Scottish and Southern Energy
Power Distribution

March 2014
Business Plan Update

Contents

01. Introduction

In March 2014, Scottish and Southern Energy Power Distribution (SSEPD) published an update to its Business Plan[1] for the RIIO-ED1 period, 1 April 2015 to 31 March 2023. This document is a summary of the changes in the March 2014 Business Plan compared with the version published in July 2013.

Material revisions fall into two categories:

1. We have reviewed those aspects of the July 2013 Business Plan which were highlighted by Ofgem in its November 2013 Assessment[2] as being inadequately justified.

   The March 2014 Business Plan incorporates significant additional evidence and justification to demonstrate the value for money of our proposals. A number of adjustments to the outputs, costs and work volumes have been made. In particular, we propose to make additional payments to customers experiencing unplanned interruptions that are equivalent to doubling the Guaranteed Standard[3]. Our changes result in a reduction in the total controllable costs[4] ("totex") forecast of £204 million[5,6] over the eight year period (Figure 1.1).

2. We have re-balanced the risk allocation to transfer more downside risk from customers to SSEPD.

   Of particular materiality are our amended proposals for regulatory uncertainty mechanisms. In light of the changes we have made, and wider considerations, we have reviewed our financeability parameters including the cost of equity.

As a consequence of these revisions, the March 2014 Business Plan presents significantly greater delivery challenges to SSEPD with significantly higher downside risk.

[1] The July 2013 Business Plan and March 2014 Business Plan are published at www.yourfutureenergynetwork.co.uk
[2] For November 2013 Assessment, see www.ofgem.gov.uk/publications-and-updates/riio-ed1-business-plan-assessment-and-fast-tracked-consultation
[3] It is proposed to make an additional payment equal to the prescribed sum for supply restoration during normal conditions (Regulation 5). Additional payments made for unplanned interruptions during severe weather (Regulation 6) would continue to be determined on a case-by-case basis. The current Electricity (Standards of Performance) Regulations 2010 can be found at www.legislation.gov.uk/uksi/2010/698/contents/made
[4] Controllable costs excludes costs which we are required to pay, for example tax, business rates and licence fees.
[5] All costs presented in this document are in 2012/13 prices unless stated otherwise.
[6] This £204 million includes an adjustment for double-counting smart meter costs in the July 2013 Business Plan.

The overall effect of these changes, compared with the July 2013 Business Plan, is a reduction in the base allowed revenue of £376 million over the eight year period. This is equivalent to a further reduction in the average domestic bill[7], in addition to that set out in our July 2013 Plan, of over £9 in our north of Scotland operational area and over £5 in our central southern England area.

Our proposals mean that the electricity distribution element of the average household energy bill for SSEPD's more than 3.5 million customers will fall by around 16% in 2015/16, and change in line with inflation thereafter.

Figure 1.1 RIIO-ED1 Business Plan proposals

Southern Electric Power Distribution (SEPD)

(2012/13 prices)	**July 2013**	**March 2014**	**Change**
Total controllable expenditure (base totex) (£m)	2,572.7	2,448.2	-124.5
Base allowed revenue (£m)	4,119.3	3,877.1	-242.2
Closing Regulated Asset Value (RAV), 31 March 2023 (£bn)	2,339.0	2,277.0	-62.0
Electricity distribution element of average household bill, 2015-2023 (£)	91.07	85.73	-5.34
Reduction in average household bill in 2015/16 (£)	-11.11	-16.45	-5.34

Scottish Hydro Electric Power Distribution (SHEPD)

(2012/13 prices)	**July 2013**	**March 2014**	**Change**
Total controllable expenditure (base totex) (£m)	1,311.8	1,232.6	-79.2
Base allowed revenue (£m)	2,179.8	2,045.7	-134.1
Closing Regulated Asset Value (RAV), 31 March 2023 (£bn)	1,152.0	1,099.0	-53.0
Electricity distribution element of average household bill, 2015-2023 (£)	154.01	144.53	-9.48
Reduction in average household bill in 2015/16 (£)	-16.22	-25.70	-9.48

[7] For an explanation of how we have calculated the average household bill, see page 30.

02.
Summary of changes

About us • July 2013 Business Plan •
Ofgem Assessment of the July 2013 Business Plan • Revisions to our July 2013 Business Plan

About us

Scottish and Southern Energy Power Distribution[8] (SSEPD) is the owner of two electricity distribution networks (Figure 2.1).

- Scottish Hydro Electric Power Distribution (SHEPD) distributes electricity to around 750,000 homes and businesses in the north of Scotland and the Scottish Islands.
- Southern Electric Power Distribution (SEPD) operates in central southern England, including the Isle of Wight, serving nearly three million customers.

SHEPD and SEPD are two of fourteen electricity distribution networks in GB. These fourteen networks distribute electricity to the vast majority of homes and businesses in the country.

The operators of electricity distribution networks are responsible for taking electricity from the national transmission system or local distributed generators and distributing that electricity to the homes and businesses that need it (Figure 2.2). This is done using a network of overhead lines, underground cables and electricity substations. The main work of network operators is looking after the existing network by undertaking regular inspection and maintenance, replacement of worn out equipment and repairing damage when it occurs. In addition, network operators will invest to strengthen or extend the network to provide new connections or in response to changing customer electricity use. The cost of electricity distribution is around 20% of the average household electricity bill[9].

The activity of the network operator ends on the outside of the meter. From there, an electricity supply company will look after the meter and bill customers for their electricity use.

[8] See www.ssepd.co.uk
[9] Source: www.ofgem.gov.uk/publications-and-updates/understanding-energy-prices

Figure 2.1 The fourteen GB electricity distribution networks including SEPD and SHEPD

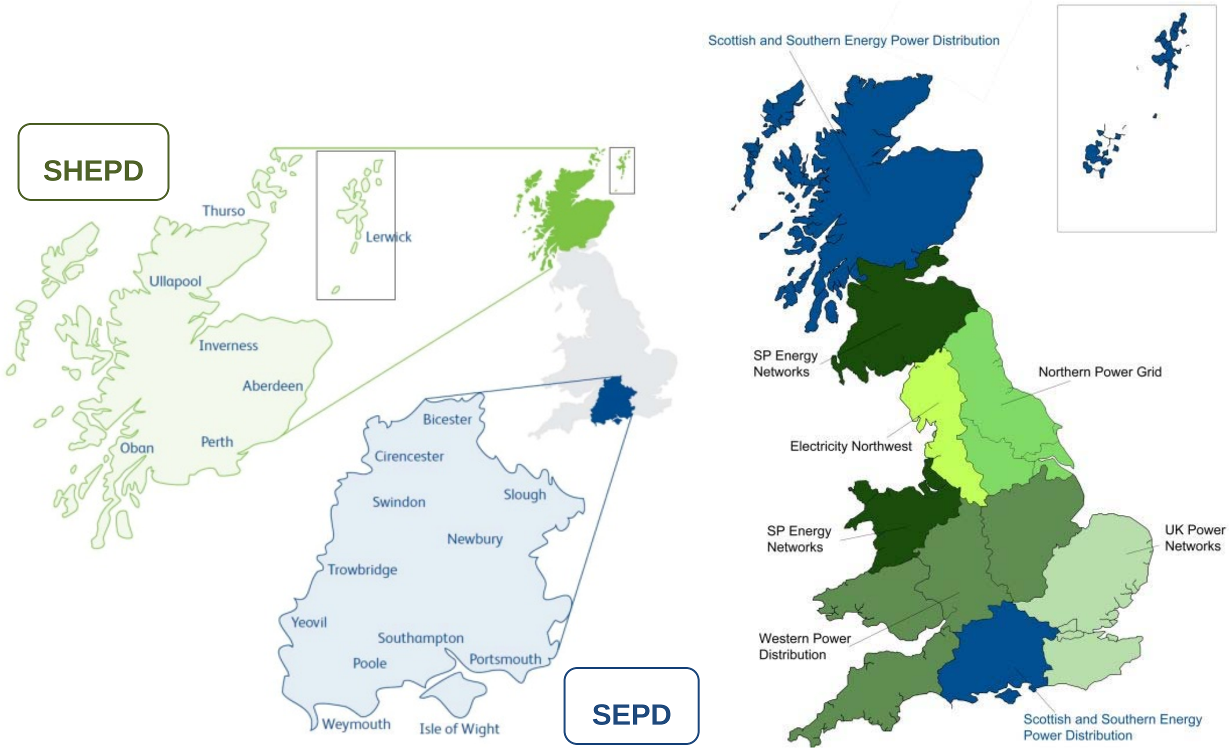
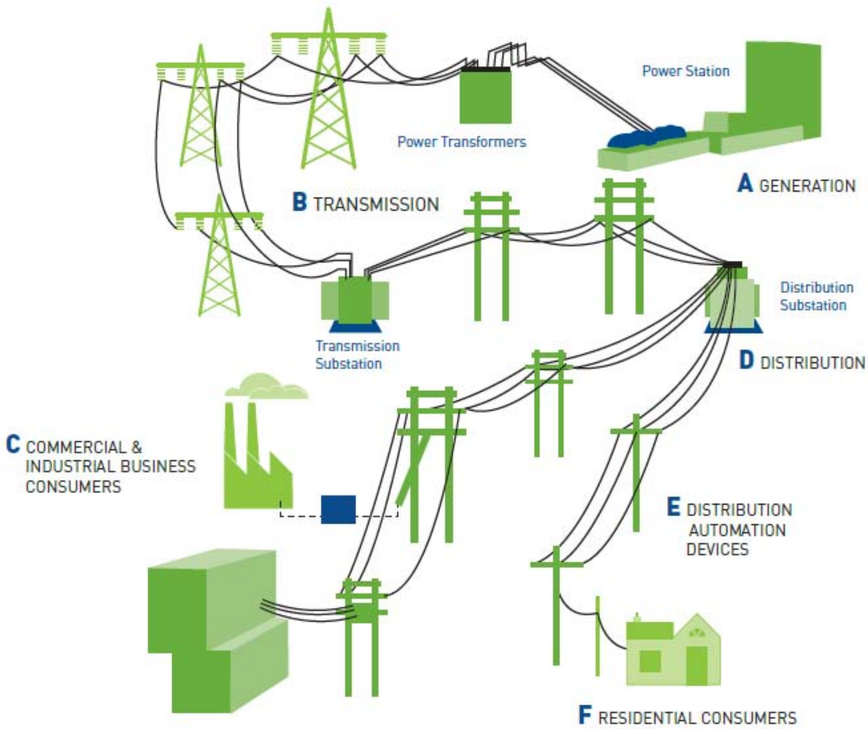


Figure 2.2 The GB electricity system



The service provided by electricity distribution network operators is a natural monopoly; customers have no alternative provider and no choice but to use that service. To protect customers and ensure that the network owners behave fairly, these networks are operated under a licence that is controlled by the energy industry regulator Ofgem[10]. Through the licence, Ofgem can determine the maximum amount that the network operators are allowed to charge their customers, can prescribe minimum standards of service and monitor the investment plans.

July 2013 Business Plan

On 1 July 2013, SSEPD published our Business Plan1 for SEPD and SHEPD setting out our proposed customer service levels, network maintenance and investment activities, and detailed expenditure forecasts. The Business Plan covers the regulatory period called RIIO-ED1[11] that starts on 1 April 2015 and ends on 31 March 2023.

During a wide-ranging consultation[12] over the eighteen months preceding July 2013, SSEPD's customers and stakeholders had consistently emphasised the importance of keeping bills down while maintaining the highest possible continuity of supply (Figure 2.3). In preparing the Business Plan, our primary objective was to balance this need to improve the service customers receive without increasing costs. Ongoing cost efficiency, particularly by deploying innovative technologies and techniques, allowed us to commit in the Business Plan to reduce our element of customers' bills and further improve the reliability of electricity supply.

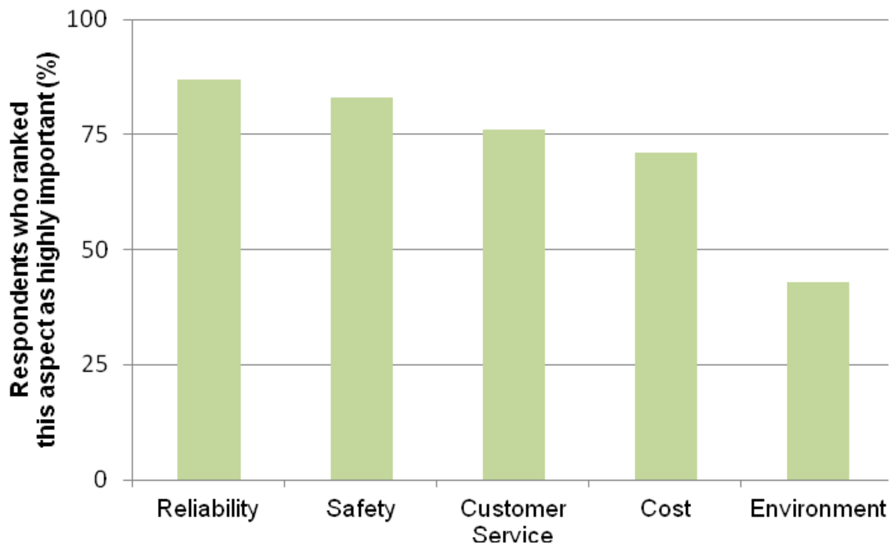
When compared to service targets and cost allowances for the five year regulatory period from 1 April 2010 to 31 March 2015, the July 2013 Business Plan set out:

- Like-for-like annual controllable cost reductions of five per cent.
- Reduction in the number of power cuts by five per cent and their duration by one quarter by 2023.
- Targeted measures to make it easier for our customers to get in touch with us and get the information they need, and also to support vulnerable customers.
- Additional payments to customers when we do not meet our service targets for planned interruptions and making new connections.
- Ten per cent reduction in our part of the electricity bill in 2015/16 and only inflationary increases thereafter.

Overall SSEPD's July 2013 Business Plan proposed a reduction in like-for-like totex and improvement in customer service standards.

[10] See www.ofgem.gov.uk
[11] RIIO-ED1 is 'Revenue = Incentives + Innovation + Outputs' for the price control period Electricity Distribution 1. See www.ofgem.gov.uk/network-regulation-—-riio-model/riio-ed1-price-control
[12] For details of the consultation and our response see www.ssepd.co.uk/haveyoursay

Figure 2.3 Customers' priorities described in Our First Consultation, March 2012[13]



Ofgem Assessment of the July 2013 Business Plan

In November 2013, Ofgem published its Assessment2 of SSEPD's July 2013 Business Plan.

The November 2013 Assessment highlighted a number of strengths in our proposals. For cost efficiency, Ofgem assessed SSEPD to be joint second of the six network ownership groups and close to the upper quartile benchmark. This is consistent with Ofgem's previous assessments of relative cost efficiency over the past two decades, which have determined that SSEPD is amongst the top performing companies. Ofgem also concluded that it was satisfied with SSEPD's proposed outputs in three of the six categories. The approach adopted by SSEPD to the financing of our business was also assessed to be consistent with Ofgem's views.

However, the November 2013 Assessment also highlighted two weaknesses in SSEPD's Business Plan that meant Ofgem was not able to accept our proposals:

- The evidence presented to justify some proposed outputs and expenditure forecasts was insufficient. In particular, Ofgem commented on the need for additional information on our customer vulnerability strategy and our proposals to improve the service to some worst served customers[14] in the SHEPD area. Furthermore, Ofgem concluded that SSEPD's cost benefit analyses, including quantifying the role of future innovations, were inadequate.

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[13] From our pre-consultation survey of over 1,000 customers, where customers were asked to rank the importance of aspects of our service. For the full results of this survey and our response, see www.ssepd.co.uk/uploadedFiles/Controls/Lists/Stakeholder_engagement_report/StreetAndTelephoneSurveyFeedbackAndOurResponse.pdf

[14] Worst Served Customers (WSC) are customers experiencing on average at least five higher voltage interruptions per year over a three year period, i.e. 15 or more over three years.

- The Plan sought to transfer too much risk to customers. In particular, Ofgem concluded that the additional uncertainty mechanisms proposed only by SSEPD could not be justified.

As a consequence, Ofgem required SSEPD to review its Business Plan and submit revised proposals by 17 March 2014. Ofgem intends to publish its Draft Determination on the March 2014 Business Plan in July 2014.

Revisions to our July 2013 Business Plan

SSEPD has considered the November 2013 Assessment in detail, and sought further clarification from Ofgem where available. We have also reviewed the feedback from our customers and stakeholders, incorporating feedback given since July 2013 (including from the recent winter storms). Based on this, we have made two material revisions to our July 2013 Business Plan (Figure 2.5):

1. We have reviewed our proposals in those areas that Ofgem considered inadequately justified, and presented additional evidence and justification to demonstrate our Plan is good value for money for our customers.

   Our objective has been to explain and set out the process that has lead us to propose undertaking certain works and, hence, quantify the net benefits to customers of the resultant outputs. A key element of the additional information provided is a fundamental revision to our approach to presenting cost benefit analyses. We have also reviewed our Innovation Strategy to demonstrate the linkage with costs and volumes.

   In a number of instances, our review has resulted in adjustments to the outputs, costs and work volumes. These adjustments either save our customers money or increase the service standards they will receive. In particular for the reliability and availability output, we propose to make additional payments to customers experiencing unplanned interruptions that are equivalent to doubling the Guaranteed Standard[15]. Our changes result in a reduction in the base totex forecast of £204 million over the eight-year period.

   As a consequence of this review, we believe we have strengthened our July 2013 Business Plan and comprehensively demonstrated that our proposals are value for money for our customers. We understand that Ofgem will repeat its relative cost assessment and expect that SSEPD will meet, or be better than, the upper quartile benchmark – further evidencing the value for money of our proposals.

[15] It is proposed to make an additional payment equal to the prescribed sum for supply restoration during normal conditions (Regulation 5). Additional payments made for unplanned interruptions during severe weather (Regulation 6) would continue to be determined on a case-by-case basis. The current Electricity (Standards of Performance) Regulations 2010 can be found at www.legislation.gov.uk/uksi/2010/698/contents/made

Figure 2.5 Revisions made in response to the November 2013 Assessment

Assessment criterion	**November 2013 Assessment**	**March 2014 Business Plan**
1 Process	GREEN	Minor additions – see page 11
2 Outputs	RED (SHEPD), AMBER (SEPD) Insufficient justification presented for proposed environment, social obligations, and reliability and availability outputs	Material additions – see page 15 Additional evidence and analysis to support proposed outputs for environment, social obligations, and reliability and availability Additional payment for unplanned interruptions (equivalent to doubling the Guaranteed Standards) Revised approach to worst served customers in SHEPD area
3 Efficient expenditure	AMBER Of the six ownership groups, joint second in cost assessment Some inadequate justification, particularly for asset replacement and load-related expenditure Not a clear picture of cost savings from smart grid solutions	Material additions – see page 20 Additional evidence and analysis to support forecast costs and volumes, with amendments where required Amended Innovation Strategy to quantify the benefits of smart grid solutions Updated smart meter strategy Revisions to forecast Transmission Connection Point Charges for SHEPD Analysis for Real Price Effects (RPEs) updated for latest economic data
4 Efficient financing	GREEN	Material changes – see page 26 Cost of equity revised to 6.4%
5 Uncertainty and risk	RED “approach ... de-risking its plan”	Material changes – see page 32 Significant transfer of downside risk from customers to SSEPD – regulatory uncertainty mechanisms aligned with March 2013 Strategy Decision

<u>Areas affected:</u> Environment output (losses, business carbon footprint, fluid-filled cables); Social Obligations output (customer vulnerability strategy); Reliability and Availability output (network risk indices, health indices, worst served customers, unplanned interruptions); Efficient expenditure (asset replacement, load related expenditure, smart meters and IT); real price effects; Efficient financing; Innovation Strategy.

2. We have re-balanced the allocation of risk to transfer more downside risk from customers to SSEPD.

   Two substantial revisions to our July 2013 Business Plan result in a significant transfer of risk from customers to SSEPD:

   i. We have withdrawn the additions and amendments to the regulatory uncertainty mechanisms to align the March 2014 Business Plan with Ofgem policy. Our proposed uncertainty mechanism for rail electrification is unchanged.

ii. We have reviewed the financeability or our proposals, the relative risk which is retained and considered additional evidence on appropriate financial parameters. Taking a balanced view, including the potential for incentive benefits for good performance, we have reduced the cost of equity by thirty basis points to 6.4%. Our position on the cost of equity is summarised on page 27.

Taken together, these changes further strengthen the value for money to customers of our Business Plan.

Areas affected: Efficient financing; Risk and uncertainty.

The next five sections of this document summarise the changes we have made in each of the five criterion of the November 2013 Assessment – process, outputs, efficient expenditure, efficient financing, and uncertainty and risk – and provides links to the relevant section of the March 2014 Business Plan where more detail can be found.

03.
Process

- **Maintained project delivery and governance structure established for July 2013 Business Plan, and publication platform.**
- **Continued with stakeholder engagement activities, and continued to learn and improve approach.**
- **No change to SSEPD strategy for the RIIO-ED1 period or our views on the long term context.**

Introduction

About criterion 1, process

A Business Plan is a statement of an organisation's strategy and goals, the reasons that these goals have been set and the activities proposed to achieve the outputs. As such, a Business Plan provides a clear direction and framework for the organisation for the duration of the Plan and beyond, recognising that some elements might change as, for example, customers' requirements change, unforeseen events occur or new ways of working are established.

An effective Business Plan must be clear and well justified. Clarity is achieved both through presentation style and articulation of consistent, rational goals. Justification comes through a robust process that seeks evidence from all parties with a stake in the organisation's outputs. In addition, the Business Plan must make sense for the long term. More explanation on what constitutes a well justified approach to process can be found in Ofgem's March 2013 Strategy Decision[16].

July 2013 Business Plan

SSEPD sought to present a clear, well-justified Business Plan in July 2013.

The business planning process began in late 2011 with the establishment of a project team, governance structure and identification of expert support. Engagement with stakeholders began in February 2012, with our initial consultation letter. A wide range of stakeholders engaged in the development of the July 2013 Business Plan and made a material contribution to the content of the Plan, most importantly in understanding customers' priorities for the eight year period.

[16] See page 16: www.ofgem.gov.uk/ofgem-publications/47069/riioed1decbusinessplans.pdf

Our Business Plan was published on a bespoke, accessible website: www.yourfutureenergynetwork.co.uk. Different presentation styles were used for documents with different audiences, based on stakeholder feedback received during the consultation period.

Ofgem November 2013 Assessment

Ofgem assessed both SEPD and SHEPD as 'Green' for criterion 1, process.

While the November 2013 Assessment concluded that SSEPD demonstrated "a reasonably robust process", it highlighted that we did not clearly explain our methodology for engagement with stakeholders. Ofgem also noted that our Plan did not have a specific section on long term delivery.

Revisions to our July 2013 Business Plan

Publication of the July 2013 Business Plan was not the end of our work, but rather a key milestone in our delivery plans for the RIIO-ED1 period, 1 April 2015 to 31 March 2023. Our March 2014 Business Plan includes a number of updates on our business planning over the past eight months.

Process and approach

The business planning process and governance arrangements have not changed from those described in the July 2013 Business Plan. These are described in 'How we put this plan together and a summary of the contents'.

We have also retained the same approach to style and presentation, and the same publication platforms.

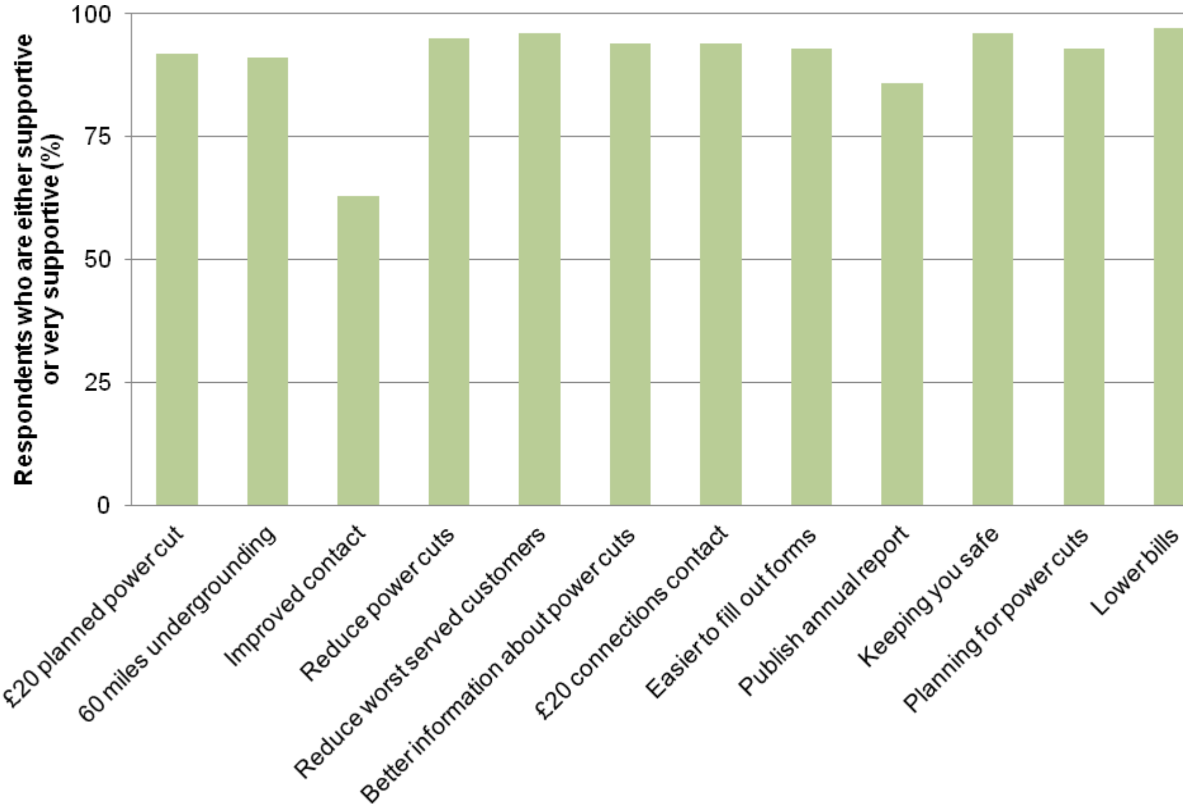
Stakeholder engagement

SSEPD's March 2014 Business Plan has a new document – 'What our stakeholders think about our Business Plan commitments' – which summarises our ongoing engagement with customers and wider stakeholders, and explains our engagement strategy and supporting business processes.

We consulted over 3,000 people across both the SEPD and SHEPD areas between July and October 2013 to test their views on 12 Commitments[17] that were central to the July 2013 Business Plan. The findings demonstrate that the commitments resonated strongly with customers and stakeholders, with the overwhelming majority of those consulted saying that the proposed commitments would be important to them personally (Figure 3.1). This consultation has also provided SSEPD with valuable insights into how customers and stakeholders want SSEPD to communicate and engage with them.

[17] The 12 Commitments were made on the basis that Ofgem accepted our July 2013 Business Plan. In the November 2013 Assessment, Ofgem raised concerns with some of our proposals that were included in the commitments. We have proposed a number of changes to address Ofgem's concerns. As described in this document, we intend to update the 12 Commitments once we have the Final Determination on the March 2014 Business Plan.

Figure 3.1 Customers' views on the 12 Commitments[18]



Long term strategy

In the July 2013 Business Plan, SSEPD considered the long term context of our Plan in five ways:

- The long term strategy and values of SSEPD.
- The priorities and future expectations of our customers.
- Drivers for change in the energy sector.
- Our investment appraisal process.
- Our Innovation Strategy.

Taken together, these place our Plan in the longer term context of our organisation, our sector, our geographic area and customer base. We have brought these elements together to summarise our overall approach to how we manage the uncertainty around low carbon scenarios and to inform the core objectives of our Innovation Strategy.

[18] Results from consultation of over 3,000 people between July and October 2013. For full details of this survey and our response, see 'What our stakeholders think about our Business Plan commitments'

Links to key documents in March 2014 Business Plan

Links will be 'live' by 28 March

Factsheet: Scottish Hydro Electric Power Distribution (Scotland)	(Replacement)
Factsheet: Southern Electric Power Distribution (England)	(Replacement)
How we put this plan together and a summary of the contents	(Replacement)
What you said: Report on stakeholder engagement	(No change)
What our stakeholders think about our Business Plan commitments	(New)
Technical appendix 01 About electricity distribution networks: now and in the future	(No change)

04. Outputs

- **Revised losses reduction strategy supported by comprehensive cost benefit analyses.**
- **Strategy for vulnerable customers.**
- **Additional payments for customers that have an unplanned interruption.**
- **Revised proposals for worst served customers supported by comprehensive cost benefit analyses.**
- **No material change to proposals for safety, connections and customer service.**

Introduction

About criterion 2, outputs

Outputs are the service standards that customers should expect for the forecast activities and expenditure.

In defining future outputs, a Business Plan must take account of customers' needs and expectations and, furthermore, how these might change in the future. Proposed outputs must be consistent with the longer-term strategy of the business so that the timing of delivering an output represents best value for money for the customer. The delivery of the output must also be shown to be achievable with the forecast expenditure and resources, taking into account technological innovations and future productivity improvements.

In its March 2013 Strategy Decision, Ofgem specified that electricity distribution operators should describe their outputs in six primary output categories: safety, environment, customer satisfaction, connections, social obligations, and reliability and availability. For many of the outputs, Ofgem also specified the baseline level of service that was required. More explanation on the requirements for a well justified approach to outputs can be found in the March 2013 Strategy Decision[19].

July 2013 Business Plan

SSEPD's proposed outputs in the July 2013 Business Plan are summarised in Figure 4.1.

[19] See page 17: www.ofgem.gov.uk/ofgem-publications/47069/riioed1decbusinessplans.pdf

Figure 4.1 July 2013 Business Plan – outputs

Output category	Ofgem March 2013 Strategy Decision – baseline outputs	SSEPD July 2013 Business Plan
Safety	Compliance with the legislative and regulatory framework regulated by the Health and Safety Executive (HSE)	*Accepted Ofgem baseline outputs* Specific activities to meet our objectives on public, staff and contractor safety
Environment	Obligation to reduce losses Reputational incentive for business carbon footprint (BCF) Allowance for undergrounding overhead lines in areas of outstanding natural beauty (AONB) and national parks Reporting requirement on broad environmental impact	*Accepted Ofgem baseline outputs* Specific targets including: ▪ Reduce sulphur hexafluoride gas leakage by 15% ▪ Reduce oil leakage by 15% ▪ Reduce BCF by 15% ▪ Put underground 90km of overhead line
Customer satisfaction	Strengthen the Broad Measure of Customer Satisfaction (BMCS)	*Accepted Ofgem baseline outputs* Commitment to make additional payment for not meeting our target on planned interruptions Commitments for greater engagement and improved communication with customers
Connections	Underlying framework of licence conditions and guaranteed standards of performance to safeguard minimum levels of performance for all customers For smaller connection types – new targets for the average time taken to connect customers For larger connection types – introduce Incentive on Connections Engagement (ICE), requiring DNOs to engage with and understand the requirements of different customers	*Accepted Ofgem baseline outputs* Target to reduce time to quote and time to connect by 10% Commitment to make additional payment for not meeting our target on customer contact Commitments for greater engagement and improved communication with customers
Social obligations	Ensure DNOs play a full role in addressing consumer vulnerability, through: ▪ improving the information they hold on customers and identifying how they can improve the assistance they provide ▪ engaging with a wide range of other agencies to ensure customers get access to support that is available ▪ identifying opportunities to enable energy solutions for vulnerable households that might also reduce demand on the network	*Accepted Ofgem baseline outputs* Commitment to publish an annual Resilience Plan so that our customers know what we will do in the event of a power cut Support for community led initiatives, including energy efficiency Range of measures to invest in local communities Measures to support vulnerable customers and engage in fuel poverty activities
Reliability and availability	Continue existing interruption incentive scheme (IIS) Improve asset health and loading indices Reduced payment threshold under the guaranteed standards of reliability and uniform coverage Continue mechanism for worst served customers New measures for network resilience	*Accepted Ofgem baseline outputs* Match targets for IIS Set out targets for asset health and load indices Accept revised payment scheme, plus additional payment for not meeting our target on planned interruptions Propose additional funding for worst served customers in SHEPD area Propose measures to improve resilience

Ofgem November 2013 Assessment

Ofgem assessed SEPD as 'Amber' and SHEPD as 'Red' for criterion 2, outputs.

For the three primary output categories of safety, customer satisfaction and connections, the November 2013 Assessment concluded that SSEPD's proposals are consistent with the March 2013 Strategy Decision and, hence, acceptable.

Environment The November 2013 Assessment accepts SSEPD's proposed activities and targets for the environment output, and comments on good practice on stakeholder engagement. However, the Assessment states that the evidence, assumptions and justification are not complete, consistent or well presented, noting in particular the lack of cost benefit analyses.

Social obligations The November 2013 Assessment states that SSEPD's proposed social outputs are broadly consistent with the March 2013 Strategy Decision. However, Ofgem is not satisfied that SSEPD has a comprehensive strategy for vulnerable customers across the full range of social issues and in both SEPD and SHEPD areas.

Reliability and availability SSEPD's historic strong performance in improving customer reliability is noted in the November 2013 Assessment, as is our commitment to meeting future targets. Ofgem comment on two weaknesses in the July 2013 Business Plan: (i) the strength of network risk, criticality and load indices, and asset health assessment; and (ii) justification for proposed additional expenditure on worst served customers in the SHEPD area.

Revisions to our July 2013 Business Plan

The primary concern about our July 2013 Business Plan was that we had not provided sufficient information and analysis to justify our proposed outputs for environment, social obligations, and reliability and availability. Hence our March 2014 Business Plan includes material additions that further evidence the value for money of our proposed outputs.

Our proposals for safety, customer satisfaction and connections outputs are unchanged.

Environment The March 2014 Business Plan has:

- Revised presentation of our losses reduction strategy supported by comprehensive cost benefit analyses.
- Additional 'signposting' to link environmental targets with costs and volumes.

There is no material change to our proposed costs and volumes or targets for the environment output. The March 2014 Business Plan describes the environmental benefits realised by the activities across the Plan, including our Innovation Strategy and those associated with smart meter roll-out.

With the exception of proposals to put overhead lines underground, we do not propose any expenditure where the customer benefit is solely related to environmental outcomes. Rather we demonstrate how environmental improvements will be achieved as part of our business-as-usual activities. For example, our asset replacement and load-related expenditure activities will result in 739GWh reduction in electrical losses.

Social obligations The March 2014 Business Plan includes our strategy for vulnerable customers. This strategy sets out our approach and activities across the range of social issues faced by vulnerable customers including priority services, the cost of energy and temporary vulnerability. It is underpinned by the means to identify and respond to vulnerability, and a commitment to engage all SSEPD colleagues in the delivery of the strategy. Use of industry best practice, ongoing research projects, partnerships and robust governance arrangements further support delivery of the strategy.

Reliability and availability The March 2014 Business Plan has three material revisions to the July 2013 Plan:

1. Network risk and load indices, and asset health assessment.
   Health, load and criticality indices are presented for each of the main asset categories, and integrated into the assessment of asset replacement and load-related expenditure. Overall, consistent with stakeholders' views, the March 2014 Business Plan is intended to maintain network risk at current levels.

2. Additional payments made to customers who experience an unplanned interruption equivalent to double the Guaranteed Standard.
   Customers are eligible for a payment under the Electricity (Standards of Performance) Regulations 2010 if they experience an unplanned interruption of longer than 18 hours[20]. We voluntarily propose to double this payment. Additional payments made for unplanned interruptions during severe weather would continue to be determined on a case-by-case basis.

3. Revised assessment of worst served customers investment proposals based on cost benefit analysis[21].
   Our analysis demonstrates the net customer benefit of four investment schemes to improve the service to around 3,400 worst served customers in the SHEPD area[22]. The total cost of these schemes is £25.2 million. These schemes would replace the worst served customer regulatory mechanism in the SHEPD area. As an exceptional item of expenditure, we argue that these costs should be excluded from the totex comparative analysis (see page 23).

Our July 2013 Business Plan proposed significant improvements in the reliability and availability output for our customers, including accepting stringent targets for customer minutes lost and customer interruptions, additional payments for not meeting targets for unplanned interruptions, investment in network resilience and removal of the Highlands and Islands exemption. We set out plans to achieve these increased service standards while decreasing like-for-like expenditure allowances.

These additional proposals in our March 2014 Plan, combined with the additional cost savings described in the next section, further improve the value for money for our customers.

[20] Ofgem has proposed that this reduces to 12 hours from 1 April 2015.
[21] Commitment 5 in the July 2013 Business Plan was subject to Ofgem accepting our proposals for worst served customers. We intend to update this commitment when Ofgem has determined on this updated proposal.
[22] The proposal is our July 2013 Business Plan to improve the service to 2,400 worst served customers in the SEPD area has not materially changed.

Links to key documents in March 2014 Business Plan

Links will be 'live' by 28 March

Technical appendix 02 Be safe	(No change)
Technical appendix 03 A reliable supply of electricity	(Replacement)
Technical appendix 03a Reliability Secondary Deliverables	(New)
Technical appendix 04 Get connected	(No change)
Technical appendix 05 Listening to our customers and providing the service that they want	(No change)
Technical appendix 06 Managing our environmental impact	(Replacement)
Technical appendix 07 Be responsible: our social obligations	(No change)
Supporting paper Strategy for customer vulnerability	(New)

05.
Efficient expenditure

- **£204 million of cost reductions, compared with July 2013 Business Plan.**
- **Substantial additional evidence to justify asset replacement and load-related expenditure forecasts.**
- **Broadly supportive of cost assessment methodology, from available evidence.**
- **Present evidence to support the exclusion of SHEPD exceptional items from totex benchmarking (transmission connection point charges and worst served customers).**

Introduction

About criterion 3, efficient expenditure

Electricity distribution networks are natural monopolies. As such, there is no competitive market pressure to drive down costs and/or drive up service standards. Accordingly, a central aspect of the setting of future cost allowances (and, hence, allowed revenues) by Ofgem is the assessment of the efficiency of cost forecasts. The Business Plan must clearly demonstrate that costs are efficient over the long term and expenditure achieves necessary outputs.

Evidence of efficient cost forecasts will come from historic performance, market testing and comparative analysis, demonstration of the application of best practice and linking expenditure with customer outputs. More explanation on what constitutes a well justified approach to efficient expenditure can be found in Ofgem's March 2013 Strategy Decision[23].

July 2013 Business Plan

SSEPD has a strong track record on cost efficiency. In assessments conducted by Ofgem in 1999, 2004 and 2009[24], SSEPD has been shown as a leading performer in the efficiency of both operating costs and capital expenditure. The July 2013 Business Plan sought to illustrate some of the tools and approaches used to achieve productivity gains and how a culture of prudent investment and operating efficiently is embedded within SSEPD.

Being innovative is central to ongoing efficiency. Our Innovation Strategy is focused on the top twenty opportunities for improving our costs and service to customers. The July 2013 Business Plan explained that

[23] See page 19: www.ofgem.gov.uk/ofgem-publications/47069/riioed1decbusinessplans.pdf
[24] For summary of Ofgem's 1999, 2004 and 2009 conclusions, see our March 2014 Business Plan: Be Efficient

roll-out of new techniques and technologies would be one of the main contributors to achieving our forecast 1.0% per annum productivity improvement.

The July 2013 Business Plan also sought to replicate, as far as possible, the comparative cost assessment being developed by Ofgem as part of the RIIO-ED1 process. We set out our views on appropriate cost drivers for this assessment and adjustments that would need to be made to SSEPD's costs in order to make a like-for-like comparison. On this basis, our analysis indicated that SSEPD would continue to outturn in the upper quartile of comparative studies.

Ofgem November 2013 Assessment

Ofgem assessed both SEPD and SHEPD as 'Amber' for criterion 4, efficient expenditure.

The November 2013 Assessment presented the results of a broad toolkit of approach to cost assessment including qualitative and quantitative assessments, review of evidence and justification, historical costs and performance data, and costs and volumes forecasts. A key element of this assessment is comparative analysis of total expenditure and for activity cost. The results of this assessment are described in the November 2013 Expenditure Assessment[25], and summarised in Figure 5.1 overleaf.

Overall, SSEPD was ranked joint second of the six ownership groups in the combined cost assessment, with SEPD ranked fourth and SHEPD seventh of the fourteen distribution networks.

Revisions to our July 2013 Business Plan

The March 2014 Business Plan presents a reduction in our total controllable cost forecast of £204 million compared with our July 2013 forecast. This includes an adjustment of £73 million for double-counting of smart meter costs in the July 2013 Business Plan.

We have undertaken a thorough review of our proposed expenditure, considering the need for that expenditure and the benefit to customers of the outputs. In a number of areas, notably asset replacement and load-related investment, we have re-presented the justification for our plans and provided additional evidence and analysis to demonstrate the benefit to customers of our preferred option. Where new evidence supports a reduction in our expenditure forecasts, we have made reductions. Likewise, where we have identified a strengthened case for investment, we have put that forward.

We support the application of the same cost assessment methodology (subject to our comments below) to the March 2014 Business Plans, and contend that the revisions we have made will improve SSEPD's performance in the comparative analysis.

A summary of revisions is presented in Figure 5.1 overleaf.

[25] For November 2013 Expenditure Assessment, see www.ofgem.gov.uk/ofgem-publications/85039/costassessmentmethdologyandresultsmasterv2.pdf

Figure 5.1 Revisions to July 2013 Business Plan – cost assessment

Expenditure category	Ofgem November 2013 Assessment	SSEPD March 2014 Business Plan
Network operating costs (NOCs) and closely associated indirects (CAIs)	For both NOCs and CAIs, Ofgem concludes that there is appropriate justification of forecast expenditure and SSEPD performs satisfactorily when benchmarked.	No material change; some minor consequential amendments. No adjustments to the historic expected frequency or intensity of exceptional events.
Asset replacement and other non-load related expenditure	Although volumes are in line with expectations, unit costs benchmark high and justification is not comprehensive.	No material change to volumes. Cost savings of £9 million. Additional justification, including cost benefit analyses, provided for: ▪ Consac (SEPD) ▪ 33kV cables (SEPD) ▪ 33kV transformers (SEPD and SHEPD) ▪ 11kV overhead line (SHEPD) ▪ Subsea cables (SHEPD) Taking into account the value of additional benefits, expect that revised costs and volumes forecast is closer to the benchmark.
Load-related expenditure (LRE)	SHEPD has realistic volumes, but unit costs are high. SEPD has high volumes and unit costs. For both SHEPD and SEPD, justification is insufficient.	No material change to volumes. Cost savings of £33 million. Undertaken complete review of LRE forecast in SHEPD and SEPD. March 2014 Business Plan includes: ▪ Explanation of investment strategy. ▪ Scheme specific analysis demonstrating need, consideration of options and justifying proposed expenditure. ▪ Options analysis considers, and can result in replacement, with innovative alternatives. ▪ Integration of load and criticality indices. Overall, expect that revised costs and volumes forecast is closer to the benchmark. See also the comments on Transmission Connection Point Charges (TCPC) below.
Business support	SSEPD benchmarks well.	Cost increase of £26 million for IT investment in customer service functions and legacy data systems.
Ongoing efficiency and real price effects (RPEs)	Overall impact of RPE assumptions is comparable. SSEPD assumptions for ongoing efficiency are the most ambitious of all DNOs.	Updated evidence for RPEs resulting in reduction of £73 million (see below). No change to ongoing efficiency assumptions. More evidence provided including linkage with Innovation Strategy.
Smart meters	Good estimation of cost and comprehensive evaluation of IT requirements. Total costs are not well justified with respect to benefits.	Revised smart meter strategy (see below), supported by updated cost benefit analysis. Cost saving of £27 million for 'best view'.
Innovation Strategy	Difficult to assess the impact of innovation in respect of costs and outputs.	Updated Innovation Strategy (see below) to demonstrate forecast business benefits: ▪ £100 million of benefits. ▪ Strong historic evidence for delivery.

Cost assessment methodology We broadly support the cost assessment methodology adopted by Ofgem that uses a range of techniques – the 'toolkit' approach. For businesses such as electricity networks that are affected by a complexity of factors, we acknowledge that any assessment methodology – be it absolute or comparative – will have issues. For this reason, we strongly support the approach of setting allowances at upper quartile levels of efficiency and would encourage Ofgem not to depart from this core principle.

Following publication of the November 2013 Assessment, we have undertaken a proportionate review of the comparative analysis models used in the Assessment to ensure: (i) there are no material errors, and (ii) there is no potential for material improvements to the models. We have largely been able to follow the assessment methodology, although in some areas insufficient explanation has been provided to justify modelling approaches and assumptions. From this, we have not identified material errors. Further, while there is room for debate over different model formats or alternative drivers, we conclude that no one model exhibits significantly superior statistical characteristics.

Based on this appraisal, we would not support substantive changes[26] to the cost assessment methodology at this stage in the RIIO-ED1 process. For the current process we believe it is essential to maintain a degree of stability in the modelling already undertaken in order for operators to effectively address why their totex proposals differ from an industry benchmark.

The June 2013 Business Plan described a number of company specific factors for SHEPD which are outwith our control, but are part of our current totex expenditure and will endure through ED1. These were broadly accepted in the November 2013 Assessment, along with an adjustment to SEPD totex for higher labour costs. In the March 2014 Business Plan we also argue, based on our review of the assessment methodology[27], that our exceptional cost forecasts in the SHEPD area for additional Transmission Connection Point Charges and worst served customers should be excluded from the top-down totex benchmarking as other networks do not incur costs on a comparable scale and value.

Innovation Strategy SSEPD is a strong advocate for investment in innovation as a means to improve customers' experiences of the electricity distribution network and to reduce network costs over the longer term. The July 2013 Business Plan was built on 20 core investments in innovation, each of which is linked to a customer need. We argued that the application of innovative solutions would be critical to achieving our target 1% annual productivity improvement; hence our investment in innovation would deliver customer savings of up to £100 million over the eight-year period. The March 2014 Business Plan provides additional evidence to support our Innovation Strategy, in particular to demonstrate the role of innovation across our business activities.

[26] We have identified a small number of simple and justified alterations to the modelling method adopted for the November 2013 Assessment which we would encourage Ofgem to adopt for subsequent iterations. These do not materially revise the methodology.

[27] Including treatment of WPD's rail electrification costs in the November 2013 Expenditure Assessment.

Smart meter strategy[28] The July 2013 Business Plan included a comprehensive strategy for supporting the mandated national programme to roll-out smart meters, to build and operate IT systems to capture and use smart meter data, and to pay to use the smart meter data and communications infrastructure. We have updated this strategy to take into account new information such as 'live working' procedures and IT design specifications. In addition, we have substantially revised our cost benefit analysis for these activities to better demonstrate the benefits to consumers of the smart meter programme. The March 2014 Business Plan sets out a reduction in our forecast expenditure for smart meters of £27 million.

Transmission Connection Point Charges (TCPC) Electricity distribution network operators are liable for charges incurred by the local transmission network owner for the cost of assets at the substation connecting the two networks (the Grid Supply Point, GSP). The July 2013 Business Plan described how major reconfiguration of the electricity transmission system is underway in the SHEPD area in response to the growth of renewable generation, with a consequential significant increase in TCPC. For the March 2014 Business Plan, we have reviewed the planned GSP works in the SHEPD area[29] with Scottish Hydro Electric (SHE) Transmission plc considering, in particular, the publication of the Government's Energy Market Reform implementation proposals[30]. Taking into account all the additional evidence, the SHEPD new TCPC forecast has reduced to £53 million.

We have based this forecast on changes which we can be relatively certain will happen. However, there is high potential that the actual TCPC will be higher if, for example, UK or Scottish Government policy increases support for renewable generation. The March 2014 Business plan presumes this risk is with SSEPD. This is a risk that is heightened in the SHEPD area, as changes to GSPs of the scale seen in the north of Scotland are not occurring elsewhere in GB. For this reason, we argue that these are exceptional costs that are not comparable with other networks' cost bases and, hence, should be excluded from comparative analysis.

Real price effects (RPEs) In the July 2013 Business Plan, we presented a paper by First Economics setting out its estimates of the RPEs that are likely to confront an efficient electricity distribution network operator in the eight-year period starting 1 April 2015. Following the November 2013 Assessment, we asked First Economics to update its forecast taking into account available new evidence. Based on this revised analysis, the total RPEs forecast in the March 2014 Business Plan is £120 million, some £73 million lower than in July 2013. We note that these revised estimates are substantially lower than those used in setting the WPD Final Determination[31].

[28] See also revisions to our proposals for regulatory uncertainty mechanisms for smart meters, page 33.
[29] In the SEPD area, the July 2013 Business Plan described planned works at three GSPs resulting in a minor adjustment to forecast TCPC payable to National Grid Electricity Transmission plc; this has not been materially revised in the March 2014 update.
[30] See www.gov.uk/government/policies/maintaining-uk-energy-security--2/supporting-pages/electricity-market-reform
[31] WPD's Final Determination includes £459 million for RPEs, largely based on the July 2013 version of the First Economics paper.

Links to key documents in March 2014 Business Plan

Links will be 'live' by 28 March

Technical appendix 08 Our expenditure forecast	(Replacement)
Technical appendix 09 Be efficient	(Replacement)
Technical appendix 12 Making innovation happen	(Replacement)
Supporting paper Smart meter strategy	(Replacement)
Independent paper Real price effects	(New – update)

06.
Efficient financing

- **Revised cost of equity from 6.7% to 6.4%; no change to other financial parameters.**
- **More information to support July 2013 proposals on capitalisation rates.**
- **Updated sensitivity analysis demonstrating that the 'best view' case is acceptably financeable.**
- **16% reduction in the electricity distribution element of the average household energy bill in 2015/16, and changes in line with inflation thereafter.**

Introduction

About criterion 4, efficient financing

The ongoing operation of electricity distribution networks is a capital intensive, long life business. These businesses operate as price controlled monopolies within a stable regulatory regime. It is a tenet of the regulatory settlement that the financing of these businesses represents value for money for current and future users of the network.

The GB regulatory regime defines two broad areas of financing costs:

- Technical accounting including the Regulatory Asset Value (RAV), regulatory capitalisation, and treatment of pensions and tax).
- Corporate finance including allowed equity market returns and financeability.

Proposals for efficient financing must demonstrate an appropriate balance between risk and reward for customers and shareholders. The long term financeability of the business must also be shown under a range of scenarios that reflect the exogenous risks faced. More explanation on what constitutes a well justified approach to efficient financing can be found in the March 2013 Strategy Decision[32].

July 2013 Business Plan

SSEPD followed the technical accounting and corporate finance policies set out in the March 2013 Strategy Decision, as set out in Figure 6.1 overleaf.

[32] See page 20: www.ofgem.gov.uk/ofgem-publications/47069/riioed1decbusinessplans.pdf

Figure 6.1 Financial parameters of July 2013 Business Plan

Cost of equity	6.7%
Cost of debt	10-year trailing average (iBoxx index)
Gearing	65%
Depreciation and transition	Linear transition to 45 years over one price control period (eight years)
Capitalisation	70%
Pensions	As Pensions Principles
Tax	As prevailing corporate tax rate using tax trigger mechanism

Ofgem November 2013 Assessment

Ofgem assessed both SEPD and SHEPD as 'Green' for criterion 4, efficient financing.

The November 2013 Assessment concludes that, for the financing criteria, our proposals are consistent with the March 2013 Strategy Decision. However, it is noted that additional information might have been provided to support the capitalisation rate.

Revisions to our July 2013 Business Plan

With the exception of the cost of equity (see below), we have not revised any of the financial parameters of the July 2013 Business Plan. The March 2014 Business Plan includes additional evidence to support capitalisation of spend into our RAV at 70%, which reflects the actual capitalisation rate seen in SEPD. We apply this rate to SHEPD as this contributes to the overall financeable package.

Cost of equity

SSEPD prepared and presented the July 2013 Business Plan taking due account of Ofgem's March 2013 Strategy Decision[33] and the associated discussions and consultations. The evidence presented in the July 2013 Business Plan supported a post-tax real cost of equity of 6.7%, within the 6.0-7.2% range set out in the March 2013 Strategy Decision.

On 6 December 2013, Ofgem issued a consultation[34] on its methodology for assessing the equity market return. In this consultation, Ofgem invited views on an alternative approach to assessing the equity market premium that gave greater weight to contemporary market evidence. SSEPD, in responding to this consultation, was of the view that there was insufficient evidence for Ofgem to revise its methodology without

[33] For March 2013 Strategy Decision, see www.ofgem.gov.uk/publications-and-updates/strategy-decision-riio-ed1-overview

[34] For December 2013 equity market return consultation, see www.ofgem.gov.uk/publications-and-updates/consultation-our-methodology-assessing-equity-market-return-purpose-setting-riio-price-controls

further consideration and consultation. Even taking into account the issues raised by Ofgem, we continued to believe that there was a strong case for the cost of equity to be set at 6.7%.

Ofgem published its decision[35] on this issue on 17 February 2014. It decided to revise its methodology to give greater weight to the influence of current market conditions in relation to the equity market return. The immediate impact of this change was a reduction of thirty basis points in Ofgem's view on the cost of equity and, hence, its central reference point for assessing networks' Business Plans. In its decision Ofgem notes the need to undertake further longer-term work to consider in detail the appropriate methodology for setting the equity market return and cost of equity in future price controls.

In preparing this March 2014 Business Plan, SSEPD has had very little time to consider and decide on these issues raised by Ofgem. We are not fully convinced by the arguments put forward by Ofgem to justify the revisions to its methodology. However, we have decided to incorporate the thirty basis point reduction in the cost of equity that Ofgem argues can be evidenced by current market conditions (Figure 6.2). This is a finely balanced decision that views the settlement 'in the round' including the potential for good performing operators to achieve additional financial rewards.

Our decision has been strongly influenced by the Final Determination[36] for Western Power Distribution (WPD) licensees that places the cost of equity at 6.4%. This Final Determination reflects both the thirty basis point recalibration and the degree of risk to which WPD is exposed in the regulatory settlement. Our analysis demonstrates that the March 2014 Business Plan exposes SSEPD to as much, if not more, downside risk than WPD's plans. For example, we note:

- Withdrawal of uncertainty mechanisms proposed in our July 2013 Business Plan.
- Significant reduction in RPEs forecast following updated assumptions that reduces our forecast materially below that agreed for WPD.
- Specific risks to SHEPD that are not faced by WPD (or other licensees) such as Transmission Connection Point Charges (TCPC), lower network resilience in Highlands and Islands and withdrawal of Guaranteed Standards exemption; as well as rail electrification, where the risks faced by SEPD are at least equivalent to WPD.
- The IQI fast track reward (2.5% totex) provides a risk "buffer" to WPD.

We are also mindful of the evidence presented during the gas distribution price control (RIIO-GD1) that electricity distribution networks are equally, if not more risky than, gas distribution networks.

Given the equivalent level of risk associated with the factors above and our relative cost efficiency position, we have also examined the theoretical parameters of the cost of equity. Our appraisal concludes that there is good academic and theoretical evidence that is consistent with Ofgem's decision that supports a cost of equity of (at least) 6.4%. This is reflective of the calibration adjustments proposed by the RPI formula effect, and Wright and Smithers, for the risk free rate and equity market returns.

[35] For February 2014 methodology decision, see www.ofgem.gov.uk/publications-and-updates/consultation-our-methodology-assessing-equity-market-return-purpose-setting-riio-price-controls

[36] Final Determination: www.ofgem.gov.uk/publications-and-updates/decision-fast-track-western-power-distribution

Finally, we support Ofgem's policy position that network licensees that perform well should be able to achieve an overall Return on Regulated Equity (RoRE) of over 10%. This position is consistent with the expectation of our equity investors that we should be able to achieve a post tax real return of 5% and be able to retain an A- credit rating. Our updated financeability analysis demonstrates that a RoRE of around 10% and A- credit rating might be achievable at a cost of equity of 6.4%, assuming good performance across the suite of financial incentives. Notably, and even with exceptional levels of performance, this is very difficult to achieve at a lower cost of equity. Therefore, placing the cost of equity at 6.4% is consistent with meeting regulatory policy.

Figure 6.2 Financial parameters of March 2014 Business Plan

Cost of equity	6.4%
Cost of debt	10-year trailing average (iBoxx index)
Gearing	65%
Depreciation and transition	Linear transition to 45 years over one price control period (eight years)
Capitalisation	70%
Pensions	As Pensions Principles
Tax	As prevailing corporate tax rate using tax trigger mechanism

Financeability assessment

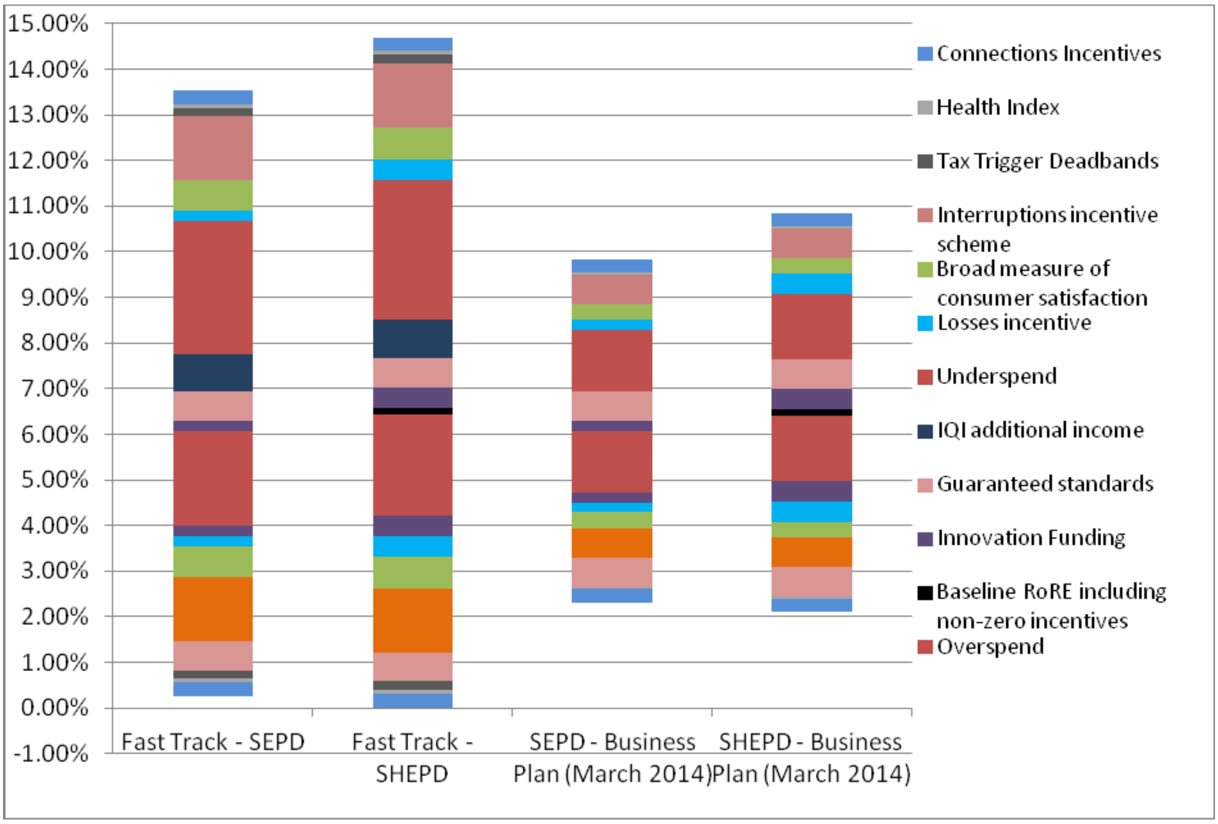
The finance parameters set out in the March 2014 Business Plan represent an acceptable financeable package that will allow SSEPD to finance the required network activities during the eight-year RIIO-ED1 period. Our proposed financial parameters are in line with the March 2013 Strategy Decision and will deliver clear value to consumers while, assuming SSEPD performs well, attracting ongoing investment through enabling reasonable returns for investors. For our 'best view' totex scenario and realistic performance outcomes[37], we model Return on Regulatory Equity in the range 2.2-10.8% (Figure 6.3). This compares with a range of 0.1-14.7% in the July 2013 ("fast track") Business Plan.

Our analysis shows that, under our proposed finance package, maintaining the required credit rating will be challenging. We do not meet all credit metrics specified by the agencies to maintain an A- rating in all years – and in some cases, we fall short of key ratios (such as PMICR) during RIIO-ED1. However, as per the March 2013 Strategy Decision, we expect that this will be balanced by qualitative factors and in particular the premise that if we perform well then we should be able to maintain our current and targeted credit rating of A-.

Combined with the revisions to our totex forecasts, the March 2014 Business Plan results in an annual base revenue reduction of 16% in real terms (2012/13 prices) from 2014/15 to 2015/16 (compared 10.4% in the July 2013 Business Plan). We have profiled our revenues to remain flat in real terms thereafter.

[37] Shown as scenarios 2 and 3 in our sensitivity analysis in Finance

Figure 6.3 Return on Regulatory Equity – sensitivity analysis



Impact on customers' bills

Ofgem provided the following guidance to determine the impact of our plans on the distribution element of the average household electricity bill:

- Charges for 2014/15 should be forecast using base revenue only.
- Charges should be calculated using the regional unit rate charge multiplied by the national average annual consumption (currently 3,300kWh), plus the regional standing charge.
- To forecast charges for the eight year period, base revenue in the base scenario should be used.
- All values should be in 2012/13 prices.

We have used this approach to determine the distribution element of the average household electricity bill in 2014/15 for a weighted average of our basket of domestic tariffs. For the eight years of the RIIO-ED1 period, we have shown the movement in this figure to match the movements in the annual base revenue. It should be noted that this methodology does not give an exact outcome for individual customers' bills. Actual charges will take into account a wider range of factors including retail price indexation, annual revenue adjustments (for example, for tax rates, regulatory incentive mechanisms and under/over recovery) and customers' consumption.

By applying this methodology to the March 2014 Business Plan, we have estimated that the distribution element of the average household electricity bill will decrease by 16% in 2015/16 and increase in line with inflation thereafter[38] (Figure 6.4). The revisions we have made to our July 2013 Business Plan equate a further saving of over £9 in the SHEPD area and over £5 in the SEPD area for each year of the eight-year period.

Figure 6.4 Distribution element of average household bill

Southern Electric Power Distribution (SEPD)

(2012/13 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
July 2013	102.18	91.07	91.07	91.07	91.07	91.07	91.07	91.07	91.07
March 2014	102.18	85.73	85.73	85.73	85.73	85.73	85.73	85.73	85.73

Scottish Hydro Electric Power Distribution (SHEPD)

(2012/13 prices)	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
July 2013	170.23	154.01	154.01	154.01	154.01	154.01	154.01	154.01	154.01
March 2014	170.23	144.53	144.53	144.53	144.53	144.53	144.53	144.53	144.53

Links to key documents in March 2014 Business Plan

Links will be ‘live’ by 28 March

Technical appendix 10 Efficiently financing our plans	(Replacement)

[38] Commitment 12 in the July 2013 Business Plan was to reduce our part of the electricity bill by 10% in 2015/16 and have only inflationary increases thereafter. We intend to update this commitment when Ofgem has determined on this updated proposal.

07.
Uncertainty and risk

- **Re-balancing of risk with significant transfer of downside risk from customers to SSEPD.**
- **Revisions to regulatory uncertainty mechanisms to align with the March 2013 Strategy Decision.**
- **No change to July 2013 Business Plan forecast for low carbon technologies.**
- **More information about how the SSEPD investment planning process can flex to maintain an efficient response to changing customer needs.**

Introduction

About criterion 5, uncertainty and risk

The RIIO-ED1 price control period is of eight years duration. To prepare a Business Plan for that period means recognising and taking account of the uncertainties that will affect the efficient delivery of the Plan. These include national and regional policy and economics, changes in customer expectations and behaviour, the labour market and supply chain, and technological innovation. Of particular concern to electricity distribution licensees is the potential take-up of low carbon technologies such as heat pumps, micro-renewables and electric vehicles. Overall, management of risk should be linked to robust long term business strategy and practices.

A well justified Business Plan will articulate the key uncertainties faced over the price control period, and the ways that those uncertainties will be identified, monitored and mitigated. Uncontrollable risks that are material might be mitigated through regulatory uncertainty mechanisms. The Business Plan will demonstrate a clear understanding of the residual risk and how that is efficiently shared by the licensee and its customers. More explanation on what constitutes a well justified approach to uncertainty and risk can be found in Ofgem's March 2013 Strategy Decision[39].

July 2013 Business Plan

The key components of SSEPD's approach to managing uncertainty were set out in the July 2013 Business Plan:

[39] See page 22: www.ofgem.gov.uk/ofgem-publications/47069/riioed1decbusinessplans.pdf

- Consideration of the evidence for future energy policy and consumer behaviour.
- Development of low carbon technology scenarios and 'best view' of volumes.
- SSEPD's risk management practices.
- Smart Meter Strategy.
- Innovation Strategy.
- Use of regulatory uncertainty mechanisms.

Taken together, these components represent the means to identify and take action to manage the material uncertainties faced by SSEPD over the eight year period.

SSEPD's July 2013 Business Plan proposed a number of amendments to the use of regulatory uncertainty mechanisms set out in the March 2013 Strategy Decision. These amendments were proposed to address previously unidentified uncontrollable risks (rail electrification), delays to the roll-out of smart meters and to align with regulatory policy in gas distribution.

Ofgem November 2013 Assessment

Ofgem assessed both SEPD and SHEPD as 'Red' for criterion 5, uncertainty and risk.

The November 2013 Assessment highlighted concerns with SSEPD's proposed changes and additions to the regulatory uncertainty mechanisms set out in the March 2013 Strategy Decision, concluding "We see the overall SSEPD approach to risk as one of de-risking its plan, which we do not consider appropriate for customers to bear."

Considering SSEPD's proposals for managing the uncertainty around low carbon technology scenarios, Ofgem concluded that, while our process and forecast volumes were reasonable, there was little detail on how our investment plan might flex during the RIIO-ED1 period.

Revisions to our July 2013 Business Plan

Uncertainty mechanisms

SSEPD's March 2014 Business Plan makes the following changes from July 2013:

- Withdrawn proposed cumulative uncertainty mechanism.
- Withdrawn proposed amendment to the DCC licence fee recovery period.
- Withdrawn proposed amendment to the smart meter roll-out tapering mechanism.

Following these changes, SSEPD is fully aligned with the March 2013 Strategy Decision on uncertainty mechanisms.

No change has been made to the proposed uncertainty mechanism for costs associated with Network Rail electrification. We note the mechanism proposed by Western Power Distribution (WPD), and accepted by Ofgem in its decision[40] of 28 February, is different from the SSEPD proposal. However, to adopt the WPD mechanism would represent a significant upfront transfer of cost and risk from SSEPD to consumers and hence we have decided not to align with WPD's mechanism.

Low carbon technologies (LCTs)

SSEPD has reviewed its best view scenario for take-up of LCTs, taking into account new information including the developments in Electricity Market Reform and the January 2014 Community Energy Strategy[41]. We have also considered the potential impact of revisions to the macroeconomic forecast and stakeholder activity.

SSEPD has concluded that there is insufficient evidence to support a change to our July 2013 LCT volumes forecast.

This review further highlights the need to retain flexibility in our business planning processes during the RIIO-ED1 period so that we can respond to the uncertainty around LCT take-up. There are a range of tools that we use to manage this uncertainty including:

- Group and Business Unit risk management practices;
- Close integration of policy development and stakeholder engagement activities with activity planning and budgeting;
- Comprehensive investment appraisal processes that incorporate change control mechanisms; and
- As a last resort, the load-related expenditure reopener mechanism.

As a consequence, SSEPD keeps its activities under review to ensure that these continue to deliver best value for money for our customers. Our investment appraisal process, in particular, ensures that our plans are able to flex in response to changing customer needs.

Links to key documents in March 2014 Business Plan

Links will be 'live' by 28 March

Technical appendix 01 About electricity distribution networks: now and in the future	(No change)
Technical appendix 11 Efficiently managing risk	(Replacement)

[40] Final Determination: www.ofgem.gov.uk/publications-and-updates/decision-fast-track-western-power-distribution
[41] See www.decc.gov.uk

A1.
Index of documents

The following documents are available on yourfutureenergynetwork.co.uk:

ABOUT THE PLAN	
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Factsheet: Southern Electric Power Distribution (England) Factsheet: Scottish Hydro Electric Power Distribution (Scotland)	/factsheet_SEPD2014.pdf /factsheet_SHEPD2014.pdf
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What Our Stakeholders Think	/RIIO-ED1_SSEPD_BP2_Mar14_what_our_stakeholders_think2014.pdf
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