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Dear David and Dermot

OFGEM'S USE OF RATCHETS DISTORTS THE OUTPUTS OF THE DISAGGREGATED MODEL

When we met the Committee of the Authority on 4 September I spent some time on the treatment of cost disallowances arising under Ofgem's disaggregated cost model. The concerns I shared in that meeting stand, but in addition to them some important new evidence has come to light that I would have majored on in our discussion had it been available to me. If it is not considered and acted upon a very important aspect of the RIIO model will, in my view, be rendered inoperative. My concerns relate to one aspect of the disaggregated model – the way in which Ofgem has used ratchets to increase cost disallowances.

Recent discussions with your team indicate that this important issue has not received any real attention at the senior level in Ofgem. The issue is not without its complications, so I will attempt to give a relatively thorough explanation in this letter, but the essence is:

- The disaggregated modelling that forms part of the Draft Determination includes a mechanism whereby ratchets are used in a number of the cost categories.
- Those ratchets have the unwelcome and inevitable effect that they distort the cost modelling by denying a company the credit for a perfectly legitimate type efficiency, and so exaggerate the extent to which the disaggregated model will fail to capture cost trade offs made by a company as it optimises its plan.
- The Ofgem team, at working level, is well aware of those distortions.
- The effect of these ratchets on Northern Powergrid's disaggregated model result is £153m – only SSE is impacted more severely.
- If the ratchets were switched off, the disaggregated model would suggest that the Northern Powergrid plan is efficient, narrowing the £270m gap that exists between the disaggregated result and the two totex models used by Ofgem.
- The Ofgem team are embarking on a process that seeks to set the secondary deliverables targets that will be the basis of the monitoring regime for asset health in the light of the modelling work...
- ...which amounts to the regulator over-writing the company's view for the secondary deliverables.
- These two steps: the distortion of the focus on total costs and the approach to setting secondary deliverable targets are set to lay waste to two of the fundamental policy intentions of the RIIO framework.
- The solution is straightforward: switch off the ratchets and take a more proportionate approach to establishing secondary deliverable targets that ensures ownership of those targets by the companies.

The distortion created by the use of ratchets

The Draft Determination, implemented a ratchet mechanism that denies efficiency benefit where a company outperforms the model's expectation on volumes. In a regulatory approach that relies heavily on incentivising information revelation and is designed to look at overall outputs and total costs without drawing the regulator into managing companies' businesses for them, I can see very little to commend the use of ratchets.

If one considers the issue narrowly and superficially, one can see why Ofgem might be attracted to the use of ratchets, since this avoids giving a company more money on a given cost line than it has asked for in its plan. But ratchets achieve this by constraining allowances for a given detailed cost category to the lower of the company's forecast or the model's assessment - i.e. if a company is efficient in its forecast of volumes, the ratchet takes that efficiency away.

So, upon closer inspection it becomes clear that ratchets bring much bigger problems of their own in the context of a price control that is concerned with the total cost of delivering a set of outputs. The essence of the problem is that it increases the extent to which the disaggregated model fails to give credit where a company achieves overall cost optimisation by trading off one class of cost for another. The fact that one pound of efficiency in one part of the cost assessment is worth a pound, whereas a pound saved elsewhere is worth zero distorts the assessment and creates very unhealthy incentives.

In addition to those objections of principle, we also have significant concerns about the impact of ratchets on practical grounds. Since I met with you on 9 September our work has revealed that these ratcheting mechanisms have been used on a widespread basis by your team to constrain our allowances (as calculated by the disaggregated model) by £153m in the Draft Determination. This is very relevant to any consideration of the model result as the ratchets have already operated to distort that assessment to our disadvantage.

We have now completed a review of the effect of the ratchets on every company. Our results bring two new important pieces of evidence to bear:

1. The use of these ratchets impacts us adversely more than most companies. Only one company (SSE) is more adversely affected.
2. With the ratchets removed, the disaggregated model result for our company would award £5m more than our plan, as opposed to £148m being disallowed.

When this is added to the fact that we received the lowest value of qualitative adjustments of any company and were hit harder than any other company by Ofgem's overly detailed (and faulty) implementation of regional wage adjustments, you will appreciate why I maintain that the outcome being proposed for Northern Powergrid is harsher than that being imposed on any other DNO. The ratchets simply exacerbate the problem.

The fact that we claim to be efficient on a total cost basis is very relevant to this issue because a total cost efficient company has most to lose from the implementation of ratchets. So far Ofgem has not advanced a single piece of evidence that we are not a highly efficient company on a totex basis. The Ofgem totex models give a consistently positive result in our case and, therefore, one can reasonably assume that the application of ratchets to a disaggregated model will fail to capture the efficient trade-offs that give rise to the positive result in the two totex models. The evidence is consistent with that.

I think this is crucial. In practice, the ratchets mean that Ofgem's position is as follows: If a company can find a way to outperform the model in terms of unit costs, then Ofgem will credit them with that benefit. But if the company is able to find a way to outperform the model in terms of the volume of activity, then Ofgem will disregard that efficiency by clawing it back immediately.

Setting appropriate targets for secondary deliverables

Having discussed the matter with your team, it seems clear that one (and perhaps the only) reason some of your working level team appear to be attracted to the retention of the volume ratchets is that they seem to be concerned that there must be a clear alignment between the volumes of work assumed by Ofgem's cost assessment modelling and the volumes of work (known as 'secondary deliverables') that will be specified in the licence as the starting point for the ex post assessment of whether companies have delivered their outputs in 2023. The staff appear to be concerned that if they switch the ratchets off they must also then increase the required volumes in the secondary deliverables to ensure an alignment between the revenues allowed by Ofgem and the work expected of a company.

I accept that these questions merit an answer - but the approach to setting and assessing detailed underlying indicators cannot be allowed to overturn fundamental components of the RIIO model. We have already started to discuss these matters with your team and the good news is that there do appear to be very workable solutions that:

- maintain a sensible framework for monitoring without sacrificing the fundamentals of a total cost price control; and
- ensure the regulator does not over-write the views of management when it comes to how best to deliver the outputs.

For example, where Ofgem is providing a set of cost allowances that broadly match those forecast by the company and Ofgem is also content with the outputs put forward by the company, intervening to ensure that there is an alignment between secondary deliverables and the underlying detail of the Ofgem cost assessment is unnecessary (and undesirable). In that case the company's proposed deliverables should stand, given that Ofgem would surely acknowledge that some modest deadband will exist in practice when it comes to the assessment and monitoring of secondary deliverables (because the actual volumes delivered will inevitably differ from the planned volumes as a consequence of the ongoing optimisation of the network over the ED1 period which may result from new information becoming available or it may result from simply making a better decision than the presumption that informed the plan).

I accept that if Ofgem has come to the conclusion that a company is proposing a plan that is inefficient in forecasting to spend more than Ofgem believes is necessary, then of course Ofgem needs to present a settlement that takes this into account and the company must take a view on whether or not it is prepared to accept that outcome, which may well mean that the new view proposed by the regulator involves a lower number of secondary deliverables than the company had in its plan.

I will elaborate on that case further in a moment, but first let me point out that the opposite is true in the case of the ratchets. In that case Ofgem's model would be suggesting that *more* work is required to support the outputs than the company has proposed - yet it is the company that must bear the risk of judgement as it implements its plan. So, if Ofgem regarded that as a legitimate efficiency by removing the ratchets, then it ought not to increase the required volumes of work in the secondary deliverables because to do so would not only distort the cost assessment by cancelling out the efficiency but it would also give preeminence to Ofgem's model over the views of the management as set out in its plan.

Returning to the case where Ofgem makes a material disallowance in a company's plan, I find it difficult to understand why Ofgem would want its view of work volumes to prevail in the monitoring mechanism throughout the ED1 period. It might well propose a settlement based on its modelled view - but surely at that point Ofgem ought to be keen to invite company management to do one of the following:

- adopt Ofgem's revision to volumes *as its own* and, from that point forward, regard these volumes as components of its own plan;

- propose something more sensible as a set of secondary deliverables that the Authority can consider; or
- use its focused appeal rights to challenge the price control on the grounds that the Ofgem cost assessment is wrong.

So, taking our case in the current circumstances. The disaggregated model, with the ratchets removed, would give us the costs in our plan - albeit we would disagree with the model's allocation of expenditure across the different cost categories. But our plan is to spend almost exactly the same as the model forecasts. In other words, with ratchets switched off, the model is actually giving a sensible answer in the round. In that instance, it seems clear to me that the volumes of activity to which we would be held accountable would be those in our plan, even though they differ significantly from the answer given by Ofgem's model.

In addition, the very prescriptive nature of the draft licence condition that will govern the ex post assessment in 2023 (that has already been applied to WPD and that we understand Ofgem presently intends to impose on the slow-track licensees) gives greater force to this point and adds to our concern. Under that condition the licensee cannot offer any evidence to justify why it has departed from Ofgem's view of volumes unless the difference arises from information that was unavailable when the final determination was made. Companies will be encouraged therefore to deliver the work volumes that arise from an Ofgem econometric model, rather than what they think the system requires.

Conclusion

I hope you will agree readily that this is precisely where Ofgem should not be going under the RIIO approach (or indeed under any regulatory regime that aims to encourage ongoing efficiency and innovation). And if you are persuaded that the ratchets should be turned off because they are distorting the cost assessment (which I think is a non-contentious statement), I hope you will also accept the corollary that the company's forecast volumes for secondary deliverables should also be carried across into the licence unless Ofgem is materially dissatisfied with the company's plan - and in that case, the company should be asked to provide the secondary deliverables that it believes match the revised level of funding. This does not amount to a change in outputs. Under RIIO, outputs are what matters and secondary deliverables are at most a leading indicator of stewardship.

I am very keen to hear your view on this point, because I suspect that you will regard it as being incompatible with appropriate total cost incentives in the sector and with the view that Ofgem will, wherever possible, avoid incentivising managements simply to adopt Ofgem's view of the needs of the network rather than doing what management thinks is necessary and efficient to deliver the outputs. I think this is a classic case of a very sensible policy principle being subverted by the realities of the detailed modelling approach.

In short, the right solution here is to switch off the ratchets and let all efficiency compete on a pound-for-pound basis. In case you are worried that the result would be to over-fund the industry relative to its plans, then I think you can rest easy. The approach of overall upper-quartiling protects against this at the macro level.

I would appreciate the opportunity to discuss this important matter with you in the near future. As I have said in another recent letter, I appreciate that time is at a premium and so hope that you will find it helpful to have my position set out in writing.

Sincerely

Phil Jones
Chief Executive