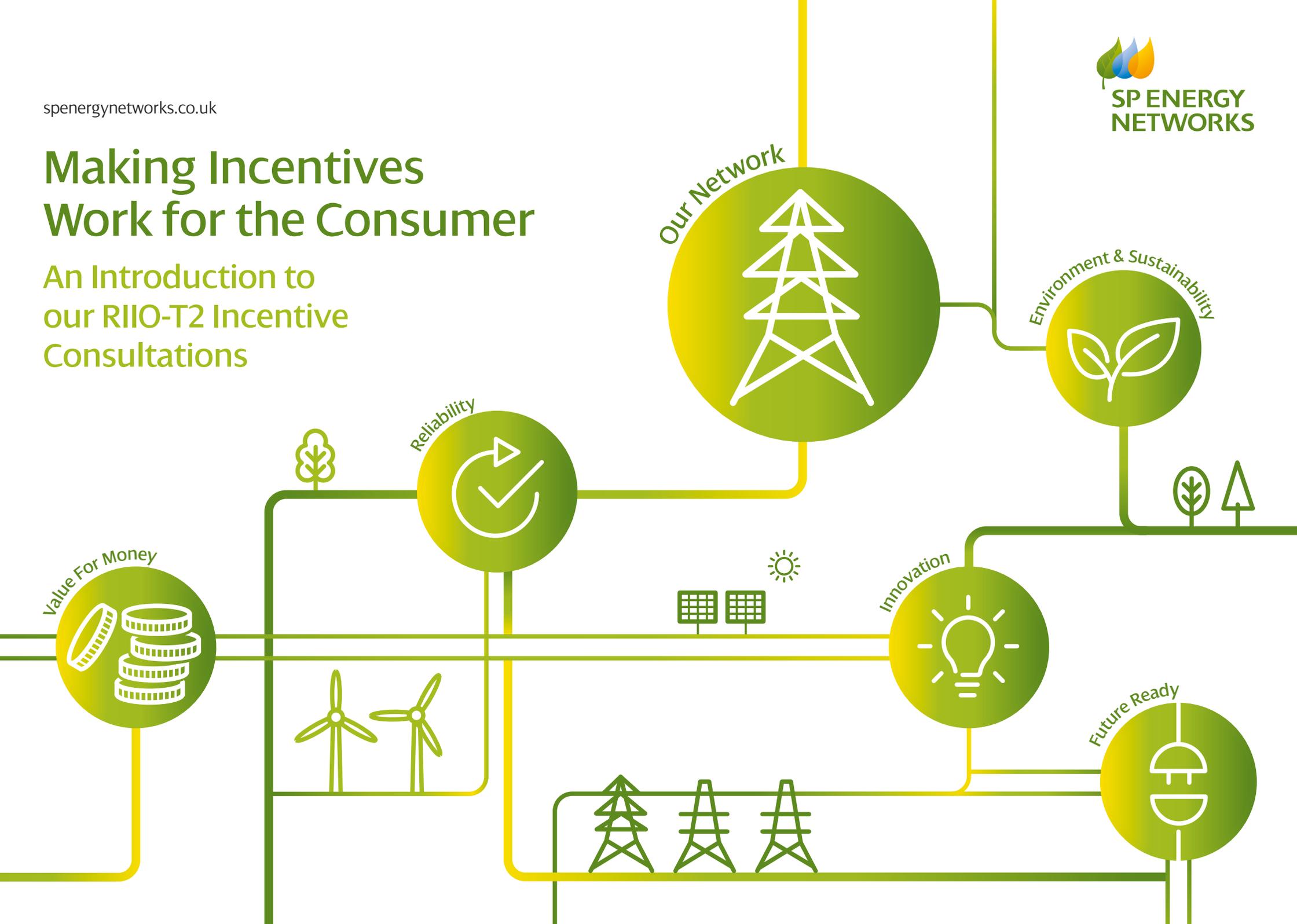


Making Incentives Work for the Consumer

An Introduction to our RIIO-T2 Incentive Consultations



Foreword

We are currently developing our 2021-2026 Business Plan for the transmission network as part of the RIIO-T2 process.

Our RIIO-T2 Business Plan will incorporate all the activities we need to fulfil our licence obligations and achieve the priorities our stakeholders want us to focus on.

In 2010 a new regulatory methodology 'RIIO' was implemented by Ofgem to meet the changes in the electricity system. Ofgem recognised the need to enable Network Companies to deliver not just lower costs for consumers but to support the low carbon energy transition that was emerging, driven by global and UK climate change targets.

The resulting incentive regulation framework arrived in 2013 with the RIIO-T1 price control and that has driven us to deliver a step change in customer satisfaction, environmental management and network reliability performance, over and above our baseline licence obligations.

We want to build on these achievements for RIIO-T2 and are inviting you to share your views on the key network, customer and environmental priorities that we should be incentivised to deliver, that will further enable the energy system transition in the period from 2021-2026.

This introductory document is supported by three consultations on each of the three incentive categories Ofgem are proposing for RIIO-T2.

Category 1: Meet the Needs of Consumers and Network Users

Category 2: Maintain a Safe and Resilient Network; efficient and responsive to change

Category 3: Deliver an Environmentally Sustainable Network

You can find the links to these on our [website](#).

This document provides:

An introduction to SP Energy Networks and our businesses

An overview of the RIIO-T2 framework

An explanation of why incentives (the first "I" in RIIO) are important and how they can work to deliver what consumers, customers, and stakeholders want.



A handwritten signature in black ink, which reads "Jim Sutherland". The signature is written in a cursive style and is positioned above the printed name.

Jim Sutherland
Chairman

SP Energy Networks Business

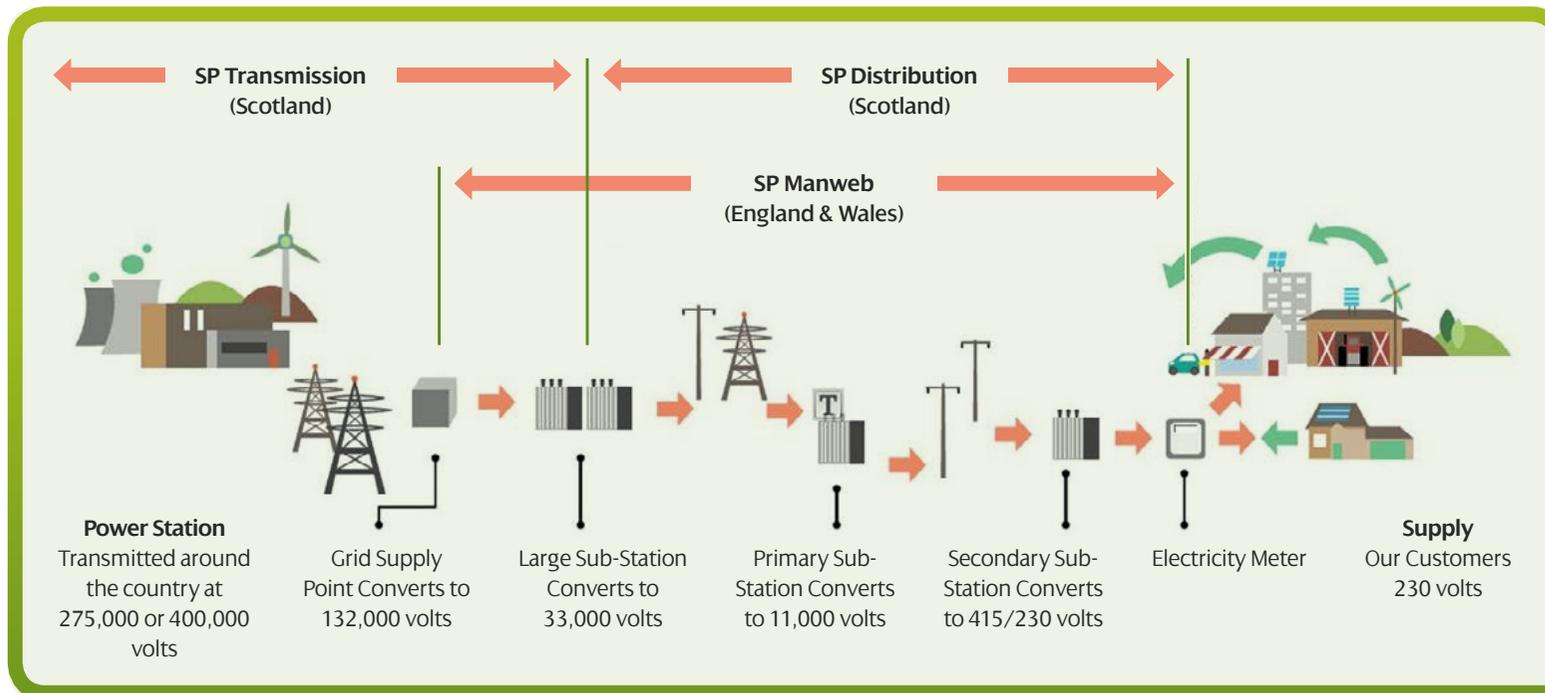
We transmit, distribute and connect electricity to and from homes and businesses over our network.

SP Transmission plc (SPT) is one of three regulated electricity network businesses owned by SP Energy Networks, which is part of the Iberdrola Group.

We are the licensed Transmission Owner (TO) for the Central Belt and South of Scotland.

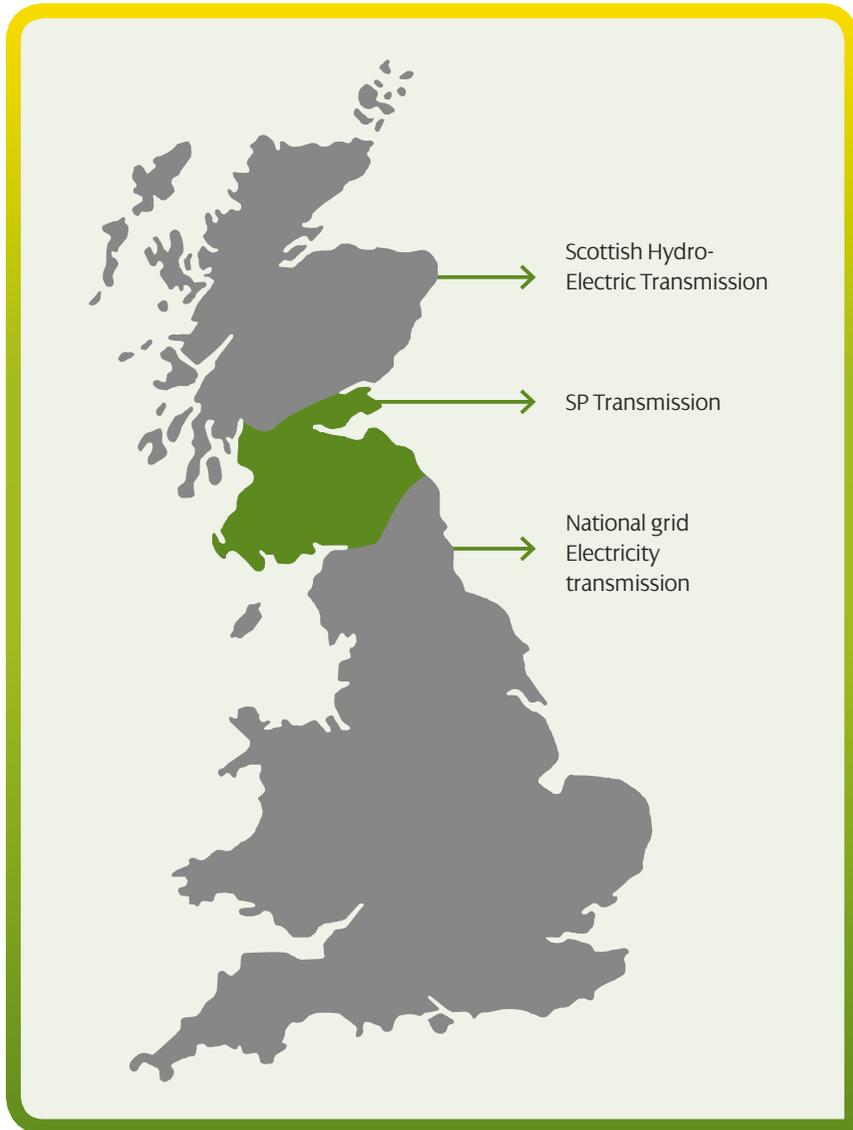
We take electricity generated from power stations, wind farms and other sites and transport it through our vast transmission network to centres of demand, providing transmission services to National Grid, who as the GB System Operator (GSO), coordinates the electricity flows by balancing generation supply and user demand.

The cost of running the transmission network in Great Britain is spread out over consumers and generators across the country. For non-half hourly metered customers (representing domestic and small business customers), the average cost of running SP Transmission amounts to approximately £4 per average domestic customer per year.



£4 average cost per customer per year

Our Network



Our transmission network comprises over 4,000 kilometres of circuits and 154 substations operating at 400kV, 275kV and 132kV.

We have a key, strategic role in facilitating the connection of renewable generation in Scotland, which is critical to meeting GB environmental targets and delivering a low-carbon energy system transition.

Over the last 5 years we have invested over £1.5bn in our transmission network as part of a demanding investment programme. Since 2013, we have connected 1,361MW of new generation directly to our transmission network and approximately 900MW of generation has been connected to the distribution network that shares our geography. We have invested heavily to maintain and upgrade our network to ensure long-term, reliable electricity supplies to our customers.

Over the next decade we expect to see major changes to the way the transmission network operates in response to the significant challenges facing the energy system as more sectors such as heat and transport look to de-carbonise through electrification. Our RIIO-T2 Business Plan will set out the needs of the future transmission network to accommodate the transition to a low carbon energy system. Our plan will seek to accommodate the needs of all supply and demand customers, help facilitate overarching decarbonisation objectives and target investments only where needed to ensure cost-effectiveness for the consumer.



The RIIO Price Control Framework

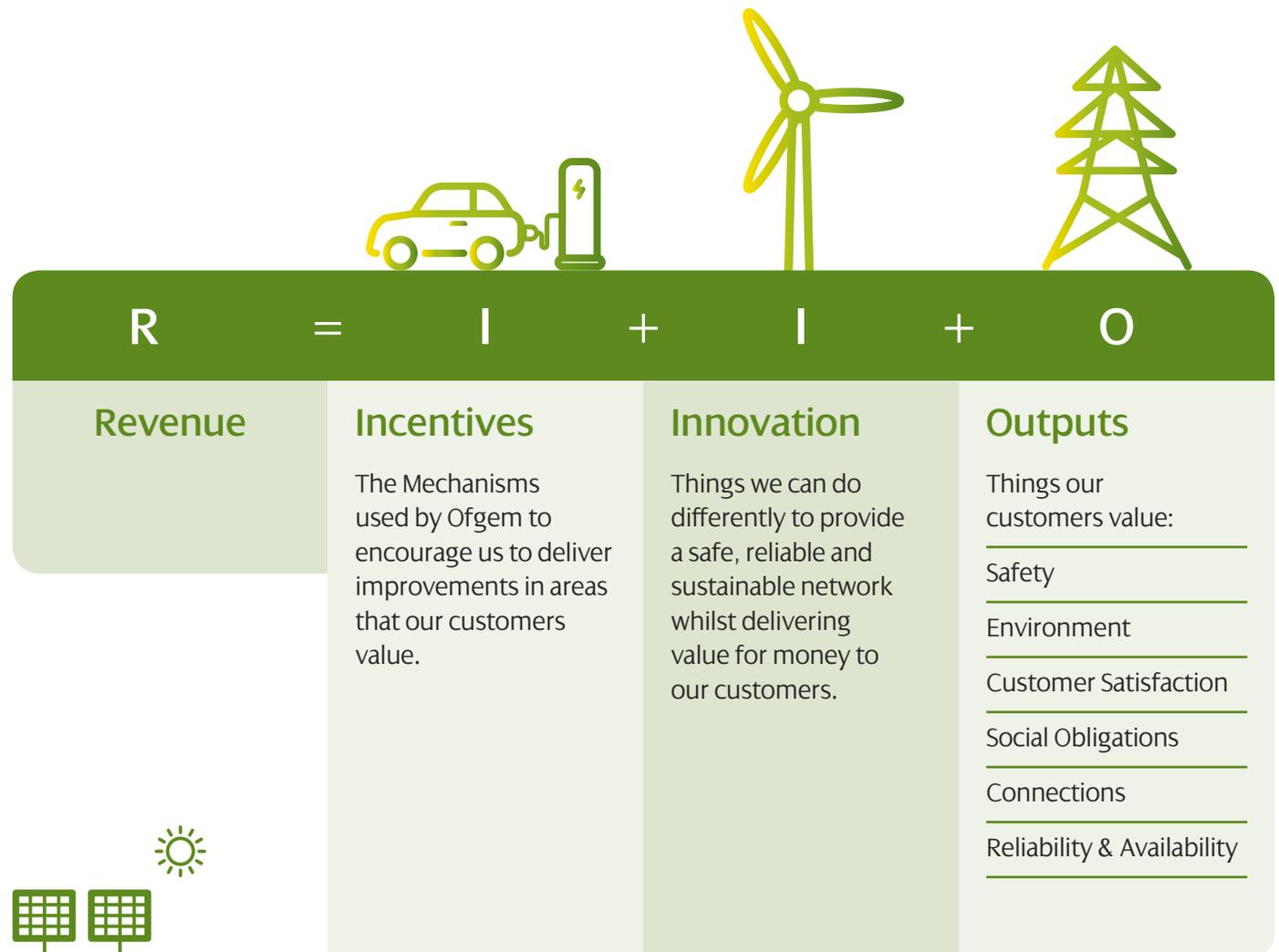
Ofgem’s framework for setting price controls is called RIIO which sets our Allowed Revenue using Incentives to deliver Innovation and Outputs.

This price control is used by Ofgem to cap the amount of money monopoly network companies like ours can recover from consumers, over a fixed period, to do their job of providing electrical energy where and when it is needed by consumers.

RIIO was introduced in 2010 by Ofgem to: *“regulate energy network companies to enable them to meet the challenges and opportunities of delivering the networks required for a sustainable, low carbon energy sector.”*

The current network price controls for electricity transmission (RIIO-T1) runs from 2013-2021. RIIO-T2 will be the next price control starting from 2021 and run for five years to 2026.

Ofgem are currently consulting on the sector methodology for RIIO-T2:
<https://www.ofgem.gov.uk/publications-and-updates/riio-2-sector-specific-methodology-consultation>



The Price Control Package

Our Price Control submission, (or our RIIO-T2 Business Plan), that we submit to Ofgem is our best view of our forecast costs, built bottom up, to estimate the expenditure we will incur in delivering our outputs and services for the whole 2021 to 2026 price control period.

We have three main cost areas in our Business Plan; **Operating costs**, **Non-load related investment** and **Load related investment**. These three elements comprise our total expenditure (TOTEX) costs.



Cost areas	Stakeholder Engagement	Efficiency	Innovation	Deliverability
Operating & Maintenance Overheads The direct overheads typical for every organisation including salaries, rates, buildings, transport etc.	Operating costs			
Asset Condition & Risk Includes all the inspection, maintenance, refurbishment and replacement of our existing assets (substations equipment, overhead lines and underground cables) to ensure they remain fit for purpose.	Non-load related investment			
Future Energy Scenarios The costs required to build new assets and increase the capability of our existing network to connect new generation sites (wind farms and other power stations) and demand customers (our cities & towns or large oil refineries and rail connections). This ensures the flow of electricity is able to be delivered from where it is generated to where it needs to be used – and to play our part in facilitating the low carbon energy system.	Load related investment			

The Price Control Package – What is our Allowed Revenue?

We submit our Total Expenditure costs (TOTEX) in our [RIIO-T2] Business Plan to Ofgem, who is the independent National Regulatory Authority responsible for assessing the Business Plans of all of GB's Transmission Operators. They will determine if our costs are efficient and deliver what consumers want and are prepared to pay for.

After assessing our costs, Ofgem determine what our TOTEX costs will be for the 2021-2026 price control.

This value is known as our **"allowed revenue"** and is the amount of money we can recover from consumers for the entire price control period. Typically, this value amounts to about £4 per year for the average domestic customer's electricity bill.

As our network is a natural monopoly, Ofgem use a range of incentives to reflect the competitive pressures we would experience in a competitive market.

Ofgem use **"efficiency incentives"** to drive us to deliver our outputs and services as economically as possible. For example, this can be by good planning, coordinating work packages, efficient use of resources, ensuring we deliver projects on time thereby avoiding unnecessary overheads; strong procurement strategies and good contracting methods.

Where we are able to achieve cost savings compared to our allowed revenue, the efficiency incentive directs us to share this 50:50 between our shareholder and consumers.

Ofgem also use other types of incentive to direct us to deliver particular outputs and services that customers and stakeholders want and bring value to consumers. These **"output incentives"** for RII0-T1 included environmental, reliability and customer satisfaction elements, and can be reputational or financial.

Ofgem will set out an overall revenue package that comprises three different elements:

1. **Baseline Allowances**
2. **Uncertainty Mechanisms**
3. **Output Incentives**

The efficiency incentive will drive our performance in the first two elements. Each output incentive has its own particular mechanism to measure our performance and determine how much money we can recover.

1. Baseline Allowances are provided in advance of expenditure based on our forecast of costs to fund most of our TOTEX expenditure in advance of completing works, because Ofgem are confident this work is required. This provides for much of the large capital costs in our load and non-load plan to operate, maintain and extend our transmission network. This, for example, means we do not unnecessarily delay connecting new generation.



2. Uncertainty Mechanisms provide the revenue for the parts of our load and non-load plans that are less certain to be required. They allow changes to our allowed revenue to be made in light of what happens during a price control. This ensure we do not invest ahead of need that may not materialise.



3. Output Incentives targets investment in areas that are less clearly defined, but still of major significance and importance for consumers in specific areas other than our main capital expenditure. These areas are identified by customers, stakeholders and consumers as important to them and has to be accepted by Ofgem as of value to consumers and society as a whole.



The Price Control Package – Our Efficiency Incentive

As explained overleaf, the total amount of money we can spend (our allowed revenue) is provided through a revenue package. The baseline allowance and uncertainty mechanisms parts of this are subject to an efficiency incentive.

The efficiency incentive sets a sharing factor on the difference in our total actual costs of delivering our outputs and services and the total allowed revenue that we were set for these. For RIIO-T1 this sharing factor is set at 50% which means an equal share of the cost difference is shared between our shareholders and consumers.

The efficiency incentive mechanism therefore incentivises us to deliver our load and non-load plan outputs as efficiently and economically as possible. The efficiency sharing factor of 50% for RIIO-T1 will be recalibrated by Ofgem for RIIO-T2 depending on how well justified and efficient Ofgem determine the costs in our Business Plan submission are.

Overall we forecast that by the end of the RIIO-T1 period in 2021 the efficiency incentive will have driven us to reduce our actual costs to £1,720 million* against our allowance of £1,772 million. This achieves a £52 million saving that we will share 50% of with consumers providing a return to them of £26 million. 50% will be returned to our shareholders so we can continue to maintain a suitable rate of return and insure external network investment in our essential national infrastructure.

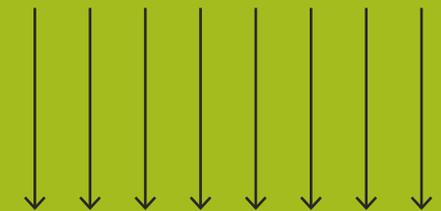
*all costs in 2009/10 prices.

Our efficiency incentive in action

Forecast Allowance
£1,772 million

Actual efficient costs
£1,720 million

Efficiency Saving shared
50% with consumers



Efficiency Saving
£52 million

The Price Control Package – Our Output Incentive

In addition to Total Expenditure (TOTEX) the efficiency incentive, a set of “**output incentives**” make up the overall revenue funding package.

The outputs are incentivised differently using a mixture of reputational and financial incentives. They require us to achieve certain standards of performance and we are rewarded or penalised according to how well we perform in the financially incentivised areas.

Output incentives ensure we invest time and effort to deliver what consumers and stakeholder value, want and need in specific areas.

In total for the full RIIO-T1 period across all our output incentives we are on track to deliver performance, against the package of outputs, that achieves a total reward of £31 million* which drives our performance in the areas consumers value.

Although it is described as a reward, it is really just an alternative way of funding our activities to ensure we focus on specific areas. In real terms, this only costs consumers a few pence on their typical annual bill. The output incentives we have in the current price control period, RIIO-T1, are listed in the table opposite with an update on recent performance provided.

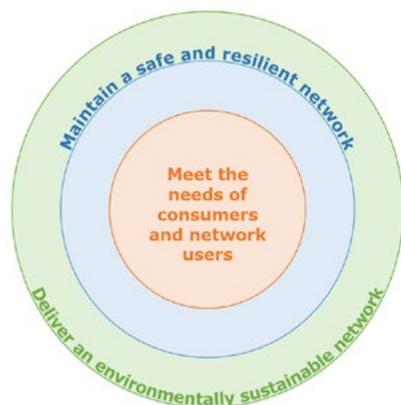
In total for the full RIIO-T1 period we are on track to deliver performance, against the package of outputs, which drives our performance in the areas consumers value.

Output	Description and Latest View of Performance
Reliability – Energy Not Supplied (ENS)	Incorporates a baseline target for the annual volume of Energy Not Supplied to demand customers at 225MWh. We achieved a level of 3.0MWh or 0.00002% of total ENS in 2017/18.
Environmental Discretionary Reward (EDR)	This is an evidence based discretionary reward scheme assessing our performance against a balanced score card comprising six key strategic and operational environmental issues. In 2017/18 we achieved 82%.
Sf6 Leakage	Incentivises the performance of our network in relation to the volume of actual Sf6 emissions compared to baseline targets. We achieved a leakage rate of 41% below target for 2017/18.
Stakeholder Satisfaction & Engagement	Provides a measure of stakeholder satisfaction based upon scores from a range of metrics. In 2017/18 we achieved our highest ever overall survey score of 8.3 and in respect of engagement moved to 1st place across transmission companies.
Timely Connections	Measures our performance in relation to delivering timely offers for connection to our transmission network. In 2017/18 the average offer timescale down to 52 days with no late offers that affected customers out of a total of 60 offers issued.
Safety	This is a reputational incentive only with no financial reward and we achieved a contractor safety level of 0.68 Zero public safety injuries.
Network Access Policy (NAP)	This is also reputational only and drives us to increase co-ordination and engagement with the GB System Operator (National Grid ESO) in taking network outages on our system to do the work to connect and maintain our assets. Year on year increase in volume of outages up to circa 1500 per annum up 50% up from start of RIIO-T1.
Visual Amenity	Is a fund set up by Ofgem that gives us the opportunity to reduce the visual impact of our existing infrastructure in certain designated areas such as National Parks. We have proposals for Loch Lomond in development.
Business Carbon Footprint (BCF) & System Losses	Our BCF and System Losses obligation in RIIO-T1 is to report annually at a business level and to present progress in these areas.

*in 2009/10 prices pre-tax.

RIIO-T2 Output Incentive Mechanisms

Ofgem published its RIIO-T2 Sector Specific consultation in December 2018. This consultation is due to close on the 14th March 2019. We will publish our response to this consultation on our website following our submission to Ofgem.



Network companies must deliver a high quality and reliable service to all network users and consumers, including those in vulnerable situations

Network companies must deliver a safe and resilient network that is efficient and responsive to change

Network companies must enable the transition towards a smart, flexible, low cost and low carbon energy system for all consumers and network users.

The Ofgem consultation framework

Source: https://www.ofgem.gov.uk/system/files/docs/2019/01/riio-2_sector_methodology_0.pdf

In Ofgem's consultation, they present three categories of output incentives as per the diagram opposite.

We would also like to understand your view of which outputs are important to you. Alongside this information leaflet we have published three consultations, one for each category.

Category 1: Meet the Needs of Consumers and Network Users

Category 2: Maintain a Safe and Resilient Network; efficient and responsive to change

Category 3: Deliver an Environmentally Sustainable Network

These give an explanation of the outputs being considered and our early thinking of how we should develop our output incentives for RIIO-T2.

We believe it is vital for customers, stakeholders and consumers that the right set of output incentives are included in our allowed revenue package, as this affects what and how we will deliver our outputs.

The benefit to the consumer of Ofgem including customer satisfaction, environmental sustainability, safety and reliability within their current output incentive mechanism is that these important areas can be prioritised above minimum level compliance.

The right output incentives provide a mechanism for network companies like SP Energy Networks to achieve effective outcomes in key areas for a relatively small proportion of our overall funding. They are essential to provide the necessary funding and incentives to ensure we can effectively play our part in the low carbon energy system transition.