanisms for NGET

Uncertainty	Proposed mechanism
Volume of new generation connections (TO only)	Volume driver for generation connections to adjust baseline expenditure each year for deviations in generation capacity connections from annual baseline profile, including an adjustment for RPEs.
New demand connections (TO only)	Volume driver for demand related infrastructure backed by commercial agreements or DNO requests to adjust baseline revenues as delivered infrastructure deviates from baseline profile of investment.
Wider reinforcement works (TO only)	Volume driver based on delivered wider works outputs (additional transfer capability) that meet Network Development Policy criteria and funded using boundary specific unit costs and delivered outputs. Strategic Wider Works (within period determination) mechanism for large reinforcements > £500m or projects not meeting NDP criteria.
Pre-construction funding (TO only)	Baseline funding for pre-construction works on onshore baseline wider works and SWW outputs. Within period determination of efficient costs of completing pre-construction engineering works in relation to a combined onshore/offshore project if the incumbent onshore TO is the party best placed to do early design work. All funding for pre-construction works will be conditional on being able to transfer deliverables into an offshore or onshore tender process if required.
Planning requirements to mitigate impacts of new transmission infrastructure on visual amenity (TO)	Volume driver to adjust revenues for cost of mitigation measures required to gain planning consent.

Uncertainty	Proposed mechanism
Licence fees, business rates[38] and Inter TSO scheme payments	Annual pass-through
Financial distress (TO and SO)	Disapplication of the price control where outside the company's control.
Range of material pre-defined events (TO and SO)	Reopener. See below for discussion
RPI Inflation	Price control indexation of allowed revenues.
Financial (TO and SO)	We are proposing to provide a number of mechanisms in relation to the financial arrangements. These cover: • cost of debt • tax legislation • pension deficit repair. These are discussed in more detail in the Finance Supporting Document.

Context for proposed uncertainty mechanisms

2.28. In a number of areas we have proposed an alternative treatment for an uncertainty identified by NGET. These are as set out below.

Reopener

2.29. We propose to retain the principle of reopeners in RIIO-T1 whereby NGET would receive a reopener associated with incurring certain costs. However, we propose to tighten the qualifying criteria such as they will only apply:

- to costs above a materiality threshold of 1 per cent of average annual forecast revenue after the application of the totex efficiency incentive rate
- at specific reopener windows in May 2015 and May 2018 resulting in potential revenue adjustments in April 2016 and April 2019 respectively
- to specific pre-defined categories of events.

2.30. Table 2.6 outlines the uncertainties identified by NGET which we propose to treat as reopeners.

[38] The largest element of business rates is network rates which we treat as a non-controllable cost. Other elements of business rates are included in totex.

Table 2.6 – Categories of reopener for NGET

Area	**Context for uncertainty**
Enhancement of physical security	NGET are undertaking a programme of work to enhance physical security in conjunction with advice from HM Government. The requirements around this work for the RIIO-T1 period are varying for which we have proposed an uncertainty mechanism.
SO security costs	NGET may have to undertake greater resilience for IT systems for the RIIO-T1 period. At the moment these requirements have yet to be fully determined but Ofgem have proposed an uncertainty mechanism should they arise.
Innovation Roll-out	A revenue adjustment mechanism that enables companies to apply for additional funding within the price control period for the rollout of initiatives with demonstrable and cost effective low-carbon or environmental benefits.

Mid-period review

2.31. Recognising the scope for significant changes in outputs during an eight-year price control period, the RIIO framework includes provision for a mid-period review of output requirements. The scope of the mid-period review will be restricted 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. For RIIO-T1 the mid-period review would take place in 2016, with any changes being implemented in April 2017.

2.32. The areas of uncertainty identified by NGET which we would propose to consider as part of the mid-period review are:

- *GB or EU market change* – cost associated with new market facilitation roles/functions stemming from GB or EU legislation
- *Low probability high impact events* – for example changes to safety and environmental standards, severe storms, vandalism and terrorism
- *Flood and erosion protection* - in the event that the Government requires NGET to contribute to flood protection or erosion schemes.

Areas where we are not proposing to provide an uncertainty mechanism

2.33. In a number of areas we have not provided for mechanisms requested by NGET. The areas and our associated reasoning are as follows:

- *Non-load related advancement* – NGET proposed a dead-band for clawing back load-related allowances so it can use them to advance non load-related expenditure. We are not proposing to provide an uncertainty mechanism in this area on the grounds that the efficiency incentive mechanism already provides some protection to financing costs.

- *Copper price tracker* – NGET proposed an uncertainty mechanism to deal with volatility in copper prices. This mechanism would adjust the RPE allowance if the price of these metals were to go outside a dead-band. We are not proposing to provide an uncertainty mechanism in this area on the grounds that NGET and its investors are better placed to manage the risk of price volatility than consumers. Further, we have recognised the propensity for metals price increases to be above RPI during the period in our proposed RPE allowances.

3. Summary of Initial Proposals for NGGT

Chapter Summary: This chapter summarises the Initial Proposals for NGGT.

Question 2: Do you have any comments on the overall package of proposals for NGGT?

Introduction

3.1. This chapter outlines the key components of NGGT's Initial Proposals in its role as TO and also in relation to its internal SO costs. These reflect our proposals but are based on information set out in NGGT's updated business plan. Further detail on each of the areas set out below is provided in the Supporting Documents.

Outputs and incentives

3.2. RIIO is an outputs-led framework. It is important that throughout the RIIO-T1 period, the TOs understand what they are expected to deliver and are held to account for delivery.

3.3. Table 3.1 summarises the outputs that NGGT will be expected to deliver during RIIO-T1. It also outlines the associated incentives. These closely reflect the package of outputs that, following consultation, we set out in our Strategy Document.

3.4. We note that a number of the incentives are linked to the percentage of allowed revenue. To maintain strong output incentives and appropriate revenue allowances for specific activities it is important that the caps and collars on these do not just reflect the opening base revenue allowance but also adjust in response to ongoing, but uncertain, changes in revenue in order to better reflect the true change in network totex and other in-period adjustments over the price control period. References to 'percentage of allowed revenue' therefore reflect a combination of the opening base revenue allowance plus within period adjustments captured through the annual iteration of the financial model. This is discussed in further detail in the Outputs, incentives and innovation Supporting Document.

3.5. We will generally consider a TO's performance against its outputs on an annual basis. We will set out in our Regulatory Instructions and Guidance (RIGs) information requirements and monitoring arrangements. We intend to publish the RIGs by the end of 2012.

3.6. In RIIO, non-delivery of these outputs is not just a matter for the applicable financial incentives. The TOs are also accountable for their delivery through the licence. This means that we may take enforcement action where there is material delivery failure. This means that even where there is a limit to the financial penalty associated with poor delivery, for example in the case of reliability, the licence enforcement process remains as a backstop. This provides additional protection for consumers in the case of significant underperformance on output delivery. Where both enforcement and financial incentives were applicable the enforcement decision would take account of the financial incentives applied.

Table 3.1 - Proposed output and incentive parameters for NGGT in RIIO-T1

Category	Output	Incentive
Safety	Compliance with safety obligations set out by the HSE. Supported by measures of asset health, condition and criticality	Statutory requirements. No financial incentive.
Reliability and availability	Compliance with its obligations to convey gas volumes in a reliable and efficient manner as required at system entry and exit points under the Uniform Network Code (UNC), NGGT's Transporter Licence and the Gas Act 1986. Keep current lead times for providing extra (incremental) capacity and, as a short-term measure, use an increased permits allowance to manage the associated risk. NGGT to undertake further work in this area. This issue is discussed in further detail below in first year.	Statutory requirements. No financial incentive.
Customer Satisfaction	Develop a customer satisfaction survey.	Up to +/-1% of allowed revenue.
	Effective stakeholder engagement.	Up to 0.5% of allowed revenue via a discretionary reward scheme.
Connections	Meet new process established under UNC modification 373.	Reputational incentive
Environmental	Business Carbon Footprint (BCF) – to publish BCF accounts at business level each year of RIIO-T1.	Reputational incentive.
	Venting – To be reduced through the development of innovative techniques to optimise maintenance scheduling, compressor operation and decompression techniques.	No formal incentive as separately incentivised through the SO external incentives. NGGT should report annually on developments and mitigation.
	Compressor replacement – changes for compliance with requirements of the IED	No formal incentive. Discussed under section on uncertainty mechanisms.

Context for proposed outputs – incremental capacity

3.7. For the most part NGGT's proposed outputs reflect the proposals outlined in its business plan which, in turn, were consistent with the position in our Strategy Document. One area where we are proposing a variation to NGGT's proposal is in relation to the arrangement for providing incremental capacity during the RIIO-T1 period.

3.8. NGGT's business plan proposes new arrangements for the release of extra capacity. The proposals lengthen the overall process (lead times) for delivering capacity but provide more certainty over the final 24 months of delivery. The proposed arrangements are in part a response to the changes to the planning law in England and Wales[39] but also to the scale of potential investment required to meet the demand for extra capacity during RIIO-T1.

3.9. NGGT's proposals are wide ranging and would have a significant impact on industry code arrangements. These changes were not fully discussed with industry until May 2012 (ie after the submission of NGGT's updated business plan). We know that industry stakeholders expect to have full discussions over any potential code changes and do not consider it appropriate that these are driven by the price control timetable. Consequently, it is widely recognised that these changes will not be in place for 1 April 2013.

3.10. Therefore, we propose:

(1) that the existing regulatory arrangements are retained in this area for the start of RIIO-T1 including the time period for the release of incremental capacity

(2) recognising the additional challenges this presents to NGGT we propose to provide an enhanced allowance of permits[40] of £19m for the year 2013/14 that would enable NGGT to take longer to provide more capacity in some cases.

3.11. We expect NGGT to be proactive in taking forward further discussion with the industry on any potential commercial changes in this area. In the event that any changes are agreed then it may be necessary to make changes to the regulatory arrangements during RIIO-T1.

[39] The Planning Act 2008 obtained Royal Assent late in 2008 but involved major changes to the planning regime in England and Wales, including establishing the Infrastructure Planning Commission which only started accepting applications in March 2010.

[40] Permits provide a means by which NGGT can move the obligate lead times for the release of incremental capacity. It can earn permits by taking on the obligation to release incremental capacity early. They enable NGGT to trade off the risk of more difficult projects with those of other projects.

Innovation

3.12. There are a number of components of the innovation stimulus package. These were summarised in Chapter 1. In its business plan NGGT sets out a consideration of innovation through its plan as well as providing a specific innovation strategy.

3.13. NGGT adopts the same approach as NGET to the coverage of innovation in its plan. Its coverage of innovation has also improved since its previous plan and it has the same strengths as NGET, namely it clearly sets out the challenges that it will seek to innovate around and how it will collaborate with 3rd parties in developing innovations. However, it also has the same weaknesses, namely a lack of specificity in the stakeholder engagement it has used to support the development of its innovation strategy and priorities, and a failure to delineate between innovations that it will take forward as part of business as usual versus that which will be funded through the specific NIA.

3.14. NGGT has also published an updated innovation strategy. NGGT requested an innovation allowance of 1 per cent of allowed revenue. We do not consider NGGT has provided sufficient justification to merit this level of allowance. However, it has met the basic requirements set out in our Strategy Document and exceeded these in the same areas as NGET. On this basis, we also propose to provide NGGT an allowance of 0.6 per cent.

Cost efficiency

3.15. There are various costs that NGGT incurs as a TO and for which it is seeking to recover revenue in its price control. The main costs areas are:

- Load-related capex – the investment required to provide new capacity to meet customers' needs and to cater for growth in demand.
- Non load-related capex – the expenditure required to replace existing assets on the network, but also including expenditure relating to network resilience, flooding and physical security.
- Opex – the ongoing costs of running the business, including asset maintenance and support services.

3.16. Table 3.2 sets out the cost parameters we propose to specify for NGGT as both TO and SO in our Initial Proposals to deliver its business plan.

Table 3.2 – RIIO-T1 total cost parameters proposed for NGGT (TO and SO)[41]

Parameter	NGGT (TO)	NGGT (SO)
	(2009/10 prices) (£/bn)	(2009/10 prices) (£/bn)
Load-related capex	2.2	0.2
Non load-related capex	1.0	
Customer contributions	0.0	-
Total capex (Best View)	**3.1**	**0.2**
Total opex (controllable and non-controllable)[42]	**1.5**	**0.3**
RPEs	0.2	0.0
Totex before IQI adjustment	**4.8**	**0.5**
IQI adjustment	**0.1**	**0.0**
Totex after IQI adjustment	**4.9**	**0.6**

Context for proposed cost parameters

3.17. In a number of areas our proposed cost parameters differ from those requested by NGGT in its business plan. The context for our proposals is as follows:

- *NGGT (TO) capex* – NGGT requested total capex of £5.4bn comprising £1.7bn baseline capex and £3.7bn through uncertainty mechanisms. We have reduced baseline volumes and unit costs for compressors and other non load-related capex. We have moved some expenditure which NGGT had proposed in its baseline into uncertainty mechanisms to reflect uncertainties on timings and amounts. Also, one of NGGT's reinforcement projects has been transferred into the baseline and subjected to an £80m efficiency reduction.

- *NGGT (TO) opex* – NGGT requested total opex of £1.5m. We have broadly accepted NGGT's requested opex but reduced the requested amount slightly reflecting TPCR4 comparisons and our engineering consultants' reviews.

- NGGT (SO) – NGGT requested total SO costs of around £0.7bn comprising £0.4bn capex and £0.3bn opex. We have reduced the SO's allowances reflecting capex and opex efficiency challenges and a reduction in requested expenditure associated with the construction of a new data centre.

- In total we have reduced NGGT requested costs by around £2.1bn for the TO and a further £0.13bn for the SO. We have also moved £0.5bn from NGGT's baseline into uncertainty mechanisms.

3.18. Further details on our cost proposals for NGGT are outlined in our Cost assessment and uncertainty Supporting Document.

[41] Totals may appear different to the sum of individual numbers due to rounding.
[42] Non–controllable costs for NGGT are around £0.8bn.

Financial proposals

3.19. The financial package comprises a number of elements. These elements combine to determine the total allowed revenue that NGGT will be able to recover over RIIO-T1. Table 3.3 sets out the key financial parameters in the Initial Proposals for NGGT as TO and SO. Table 3.4 sets out the proposed allowed revenues.

Table 3.3 – Key financial parameters proposed for NGGT (TO and SO)

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

Table 3.4 – Proposed Allowed revenues

2009-10 Prices £m Best View	2012/13 per Rollover	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
	586	559	567	595	638	744	720	742	770
Yr on Yr change		-4.5%	1.4%	5.1%	7.2%	16.6%	-3.2%	3.0%	3.7%
Cumulative change		-4.5%	-3.2%	1.7%	9.0%	27.0%	22.9%	26.7%	31.4%

Context for proposed financial parameters

3.20. In a number of areas our financial proposals differ from those requested by NGGT in its updated business plan. The context for our proposals is as follows:

- *Cost of equity and notional gearing* – NGGT proposed a cost of equity of 7.5 per cent and 55 per cent notional gearing. In our Strategy Document we set out a range of 6.0-7.2 per cent for the cost of equity. We consider that this range remains appropriate for RIIO-T1. Under RIIO principles the allowed return should reflect cash flow risk. Having assessed cash flow risk in our Initial Proposals package, we consider that NGGT faces lower cash flow risk than NGET, in part due to it having a lower investment rate (relative to RAV). Therefore, we consider the appropriate package for NGGT comprises a 6.8 per cent cost of equity and 62.5 per cent notional gearing.

- *Cost of debt* – NGGT accepted our approach to annually updating the cost of debt assumption based on a 10-year simple trailing average index. For the purpose of modelling allowed revenue, we have used the same 3.03 per cent assumption as in the fast-track Final Proposals. We will update this value ahead of Final Proposals.

- *Asset lives and depreciation* – Asset lives are currently 45 years for NGGT. We do not propose to change this position. This is in line with our Strategy Document and NGGT's business plan proposals.

- *Totex capitalisation* – NGGT sought split capitalisation rates between base totex and incremental totex. We consider this appropriate in the case of NGGT, where incremental totex may result in significantly higher overall spend than the base level. NGGT proposed a split capitalisation rate of 57 per cent for base totex and 90 per cent for incremental totex. We propose a slightly lower capitalisation rate of 53 per cent for base totex, this reflects the adjustments we have made to the submitted values. We have used NGGT's proposed capitalisation of 90 per cent for incremental totex.

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

3.21. Further details on our financial proposals for NGGT are outlined in our Finance Supporting Document.

Uncertainty mechanisms

3.22. In its updated business plan NGGT proposed a range of mechanisms to help it manage the potential uncertainty it has identified during the eight-year price control period. One key uncertainty mechanism is the efficiency incentive rate. The efficiency incentive rate is calculated by the application of the IQI mechanism using the companies' updated business plans adjusted for output changes. When calculated for NGGT it gives an incentive rate of 45 per cent.

3.23. Table 3.5 sets out an overview of these mechanisms.

Table 3.5 - Uncertainty mechanisms proposed for NGGT

Uncertainty	**Proposed mechanism**
Incremental exit and entry	Retain existing arrangements whereby revenue drivers are calculated at the start of the price control process whilst options for delivery of incremental capacity are developed. We expect NGGT to bring forward further work in this area including commercial changes which, if approved, would lead to changes in the regulatory arrangements in this area during the RIIO-T1 period. This was discussed in more detail in the outputs section of this chapter.
Constraint management/buy-back	We are seeking views on two options: (1) status quo – retain separate arrangements for the treatment of constraint management actions at entry and exit. (2) Reflecting NGGT's business plan, create a single incentive scheme combining exit and entry with the operational buyback scheme. However, remove caps and collars on risk. This is discussed in further detail below.
Financial distress	Disapplication of the price control where outside the company's control.
Licence fees, Business rates, Armed guards, Conveyance of gas to independent systems	Continued pass through.
Network flexibility	Limited reopener to meet future peak day requirements triggered by NGGT proposal supported by stakeholder engagement. This is discussed in further detail below.
Range of material pre-defined events	Reopeners. This is discussed in further detail below.
RPI Inflation	Price control indexation of allowed revenues.
Financial (TO and SO)	We are proposing to provide a number of mechanisms in relation to the financial arrangements. These cover: • cost of debt • tax legislation • pension deficit repair. These are discussed in more detail in the Finance Supporting Document.

Context for proposed uncertainty mechanisms

3.24. In a number of areas we have proposed an alternative way of treating an uncertainty identified by NGGT. These are as set out below.

Network flexibility

3.25. NGGT has argued it will require funding during RIIO-T1 to increase the flexibility of its network to meet existing capacity obligations and changing peak day scenarios. It has requested both baseline funding of £60m and a re-opener for future projects, which it estimates may require a further £250-£300m during RIIO-T1.

3.26. We propose to differentiate network flexibility expenditure between investment to meet future peak day requirements, and expenditure required to meet commercial obligations. For the former, we propose multiple re-opener windows to ensure that supply obligations can be met. For the latter, we propose this will be captured by the mid-period review.

Constraint management

3.27. There are currently separate arrangements for the treatment of constraint management actions at entry and exit. NGGT is proposing that both entry and exit capacity constraints be considered within a single incentive scheme but also that it combines these with the operational buyback scheme. NGGT favours this approach on the basis that the dynamic nature of the system means that in reality constraints on the system can be managed by a combination of actions at entry and exit.

3.28. We consider there are merits with NGGT's proposed approach. Creating a single scheme could provide a framework in which constraints are managed in the most cost effective manner overall. It would also simplify the current suite of incentives. However, combining the incentives also has the potential to reduce NGGT's own risk exposure if all the buybacks are subject to the same cap. Also, critically we note that NGGT has not sufficiently engaged with stakeholders in the development of the detail of its proposals in this area.

3.29. In light of this we propose to consult on alternative options:

(1) A modified version of NGGT's proposals whereby there are no caps and collars and whereby NGGT is not provided with a risk premium. This is to reflect the need to balance the risk facing NGGT with the risk passed on to users. We consider the risk of removing caps and collars based on NGGT's analysis to be reasonable. We have factored this in to our general risk analysis of the overall package.

(2) Retention of the status quo. This reflects the limited engagement stakeholders have had in this area to date and is to provide stakeholders with the opportunity to set out further views before a decision is taken in this area.

Reopeners

3.30. We propose to retain the principle of reopeners in RIIO-T1 whereby NGGT would have a reopener associated with incurring specific costs. However, we propose to tighten the qualifying criteria such that they will only apply:

- to costs above a materiality threshold of 1 per cent of average annual forecast revenue after the application of the totex efficiency incentive rate
- at specific reopener windows in May 2015 and May 2018 resulting in potential revenue adjustments in April 2016 and April 2019 respectively
- to specific pre-defined categories of events.

3.31. Table 3.6 outlines the uncertainties identified by NGGT which we propose to treat as reopeners.

Table 3.6 – Categories of reopeners for NGGT

Area	Context for uncertainty
Pipeline diversion costs (TO)	Liability for costs associated with diverting existing pipeline.
XoServe (SO)	Recognising Ofgem's current Xoserve review[43] will change funding arrangements once RIIO-T1 has started.
Asset health - material only (TO)	Provides for funding in the event of a low probability, high impact unexpected event such as a material safety notice from the original equipment manufacturer. We are proposing to set a higher materiality threshold than for other reopeners of £50m (pre application of the efficiency incentive rate).
Quarry and loss of development claims (TO)	Material one-off claims from landowners for compensation due to pipeline developments.
Integrated Pollution Prevention and Control Directive (TO)	Requirement to replace compressor units with either electric drives or compatible gas drives in order to comply with the Integrated Pollution Prevention and Control Directive (IPPCD).
Enhancement of physical security (TO)	NGGT are undertaking a programme of work to enhance physical security in conjunction with advice from HM Government. The requirements around this work for the RIIO-T1 period are varying for which we have proposed an uncertainty mechanism.

[43] Xoserve provides a range of centralised data services to support the operation of the GB gas industry. We have recently undertaken a review of Xoserve's funding, governance and ownership arrangements. The purpose of the review was to examine whether the current arrangements facilitate the provision of an efficient and high quality service, and one that is responsive to network users' needs, and wider industry change.

Area	Context for uncertainty
SO security costs (SO)	NGGT may have to undertake greater resilience for IT systems for the RIIO-T1 period. At the moment these requirements have yet to be fully determined but Ofgem has proposed an uncertainty mechanism should they arise.
Innovation Roll-out	A revenue adjustment mechanism that enables companies to apply for additional funding within the price control period for the rollout of initiatives with demonstrable and cost effective low-carbon or environmental benefits.

Mid-period review

3.32. The areas of uncertainty identified by NGGT which we would propose to consider as part of the mid-period review are:

- *GB or EU market change* – costs associated with new market facilitation roles/functions stemming from GB or EU legislation
- *Flood and erosion protection* – in the event that the Government requires NGGT to contribute to flood protection or erosion schemes
- *Network flexibility* – costs to increase the flexibility of its network to meet commercial obligations
- *Industrial Emissions Directive (IED)* - Requirement to replace compressor units with either electric drives or compatible gas drives in order to comply with the IED.

Areas where we are not providing an uncertainty mechanism

3.33. NGGT requested provision for an uncertainty mechanism to deal with volatility in steel prices, which we are not proposing to adopt. Under NGGT's proposal a *steel price tracker* mechanism would adjust the RPE allowance if the price of these metals were to go outside a dead-band. We are not proposing to provide an uncertainty mechanism in this area because we consider that NGGT and its investors are better placed to manage the risk of price volatility than consumers. Further, we have recognised the propensity for metals price increases to be above RPI during the period in our proposed RPE allowances.

4. Next steps

Chapter Summary

The purpose of this chapter is to set out the next steps in setting the RIIO-T1 price control for NGET and NGGT.

4.1. We welcome the views of interested parties in relation to any of the issues set out in this document, the three Supporting Documents, our Impact Assessment or the associated consultation on the initial licence drafting. Responses should be provided to RIIO.T1@ofgem.gov.uk no later than **21 September 2012**. Unless clearly marked as confidential, responses will be published on our web forum.

4.2. In light of respondents' views, we will publish our Final Proposals for NGGT and NGET in December 2012.

4.3. The Final Proposals will come into effect through changes to the transmission licences on 1 April 2013. The licence obligations will also be set out in a series of supporting methodologies. In addition we will be developing a set of RIGs for RIIO-T1. The RIGs will provide the framework under which we will monitor the performance of the TOs against their price control obligations.

4.4. We intend to publish a further consultation on the licence conditions in October 2012 and the Statutory Licence consultation in December 2012.

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, the Supporting Documents, the IA and our initial licence drafting. In particular, we would like to hear from consumers and their representatives, gas and electricity transmission and distribution companies, generators and offshore gas producers/importers, suppliers, shippers, debt and equity investors, those with sustainable development interests, academics and other interested parties.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of Chapters 2 and 3 of this document and in our three Supporting Documents. These are replicated below for all of these documents.

1.3. Responses should be received by 21 September 2012 and should be sent to:

- RIIO.T1@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 and subject to the views provided Ofgem intends to publish Final Proposals for NGGT and NGET and a statutory consultation on implementing licence conditions in December 2012. Any questions on this document should, in the first instance, be directed to:

- Grant McEachran
  Head of RIIO-T1
  107 West Regent St, Glasgow, G2 2BA
  0141 331 6008
  grant.mceachran@ofgem.gov.uk

Questions in Overview Document

CHAPTER: Two

Question 1: Do you have any comments on the overall package of proposals for NGET?

CHAPTER: Three

Question 2: Do you have any comments on the overall package of proposals for NGGT?

Questions in Outputs, incentives and innovation Supporting Document

CHAPTER: Two

Question 1: Do you have any comments on our Initial Proposals on NGET's output and incentives?

Question 2: Do you have any views on our Initial Proposals on setting an expenditure cap for the start of RIIO-T1 in relation to addressing the visual amenity impacts of existing infrastructure in designated areas?

CHAPTER: Three

Question 3: Do you have any comments on our Initial Proposals on NGGT's output and incentives?

Question 4: We welcome your views on the appropriate permits arrangements from 1 April 2014 if no other changes to the incremental capacity arrangements have been made?

Question 5: We welcome your views on the two options on constraint management tools retained in our Initial Proposals. Are you aware of any evidence that might help us in judging between these two options?

CHAPTER: Four

Question 6: We welcome your views on the proposed level of funding for the licensees' NIA, based on the quality and content of their innovation strategies.

Question 7: In relation to funding the Gas NIC for 2013/14, do you support either Option 1 (run the NIC and raise the required funds from the winning licensee's customers) or Option 2 (no Gas NIC, but roll-over funds to 2014/15). If NIC is delayed beyond 2014/15, what option would you support?

Questions in Cost assessment and uncertainty Supporting Document

CHAPTER: Two

Question 1: Do you agree with our assumptions for real price effects and ongoing efficiency?

Question 2: Do you agree with our proposed materiality thresholds of 1 per cent (subject to the efficiency incentive rate) for the majority of costs to be treated under the reopener mechanism?

Question 3: Do you agree with our proposal to restrict the reopeners for the roll-out of innovation to the two standard reopener windows, ie 2015/16 and 2018/19?

Question 4: Do you have any other comments in relation to our approach to uncertainty mechanisms?

CHAPTER: Three

Question 5: Do you consider that our proposed funding baseline for NGET (TO) has been set at an appropriate level?

Question 6: Do you consider that our proposed uncertainty mechanisms for NGET (TO) are appropriate?

CHAPTER: Seven

Question 7: Do you consider that our proposed baseline for NGGT (TO) has been set at an appropriate level?

Question 8: Do you consider that our proposed uncertainty mechanisms for NGGT (TO) are appropriate?

Question 9: Do you agree with our proposals to expand the provisions of the reopener mechanism for NGGT to cover a number of additional cost areas?

Question 10: Do you agree with our proposed materiality thresholds of 2 per cent (subject to the efficiency incentive rate) for the reopener mechanism in relation to asset health shocks?

CHAPTER: Eight

Question 11: Do you consider that our proposed baseline for NGET (SO) has been set at an appropriate level?

Question 12: Do you consider that our proposed uncertainty mechanisms for NGET (SO) are appropriate?

Question 13: Do you consider that our proposed baseline for NGGT (SO) has been set at an appropriate level?

Question 14: Do you consider that our proposed uncertainty mechanisms for NGGT (SO) are appropriate?

Question 15: Do you agree with our proposals in relation to uncertainty with respect to Xoserve's costs?

Questions in Finance Supporting Document

CHAPTER: Three

Question 1: Do you have any comments on our relative risk assessment?

Question 2: Do you agree with our proposed elements of the allowed return?

CHAPTER: Four

Question 3: Do you agree with our proposal for eight-year transition on NGET's asset lives for assets constructed after the start of RIIO-T1?

CHAPTER: Five

Question 4: Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?

Question 5: Do you agree that the costs of contingent assets may be allowed if considered to be in consumers interests?

Question 6: Do you agree with the thresholds for pension scheme administration costs and Pension Protection Fund levies?

CHAPTER: Six

Question 7: Do you agree with our amended treatment for modelling the cash flows of Corporation Tax payments?

Question 8: Do you agree with conforming the revenue adjustment for tax clawback to be annually in line with the annual iteration process?

Question 9: Do you agree with our treatment of expenditure for tax modelling?

CHAPTER: Seven

Question 10: The annual iteration process does not currently include any adjustment to TIRG values. We propose to add an adjustment. Do you agree?

Question 11: Do you have any views on the calculations and layout in the financial model?

Question 12: Should the financial model also capture, for presentational purposes only, the revenue from all incentive schemes?

Appendix 2 – RIIO-T1 Timetable

Phase	Year	Month	Milestone
Initial Proposals Non-Fast-Track	**2012**	**July**	Monday 16th - Headlines Published
			Friday 27th - Non-Fast-Track Initial Proposals Published Consultation on initial licence drafting for all TOs and GDNs
Final Proposals Non-Fast-Track		**October**	Second consultation on licence drafting for all TOs and GDNs
		November	Late November - Committee Session - Non-Fast-Track Final Proposals
		December	Thursday 13th - GEMA - Non-Fast-Track Final Proposals Decision Monday 17th - Non-Fast-Track Final Proposals Published Statutory Consultation on Licence Modifications
Launch	**2013**	**March**	New licences and RIGs issued
		April	Monday 1st - New Price Controls Commence

Appendix 3 – Summary of responses to our March consultation

1.1. We received five responses to our March 2012 consultation on the updated business plans on NGET and NGGT. None were marked as confidential.

Process

1.2. All respondents suggested that the updated plans demonstrated an improvement on the initial business plans. One respondent considered both plans to be comprehensive. Another two respondents agreed that NGGT's plan was comprehensive. In relation to NGGT's plans, one respondent agreed that they were better structured and easier to navigate. The same respondent noted that the links between Ofgem's strategy and NGGT's proposals had been strengthened thereby providing a clear explanation of what output each proposal aims to facilitate.

1.3. Two respondents commented that it was not immediately clear how the updated plans differed from the initial plans and therefore that a brief explanation of the main changes would have been helpful.

1.4. One respondent welcomed the publication of NGGT's plan and the transparency this brought. However, another respondent noted that, due to the confidential nature of future investments, the plans did not include all the relevant information to understand the impact of those plans. They noted that this meant that only Ofgem could fully scrutinise and challenge NGGT in this area.

1.5. One respondent considered that the section on National Transmission System (NTS) connections in NGGT's plan was overly complex and required further consideration and development.

1.6. Another respondent, while it considered that the plans were both sufficiently clear on what NGET and NGGT wished to achieve and how they would deliver against those plans, noted that it was difficult to navigate specific parts of the plans and that more clarity and detail could have been provided. The respondent identified sustainability commitments as an example of such an area.

1.7. One respondent noted that the documents were protected and that it would have been helpful to be able to cut and paste from them given the amount of information and data provided.

1.8. One respondent supported the greater focus on Europe in the plans and recognised the implications of this for increased resources on the part of NGGT.

Stakeholder engagement

1.9. One respondent welcomed the comprehensive stakeholder engagement processes that NGGT had employed as a significant improvement on the previous 'behind closed doors' approach. The respondent considered NGGT had taken on board feedback.

1.10. Another respondent agreed that both NGGT and NGET had made a considerable effort to ensure all stakeholders had fully participated.

1.11. A third respondent noted that both plans broadly reflected stakeholder feedback.

1.12. One respondent set out the view that it was important that engagement continues where regulatory or commercial changes arise from the price control settlement to ensure there are 'no surprises'. They argued that the Transmission workgroup was the appropriate forum for such discussions.

1.13. Another respondent noted that there were two areas of NGGT's plan that required further development in close collaboration with network stakeholders – governance of NTS connections and network flexibility. In particular, in relation to the governance of NTS connections they expressed concern about the lack of engagement on a number of the specific arrangements set out in Appendix B of its plan. The respondent argued that industry stakeholders should have the opportunity to discuss the validity of the proposed arrangements before Ofgem makes its final assessment.

Outputs

1.14. One respondent considered that both NGET's and NGGT's plans lacked a sustainability strategy to explain how the individual initiatives it has identified have been linked together and with other business commitments. The respondent also noted that there was no explanation of why the proposed approaches are the most efficient options.

1.15. Two respondents considered NGGT could do more to reduce gas losses including a plan to reduce unaccounted for gas (UAG) and measures to provide for a better detection of gas theft. One of those respondents also noted that there was a lack of consideration of how the impact of gas combustion on CO_2 emissions could be reduced.

1.16. One respondent argued that it was important that standards of customer service do not drop as a result of the amount of industry change and uncertainty envisaged. The respondent did not agree that there should be an incentive reward for good service as it is a monopoly activity. Rather, it supported penalties for poor performance.

1.17. On connections, one respondent considered that this was an area that could be greatly improved and streamlined to facilitate new loads and services. Another respondent supported the implementation and principles of UNC (Uniform Network Code) Mod 373[44] and agreed that processes around Planning Act changes would require some evolution.

Capacity and connections

1.18. One respondent noted that a number of the changes proposed by NGGT – aligning capacity and connection processes and separating the release of baseline and incremental capacity – would require development of the commercial framework and that these should be progressed as a matter of urgency to enable introduction from 1 April 2013.

1.19. Two respondents welcomed the proposal to reduce the lead time for the delivery of capacity following a firm investment signal to 24 months. However, one of those respondents noted the requirement for further detail on how a pre-determined model would be used to provide permits for early delivery and how this would interact with the SO buyback incentives to avoid double counting. The other respondent noted that the arrangement would need to provide mechanisms to address the fact that developers may want delivery of capacity in a month other than October and that the final investment decision may not be made immediately after a project is granted planning consent. The same respondent also noted that the impact on charging needed to be further elaborated.

1.20. Two respondents raised issues on the sale of baseline and incremental capacity through separate processes. One noted that such an approach may be more consistent with European models but that it should be recognised that spare capacity exists in certain locations of the network such that investment would not be required to meet incremental requests. The other respondent questioned why this change was appropriate and noted that it would prefer a generic, non-discriminatory, industry wide agreement for all customers in terms of user commitment and project timelines. Both respondents saw the need for further engagement with stakeholders in this area through the usual governance processes.

Cost assessment

1.21. One respondent noted that both plans were dominated by load-related expenditure and that this was driven by the use of the Gone Green scenario. The respondent argued that there should be further debate around alternative baseline scenarios to deliver the 2020 targets. The same respondent noted that some sensitivity of the input assumptions would help in the justification of some of the specific transmission cases presented. Another respondent supported the use of the Gone Green scenario as the benchmark for the investment plan.

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[44] A modification proposal to the UNC to improve the process for connections to the NTS and create a framework within which NGGT shall operate its NTS connection offer processes. Notice of implementation was on 4 July 2012. It is to be implemented on 1 August 2012.

1.22. One respondent argued that NGET should identify more clearly anticipatory investments and that any such mechanism must mitigate the risk of asset stranding and imposing unnecessary costs by being guided by user commitment.

1.23. One respondent considered that both plans had correctly identified the types of investment needed during RIIO-T1 but that any investment should be considered against other more efficient and market based methods on managing the networks.

1.24. Two respondents did not agree that the £61m of ex-ante funding associated with network flex was warranted. Both considered that more efficient methods of managing the networks should be considered and expressed disappointment that NGGT had not proposed the option of developing additional commercial tools/market arrangements such as demand-side management to deliver additional flexibility.

1.25. One respondent did not agree that all investments identified by NGET were warranted and noted that there were other methods of managing networks that could have been considered. It identified weather based dynamic line rating techniques as an approach for better managing the likelihood and size of constraints, particularly in Scotland.

Uncertainty

General

1.26. Three respondents agreed with the arguments about increasing risk and uncertainty and the fact that uncertainty mechanisms would have an important role to play.

1.27. One respondent noted that the regulatory framework should not be designed as a safety net against all forms of risk. It further noted that the interactions between outputs, incentives and uncertainty mechanisms were not overly transparent and welcomed NGET's proposal to simplify its range of mechanisms. It further noted that an alternative funding mechanism such as TIRG/TII could be considered for specific investment in the gas network above a predefined threshold.

1.28. One respondent noted that there were a number of outstanding industry initiatives which may affect investment assumptions including TransmiT, EMR, the SO incentives review and measures to support efficient coordination with offshore transmission. It questioned whether the proposed uncertainty mechanisms had been calibrated to manage the range of potential outcomes or whether they would be dealt with by reopeners or at the mid-term review.

1.29. One respondent considered NGGT proposed appropriate strategies to deal with risk and uncertainty.

1.30. Another respondent noted the significant investment requirement set out in NGGT's plan including a significant amount associated with user commitment based on forecasts. It agreed with the principle of this funding being held outside the price control until triggered by an uncertainty mechanism but noted that the detail of the user commitment and uncertainty mechanism remained to be determined.

Operational buybacks and constraints

1.31. One respondent saw merit in combining the entry and exit incentives into one scheme. It noted that setting the target for this incentive would be challenging and noted it was not clear that NGGT's proposed model had been tested on real data. The respondent also noted that it would like to better understand the interactions between this and the other proposed incentive mechanisms.

Incremental entry and exit capacity

1.32. Two respondents commented on the details of these mechanisms:

- one supported the introduction of a standardised process for determining revenue allowances and the two stage process pre and post capacity signal as reasonable
- one respondent questioned how the costs associated with long lead times would be managed if a project was subsequently abandoned, as they noted it was important to avoid a repeat of the issues associated with Fleetwood
- one respondent supported the introduction of a long-term interruptible product to manage "in flight" projects that might not be delivered due to the IPC timescale but noted it would not support the use of a buy back fund which would result in a non-cost reflective smearing of costs
- one respondent noted that not all requests would require investment and some would be met from existing network capability or substitution
- both expressed concern at the proposal to limit capacity applications to certain times of the year as restricting customer choice and noted that the principles of Mod 376[45] should not be undermined
- one questioned the treatment of consented CCGTs that are yet to signal capacity requirements.

Network flexibility

1.33. Two respondents supported the use of an uncertainty mechanism in relation to network flexibility. One noted it was required to cope with the impact on the system of increased wind intermittency but that further stakeholder engagement was required on how the mechanisms would work. The other respondent noted that both a more detailed consideration of the interaction with other uncertainty mechanisms

[45] A proposed modification to the UNC to increase the level of choice available to Users when applying for Enduring Annual NTS Exit (Flat) capacity. Notice of implementation was on 3 February 2012. Modification is to be implementation on a date to be confirmed.
http://www.gasgovernance.co.uk/sites/default/files/Final%20Modification%20Report%200376%20&%200376A%20v2.0.pdf

and a holistic oversight of development was needed to bring forward the more efficient and effective solution overall.

Other

1.34. One respondent considered that the proposed uncertainty mechanisms for asset health, the Industrial Emissions Directive, Critical National Infrastructure and GB/UU Market Facilitation all seemed reasonable. However, they noted that, in the case of asset health it should be restricted to exceptional unseen events. Also, in relation to GB and EU Market Facilitation it considered that further clarity was required on which regulatory and system changes would be covered by baseline allowances.

Financial

1.35. Two respondents considered the introduction of the principle of “fast-money” would undermine cost reflectivity as a different set of customers will fund the capacity than those who triggered and will use the capacity.

1.36. Four respondents noted the importance of charge predictability stability and transparency and expressed concerns about charge volatility arising from the complexity and uncertainty of the proposals and with NGGT’s associated proposals in relation to a higher capitalisation rate (90 per cent). One respondent welcomed the recognition of this issue through the Charging Methodology Forums but noted there was still work to be done. Another of the respondents argued that NGGT had not provided any details as to how a higher rate of capitalisation would stabilise charges and whether this proposal was suitable for the given scenario of high network flexibility. The third respondent considered that a higher capitalisation rate and the treatment of “fast cash” would actually increase charging volatility when combined with uncertainty around future investment. The fourth respondent noted that the changes may create a more challenging environment for developers making investment decisions.

Appendix 4 - Feedback Questionnaire

1.37. 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?

1.38. Please send your comments to:

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