Lloyds Court
78 Grey Street
Newcastle Upon Tyne
NE1 6AF

David Gray - Chairman
Dermot Nolan - Chief Executive
The Gas and Electricity Markets Authority
9 Millbank
London
SW1P 3GE

phil.jones@northernpowergrid.com
Tel: 01977 605452
Fax: 01977 605100

29 September 2014

Dear David and Dermot

INTERNAL INCONSISTENCIES IN OFGEM'S SENSE CHECK TO LCN FUND SAVINGS

We have written to Maxine setting out our concerns in respect of the use of top-down evidence from Low Carbon Network Fund ('LCNF') bids to quantify the potential savings available from smart grids within the ED1 period. I have summarised our position on this material issue below.

The IRR implied for the portfolio of LCNF Projects is implausibly high

- For Ofgem's stated investment of £450m by 2015-16, DNOs are being expected to realise £1bn in cost reductions, in addition to those that flow to connectees of up to £1bn.
- A simple discounted cash-flow assessment of a £450m investment that yields these benefits over this period of time implies an expected guaranteed annual real rate of return for the whole portfolio of projects in the range of 15% to over 30% (depending on whether any benefits flowing to connectees are included and whether one assumes that benefits continue at a similar rate in the ED2 period rather than stopping dead in April 2023).
- Even based on an extremely conservative estimate at the lowest end of this range (where there are no benefits to connectees and all benefits cease in 2023), these figures are implausibly high for a portfolio of projects which Ofgem states were virtually certain to deliver the stated benefits at their conception.
- The flaw in the assessment is that the high risk of failure (which is correctly implied by the high IRR) associated with the projects has not been factored into a risk adjusted return for the portfolio as a whole. What your team has done is the equivalent of an oil and gas business valuing itself on an assumption that too many of its exploration projects will be successful enough to make it through to full production.

LCN fund bids are not based on the same levels of low carbon take-up as the business plans

- DNOs' plans forecast lower levels of cost reductions flowing from LCNF projects than the LCNF bids do.
- This pattern is entirely consistent with the figures in the LCNF bids having been prepared on the assumption that there would be relatively high take up of low carbon technologies in the ED1 period.
- The resubmitted slow-track DNO business plans - quite properly - assumed a risk accepting, relatively low, level of low carbon technologies take-up.
- This means that they are consistent with a lower level of 'near certain' smart grid savings than the £1bn Ofgem has assumed.

Conclusion
As a point of principle, I think a regulator should set a much higher bar than Ofgem appears to have done before it decides that the results of its own carefully constructed process that is designed to incentivise information revelation from companies can be safely discarded in favour of a flimsy, unauditable assessment carried out by civil servants. This becomes even more problematic when the subject of that assessment is both highly uncertain and highly technical. In my view, these factors alone should be enough to cause the Authority to insist on a rethink.

For a moment, I will set aside that significant concern and assume that it is safe to use the information contained in a series of bids for innovation projects (that have yet to deliver) to arrive at a number that will be used to deny costs that have survived a comprehensive benchmarking process. In order to provide a meaningful guide to a bottom-up calculation, the expectations of the benefits that might accrue from the portfolio must be credibly risk adjusted before they are used in anger. We have provided your team with such an analysis and it shows that such a sense check would place an absolute upper limit of £620m on the 'near-certain' benefits that could flow from the LCNF projects in the ED1 period. In this context it is essential that your team revisits their calculations to identify where errors may have been made, and also make all their calculations available so that the consultation process can be effective.

I realise that I have used some strong terms to criticise the work that has been done. I do not do that lightly. The suggestion that Ofgem is making that it has drawn a reasonable assumption about the scale of available smart grid benefits by examining the bids made into LCNF does not stand up to scrutiny. Even a relatively straightforward inspection reveals that the assessment has mistakenly factored in an implausibly high success rate for the portfolio of projects. In addition, it seems clear that Ofgem has made no attempt to square the underlying assumptions that may (or may not) have prevailed at the time of the LCNF bids about the potential take-up of low carbon technologies with the explicit take-up assumptions made in company business plans. I think the evidence points conclusively to a need for the Authority to rethink its position before proceeding to make its Final Determination later this year.

We have shared with your team the detail of our assessment and set out the potential to introduce a mid-period review to deal with those aspects of smart savings that are subject to too much uncertainty for a sensible ex ante judgement to be made. That does not rule out the prospect of there being some component of ex ante benefit assumption factored into the allowances, but only where the rationale can be seen to be adequately strong. I would appreciate the opportunity to include this subject in our next discussion on the price control, given its importance and the need for a marked change of approach by Ofgem.

Sincerely

Phil Jones
Chief Executive