

Sara McGonigle
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Ofgem
9 Millbank
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15 September 2014

Dear Sara,

APPLICATION OF A RATCHET IN THE BENCHMARKING OF NON-OPERATIONAL PROPERTY COSTS

At our costs team bilateral on 29 September, we discussed the application of a ratchet in the benchmarking of non-operational property costs, whereby the proposed allowances are set by the lower of the cost in the company's plan or Ofgem's benchmark.

During the meeting you implied that a ratchet was justified because non-operational property costs are not very controllable or comparable across companies.

I am writing to reiterate my response in the meeting that this is not the case. These costs are controllable and, in nearly 25 years since privatisation, companies have had significant opportunity to reduce them. It is Northern Powergrid's actions over the years to cut costs in this area that have created its cost advantage over other companies. For example:

- The company has relocated all its call centre services to the North East, which required the closure of a pre-existing call centre in Yorkshire.
- The company's office in Newcastle has progressively scaled back over the years relative to the large head office that was maintained at the time of privatisation. Most office staff who would previously have been located in Newcastle are now located at much cheaper properties at Shiremoor, other parts of the North East and in Yorkshire.
- The company's office in Leeds has been progressively scaled back over successive years, such that the company now occupies only part of one building (principally a control centre). Most office staff who would previously have been located in Leeds are now located at cheaper accommodation in Castleford and other sites in Yorkshire and the North East.
- As well as relocating many functions over the years, the company has minimised office refurbishment and fit-out costs on the property portfolio it has maintained, to the extent that Ofgem's property consultants over the years have specifically noted the company's actions to control costs in this area.
- We have benchmarked and market tested a number of different service delivery options for our property facilities services. By implementing the most efficient service delivery blend we have reduced costs by around 30% over the last decade.
- Where we undertake similar types of works on our operational and non-operational premises (such as ground maintenance) we let these as a single contract for both

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categories of location. This has produced significantly lower unit costs due to the larger volumes of work being competitively tendered.

- We made significant savings on our electricity costs by contracting directly with a niche generation provider following a competitive tender process.
- Improvements in the efficiency of our logistics processes such as deliveries direct to site and the use of small unmanned stores in operational substations have reduced the volumes of materials that we need to keep at our depots. At the same time we have moved towards site starts for the vast majority of our workforce avoiding the need for them to come to depots. These two initiatives have allowed us to reduce the number and size of our depots with commensurate reductions in property operating costs.

We are concerned that Northern Powergrid has been significantly disadvantaged in the benchmarking exercise, relative to other DNOs, by the decision to apply a ratchet to this area of costs. It effectively cherry picks our plan in an area where we have sector-leading low costs. While the 'benchmark of the benchmarks' at the end of the process moderates the extent of the sector-wide under-funding due to such cherry picking, Northern Powergrid is still disadvantaged relative to other DNOs by the decision to apply a ratchet to this area of costs. This is despite the fact that the company has created its sector-leading cost position in this area through its own cost control actions.

Moreover, the application of a ratchet to this area of costs will weaken the incentive on other DNOs to act to control their costs in this area. It would signal that Ofgem does not believe the costs to be controllable. Other DNOs may then expect that, should they act to reduce their costs in this area, they would lose any benefit this creates at the end of the ED1 period.

Lastly, removing the ratchet in this area of costs will not necessarily lead to an increase in costs funded by customers, since Ofgem's benchmark of the benchmarks should avoid any overall over-funding. Removing the ratchet will however solve a problem with Ofgem's relative assessment of the cost efficiency of DNOs.

I hope you find that this letter has given you the evidence you need to support a decision to remove the ratchet in this category of costs. But if you need any further evidence please let us know as we would be happy to provide it.

With kind regards



Keith Noble-Nesbitt
Economic Regulation Manager