

Lloyds Court
78 Grey Street
Newcastle upon Tyne
NE1 6AF

Chris Watts
Senior Advisor, RIIO controls, SG&G
Ofgem
9 Millbank
London
SW1P 3GE

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Dear Chris

THE PLACE OF HISTORICAL EFFICIENCY SCORES IN THE BENCHMARKING OF FUTURE COST ALLOWANCES AT ED1

During our bilateral meeting on 19 August 2014 we discussed the role that DNOs' historical efficiency performance has played in the slow-track cost assessment.

I don't think we have a different view of the way that Ofgem has been conducting its benchmarking at ED1, but I want to make sure that we have precisely the same understanding as you and Maxine before we get to our meeting with the Committee of the Authority on 4 September.

Before I set out how we think that Ofgem has used historical data in the cost assessment to date, I want to make four things clear:

- First, we are not now proposing an alternative approach to benchmarking that would give historical data a more central role. We recognise that you have reached a point in the process where it would be difficult to introduce new benchmarking methods.
- Second, we recognise that historical data has been used to determine the cost functions - as distinct from the historical efficiency of the companies - that Ofgem uses in the benchmarking of the DNOs' plans.
- Third, we recognise that the object of the exercise is to determine the efficient cost allowances for the ED1 period and that, to arrive at this judgement, Ofgem is, for the first time in this sector, benchmarking future plans.
- Fourth, we recognise that a company with a sector-leading efficiency today should not get more money as a reward for its current efficiency if its business plans for the future are shown not to be efficient.

The reason we think that our proven historical efficiency is relevant to the cost assessment is very straightforward. Ofgem has to decide whether the justification that we have provided for our efficiency on a number of cost lines is persuasive. We believe that in the presence of two totex models that indicate that our plans are efficient and a substantial set of written justifications that we still expect Ofgem to find compelling, it is relevant that Northern Powergrid is at the forefront of efficiency today using broadly the same models that Ofgem is

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using to assess the plans. Our proven efficiency is an essential piece of information that should be given weight in your consideration of whether we have justified our costs. Indeed, we think it should carry considerably more weight than any forecasts that a currently inefficient company has made about the cost efficiencies that it aspires to achieve in future. At previous reviews the *current* level of efficiency would be the starting point for the assessment of *future* cost allowances. Under the ED1 approach the benchmarking of future plans leaves the current level of efficiency out of Ofgem's consideration of the plausibility of those future plans.

Having summarised our position, I shall now set out more fully our understanding of the role that historical data has - and has not - played in your ED1 cost assessment to date. I shall also make some observations about Ofgem's approach at the recent GD1 review. I would appreciate if you would let me know if any of this description is wrong.

In Ofgem's ED1 modelling approach, historical efficiency performance does not affect the efficiency scores

In our letter of 25 March 2014, we set out in detail why historical efficiency performance did not affect the efficiency scores in the fast-track cost assessment.

The key points of our previous letter were as follows.

- The modelling approach adopted takes the following steps:
 - First, Ofgem estimates the relationship between cost drivers and costs.
 - Second, Ofgem uses this estimated relationship to project forward modelled costs for 2015-23, on the basis of each DNO's forecast cost drivers.
 - Finally, the modelled costs resulting from this projection are compared to the DNO's cost forecasts for 2015-23 to derive an efficiency score.
- The objective at stage one is to obtain a robust estimate of the underlying relationship between costs and cost drivers. While this sector-wide relationship has been derived from a dataset which includes some historical years, there is no assessment of each DNO's historical efficiency *performance*. The latter would require Ofgem to compare modelled costs *for a historical period* with outturn costs *for that period*. Ofgem has not done this at either the fast-track or slow-track cost assessment.
- Once the relationship between costs and cost drivers has been estimated, it is used at stage two to project modelled costs. These 2015-23 modelled costs are the benchmark against which DNOs' forecasts are compared by Ofgem. In other words, the benchmark is a modelled cost *forecast*, not an historical modelled cost.
- Finally, as noted above, this modelled cost *forecast* is compared to each DNO's cost *forecast* to derive an efficiency score.
- So while historical data is used to estimate the relationship between CSV and costs that generates the benchmark cost forecast, achieved historical efficiency performance of each company plays no part in the analysis. We demonstrated this with an example in our previous letter.

If we have misunderstood the approach, we would appreciate clarification from Ofgem on this point.

Ofgem's ED1 modelling approach is not similar to the GD1 modelling approach

At the meeting on 19 August, I think you made a further point that we had not heard before, namely that Ofgem's ED1 treatment of historical efficiency is similar to the GD1 treatment of historical efficiency. Our understanding of the GD1 approach is that the cost assessment framework was explicitly set-up to take account of historical efficiency performance in setting final allowances. As such, in our view, it is not similar to the approach Ofgem has used in the slow-track cost assessment at ED1.

At GD1 Ofgem used both totex and disaggregated analyses, and for each of these models it used the following approach to set final allowances.

- First, an historical regression was run on four years of data, and the results from this were used to calculate an historical efficiency score for the year 2011/12. The upper-quartiled efficiency score was applied to the actual costs from 2011/12 to determine modelled costs for 2011/12. These costs were rolled forward over a nine-year period, to take account of changes in outputs, workload volumes, RPEs and on-going productivity. This provided a modelled cost profile over the GD1 period, based on the historical efficiency score.
- Second, a regression was also run on two years of contemporaneous forecasts (2012/13 and 2013/14), the results of which were used to calculate a forecast efficiency score for 2013/14. The upper-quartiled efficiency score was applied to the forecast costs from 2013/14 to determine modelled costs for 2013/14.¹ As above, these modelled costs were rolled forward to determine a cost profile for the GD1 period.
- Finally, the final cost allowance was based on an unweighted average of modelled costs for the GD1 period from the following:
 - a totex model run over four years of history, based on an historical (2011/12) efficiency score;
 - a totex model run over two years of contemporaneous forecasts, based on a forecast (2013/14) efficiency score;
 - a bottom-up model run over four years of history, based on an historical (2011/12) efficiency score; and
 - a bottom-up model run over two years of contemporaneous forecasts, based on a forecast (2013/14) efficiency score.

In our view - and please tell us if we are wrong about this - Ofgem's GD1 approach therefore placed a 50% weight on historical performance. However, our understanding of Ofgem's ED1 approach - and again we would welcome Ofgem's clarification on this point - is that Ofgem placed 100% weight on its forecast efficiency scores, and no weight on its historical efficiency scores.

I would like to make sure that we have a shared understanding of the role that historical data has played at ED1 thus far and at the GD1 review. We will then be confident that we can make the points we want to make to the Committee of the Authority safe in the knowledge that you will not have to correct our account after we have left the room. In particular, I think the following statement is completely accurate:

¹ Note that Ofgem assumed that the GDNs would close only 75% of the assessed gap between their forecasts and the upper-quartile.

'The actual (as opposed to the forecast) *efficiency* of the companies plays no functional part in the cost assessment methodology used so far at ED1. This is unprecedented in electricity distribution price control reviews and it was not true of the GD1 review.'

If you agree with this statement it will be sufficient for you simply to acknowledge this. If you think it is inaccurate or requires qualification in some way please let me know. I want to make sure that we don't say something that does not correspond with your understanding of what you have done.

Yours sincerely

A handwritten signature in black ink that reads "John France". The signature is written in a cursive style, with the first name "John" and the last name "France" clearly legible.

John France
Regulation Director