CONSULTATION ON THE INITIAL PROPOSALS FOR RIIO-T1 AND GD1

THE RESPONSE FROM NORTHERN POWERGRID

21 September 2012

CONTENTS PAGE

OVERVIEW 1

OUTPUTS AND INCENTIVES 1

COST ASSESSMENT 6

FINANCE 9

OVERVIEW

1. This is the response from Northern Powergrid Holdings Company and its subsidiaries Northern Powergrid (Northeast) Ltd and Northern Powergrid (Yorkshire) plc to Ofgem's consultation on the *RIIO-T1 and RIIO-GD1 Initial proposals* (the *Initial proposals*).

2. As Northern Powergrid operates an electricity distribution network, this response does not comment on those aspects of the proposals that require industry specific expertise that we do not have. We have directed our comments towards those policy points that apply more generally to regulated network activities, such as our own.

3. We have chosen to combine our responses to the two consultations, as in many areas the points we make apply to both. Where our responses are relevant to both RIIO-T1 and RIIO-GD1, or only one of these, we have clearly highlighted this in the sub-headings to the document.

4. The rest of this document provides comments on the three principal areas of Ofgem's consultation in turn:

    a. outputs and incentives

    b. cost assessment; and

    c. finance.

OUTPUTS AND INCENTIVES

T1 Outputs and incentives document, Chapter 2, Question 1: **Do you have any comments on our Initial Proposals on NGET's output and incentives?**

5. We have confined our comments on the proposed outputs and incentives in RIIO-T1 to two areas: the reputational incentive included in the *Initial proposals* on National Grid Electricity Transmission's (NGET's) system losses, and the connections outputs proposed for NGET.

6. In terms of outputs for losses, we understand that the patterns of use of the transmission system, determined by third parties, can have a significant impact on transmission system losses. In such cases, where an output of the regulated network is likely to be significantly influenced by the actions of third parties, financial incentives are inappropriate unless it is expected and accepted that the licensee will be able to send an appropriate price signal that may change the behaviour of the relevant third party. We therefore support the fact that no financial incentive is being placed on NGET.

7. Moreover, the reputational incentive proposed appears to be of an appropriate design. Since third parties can affect the level of transmission losses, a simple reputational incentive based on the level of losses would not be appropriate, because this may not reflect on the performance of NGET. We therefore support the more holistic assessment which the reputational incentive is based on, since it involves NGET publishing its strategy for how it intends to reduce losses, and reporting annually on its progress in implementing its strategy (including an estimate of the impact it has had on losses).

8. In terms of outputs proposed for connections to NGET's network, we recommend that Ofgem gives consideration to introducing a requirement on transmission companies to provide information on the composition of costs associated with connection requests to a similar level as distribution companies do now for connections to their networks. In particular such a requirement would be helpful in addressing the information asymmetry which arises with regard to assessing how the Section 9 obligations that bear on the transmission and distribution licensees have been taken in to account in making offers for new connection points. Such transparency would be a benefit to the overall efficiency of the system.

GD1 Outputs and incentives document, Chapter 2, Biomethane connection incentives:

9. The *Initial proposals* state that there will be a reputational incentive based on the performance of companies in connecting biomethane. However, it is not clear to us whether these proposals will simply involve publication of volumes connected, or involve an assessment of how companies have performed in making connections.

10. While we agree that it may be appropriate to publish volumes of biomethane connected on an on-going basis to aid transparency, it would not be appropriate to make comparisons between companies as part of a reputational incentive based on this data. As Ofgem states, volumes connected may depend more on the decisions of third parties than those of a gas distribution network (GDN). If information on volumes connected is published in a manner that could lead stakeholders to believe that it can be directly interpreted as a comparative assessment of performance, it should be explicitly explained as being something that, on its own, cannot be used for this purpose.

11. Any reputational signals which Ofgem wishes to send as part of its incentive regime could be more appropriately targeted based on a qualitative assessment of how well companies have facilitated connection of biomethane, or indeed based on the results of the broad environmental incentive.

GD1 Outputs and incentives document, Chapter 2, EEI/shrinkage incentive:

12. The fact that this incentive uses a modelled approach to determining gas lost from the network, unlike the losses incentive in electricity distribution, should mean that the incentive is not susceptible to the risk of material corrections to the data by third parties.

13. Ofgem proposes that this model be reviewed once more data becomes available from smart meters. We agree this would be appropriate, and that a full roll out of smart meters should lead to more accurate measurement of energy leaving distribution networks. Any material changes in the modelled shrinkage that result from this review (upwards or downwards) should be corrected for in the incentive to avoid material penalties or windfalls.

14. We also agree with Ofgem that the rolling incentive should in principle act on both the commodity cost and the carbon cost of gas. To apply it only to the commodity cost would be logically inconsistent.

GD1 Outputs and incentives document, Chapter 3, Question 1: *We would welcome views on our proposed approach to the broad measure…*

15. Ofgem is correct to state that its establishment of targets for the whole price control period based on trial performance should ensure a strong incentive for improving performance. However, the incentives to improve would diminish in final years of the price control period if there is no 'incentive roller'. This could be addressed in a number of ways, for instance establishing an 8 year incentive rolling mechanism (which would effectively define targets beyond GD1).

16. We note that the weights on various elements of the broader measure have been based on those adopted at the fifth electricity distribution price control review (DPCR5), but that the weight placed on adverse ombudsman findings has been reduced. One objective of setting these weights (and overall incentive strength) should be to ensure rewards and penalties that are proportionate and encourage efficient company behaviour. For example, the financial impact of adverse ombudsman findings should not be so adverse that companies are discouraged from allowing cases to proceed to the ombudsman where this is appropriate. In particular, this could prevent novel cases going to the ombudsman, where a view from proceeding to this stage would be helpful. And in the long term, it could raise costs to the industry from meeting what may be unreasonable customer demands (to the detriment of other customers who would ultimately bear such costs through future price controls). The lower weight in this area, relative to the weighting at DPCR5, appears to us, therefore, to be appropriate.

GD1 Outputs and incentives document, Chapter 4, Question 2: *We would welcome your views on the proposed number of fuel poor connections*

17. While we do not have any comments on the exact number of fuel poor connections, the inclusion of the 'economic test' in the mechanism will be important in ensuring that only those connections which are well justified go ahead through this route. Other customers must pay for any additional costs added to the price control, and general taxation would be a more appropriate and transparent funding route if what is required is a major programme of subsidy.

18. We do however believe that network companies can play a role in addressing social issues, and that funding via the price control may well be justified in cases where the network companies are uniquely placed to take action. One example would be the information network companies have about the location of outages. In such cases, the stakeholder engagement element of the broad measure should provide direct financial incentive for companies to demonstrate good practice. Over the longer term, learnings from awards under the incentive should lead to more companies adopting best practice and, as such, any associated costs would be built into the cost base at future price control reviews.

19. We also note Ofgem's comment that greater cross-industry working in future may be required to ensure that the 'least-cost' approach can be taken to the needs of people who are not on the gas grid. Accordingly, we expect to play a greater role in this area in the future.

GD1 Outputs and incentives document, Chapter 4, Question 3: *We would welcome your views on our proposed approach to CO issues including setting an output measure based on improving CO awareness*

20. Ofgem states that it does not have an output measure for improvements in carbon monoxide (CO) awareness that depends only on the actions of GDNs, or a robust valuation for the increase in awareness, and so a reputational rather than financial incentive will be established.

21. We agree that in these circumstances a financial incentive would be inappropriate, in particular since it would expose companies to windfall gains and penalties due to the actions of others. However, we also believe that some caution should be exercised in how any reputational incentive is implemented. While it is entirely appropriate that transparent information on levels of CO awareness be published, careful interpretation (not just a simple league table ranking) would be required to draw conclusions, in order to strip out any effects due to the actions of others.

22. In making these comments we note that the stakeholder engagement element of the broad measure, where detailed assessment of the actions undertaken by companies (and

their impact), could offer an effective way of creating both a reputational and (in cases where it was justified) a financial incentive.

COST ASSESSMENT

GD1 cost assessment document, Chapter 1: *Do you consider our overall approach to cost assessment appropriate, and if not what changes would you propose?*

23. We support Ofgem's use of a toolkit approach to cost assessment. This should help lead to more robust results.

24. We also support Ofgem's use of total expenditure (totex) benchmarking as part of this toolkit. By adding together all costs of the business before comparisons between companies are made, the use of totex benchmarking helps to minimise the unequal incentives to favour certain classes of cost that cost assessment can create. By considering total costs, it also represents the most comprehensive single view of whether a company's expenditure and plans is comparatively good value.

GD1 cost assessment document, Chapter 2: *Do you consider our approach for regional adjustments and company specific factors is appropriate, and if not what changes would you propose?*

25. Some of these pre-regression adjustments appear significant and so we believe that Ofgem should pay particular attention to ensuring they are robust. Indeed, the use of post-regression adjustments in business support costs, including changes to the results based on the findings of other analysis, seems to indicate that Ofgem does not believe the base analysis is fully robust.

26. In terms of potential further analysis that could be considered, to the extent data availability allows these to be included as cost drivers in regression analysis, this could be explored as an alternative approach.

GD1 and T1 cost assessment document, RPEs: *Do you agree with our assumptions for real price effects and ongoing efficiency?*

27. We do not comment on whether the specific indices used by Ofgem in its assessment of real price effects (RPEs) and ongoing productivity growth are appropriate for the transmission and gas distribution sectors, as the companies in those sectors will be better placed to review whether the chosen indices reflect their own patterns of cost and productivity growth.

28. However, as a general point we note that Ofgem expects RPEs to rise as the economy recovers from the recession. This fits the likely pattern based on both economic theory and evidence.

29. We also note that Ofgem states at paragraph 2.29 of its RPE appendix document that it has not used commodity price indices in developing materials RPEs as 'the network companies do not purchase raw materials but the final manufactured good', and since it has concerns that the indices will not reflect the cost of the final goods actually purchased. This appears inconsistent with the use of the machinery and plant input producer price index (PPI) as one of the components in determining the RPE for equipment and plant. Input PPI measures capture only the costs of fuel and materials purchased by manufacturers. Since this issue does not apply to the machinery and plant output PPI (which is also included), it is not clear why additional weight has been placed on a sub-set of manufacturing input costs.

GD1 cost assessment document, Chapter 3: *Do you consider our approach to totex is appropriate, and if not what changes would you propose?*

30. We do not comment on the majority of the detailed cost assessment work, as in different sectors different approaches may be warranted, and our own experience may not be relevant.

31. As a general point, however, we believe that cost assessment should be implemented in a way that avoids reintroducing unequal incentives through the cost assessment approach used.

32. In this regard, we note that the cost drivers in totex analysis also appear to include measures of workload. This may reduce the extent to which the totex analysis captures differences in efficiency which arise from approaches that reduce workload (to the extent this is possible). This is a general shortcoming of any analysis which focuses on unit costs, and the use of totex benchmarking can help balance this shortcoming of detailed unit cost assessment as part of the regulatory toolkit. Allowing it to be contaminated to a degree with measures of workload (rather than, for example, network scale) may reduce the benefits from including totex as part of the toolkit.

GD1 and T1 cost assessment document, IQI: *Do you agree with how we have applied IQI, and if not what would you propose to change? Do you agree with our approach to combining elements of the cost analysis?*

33. A specific question on the information quality incentive (IQI) has only been asked in the GD1 consultation. However, our general comments apply to both T1 and GD1 reviews as a similar approach appears to have been followed in both reviews.

34. Firstly, we agree with Ofgem's decision to establish positive rewards for companies that submit challenging cost forecasts. Particularly in sectors where costs are assessed through comparative benchmarking, failure to do so would 'bake in' an expectation that average rewards from the incentive would be negative.

35. Secondly, we have long held the view that the calibration of the IQI that is typically used at regulatory reviews fails to distinguish sufficiently between companies that have submitted challenging cost forecasts (and exposed themselves to the associated cost risk) and those which have effectively purchased low cost insurance against cost over-runs by self-selecting into one of the right hand columns. By increasing the financial difference between columns, this type of behaviour could be discouraged.

GD1 cost assessment document, Chapter 4, Question 2: *Do you agree with our proposals for smart metering?*

36. Although we are not familiar with the detailed position in the gas sector, our own experience in electricity distribution leads us to agree with Ofgem that the level of costs, and the extent to which network operators are responsible, is uncertain.

37. Given this, Ofgem's approach to providing some funding for one-off set-up costs in preparation for the roll-out appears appropriate. A re-opener to set efficient levels of expenditure, once these are known with greater certainty, also appears appropriate. We note, however, that Ofgem has not provided any up-front funding for costs (other than set-up costs) that are likely to be incurred once the roll-out starts but before the re-opener takes place. Although efficient expenditure will subsequently be funded at the reopener, Ofgem also has the option of providing 'place holder' funding for rollout costs. The extent to which individual companies have justified their expected levels of expenditure should determine whether this option is taken.

FINANCE

GD1 Finance and uncertainty document, Chapter 2: *Do you agree with the approach of using the profile for the release of backlog depreciation as a mechanism to smooth revenues and reduce their volatility through the RIIO-GD1 period?*

38. Providing that revenue smoothing is undertaken in a net present value (NPV) neutral way, does not cause potential financability issues, and is clearly signalled, we have no serious concerns with its application. This is true regardless of whether there is a notional pot of revenues arising from depreciation catch up which can be used for the purposes of revenue smoothing, or not.

39. We also note that the expected trajectory of network charges beyond the GD1 price control period may be relevant in exactly how any revenue smoothing is implemented. It is possible that the application of smoothing in this price control may lead to a larger jump in prices at the start of the next price control (or the need for further, artificial, smoothing).

T1 and GD1 Finance document, Chapter 3: *Do you have any comments on our relative risk assessment? Do you agree with our proposed elements of the allowed return?*

40. We note that early discussions of financial issues, including relative risk and elements of the allowed return, have taken place in the RIIO-ED1 finance working group. Our comments on these aspects of the proposals are therefore brief.

41. On relative risk, we note that some of the analysis in the RIIO-GD1 document covers electricity distribution. Discussions in the finance working group have highlighted that other factors could be relevant to this analysis (such as operational gearing, or the ratio of opex to RAV). However, we expect that detailed consideration of such factors will be more important when considering electricity distribution in detail, rather than in the GD1 analysis where a comparison with the DPCR5 settlement is only part of the overall picture.

42. On the cost of equity, the continuation of a long term approach to parameters remains appropriate, given volatile financial markets which at the same time suggest lower risk free rates but elevated equity risk premia.

43. On gearing, we agree that cash flow risk is a relevant consideration in identifying the level of gearing which is consistent with a given cost of equity (and an investment grade cost of debt).

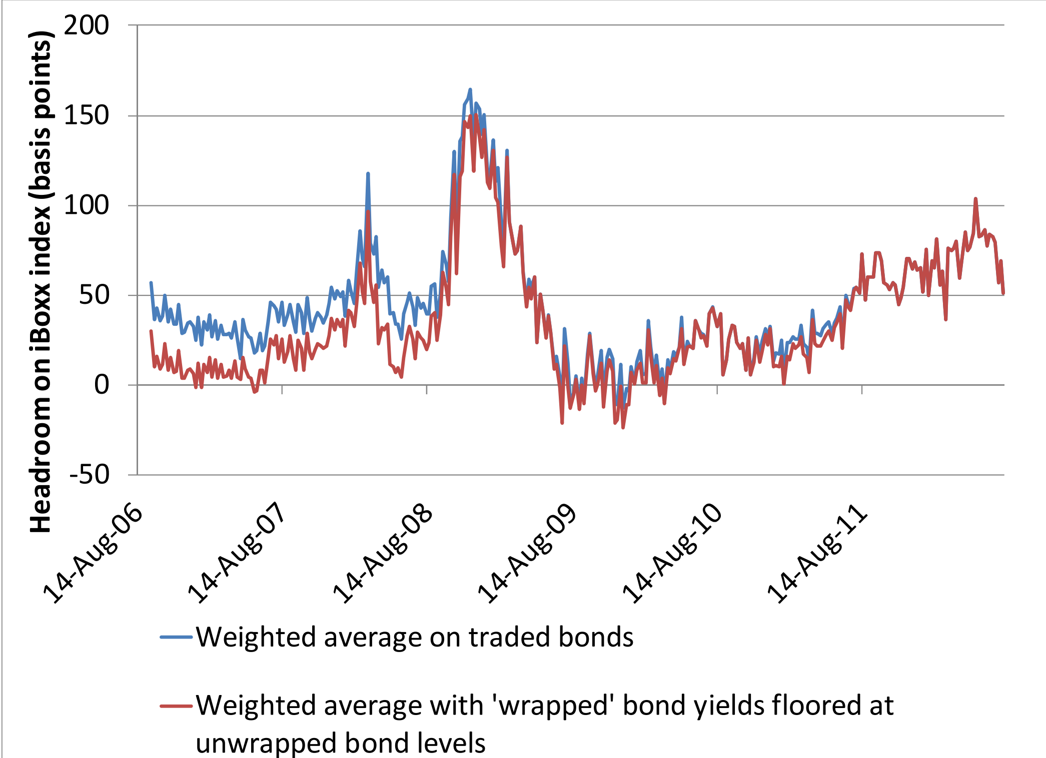
44. Finally, on the cost of debt, we appreciate Ofgem's statement that it will continue to monitor financial markets over the coming months. The index should be set at a level that allows companies to fund efficiently incurred debt, including issuance costs. Changes in the composition of the index over time could also rapidly erode any headroom that is currently being allowed, leaving the allowed cost of debt too low to cover the real cost of financing a company even if the headline debt rates match the index.

45. We also support Ofgem's proposal to make a technical adjustment to the calculation of the index. In normal debt market conditions, with positive real interest rates, failure to make this adjustment would lead to lower actual real rates being allowed than the 'headline', which would be confusing to stakeholders, and also worsen the risk that the index will not fund efficiently incurred debt funding costs.

46. To support our point that Ofgem ought to make an allowance for issuance costs over and above the value that arises from the index, we have analysed market yields on Northern Powergrid's debt portfolio to assess headroom against the index in recent years, adjusting for a credit wrap which has been paid for in fees and otherwise reduces

Northern Powergrid's cost of debt below its true level. Our findings are shown in figure 1 below.

Figure 1: Northern Powergrid's cost of debt relative to the iBoxx index



Source: Analysis based on Northern Powergrid's publically traded bonds at August 2012.

Note: The sample contains two bonds which benefit from a 'wrap' to boost their credit rating, for which significant fees have been paid. To adjust for this, the yields on these bonds have been 'floored' based on the closest comparator bond in the sample.

47. The analysis shows that under pre debt-crisis market conditions, and during the period of relative debt market stability during mid-2009 to late 2010, the iBoxx index would have only just covered the market interest rate on debt issued by Northern Powergrid.

48. Only during periods when the impact of the financial crisis has been most severe has the index included noticeable headroom relative to the rates at which Northern Powergrid's debt has been traded. These include spikes in headroom when Bear Stearns collapsed in March 2008 and a longer period later in 2008 following the collapse of Lehman Brothers and the subsequent financial difficulties of several banks

including RBS and HBOS. They also include a recent period as headroom has steadily built during the progressive emergence of the Greek crisis in 2011 and 2012.

49. The conclusion is therefore that, in practice, during more normal periods in debt markets, regulated companies will be unable to recover their efficient debt costs because there will be no headroom between the index and their headline coupon rate, leaving no allowance for issuance costs such as fees and costs of carry. Based on the amounts that we are quoted and charged when we issue debt, we believe that the use of the index to cover the cost of debt throughout the price control period should be accompanied by a premium that we estimate to be about 20-30 basis points if this mechanism is going to give a reasonable proxy for the true cost of corporate debt.

T1 and GD1 Finance document, Chapter 4: *Do you agree with our proposals for transitional arrangements?*

50. We do not have specific comments on whether the proposed package of transitional arrangements is appropriate as the *Initial proposals* do not appear to set out the detailed financial ratios that result.

51. However, we note that in a number of areas across both transmission and distribution, Ofgem has shown itself willing to use changes to the capitalisation rate as a policy tool. We have previously encouraged Ofgem to consider all the options it has available to it to address transitional issues, including the capitalisation rate, and so support Ofgem's exploration of wider options beyond those which were most immediately apparent.

52. We also support the use of company specific capitalisation rates as in the RIIO-T1 *Initial proposals*, reflecting the individual position of the company both in relation to transitional issues and its programme of expenditure. If there are any significant differences between the gas distribution companies (either in their programmes of expenditure, or modelled financial ratios) then we believe a company specific approach should also be considered for RIIO-GD1.

T1 and GD1 Finance document, Chapter 5, Pensions, Question 1: *Do you agree that companies must demonstrate a robust approach as to how their de-risking strategies, especially if aggressive, are protecting future scheme funding and that they should clearly demonstrate the benefits that they expect to flow to consumers?*

53. We firstly note that it is the Trustees of a pension fund that determine its investment approach, and not the companies as the question incorrectly states. We are concerned that this may be more than merely imprecision in drafting. Whilst we accept that it is appropriate that the Authority should seek to hold the licensees accountable for their managerial activity in relation to pension costs, it is essential that Ofgem ensures that it bases its assessments on the reality of the situation, in particular on the level of influence that management actually has on pension schemes that are specifically protected by law and are governed strictly by the regulations and legal obligations that stem from pensions regulation. It is unhelpful that Ofgem, from time to time, appears to presume that the schemes are run by the licensees and that a company's management has more influence over scheme rules, investment decisions and deficit valuations than it actually has.

54. The principled approach to assessing the established deficit was set out in the June 2010 decision on the price control treatment of pension costs. Provided that the rigorous, two-stage process envisaged when this approach was developed is followed, then customers should be protected from poor stewardship of pension schemes. There is no reason that additional tests should be required regarding demonstrating benefits to customers, and we believe that implementation of any such tests would be a material departure from commitments made by Ofgem at previous price controls. We believe that it is very important that Ofgem is not seen to be re-opening any element of its pension commitments. Failure to observe the process that has already been set out or the introduction of additional tests casts doubt upon that commitment. This increases investors' perception of risk and makes it harder for them to have confidence in regulatory stability.

55. We do however appreciate that Ofgem may be concerned that the maturing age profile of many network operator defined benefit schemes may be causing Trustees to pursue de-risking strategies at precisely a time when customers *may* stand to benefit if higher

risk (e.g. equities based) investment strategies are pursued. If Ofgem believes that such potential benefits for customers outweigh the risk associated with such investments (coupled with the need to make payments to pension scheme members regardless of investment performance), then Trustees *may* be willing to adopt such strategies if Ofgem makes firm commitments to fund pension provision even if riskier investments perform badly. Both the rewards and risk from the investment strategies could then be transferred to customers, which would be a balanced outcome.

T1 and GD1 Finance document, Chapter 5, Pensions, Question 2: *Do you agree that the costs of contingent assets may be allowed if considered to be in consumers interests?*

56. The *Initial proposals* do not provide details of the costs of contingent assets proposed by NGET, making comment difficult.

57. However, as a general point, and as noted above, the principled approach to assessing the established deficit agreed as part of previous price control reviews should be used to determine if the stewardship of schemes is reasonable and efficient. Additional tests for whether the costs associated with particular assets should be allowed are not necessary.

T1 and GD1 Finance document, Chapter 5, Pensions, Question 3: *Do you agree with the thresholds for pension scheme administration costs and Pension Protection Fund levies?*

58. We cannot comment on whether the thresholds Ofgem is proposing are appropriate for the schemes of other companies. However, if the thresholds are set at a level which is unlikely to be breached, then Ofgem should pay careful attention to ensuring that it does not set the allowances at a level that is too low. Otherwise, there would then be no mechanism for reasonable and efficient costs above the allowance to be recovered, and costs above allowance would persist for the whole review period.

T1 and GD1 Finance document, Chapter 5, Pensions, Other comments:

59. We note that paragraph 5.3 of the RIIO-GD1 document the document indicates that the regulatory fraction will be determined by the new pension deficit allocation methodology *for all network operators*.

60. This comment should be clarified, as the June 2010 decision on price control treatment of pension costs was more specific on how the regulatory fraction would be determined for some network operators. In particular, for electricity distribution network operators (DNOs) this includes the provision that the fraction is likely to rise over time, where DNOs can justify this based on the records they hold.

T1 and GD1 document, Chapter 6, Tax, Question 8, *Do you agree with conforming the revenue adjustment for tax clawback to be annually in line with the annual iteration process?*

61. Based on the experience in the gas distribution, where the relevant amounts are small, there appears to be no reason that the tax clawback should not be conducted annually through the normal process.

62. We also note that, at paragraph 6.26 in the RIIO-T1 document, an argument by NGET that the tax clawback for excess gearing should be relaxed up to a certain threshold is dismissed on the basis that companies will be funded for issuance of new equity.

63. While this may be the case for those companies that have been given an allowance for notional equity issuance, it appears inconsistent with the threshold used in calculating whether an allowance should be made for notional equity issuance. To ensure consistency, the same gearing threshold could be applied to tax clawback as is used for notional equity issuance (for those companies which do not receive an allowance).