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Dear David and Dermot

Thank you for your time on Tuesday. Greg and I both greatly appreciate it. In our meeting we agreed that we would follow up on some specifics. To that end I attach some single-page exhibits that are intended to make the key points clear. Those items relate to:

1. *The fact that our efficient starting point must be properly factored into the overall assessment of whether the outcome is fair.* The evidence shows that an outputs gap cannot be said to explain the difference between your treatment of us and our comparators. We are being asked to deliver outputs that are equivalent to other companies with cost allowances that are insufficient to allow us to compete on a level playing field. Please see annex 1.

2. *The need for Ofgem to make proper adjustments to its modelled results where we have provided clear evidence that the model is wrongly indicating inefficiency in particular categories of cost.* The analysis shows that without the line-by-line adjustments that Ofgem has made, Northern Powergrid would rank first in the disaggregated modelling. Fair treatment demands that equivalent adjustments are made to deal with the invalid comparisons that we have highlighted. Please see annex 2.

3. *The specific problems that we have highlighted to the Ofgem team in relation to the real price effects calculation.* Annex 3 highlights that the problem stems from two simple gaps in the Ofgem method. Firstly, the calculation for labour RPEs fails to apply any specialist labour premium for the years prior to 2015/16, despite the fact that Ofgem accepts that one exists for that section of our workforce. The second is simply that Ofgem's calculation has, so far, neglected to use the accurate data that has been provided in relation to the proportion of our workforce that is in the specialist category.

Over the coming days I will follow up with Dermot to make sure that any remaining points of disagreement are clearly understood on both sides.

Sincerely

Phil Jones
Chief Executive

ANNEX 1: DEMONSTRATION OF THE FUNDING GAP THAT EXISTS FOR NPg

	NPg	SSE	OTHERS		
			Avg	Range	
				Min	Max
1. EFFICIENCY ASSESSMENT (2010/11 - 2012/13)					
A. Efficiency score based on latest audited data	89.7%	88.6%	*100.2%*	*96.3%*	*104.7%*
B. ED1 allowed expenditure relative to DPCR5 actuals	(4.9%)	4.1%	*(4.7%)*	*(8.1%)*	*2.7%*
C. *Implied efficiency target for ED1 (=A+B)*	*84.8%*	*92.7%*	*95.5%*	*88.3%*	*104.0%*
Funding gap (relative to SSE settlement) - %	(7.9%)	-	*2.8%*	*(4.4%)*	*11.3%*
Funding Gap (relative to SSE settlement) (£m pa)	**(31.3)**	**-**	***32.8***	***(10.5)***	***97.8***
2. OUTPUTS ASSESSMENT					
Asset related outputs - 3-year progress					
Proportion of DPCR5 Network Investment spent	50%	53%	*53%*	*52%*	*54%*
Proportion of NI linked to outputs	59%				
Proportion of original output commitment reported	50%	72%	*66%*	*44%*	*78%*
Output-related investment	179.3				
Asset-related outputs 5-year forecast					
D. Forecast level of outputs for DPCR5	116%	-	-	-	-
E. Average DPCR5 Output-related investment (£m pa)	61.2	-	-	-	-
F. Cost of each percentage point of output (£m pa)	0.53	-	-	-	-
Customer Service Output Rewards (£m) (2010/11 - 2013/14)					
IIS rewards / (penalties)	27.9	14.0	*97.9*	*29.4*	*197.6*
BMCS rewards / (penalties)	(3.9)	(2.1)	*0.1*	*(8.8)*	*15.1*
Discretionary reward	1.6	1.3	*1.9*	*0.6*	*3.7*

1. EFFICIENCY ASSESSMENT

- NPg and SSE lead the sector in terms of actual efficiency (89.7% and 88.9%, respectively).
- SSE have a 4.1% increase relative to its DPCR5 forecast, while NPg received a 4.9% reduction.
- The 7.9% differential amounts to £31.3m pa relative to SSE, despite the similar efficiency scores.

2. OUTPUTS ASSESSMENT

- There is a headline discrepancy across the sector in relation to the volume of network outputs being reported (44%-78% after three years, despite the spend levels all being within a 4% range).
- The apparent discrepancy does not stand scrutiny.
  - Companies establish their own output targets.
  - The reporting is not subject to consistency checks between companies.
  - Large proportions of the network investment are not linked to outputs – in NPg's case, the outputs are attributable to 33% of the overall capex programme.
- It costs NPg £0.53m to deliver each percentage point of network outputs (E/D=F).
- To explain a £31.3m funding gap by reference to a network output shortfall would require the validated gap to be of the order of 60 percentage points of outputs (requiring 176% over the DPCR5 period). This is not credible.
- This treatment cannot be justified by reference to NPg's customer service outputs:
  - NPg has performed better than SSE relative to Ofgem's quality of supply targets.
  - NPg's performance on BMCS and the discretionary reward is very similar to that of SSE.

CONCLUSION

- NPg starts the ED1 period from a position of existing efficiency, yet it is being asked to deliver outputs equivalent to the rest of the sector without the proper level of funding to enable it to compete fairly.

ANNEX 2: IMPACT OF OFGEM ADJUSTMENTS

1	2	3	4	5	6	7	8
DNO GROUP	TOTEX SUBMISSION (£m)		ADJUSTMENTS			TOTAL ADJUSTMENTS (£m)	% OF TOTEX
		Unadjusted modelling result	Regional labour	Ratcheting	Qualitative and company specific		
			% of Totex				
UKPN	6,318	114.6% (6)	4.9% (1)	-3.5% (3)	4.0% (2)	339	**5.4% (1)**
ENWL	1,794	99.5% (1)	-1.6% (4)	-4.3% (4)	5.5% (1)	-6	**-0.4% (2)**
SP	3,336	104.7% (5)	-1.7% (5)	-2.6% (2)	3.3% (4)	-31	**-0.9% (3)**
WPD	6,469	102.9% (3)	-1.2% (3)	-2.5% (1)	2.6% (5)	-76	**-1.2% (4)**
SSE	3,513	103.5% (4)	1.2% (2)	-6.4% (6)	3.9% (3)	-46	**-1.3% (5)**
NPg	3,025	99.5% (1)	-2.0% (6)	-5.0% (5)	2.5% (6)	-135	**-4.5% (6)**
Total	**24,455**	**105.9%**	**0.5%**	**-3.8%**	**3.5%**	**45**	**0.20%**

- NPg ranks equal first under the disaggregated model when no adjustments are made. (Column 3)
- Ofgem makes a series of adjustments to this model - many on a line-by-line basis. (Columns 4-6)
- NPg has been the most adversely affected by Ofgem's adjustments to the modelled outcomes
    - The impact is a hit of £135m, or 4.5% of totex. (Columns 7-8)
    - No other company suffers anything like this from Ofgem's interventions to its own model.
- We have made representations to Ofgem about the specific cost items that Ofgem's modelling has indicated to be inefficient.
    - We have met with the response that Ofgem 'does not do line-by-line assessments'.
    - This position is untenable since Ofgem's process:
        - disallows costs on the basis that particular lines are indicated to be inefficient by the model; and
        - specifically reinstates some disallowances in the form of adjustments to the unadjusted modelled results.
- Northern Powergrid has submitted a significant body of evidence to support the same kind of changes to the modelled outcomes in relation to its cost base.
    - There are clear-cut examples of where Northern Powergrid's assets are very different from those assets of other companies with which the model draws comparisons.
    - The costs of working on such assets are higher than those associated with the comparator assets, but the lowest overall cost for customers is achieved by retaining these unusual specifications.
    - Examples include the 66kV and 20kV networks, steel mast overhead lines and bespoke requirements for Black Start capability.
    - Correction of the modelled outcomes for these assets would restore £45m to the Northern Powergrid settlement.
    - The value of these items, although material, is less than the value of positive adjustments that Ofgem has made for other companies.

CONCLUSIONS

- Ofgem's position that 'it does not do line-by-line analysis' in a price control review cannot be reconciled with the line-by-line disallowances and adjustments that it has made under the disaggregated cost assessment model.
- We require that Ofgem treats us equitably with other DNOs and considers properly the justifications that we have put forward.

ANNEX 3: CORRECTING THE RPEs STARTING POINT

WHY OFGEM'S ONE-YEAR ROLL-FORWARD CREATED A LARGE MOVEMENT IN RPEs

CALCULATION STEPS	2015-16 RPE INDEX[1]	NPg RPE BENCHMARK	ALLOWANCE IMPACT
Ofgem June 2013 view	**100.1**	**£53.0m**	**£39.8m**
Step 1. Update materials component of RPEs by replacing one year of forecasts with one year of actuals	*-1.1*	*-£34.2m*	*-£25.6m*
Step 2. Update labour component of RPEs with Ofgem's latest view of actuals and near term forecasts – which compounds pre-existing flaws in the starting point	*-1.1*	*-£32.6m*	*-£24.4m*
Ofgem June 2014 view (as per *Draft Determination)*	**97.9**	**-£13.7m**	**-£10.3m**

[1] 2012-13 = 100 so a value below 100 implies a reduction in real terms over the period to 2015-16.

- Step 1 replaces one year of forecasts with one year of actuals in the indices that drive material prices. No strong case is being made to suggest that these indices are not reflective of the costs that DNOs face.
- Step 2 does the same thing for labour-related costs and also updates the near-term labour forecasts. Inherent in the Ofgem method is a flaw whereby the data taken for actual indices and near-term forecasts has not been adjusted for a specialist labour premium – even though the longer-term forecasts correctly contain one.
  - The near-term forecast for 2013-14 is replaced by a set of 'actuals' measured using an index that the ONS has highlighted is significantly affected by economy wide structural change.
  - The near-term economy-wide forecast for 2014-15 is updated (building in a stronger effect from ongoing economy-wide structural change as higher paid jobs are being replaced by lower paid ones) while still not including any specialist premium.
  - The newly available near-term forecast for 2015-16 is incorporated (and in doing so the specialist premium previously applied to this year is deleted).

CONCLUSIONS

- The combined effect of these steps created:
  - A step down of 2.2% in real terms as a result of the roll forward.
  - A result that suggested that DNO costs would experience 2.1% of negative RPEs in that period, rather than staying virtually flat in real terms between 2012-13 and 2015-16.
- The step down is created by the lack of application of a specialist premium in near-term forecasts and actuals, combined with Ofgem's method that implicitly assumes the shift in the wider economy towards lower paid jobs is equally a characteristic of the DNO workforce.
- For this reason, the calculation is not reflective of the reality of DNO costs.

ANNEX 3: CORRECTING THE RPEs STARTING POINT

CORRECTING THE RPE STARTING POINT TO PROPERLY REFLECT SPECIALIST LABOUR EFFECTS

CALCULATION STEPS	2015-16 RPE INDEX	NPg RPE BENCHMARK	ALLOWANCE IMPACT
Ofgem June 2013 view	**100.1**	**£53.0m**	**£39.8m**
Step 1. Correctly apply the specialist premium to the starting point	*+0.8*	*+£41.0m*	*+£30.8m*
Ofgem June 2013 view with correction to specialist labour calculations	**100.9**	**£94.0m**	**£70.5m**
Step 2. Update materials component of RPEs by replacing one year of forecasts with one year of actuals	*-1.1*	*-£34.2m*	*-£25.7m*
Step 3. Roll forward labour component of RPEs by reflecting the latest data – properly recognising the evidence published by the ONS	*+0.1*	*+£2.9m*	*+£2.2m*
Corrected Ofgem June 2014 view	**99.7**	**£63m**	**£47m**
Variance relative to Draft Determination	*+1.8*	*+£76.4m*	*+£57.3m*

Step 1 comprises the two changes needed to correct the errors in Ofgem's starting point:

- Reinstate the appropriate specialist labour premium missing from Ofgem's June 2013 calculation for the years 2013-14 to 2014-15.
- Set specialist weights to 70% to reflect the sector's actual mix of specialist labour (engineers and skilled field staff) as per responses to the Ofgem 2013 data request on employee mix.
    - Ofgem's existing calculation uses an average of figures DNOs used in calculating their own RPEs which had no definition set by Ofgem.
    - Only two DNOs – SP and WPD – adopted the same definition as Ofgem in their RPE business plan data and so the average used by Ofgem is too low.
    - Companies have submitted consistent data in response to a data request from Ofgem.
- Step 2 recognises that materials input prices have fallen in real terms (principally due to lower copper prices) and so uses the same method as Ofgem's existing method.
- Step 3 refreshes the forecast for new actuals and updated forecasts without removing the specialist labour premium from the result:
    - Actuals for 2013-14 have been estimated from ONS data for wage increases in sectors which have not been affected by structural change.
    - The 2014-15 near term forecast has been updated but now includes a specialist premium.
    - The newly available near term forecast for 2015-16 is incorporated but, unlike in Ofgem's calculation, the specialist premium has not been deleted from this year.

CONCLUSIONS

- As at June 2013, Ofgem's *Draft Determination* methodology *with a specialist labour premium properly incorporated* implies 2015-16 real terms prices about 1% above the 2012-13 price base.
- Falling materials prices in 2013-14 are incorporated into the calculation, so the 1% increase has been wiped out, leaving expected 2015-16 prices slightly below 2012-13 prices.
- Step 3 shows that, *when properly calculated*, the update of labour for the latest evidence does not materially affect the RPE index in 2015-16.
    - Actual labour costs for a company that makes heavy use of specialist labour in a sector that has not been affected by a significant rise in part time and low-paid workers will not see significant real pay reductions.
    - This would bring Ofgem's forecast into line with market evidence that DNOs have provided in relation to pay bargaining settlements and service-related contract renewals.
- The revised calculation creates an ED1 period allowance for RPEs that is very close to the level we calculate that the CMA's methodology for NIE would set if applied to Northern Powergrid.