

Guidance

RIIO-3 Business Plan Guidance Annex 5: Business Plan Incentive Stage B and Stage C

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Guidance – RIIIO-3 Business Plan Guidance

Annex 5: Business Plan Incentive Stage B and Stage C

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1. Business Plan Incentive Stage B examples

A1.1 This annex provides some illustrative examples of how the reward or penalty for Stage B of the BPI would be calculated in practice. It is intended to cover a range of cases; this is done for illustrative purposes only, with no implication as to the likelihood of a specific case materialising in practice.

Overall mechanism

A1.2 As explained in Chapter 10 of the Business Plan Guidance, the overall reward or penalty for Stage B of the BPI will be the result of a weighted average between the rewards/penalties for two distinct categories of costs.

A1.3 The reward or penalty for comparatively assessed costs will range from a reward of +40 bps of RoRE to a penalty of -10 bps of RoRE, both weighted by the proportion of submitted costs which are comparatively assessed. The reward or penalty for bespoke costs will fall within a symmetric range of ± 20 bps of RoRE, weighted by the proportion of submitted costs which fall into the bespoke category.

A1.4 As an illustrative example:

- i) Suppose that 70% of a company's costs are comparatively assessed, with the remaining 30% being bespoke.
- ii) Suppose that the company is relatively inefficient on its comparatively assessed costs, such that, before applying the relevant weight, its comparatively assessed costs would receive a penalty of -5 bps of RoRE.
- iii) On the other hand, suppose that the company's bespoke costs are well justified across most cost areas, such that the before weights are applied its bespoke costs would be awarded a reward of +15 bps of RoRE.
- iv) The company's overall Stage B reward/penalty would be calculated as follows:
$$(-5 * 70\%) + (+15 * 30\%) = 1.$$
- v) The company would therefore receive a reward worth 1 bps of RoRE.

A1.5 Unweighted rewards or penalties for comparatively assessed costs will be calculated using the methodology in paragraphs 9.25 to 9.29 of the RIIO-3 Business Plan Guidance, with an example provided in the footnote.

A1.6 Unweighted rewards or penalties for individual categories of bespoke costs will be calculated using the methodology set out in paragraphs 9.30 to 9.38 of the RIIO-3 Business Plan Guidance. The following section provides an example.

Bespoke cost reward or penalty calculation example

A1.7 Suppose that a company’s bespoke costs were split into four distinct cost areas as follows:

- i) Cost Area 1 comprises 35% of bespoke costs;
- ii) Cost Area 2 comprises 30% of bespoke costs;
- iii) Cost Area 3 comprises 10% of bespoke costs; and
- iv) Cost Area 4 comprises 20% of bespoke costs.

A1.8 Suppose that the company had received the following ratings for each cost area:

Bespoke cost ratings	Quality of cost evidence	Justification of efficient unit costs	Justification of efficient volumes
Cost Area 1	Comprehensive	Adequate justification	Robust justification
Cost Area 2	Fair	Poor justification	Poor justification
Cost Area 3	Fair	Robust justification	Adequate justification
Cost Area 4	Poor	Poor justification	Adequate justification

A1.9 For Cost area 1, the company would receive an unweighted reward worth +6.7 bps of RoRE¹ (ie one third of 20 bps of RoRE, the maximum reward) for “Quality of cost evidence” and a further +6.7 bps of RoRE for “Justification of efficient volumes”, for an unweighted total of 13.3 bps of RoRE.

A1.10 For Cost Area 2, the company would receive an unweighted penalty of -6.7 bps of RoRE (ie one third of -20 bps of RoRE, the maximum penalty) for “Justification of efficient unit costs” and a further -6.7 bps of RoRE for “Justification of efficient volumes”, for an unweighted total of -13.3 bps of RoRE.

A1.11 For Cost Area 3, the company would receive an unweighted reward of +6.7 bps of RoRE for “Justification of efficient unit costs”.

A1.12 For Cost Area 4, the company would receive an unweighted penalty of -6.7 bps of RoRE for “Quality of cost evidence” and a further -6.7 bps of RoRE for

¹ We will use exactly one third of 20 bps of RoRE when calculating rewards and penalties associated with bespoke costs in Stage B.

“Justification of efficient unit costs”, for an unweighted total of -13.3 bps of RoRE.

A1.13 The company’s overall reward/penalty for bespoke costs (before the weight for bespoke costs is applied) is calculated as follows:

$$(+13.3 * 35\%) + (-13.3 * 30\%) + (+6.7 * 10\%) + (-13.3 * 20\%) = -2$$

The company would therefore receive a penalty of -2 bps of RoRE multiplied by the proportion of overall submitted costs falling into the bespoke category.

Multiple separate comparative assessments combined with bespoke assessment

A1.14 As set out in paragraph 9.29 of the Business Plan Guidance, there may be cases in which a company’s costs are assessed based on multiple, separate comparative assessments, each resulting in a separate comparative efficiency score for the company.

A1.15 In such cases, we will calculate the reward or penalty for comparatively assessed costs as the weighted average between the rewards/penalties calculated for each individual comparative assessment, weighted by the proportion of comparatively assessed costs covered by each. This reward or penalty will in turn be weighted by the proportion of submitted costs which are comparatively assessed.

A1.16 As an illustrative example, suppose that:

- i) 50% of a company’s submitted costs are comparatively assessed, of which:
 - (1) 20% assessed through a form of unit cost benchmarking across the sector; and
 - (2) 30% assessed as part of an econometric model.

Now, suppose that:

- ii) The company would receive an unweighted penalty of 10 bps RoRE on the proportion of its comparatively assessed costs that were assessed using comparative unit cost benchmarking;
- iii) The company would receive the unweighted maximum reward of 40 bps of RoRE on the econometrically benchmarked component of its comparatively assessed costs; and

iv) The company would receive an unweighted penalty of -10 bps of RoRE for its bespoke costs, constituting the remaining 50% of submitted costs.

The company's overall Stage B reward or penalty would be calculated as follows:

$$(-10 * 20\%) + (+40 * 30\%) + (-10 * 50\%) = 5$$

The company would therefore receive a reward worth +5 bps of RoRE.

Comparatively assessed costs maximum reward / penalty adjustment example

A1.17 As set out in paragraph 9.28 of the Business Plan Guidance, under exceptional circumstances we may choose to reduce the maximum reward and/or maximum penalty for comparatively assessed costs.

A1.18 As an illustrative example, suppose that in the same situation set out in the previous example, we decided to reduce the maximum reward for the econometrically benchmarked component of the company's comparatively assessed costs to 20 bps of RoRE because, for example, companies' efficiency scores are very close to the benchmark.

A1.19 The company would still receive the unweighted maximum reward for the econometrically benchmarked proportion of its comparatively assessed costs, now equal to 20 bps of RoRE (unweighted).

A1.20 The company's overall Stage B reward or penalty would be calculated as follows:

$$(-10 * 20\%) + (+20 * 30\%) + (-10 * 50\%) = -1$$

The company would therefore receive a penalty worth -1 bps of RoRE.

2. Business Plan Incentive Stage C Scorecards

Overall Clarity Scorecard

<i>Reward/penalty (RoRE)</i>	<i>+7 bps of RoRE</i>	<i>0 bps of RoRE</i>	<i>-7 bps of RoRE</i>
Criteria	Outstanding	Acceptable	Poor
Overall description for rating	The business plan as a whole is presented in a clear and coherent manner with a strong golden thread running through it, as demonstrated by the following criteria:	The business plan is, for the most part, presented in a clear and coherent manner, as demonstrated by the following criteria:	The business plan is not presented in a clear and coherent manner, as demonstrated by the following criteria:
Layout and structure	<ul style="list-style-type: none"> The layout and structure of the business plan is clearly signposted and flows coherently. 	<ul style="list-style-type: none"> The layout and structure of the business plan is, for the most part, clearly signposted and flows coherently’. 	<ul style="list-style-type: none"> The layout and structure of the business plan is not clearly signposted or does not flow coherently.
Accessibility and conciseness	<ul style="list-style-type: none"> All information provided in the business plan is presented in accessible language and only uses technical language where absolutely necessary (and explains technical language in plain English), meaning it can be clearly understood by all stakeholders. The business plan and its component parts do not exceed the page limits set out in Chapter 8 of the Business Plan Guidance. 	<ul style="list-style-type: none"> Information provided in the business plan is, for the most part, presented in accessible language, meaning it can be understood by all stakeholders. The business plan and its component parts do not for the most part exceed the page limits set out in Chapter 8 of the Business Plan Guidance. 	<ul style="list-style-type: none"> Information provided in the business plan is not presented in accessible language and in many instances uses technical language that is not explained in plain English. The business plan and its component parts materially exceed the page limits set out in Chapter 8 of the Business Plan Guidance in places.
Relevance of the information provided	<ul style="list-style-type: none"> Only relevant data and other information is included within the business plan with the relevance being made clearly apparent to the reader. 	<ul style="list-style-type: none"> Only relevant data and other information is included within the business plan. 	<ul style="list-style-type: none"> Significant amounts of irrelevant data and other information is included within the business plan.

<i>Reward/penalty (RoRE)</i>	<i>+7 bps of RoRE</i>	<i>0 bps of RoRE</i>	<i>-7 bps of RoRE</i>
Criteria	Outstanding	Acceptable	Poor
Clarity of information that supports the demonstration of value to consumers	<ul style="list-style-type: none"> The business plan contains clearly presented and justified evidence of how and where value to consumers has been identified and how this has translated into different parts of its business plan through commitments, proposed spend and other consumer benefits. The business plan clearly differentiates between opinions, views and conclusions on the one hand and statements of fact on the other precisely and with clarity. 	<ul style="list-style-type: none"> The business plan contains adequate evidence of how and where value to consumers has been identified and how this has translated into different parts of its business plan through commitments, proposed spend and other consumer benefits. The business plan, for the most part, clearly differentiates between opinions, views and conclusions on the one hand and statements of fact on the other precisely and with clarity. 	<ul style="list-style-type: none"> The business plan contains insufficient evidence of how and where value to consumers has been identified and how this has translated into different parts of its business plan through commitments, proposed spend and other consumer benefits. The business plan fails to clearly differentiate between opinions, views and conclusions on the one hand and statements of fact on the other.
Coherence and justification	<ul style="list-style-type: none"> The business plan is a coherent product of its different parts and clearly demonstrates how and why the company will carry out the activities within it, including reference to stakeholder engagement where this is appropriate, via a clearly visible golden thread. 	<ul style="list-style-type: none"> The business plan is coherent overall, but some parts lack a clear golden thread connecting them to the rest of the business plan. Proposed activities are justified, with reference to stakeholder engagement where appropriate. 	<ul style="list-style-type: none"> The business plan is incoherent, lacking a clear thread that bring its different parts together. Activities are insufficiently justified, with limited or no evidence of stakeholder engagement.

Business Plan Commitments Scorecard

<i>Reward/penalty (RoRE)</i>		<i>+13 bps of RoRE</i>	<i>0 bps of RoRE</i>	<i>-13 bps of RoRE</i>
Rating	Outstanding	Acceptable	Poor	
Overall description for rating	<ul style="list-style-type: none"> The business plan commitments put forward by the company are highly ambitious ie they deliver value for consumers over and above what is currently delivered under RIIO-2 and demonstrate a clear link with what consumers value for RIIO-3. <p>Commitments are underpinned by highly credible evidence of the needs case and a highly credible plan to deliver them up to the proposed standard.</p> <p>The additional benefits generated by the commitments set out in the business plan are substantial and underpinned by a clear and well justified needs case and will help set industry best practice with regards to one or more RIIO-3 outcomes.</p>	<ul style="list-style-type: none"> The business plan commitments put forward by the company are sufficiently ambitious ie they deliver value for consumers at least in line with what is currently delivered under RIIO-2 and demonstrate a link with what consumers value for RIIO-3. <p>Commitments are underpinned by sufficient evidence of the needs case and a credible plan to deliver them up to the proposed standard.</p> <p>There is a clear, tangible link between benefits that are generated by the commitments set out in the business plan and the delivery of one or more RIIO-3 outcomes.</p>	<ul style="list-style-type: none"> The business plan commitments put forward by the company are not ambitious ie they fail to demonstrate a clear link with delivering what consumers value for RIIO-3, are at the risk of delivering demonstrably less value than what is currently delivered under RIIO-2 or fail to be underpinned by a credible plan. <p>Where new commitments are proposed, there is insufficient justification of the needs case or clear evidence to suggest that they would deliver tangible benefits for consumers or any of the RIIO-3 outcomes.</p>	

<i>Reward/penalty (RoRE)</i>		<i>+13 bps of RoRE</i>	<i>0 bps of RoRE</i>	<i>-13 bps of RoRE</i>
Rating	Outstanding	Acceptable	Poor	
Deliverability	<ul style="list-style-type: none"> Business plan commitments relating to all activities funded as part of RIIO-3 baseline are underpinned by clear and credible plans for delivery which are supported by high-quality evidence, taking appropriate account of all relevant delivery risks. Timelines are provided for the implementation of commitments which are well justified and evidenced. 	<ul style="list-style-type: none"> There is an evidence-based plan to deliver business plan commitments relating to all activities funded as part of RIIO-3 baseline, taking account of most relevant delivery risks. Credible timelines are provided for the implementation of commitments. 	<ul style="list-style-type: none"> The timeline or plan put forward for the delivery of business plan commitments relating to all activities funded as part of RIIO-3 baseline does not appear to be credible based on the available evidence, fails to engage with relevant delivery risks or has not been provided. 	
Consumer value and additionality	<ul style="list-style-type: none"> There is a clear link between specific business plan commitments and the overarching RIIO-3 outcomes that they seek to achieve, with consumer needs prioritised and evidenced throughout. The business plan commitments generate significant additional value for consumers above what is currently delivered under RIIO-2 and is demonstrated by clear evidence, such as consumer research. 	<ul style="list-style-type: none"> The business plan commitments clearly demonstrate value for consumers in line with what is currently delivered under RIIO-2 and their expectations for RIIO-3 and are supported by clear evidence. 	<ul style="list-style-type: none"> Business plan commitments fail to demonstrate a clear link with what consumers value for RIIO-3 or are at the risk of delivering demonstrably less value than what is currently delivered under RIIO-2. 	
Stretching performance	<ul style="list-style-type: none"> Targets are proposed in respect of business plan commitments that are materially more stretching than targets set in RIIO-2, with justification demonstrating why the new targets can be met. 	<ul style="list-style-type: none"> Targets in respect of business plan commitments may not create stretch on targets from RIIO-2, but clearly justify the rationale behind this. 	<ul style="list-style-type: none"> Targets in respect of business plan commitments, stretching or otherwise, are not well justified. 	
New company proposals	<ul style="list-style-type: none"> New business plan commitments are only proposed in targeted instances where additional consumer value is clearly demonstrated. The principles set out by Ofgem in the Business Plan Guidance are followed throughout, and all information required for Ofgem to assess the commitment is provided. 	<ul style="list-style-type: none"> Where a new business plan commitment is proposed, this is done where a clear consumer value has been identified. The principles set out by Ofgem in the Business Plan Guidance are followed throughout, and key information required for Ofgem to assess the commitment is provided. 	<ul style="list-style-type: none"> New business plan commitments are proposed that do not follow the principles set out by Ofgem in the Business Plan Guidance, or where a clear consumer value has not been identified. 	

