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Dear Maxine

SMART SAVINGS

I refer to the teleconference on the quantification of smart savings that took place on 31 October.

I must start by saying that the fact that we find ourselves in a position where so much work is being done at this late stage in the process justifies our comment that the smart savings disallowances that first appeared in the *Draft determination* were indeed hastily improvised. The RIIO method was designed to settle these sorts of things early on, not add them as an afterthought at the end of the process. Only yesterday we received a supplementary question which we presume was aimed at developing a consistent dataset to complete the calculation exercise. We think your prospects of success in this endeavour are remote and the fact that it is necessary for you to do this at this stage is itself a cause for concern because decisions made under these circumstances are unlikely to be well justified.

Nevertheless, we are grateful to Ofgem for giving us some information about the way your team is proposing to update your approach. We can see merit in some of the changes – particularly making the savings in the reinforcement category proportionate to each DNO's reinforcement budget and the removal of the part of the assessment that was said to be grounded in DECC's smart meter assessment.

However, we still have concerns about some of the fundamentals in the Ofgem position that we think have the *potential* – until we see the final proposals we cannot say more than this – to result in an unjustified deduction from our assumed costs.

Our concern begins with your assumption that the benchmarking of business plans that Ofgem is content to use to reach a view of companies' efficient costs is not sufficient for your purposes in the category of smart savings. This is extraordinary because Ofgem and its cost assessment working group spent more than a year developing cost assessment models that included these costs. You have never explained what it is about smart savings that you think justifies an exercise that identifies an additional tranche of savings from those in the companies' business plans. But if we leave that observation aside and we assume that there is something unique about smart savings that justifies a second bite at the costs in the business plans, we see some potential inconsistencies and injustices in the way that we understand you to be approaching the quantification of the assumed savings.

Your team is proposing to use benchmarking of one kind or another to identify the *additional* savings that each DNO should make. Since these benchmarked smart savings occur in expenditure categories that have already been benchmarked in the cost assessment exercise, there must be a risk that the savings (or some part of them) have been double-counted. We are not clear whether your team is taking sufficient steps to ensure that this is not the case. Although the slides presented to the teleconference show an awareness of the problem of double-counting, it is restricted to the 'Other' category and it is not clear where in the benchmarking of this category the team thinks the risk of double-counting occurs.

Ofgem's quantification of the smart savings relies on the information provided by DNOs in their business plans and the answers to supplementary questions from the Ofgem team. The validity of this approach rests on the assumption that the definition of what is a 'smart saving' and what is embedded in 'business as usual' costs was applied consistently by DNOs in both the business plan submissions and the answers given to Ofgem's supplementary questions, and is now being applied consistently in the calculation that Ofgem is now undertaking. The potential for a discriminatory outcome is illustrated by the example of two identical companies, one of which treated a particular technique as 'business as usual' whilst the other treated the same technique as 'smart'. Under your current approach the two companies could end up with different outcomes. Suppose both companies require £100m when the technique, which saves £10m, is used. Both intend to use it and submit their plans at a net £100m; but company A submits a vanilla £100m because it viewed the technique as 'business as usual' whereas company B's £100m net forecast is the result after applying the £10m of smart savings to the pre-smart savings costs of £110m. When benchmarked in the main cost assessment exercise both companies are found to be equally efficient (because £100m goes into that benchmarking exercise in both cases). However when the smart/innovation benchmarking is carried out company A is found to be lacking £10m of smart savings and therefore receives an allowance that is £10m lower than company B will receive.

We think that your team may be alert to this problem and this may be why we have recently received requests for information and for further submissions of savings in the light of other companies' smart savings submissions. However, the requirement that these further submissions must refer to practices that are referenced in companies' business plans means that the problem referred to above could still arise.

Taking the example referred to above, if the reason that company A viewed the technique as 'business as usual' was that it had been using the technique for a number of years such that the technique had become so fully embedded in its processes that it did not even refer to it in its business plan, the method proposed for benchmarking the smartness and innovativeness of companies would still reward the less innovative company B for its late adoption of the technique. Company A would be correspondingly penalised for its early adoption.

We do not think that this will directly affect Northern Powergrid, as we think that all the techniques that we have treated as 'business as usual' but which others may have treated as 'smart savings' are referenced in our plan. However, we believe it will affect some other companies and we are not sure how you intend to address this.

So, as things stand, we cannot yet tell whether we are going to be the victims of a miscarriage of justice, but I am sure you will appreciate our sensitivity to the possibility. The only way that we can see that would safeguard us from that outcome would be for your team to recognise that some items that we treated in our business plan as 'business as usual', but which Ofgem is treating as 'smart savings' because that is how some other companies treated them (e.g. CBRM, transformer oil regeneration, perfluorocarbon tracers for EHV pressure cable fault location, LV fault finding techniques and use of mobile devices for fault response), should also be treated in your final assessment as smart savings that have been offered by Northern Powergrid. Any other treatment will penalise us because the total pot of notionally available smart savings has been enlarged by these initiatives, but our adoption of them may go unrecognised in your calculation. I stress we do not know whether your team is poised to make such an error, but we are unable to be confident that this outcome will be avoided.

There are two other issues specific to Northern Powergrid that continue to cause us concern.

The first is the treatment of Thornhill, a 132kV reinforcement scheme that will address P2/6 issues affecting three 132/33kV sites across two separate NGET infeeds.

The second is Blyth, a 66kV fault level reinforcement scheme where our options are severely limited by the voltage and because this is an NGET infeed point with multiple supergrid transformers defining the fault level.

The Ofgem team that is considering smart savings appears to be adopting an approach whereby both of these schemes would be expected to produce smart savings. However schemes of this size and at this degree of development (both are fully designed and papers have been submitted to Ofgem) should be treated on their merits.

For Thornhill, the individual assessment of the merits and efficiency of the scheme has already been carried out in the cost assessment benchmarking exercise. Your consultants, DNV KEMA, found the scheme to be efficient. This being so, it would be unreasonable to impute smart savings to this single project based on a benchmarking exercise which takes no account of the actual scheme which already incorporates a high degree of smart thinking and represents excellent value for money in its current form.

The Blyth reinforcement scheme is a scheme that transferred from the customer connections investment stream to the fault level reinforcement stream late in the process after a customer cancelled an accepted connection. We do not know if Ofgem has completed the individual assessment for that scheme. We do not consider that there are any smart benefits available in that scheme that we have not incorporated. If you or your consultants think otherwise, we would like to know what aspects of the scheme you think could give rise to smart savings.

In short, we are unable to be tell whether the changes your are presently contemplating to the smart savings approach set out in the *Draft determination* will be sufficient to avoid the potential errors that I have set out above. However, I accept that there may be no further conversations between us on this and if we hear nothing more from you in the next few days we must wait to see how you have taken this forward when we read your final determination.

Yours sincerely

John France

John France
Regulation Director