CONSULTATION ON THE STRATEGY FOR RIIO-ED1

THE RESPONSE FROM NORTHERN POWERGRID

23 November 2012

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EXECUTIVE SUMMARY

1. Northern Powergrid believes Ofgem's strategy consultation is a positive step in the implementation of the first 'Revenue set using Incentives to deliver Outputs' based price control for the electricity distribution sector (RIIO-ED1).

2. The review has been conducted effectively to date. Ofgem's working groups have helped ensure that there were no major surprises in the strategy consultation. We also welcome the fact that Ofgem has taken early 'minded to' decisions where the good work done at the fifth electricity distribution price control review (DPCR5) made it feasible to continue established policies. This approach has allowed more time to be devoted to the more challenging issues of the review.

3. The facilitation of low-carbon technologies is a key challenge for the review to which significant effort is being dedicated. We believe that the correct approach is being taken in this regard, and we support Ofgem's approach in three key areas.

    - *Firstly, the adoption of a 'technology neutral' approach that sees companies incentivised to provide good customer service and fast connection times, regardless of whether the connection is traditional or low-carbon.* By putting in place appropriate incentives across the board, Ofgem will achieve its objectives for all customer groups *including* customers connecting low-carbon technology.

    - *Secondly, Ofgem's proposal to adopt a low-carbon technology volume driver, an innovation that we have undertaken significant work to develop.* Allowances that flex in response to the level of low-carbon technology actually connected will allow companies to respond with the required investment, while avoiding the need for customers to fund significant reinforcement before requirements are clear.

- *Thirdly, the uncertainty mechanism for certain smart meters roll-out costs.* This mechanism is appropriate because while companies have forecasts of the volume of work required, this is based on limited evidence to date.

4. Northern Powergrid is also positive about the proposed approach to outputs and associated incentives, in each of the six output areas.

- **Environment:** the arrangements for network losses are probably the best that are possible, given the measurement problems that exist with the data.

- **Reliability:** the retention of the interruptions incentive scheme (IIS) in its current form, with a similar incentive rate, is a policy we support that makes use of the established framework from DPCR5. The preferred option of setting upfront targets is sensible, given the relatively well understood approaches to target setting, and the fact that this allows companies the opportunity to fund improvements through the incentive scheme. Likewise, the facility for rebasing targets if significant disruption is caused by the smart meter roll-out revealing data issues is an important complement that limits otherwise significant risk.

- **Customer service:** The proposed strengthening of the broad measure of customer satisfaction (BMCS) incentive makes sense now that the scheme is bedding in. The developments proposed to the survey (such as a separate survey for major customers, and including all channels of communication) are largely ones we have advocated through working groups as they improve on the existing arrangements.

- **Connections:** A time to connect incentive could also have advantages, though the system will need to be designed carefully to avoid perverse incentives.

- **Safety:** We support the proposed approach as it recognises the established and effective role of the Health and Safety Executive (HSE) in setting and assessing the primary output, while making safety one of the relevant factors in the framework for the asset health secondary deliverable.

- **Social:** Ofgem is right to identify that any social outputs should be close to the core purpose of the network, and while this places a limit on the scope of initiatives that distributors can pursue, we believe that innovative approaches to collaborative working are possible and would be worthwhile.

5. We strongly endorse the proposed increase to the incentive rate for cost efficiency within the price control period. This reflects the maturity of the sector (in the sense that incremental savings generally become more difficult to achieve as efficiency levels improve), and the imperative during the low-carbon transition to ensure that cost savings due to innovative approaches are found so they can be passed to customers in future. However, the proposed incentives for achieving fast-tracking, and developing challenging forecasts (the information quality incentive), should be strengthened since they are currently not 'incentive-compatible' with fast-track being the most advantageous outcome for both licensee and customers. These incentives can deliver significant benefits to customers in terms of lower long-term costs, and are important in ensuring that the best-performing companies are capable of earning double digit equity returns. Likewise, there should also be a commitment that fast-tracked companies will receive an increase in their rewards in the unlikely event that a slow-tracked company receives an overall more rewarding deal, to ensure that the incentive to pursue fast-track is retained for the long-term.

6. Ofgem's strong endorsement of total cost benchmarking is welcome because it reinforces one of the cornerstones of the RIIO framework. While we expect Ofgem to make full use of its 'toolkit' approach to cost assessment, total cost

benchmarking does not favour any particular delivery approach (operating cost, or capital-intensive), and places emphasis solely on minimising costs to customers. While other approaches, such as the 'bottom-up' benchmarking of unit costs, can reveal important information, they do not assess the volume of work undertaken, and so miss a fundamental determinant of what end-users pay. Crucially, the top-down, total cost approach is the only approach that allows a company that spends money to work out how to manage with less capital investment activity to be properly assessed.

7. Finally, in terms of financial issues, the setting of a relatively narrow range for the cost of equity at an early stage helps give investors the certainty they need to continue making long term decisions to fund assets, and the level set and approach to assessment has been well consulted on in the RIIO-T1 and GD1 reviews. The indexed approach to the cost of debt is a concept to which we have no objections, although the lack of a long enough data series and any specific treatment of issuance costs means that the application of the 'vanilla' method would set the allowed cost of debt well below our actual debt costs. We believe that it is reasonable for Ofgem to make an allowance for issuance costs and to contemplate progressively lengthening the data series as it becomes available. In the meantime, Ofgem should consider making short-term, pragmatic adjustments to the raw output of the trailing average calculation. The approach to establishing gearing within the RIIO framework, based on factors such as cashflow risk, is appropriate and is the one we expect to use in our business plan. And lastly, Ofgem is right to recognise that transitional arrangements may be needed in light of the extension of asset lives, and that companies should be required to justify their approach to transition in their business plans.

INTRODUCTION

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 *Strategy consultation for the RIIO-ED1 electricity distribution price control* (the Consultation).

2. This document sets out Northern Powergrid's views on key aspects of the Consultation.

3. We are also providing a separate supplementary document in which we set out our answers to the specific questions Ofgem has asked.

4. In this document we set out Northern Powergrid's views on key issues covered by the Consultation, in each of the following areas.

    - Overall reaction, including Ofgem's process of stakeholder engagement and the form of the control;
    - The proposals for facilitating the deployment of low-carbon technologies;
    - Outputs, incentives and innovation;
    - Assessing and rewarding efficient costs;
    - Managing uncertainty; and
    - Financing delivery.

We cover each area in turn below.

OVERALL REACTION

The form and structure of RIIO price controls has been consulted on well.

5. The form and structure of RIIO price controls has been consulted on through the RPI-X@20 review process, the publication of the RIIO handbook, and the consultations that have taken place through the RIIO-GD1 and RIIO-T1 process.

6. The overall approach is one that we welcome and look forward to continuing to work within.

Ofgem's RIIO-ED1 working groups have been a success.

7. The RIIO-ED1 working groups have facilitated a dialogue that has resulted in very few surprises for Northern Powergrid in the Consultation.

8. Overall the amount of time devoted to the topics has meant it has been possible to cover everything to a reasonable degree. The introduction of other, non-industry, stakeholders to the process has broadened the interests that are represented in the process.

The policy thinking is clearly well advanced in many areas.

9. The proposals set out in Consultation demonstrate that Ofgem's thinking is well advanced in many areas.

10. While this reflects where the RIIO process requires us to be, Ofgem should be congratulated for having achieved it, especially given the relative newness of the framework.

We welcome the fact Ofgem has taken early decisions where possible.

11. The degree to which the policy thinking has been progressed so far to date no doubt reflects Ofgem's willingness to take a proportionate approach to areas where DPCR5 provided a well-established framework, and to take decisions early in these cases.

12. This has freed up more time to concentrate on the more challenging areas to date, and also means that more time can be devoted to policy areas that still require further development between now and the strategy decision in February 2013.

…and we appreciate the added clarity on process the document brings.

13. The additional details on process and timetable set out in the Consultation bring helpful clarity.

14. We especially welcome the commitment to take a fast-track decision alongside the initial assessment. Although Northern Powergrid believed it was appropriate for Ofgem to provide iterative feedback to the transmission companies during their fast-track process, because they were the first companies to go through a new process, the requirements should now be clear. By removing any iterative feedback process, the incentives for the submission of a well justified business plan in the first instance are strengthened.

15. We also support the recognition by Ofgem that there may still be the need for some adjustments to the detail of a fast-tracked company's business plan.[1] While we support the proposal that there should not be a process of iterative feedback, a business plan which meets the overall required standard for fast-tracking may still have specific areas that warrant changes.

Opportunities to address the Authority are also an important aspect of due process.

16. The RIIO-ED1 process should give Distribution Network Operators (DNOs) the opportunity to address the Gas and Electricity Markets Authority (the Authority) at all relevant stages of the price control.

[1] See the Consultation, Business plans and proportionate treatment document, paragraph 3.10.

17. Ofgem is right to propose that all DNOs should have the opportunity to address the Authority upon submission of their initial business plans. For any slow-tracked DNOs, this should also include a similar opportunity upon submission of their revised business plans, and upon publication of Ofgem's draft determination. This opportunity to address the Authority after publication of the draft determination is an important element of due process, since at this stage slow-tracked companies will, for the first time, have had sight of the settlement Ofgem is proposing to make, which may well differ from the settlement they had proposed in their own business plans.

18. There may even be a need for any fast-tracked companies to address the Authority at this stage of the process. This would be the case if the fast-tracked company considered that the proposals for the slow-tracked companies were more favourable in an important respect and that the fast-tracked company had been disadvantaged by accepting the fast-track proposition.

FACILITATING LOW-CARBON TECHNOLOGIES

We agree with Ofgem that our role is to facilitate low-carbon technologies in the same way we facilitate any technology.

19. Low-carbon technologies require available capacity, timely connections and good customer service in the same way that traditional technologies do. Ofgem's approach to ensuring good customer service and the facilitation of connections for low-carbon technologies by putting in place a framework to encourage companies to provide *all* customers with good service is therefore appropriate.

20. The BMCS and time to connect incentive are just as appropriate for connecting low-carbon technologies (both demand and generation) as they are for all other technologies. Likewise, the behaviours encouraged by the IIS benefit both the users of traditional and low-carbon technologies. Overall, this technology neutral approach ensures that there should be no distortion,

either to hold back or favour, low-carbon technologies, and reflects the role of the DNO as a facilitator of customer needs.

Uptake is uncertain, so we agree a low-carbon technology revenue driver is needed…

21. While customers' behaviour with respect to traditional technologies is relatively predictable, allowing network reinforcement allowances to be largely fixed in advance, the uptake of low-carbon technologies is subject to significant uncertainty.

22. A revenue driver is therefore required for low-carbon technologies, to cover the associated reinforcement costs that are not covered in base allowances, or covered by customer contributions. The purpose of this revenue driver should not be to incentivise the deployment of low-carbon technologies but to allow DNOs to be remunerated where this occurs.

23. Northern Powergrid advocated such revenue drivers in its initial issues consultation response. The company believes that any such framework should:

- be simple and easy to implement and understand;
- relate directly to the take-up of low-carbon technologies by end-users, rather than network interventions that may occur because of other factors;
- ensure that customers pay only for assets or other technical or commercial solutions that they actually require; and
- maintain the strongest possible incentives for DNOs to innovate and achieve cost savings during the transition to the low-carbon economy.

...which should use the £/MW of connected low-carbon technologies as the revenue driver to ensure that strong incentives for cost efficiency and innovation are maintained.

24. Northern Powergrid's full views on the appropriate revenue driver to adopt are set out in our paper, presented to the flexibility and capacity working group in August 2012. This paper is attached as a supplementary paper to this consultation response. Since that time we have continued to work on developing these proposals and in light of more recent discussions we propose to update the paper and submit this to Ofgem for its consideration.

25. Our view remains that the £/MW of connected low-carbon technologies revenue driver has significant advantages over the alternative option set out in the Consultation, because it maintains stronger incentives for companies to innovate and find ways of reducing costs during the transition to a low-carbon economy, which is one of the key objectives of the RIIO framework.

26. Although we have already undertaken significant work to develop a workable mechanism based on these principles, we expect to undertake further work with the industry and Ofgem to develop the approach further in time for the strategy decision. In particular, we expect that it will be possible to develop a revenue driver based on pounds per MW of installed low-carbon technology that avoids potential boundary issues with the connections funding arrangements. For example, for existing class 1-4 customers who are installing low-carbon technology, the socialisation of connection charges will mean that the only funding route is via the price control uncertainty mechanism.

A new uncertainty mechanism is also needed for smart meter roll-out.

27. The nationwide roll-out of smart meters is another key development in the move to a low-carbon economy. While DNOs are not responsible for the roll-out, it will impact on assets we own or operate, and could also reveal pre-existing problems with these assets that require action.

28. Northern Powergrid, as well as other companies, has already undertaken work to estimate the scale of the potential underlying issues. These estimates have, however, been based on limited data and the exact frequency of DNO intervention will only become clear as the roll-out begins to make significant progress. An uncertainty mechanism based on a volume driver is therefore appropriate.

29. We expect to include other costs as part of our business plan, such as for the IT systems required, and the licensing fees that must be paid to the data communications company (DCC). While we are unlikely to have completed the procurement exercises necessary to include exact expected costs, we should know enough about requirements to include reasonably well justified costs in our business plan (provided there are no delays to the concurrent processes involved in the smart meter roll-out).

There is no longer a need for a separate DG incentive.

30. The purpose of the Distributed Generation (DG) mechanism was primarily to provide funding to cover the network costs associated with DG uptake.

31. Extension of provisions for demand connections to cover generation is appropriate and could usefully be combined with the low-carbon technology revenue driver in order to provide this funding through an alternative route. The extended range of incentives Ofgem proposes for timely connections that are provided with good customer service should also benefit customers who require a connection for any reason (including because they are installing low-carbon technologies).

32. Northern Powergrid therefore agrees with Ofgem that there is no need for the existing DG incentive to remain in place.

The change to connection boundaries for class 1-4 customers is a practical step.

33. Northern Powergrid agrees with Ofgem that connection charges play an important role in sending locational signals, so that customers take into account the full costs of their decisions.

34. However, it would be practically difficult to impose connection charges on new installations of technology by individual domestic or small business (class 1-4) customers at premises that are already connected. We therefore support Ofgem's proposal to 'socialise' the costs associated with these existing customers installing low-carbon technologies (in the same way it would in practice be socialised at present if their installation of an additional washing machine or fridge freezer were enough to trigger reinforcement requirements and they were not exceeding the normal capacity considered appropriate for domestic premises).

35. The proposed exception for customers who install devices which, in and of themselves, cause power quality issues, or where a third party (such as a housing association) triggers widespread installations of new technology, are appropriate. We also believe that these proposals are broadly in line with current arrangements, and that they should therefore be entirely implementable through existing industry arrangements. The power quality exemption should act to incentivise the sale and installation of devices which meet industry accepted standards, while the carve out for organisations triggering multiple installations in a particular area reflects the fact it is significantly more practical to levy connection charges in such circumstances.

Smart grids and the role of the DSO can evolve in parallel to the review process.

36. We agree with Ofgem that the current regulatory arrangements present no specific barriers to DNOs rolling out smart grid solutions, or taking a more active role in managing demand and generation on their networks (i.e. a

distribution system operator, (DSO) role). The package of incentives being put in place should also actively encourage companies to identify the lowest cost solutions to any given issue, and where smart grid solutions are appropriate companies should have every incentive to implement them.

37. Furthermore, we also agree with Ofgem that the development of mechanisms to ensure that the role of the DSO leads to the most efficient outcomes across the whole value chain is not something which requires consideration as an immediate issue during the RIIO-ED1 period. This may therefore be addressed through a parallel, evolutionary, process.

We agree that a review of the Network Innovation Competition two years into RIIO-ED1 makes sense.

38. Northern Powergrid is an active participant in the DPCR5 Low-carbon Networks (LCN) Fund, and is implementing the largest project approved under the arrangements to date.

39. A large amount of customers' money is being invested, and so it is appropriate that Ofgem should want a full value for money appraisal of the scheme to inform the future approach.

40. Providing Network Innovation Competition (NIC) funding for the first two years of RIIO-ED1, at the levels proposed in the Consultation, is sensible. This should allow time for the benefits of the DPCR5 LCN Fund to be assessed through a full review conducted in 2016, while in the meantime allowing levels of electricity distribution funding to continue at or reasonably close to DPCR5 levels (depending on levels of demand relative to transmission).

OUTPUTS AND INCENTIVES

The new losses arrangements are the best that can be done in a challenging area.

41. Quality problems with losses data mean that the losses arrangements put in place at DPCR5 could not be retained in the DPCR5 period or in the RIIO-ED1

period, and we welcome the fact that this has been recognised by Ofgem in its proposals.

42. The decision to take a different approach to incentivising loss reduction has another positive aspect. Although it is always desirable for network losses to decrease in any situation where all other things remain equal, it must also be acknowledged that changing patterns of use of the network also have scope to increase levels of network losses while overall carbon intensity is reduced (for example due to the deployment of distributed generation). Setting rigid targets against this background would either expose DNOs to significant penalties, or create an incentive for companies to fail in facilitating their deployment. This outcome would not be appropriate.

43. Ofgem has sensibly drawn together elements from several proposals to put together a comprehensive package of measures which does not suffer from the problems described above.

44. The losses reduction discretionary reward is an appropriate complement to a duties- and allowance-based approach. At £32m the reward appears to be calibrated to a sensible level, giving scope for significant rewards where any individual DNO is able to make significant contributions to future best practice.

We support the further development of asset health and loading secondary deliverables…

45. Northern Powergrid agrees that it makes sense to incorporate criticality into the asset health indices (HI). We also agree that establishing a profile for load indices (LI) makes sense, in a world where significant deployment of distributed generation will alter load by an uncertain amount, and given the proposals that we would receive additional cost allowances through an uncertainty mechanism.

46. Ofgem is correct to stress its intention that there will be no in-period financial incentives attached to moving outside the bands. To implement

such an approach would constrain DNOs from taking decisions to re-profile expenditure and work programmes in ways that could otherwise have significant benefits for customers, for example through achieving lower costs.

47. We believe that it should be possible to establish a common framework for measuring these secondary deliverables across DNOs, to ensure a degree of consistency, and support Ofgem in its ambition to establish this.

…but believe that Ofgem is right to ensure that these indices remain secondary.

48. We believe that, used appropriately, load and health indices provide a sense-check on whether a DNO may have under-delivered over the course of the price control period. However, we can also see that this is an area where it would be relatively easy for Ofgem's decisions unintentionally to lead to a stifling micro-management of company decisions. As set out in our response to the initial issues consultation, we believe that avoiding this risk should be one of the strategic imperatives for the review.

49. If a company has not met its secondary deliverables, that is the time for more detailed investigation to understand whether under-delivery of outputs has actually occurred. If this is found to be the case, Ofgem should be able to take this into account at future reviews, including through adjusting the value of the future settlement to reflect justified over-delivery, or unjustified under-delivery.

50. The indices are not, however, well suited to *mechanistic* financial incentives or comparison across companies. Put simply, they do not measure an output, and should only ever be treated as a means to an end. Any move to harmonise the industry onto a single metric for the HI (for example) that quantifies all its components on a common basis, would effectively lock the industry into a set of assumptions that may be flawed, and outcomes based on those decisions would reflect these flaws.

51. Likewise, the more that delivery against these indices is rigidly interpreted, the less incentive companies will have to innovate or improve their data. Although we appreciate that Ofgem still wants companies to take these actions, relying too heavily on these indices (or mechanistic financial consequences based upon them) will have a damaging impact on incentives, at a time when the opposite is needed. We do, however, welcome the fact that Ofgem has made clear its intent that over-delivery of outputs could be given financial reward. But we still believe that (as in the case of under-delivery) detailed case specific scrutiny would be required to decide that a reward was justified, and that customers were receiving a benefit proportionate to the reward enjoyed by the over-delivering company.

Setting out draft targets for the IIS gives us a clear long term goal…

52. We support Ofgem's preferred option for establishing IIS targets at the outset of the review.

53. Targets that are fixed well in advance are easy to communicate to stakeholders and employees. But more importantly, they provide a mechanism through which companies can fund service improvements. In the case of IIS, this is underpinned by an incentive rate that has been based on the willingness to pay of customers.

54. The methodology that has been used to establish the draft targets is well understood across the industry. Although some work will be needed to fine tune calculations underlying the proposed targets, Ofgem's expedited treatment of this area is therefore welcomed as being proportionate. The one significant issue we believe should be addressed is the inappropriately high improvement factors assumed for customer interruptions where companies are below benchmark, given that this is an area where it is relatively expensive to achieve improvements. We also note that if cut-out failures are included in the mechanism then targets would need to be adjusted to take this into account, and this may be easier to implement at RIIO-ED2 after the roll-out of smart meters.

55. The other potential approaches to target setting are inappropriate. A rolling, downwards-only ratchet mechanism is inappropriate because of the volatility of the data due to weather patterns, while a relatively short term ratchet (e.g. three years) would reduce the funding companies can utilise for service improvements to levels that are well below the value suggested in willingness to pay surveys. Likewise, targets that are regularly re-set based on comparative performance make the ability of companies to fund improvements through the mechanism far less certain, and companies could find that having improved reliability they end up without the funding that pays for the improvement. Although it could be argued that uncertainties like this are common in competitive markets, they are not compatible with the low cost of capital assumed by Ofgem for network companies.

56. The mechanism Ofgem proposes for re-basing of the targets if the roll-out of smart meters causes a significant discontinuity in the dataset is an important aspect of the proposals that Northern Powergrid supports. Otherwise the roll-out of smart meters has the potential to create significant windfall gains or penalties through the IIS. This would increase the risk of the settlement with no offsetting benefit for customers.

57. Finally, we also note Ofgem's request for views on whether a rolling incentive similar to the shrinkage incentive in gas should be introduced. This sort of approach has the advantage of maintaining strong incentives towards the end of a price control period, and also basing targets on a company's own historic performance, which reflects the inherent characteristics of its distribution services area. However, it would be a significant departure from existing arrangements and so would have to be implemented in a way that avoided serious discontinuities, or suffered from the fundamental problems that affect the rolling average options set out in the Consultation.

…while a symmetric cap would not be inappropriate…

58. In terms of potential rewards or penalties, the re-introduction of a cap on out-performance under the scheme would be reasonable if Ofgem wishes to implement this aspect of its proposals.

59. Although it could potentially limit the incentive for companies to seek further improvements, provided it is symmetric with the collar this balances risk between companies and customers in an appropriate way. The level of the cap should be set at a level that allows for the investments that support the improvements to the network that are required to meet the target. The range suggested by Ofgem (250-300 basis points on the return on regulatory equity (RORE)) should allow this.

60. The increase in downside exposure relative to the DPCR5 settlement (which limited exposure to 139 basis points on RORE), would however increase the level of risk facing companies. Ofgem would need to take this into account in calibrating the overall RIIO-ED1 settlement,

… and the incentive rate should be maintained at DPCR5 levels.

61. The incentive rate used in the DPCR5 period has proven itself to be a level capable of funding significant improvements in DNO performance. There is no strong reason to change significantly the incentive rate for RIIO-ED1.

62. We recognise Ofgem's desire to maintain consistency with the incentive rate used in the RIIO-T1 settlement. However, the wide range for willingness to pay established by Reckon and used as the basis for business plans in that sector is also likely to contain the DPCR5 value, indicating there is no need for any significant change in the electricity distribution arrangements. Moreover, if consistency with the reliability aspects of the RIIO-T1 outputs was viewed to be especially desirable, there could be no justification for Ofgem's proposed cap on outperformance in RIIO-ED1, since the RIIO-T1 incentive has none (other than the natural 'cap' at zero energy not supplied).

63. Similarly, while we accept the logic that the efficiency incentive rate should be applied to the amount customers are willing to pay, this is not the only factor which should determine the IIS incentive rate. This is because company expenditure is not the only determinant of performance under the scheme. From year to year there is also significant volatility due to prevailing weather conditions. Any increase in the incentive rate would therefore increase cashflow volatility and thus impact on the cost of capital (through the gearing rate under the RIIO approach to establishing financing parameters). Therefore, any reason to increase the IIS incentive rate for the RIIO-ED1 period is mitigated, at least to some degree, by the additional capital cost which would be imposed by such a change.

64. We note that Ofgem has stated that it would be willing to consider company proposed incentive rates, and Northern Powergrid would support such a policy as being consistent with the RIIO principles which place more emphasis on the total package being proposed by companies.[2]

We do not intend to oppose the proposed change to a 12 hour restoration standard but we do not think this is the best use of the money that is needed to meet it.

65. While we can accept the change to guaranteed standards (GS) from 18 hours to 12, we must be clear that this move is not costless. We have not identified this move as a priority for customers through our stakeholder engagement, and therefore believe that there would be better ways to spend the money this will drive into our business plan, for example on improving the service to connections customers, where we believe there is a more compelling case for continuing improvements across the sector.

66. If we perform as we currently do, making payments to our customers who have a power cut that lasts between 12 and 18 hours long will cost £1.4m to £1.9m in additional payments per annum across Northern Powergrid's

[2] See the Consultation, Reliability and safety document, paragraph 4.9.

distribution services area (depending on the level the payment is set at). The costs of meeting the new standard are ones which we will have to include in our business plan, although we would have preferred not to do so.

The developments to the Broad Measure of Customer Satisfaction are in the right direction…

67. Northern Powergrid supports the changes that Ofgem is proposing to make to the BMCS.

68. The increase in incentive exposure is correctly judged given we are now developing experience of the arrangements in the DPCR5 period.

69. The changes to the survey Ofgem is considering are also sensible developments. In particular it makes sense to separate major from minor connections, as these two groups have very different needs, and because major connections customers spend very sizeable amounts of money but at present will receive very little weight in the survey outcomes (since the value of each connection they undertake will be much higher than that of the average customer, but they will have only an average likelihood of being chosen). As Ofgem notes, the survey may need to be more qualitative in nature, since the current 'one size fits all' approach may not adequately reflect their requirements, and as a result it will need careful attention if it is to be designed appropriately.

70. Ofgem has also consulted on whether it is appropriate to place additional weight on the satisfaction of connections customers with the information that they receive from DNOs. We believe that additional weight would be worthwhile in this area, because at present only those customers who take forward a quote are surveyed, while good information can actually benefit a much wider pool of customers. In particular, if customers receive good information that allows them to take a decision not to go ahead with a connection before they have received a quote, they may be very happy that their time has not been wasted. However, the current arrangements would

not capture the views of these customers. An easy adaptation to the arrangements, to increase the weighting on the information provision component of the questions for customers whose details are available, would balance this current shortcoming in the survey's design.

71. Ofgem has also consulted on whether customers who make contact (or are contacted) via a range of routes should be included in the survey. Northern Powergrid believes that, where individual contact is made with a specific customer, those customers should be included in the survey sample. This includes examples such as where a customer makes specific contact via social media, and changes to the survey to reflect this should remove any potential distortion for DNOs to concentrate only on traditional routes of communication (when there may in fact be customer demand for other routes as well).

72. Northern Powergrid also believes that the same approach should be applied to outbound communications, provided that specific contact is being made with individual customers. This would include outbound calls by DNOs to customers (or potentially communications via other routes). For example, best practice might be to contact customers suffering an intermittent fault as soon as a DNO knows that they have been interrupted again, by calling or texting, to let them know the company is aware they are off power and working to solve the problem. At present, however, these customers would not be captured in the sample. There are of course a number of design issues that would be addressed in incorporating outbound communications but we believe they should be possible to resolve. In particular, 'broadcast' messages should not be included (whether via social media, text,[3] or telephone campaign) to ensure they do not swamp the sample, as Ofgem notes would be a possibility in the Consultation.

[3] Other than text messages that are specific to a particular premises, which should be in-scope.

… and serious consideration should be given to fixing absolute performance targets for the RIIO-ED1 period.

73. The current arrangements drive incentive outputs annually based on comparative performance of the various DNOs. The drawback of this approach is that it weakens the ability of companies to fund improvements in customer service through the incentive scheme, since better performance may not lead to higher allowed revenues if the benchmark moves.

74. A set of arrangements that fix targets for the duration of the RIIO-ED1 period, as is being implemented in the RIIO-GD1 price control, would solve this issue, and ensure that companies can plan their customer service improvements based on a judgement of whether the improvements targeted are worthwhile under the incentive scheme.

Care must be taken to avoid perverse incentives if a telephony response incentive were to be reintroduced…

75. The consultation also asks for views on the reintroduction of the telephony answer rate as part of the BMCS incentive arrangements.

76. Northern Powergrid is concerned about this development because of its potential to reintroduce distortions. Its removal from the DPCR5 arrangements once the BMCS was active was a deliberate choice, and any move to reintroduce it would need to give serious consideration to how the following problems could be dealt with.

- Firstly, the data across DNOs is not comparable (due to differing capabilities of telephone systems or service provision arrangements for monitoring dropped calls).

- Secondly, an incentive to maximise the answer rate (and minimised 'dropped calls') creates a perverse incentive to try and keep customers on the line *even when they may be better served by another route*. For example, giving customers in a telephone queue the option of a call

back, or a text update service on a power cut, would be penalised under a simple response rate incentive as the number of dropped calls would increase.

…and incentives on competitive connections market segments should be proportionate.

77. Ofgem is right to propose that both the BMCS and the time to connect incentives will be withdrawn from connections market segments that have passed the competition test. Once competition is known to be effective, the incentives would no longer be required (since competition provides a customer based incentive that balances good customer service and low prices). Once the test is passed, continued incentives could serve only to distort the market (even if they are penalty only, since DNOs may be encouraged to take actions to avoid the risk of a penalty that they would otherwise not pursue).

78. The arrangements should be designed in a way that ensures that incentives on any remaining market segments are proportionate. The Consultation suggests reducing the scale of the incentive depending on the *number* of market segments that have not yet passed the test. It would be more proportionate to scale the incentives back based on the proportion of activity *by value* that takes place in the respective market segments.

79. In Northern Powergrid's experience the difference can be significant. For example, across the company's two licensees in 2011-12 we estimate that two market segments account for around 80% of activity by value. If these market segments passed the test, it would be appropriate for about 80% of the incentive strength to be withdrawn (to reflect the scale of the remaining segments). However, if the number of market segments were used to scale back the incentive, 75% of the incentive strength would be concentrated on only 20% of the activity. This would be a disproportionate incentive on a small proportion of transactions (by value).

80. Since market value can only be estimated by DNOs (where other companies have undertaken work), and can change from year to year, a practical way of recognising this issue would be to establish *ex-ante*, either for each DNO or for the whole of GB, the approximate value of each market segment, and establish a basket of weights for the withdrawal of the incentive based on this.

81. The same principles should also apply to the strength of the incentive placed on each individual market segment when the incentive is in operation.

The time to connect incentive will need to be carefully monitored as it beds in.

82. Ofgem is correct to note that the speed of a connection is only one aspect of customer service. The overarching connections customer service incentive should itself incentivise companies to provide faster connections.

83. Based on the results of our own stakeholder engagement we also agree with Ofgem that speedy connections are an important customer demand that require special focus. We therefore agree with Ofgem's ambition to increase the degree of focus on this area in general.

84. However, Northern Powergrid believes that any time to connect incentive must be designed carefully in order to avoid the potential for perverse incentives.

- It should be as broadly based as possible, to avoid encouraging DNOs to favour fast delivery of one type of activity over another.
- 'Stop the clock' provisions should be avoided, as they could remove the incentive for DNOs to work to try and resolve the issues with the customer as soon as possible.
- There should be no ability to remove quotes from the process where customers have filled in forms incorrectly, as this could remove any

incentive to develop forms that are easier for customers to fill in correctly in the first place.[4]

85. In implementing a time to connect incentive, we also expect that there will be significant work required to ensure data comparability across the DNOs.

86. Having regard to all these issues, we agree with Ofgem that the incentive strength should be limited, in order to ensure it does not outweigh the direct incentives for good customer service already provided through the BMCS. This should allow the BMCS to balance the risk of perverse responses to the BMCS.

87. Ofgem should also consider retaining the option of reviewing the incentive at the mid-period review of outputs in order to assess whether the incentive is delivering on customer requirements. If fixed targets have been established (as Northern Powergrid advocates) these would therefore have to be set under the expectation that the incentive scheme may be significantly modified at the mid-period review if experience suggests that the arrangements need to be re-designed to better deliver on customer requirements.

The proposals for monitoring wider environmental performance are well judged.

88. The approach Ofgem proposes to take in this area is sensible and proportionate, given the aspiration set out in the initial issues consultation to minimise the time spent on areas where current arrangements provided a well understood framework.

89. We agree with Ofgem's proposals to retain arrangements similar to those in place at DPCR5 for fluid filled cables, undergrounding in areas of natural beauty, and business carbon footprint reporting.

[4] While a system that has no stop codes could itself encourage companies to 'rush' customers through the process even when they want to go slowly, we believe that this would be a significantly less perverse outcome than the myriad of problems that could result from the use of stop codes.

90. We also agree that enhanced reporting of SF_6 is appropriate, while operating within the DEFRA policy statement for noise levels is an appropriate output.

91. Finally, we also believe that there is no need for a separate environmental discretionary reward, given the overall package of measures Ofgem is putting in place, including a losses reduction discretionary reward.

Ofgem has adopted a sensible position on social outputs.

92. Where a DNO's unique position gives it access to information on the needs of network users that others do not have, it is correct that it should make use of this information where possible, and undertake actions where these are closely linked to the network. If what is instead needed is a programme of subsidy for purely social reasons, without close links to the distribution network activities of DNOs, the price control is not the appropriate mechanism through which to provide this.

93. In this respect, it is not easy to identify specific outputs that are closely linked to the network. This makes the establishment of a 'fixed' output through the price control process challenging. Innovative approaches are likely to be needed to identify areas where there may be a role for DNOs, such as greater collaborative working with other parties. This output area therefore lends itself to qualitative, not mechanistic, measurement of outputs, such as a discretionary reward.

94. Since the BMCS stakeholder engagement award is in place already using a panel based assessment approach, this could be used to incentivise this area without leading to additional administrative burden. Northern Powergrid would therefore be supportive of an Ofgem decision to use this route rather than establishing an additional reward scheme.

95. It is however possible that DNOs may be best placed to undertake some direct actions that result from better use of information in future. Since this is not part of the established business as usual requirements for the network, Ofgem is right to consider whether a separate source of funding is needed as

part of the Consultation. If any such mechanism were to be put in place, strict eligibility criteria should be included that would limit its scope to actions that are closely linked to the core purpose of the network. These eligibility criteria should include a requirement that the action gives good value for money. The cost benefit analysis approach Ofgem is suggesting for other areas of the price control would be one tool which might be suitable for ensuring this.

We support Ofgem's proposed output for safety.

96. Ofgem is correct to recognise the primary role of the Health and Safety Executive (HSE) in setting the framework for safety outputs, and assessing company performance.

97. These arrangements are already well understood by all relevant parties, and any financial or reputational incentive placed on top of these arrangements by Ofgem could lead to distortions of an already well-functioning regime.

98. Meeting HSE requirements is therefore an appropriate output. By relying on the established arrangements, Ofgem's proposed approach also has the added advantage that it helps create more time for development of other aspects of the RIIO-ED1 output framework.

ASSESSING AND REWARDING EFFICIENT COSTS

The commitment to using total cost benchmarking as part of the cost assessment toolkit is welcome.

99. The use of total cost benchmarking to assess costs is a principle that was established as part of the RIIO framework, as set out in the handbook.

100. There are two key reasons that we agree it should be a significant consideration in the assessment of cost efficiency at RIIO-ED1. Firstly, it avoids the risk of inadvertently favouring different solutions through the cost assessment process (e.g. capital versus operating cost). Secondly, it takes

into account all factors that determine the amount customer must pay for a network, including for example the volume of activity being proposed.

101. The 'high level' view it provides of overall cost efficiency means it is ideally suited to fast-tracking decisions. But it should also be used even where more detailed assessment is being undertaken, as it provides a perfect complement to other approaches (such as unit cost benchmarking, which is a valuable analysis but suffers from the serious weakness that it cannot assess whether an efficient volume of activity is being proposed).

102. We therefore agree with Ofgem's position in the Consultation that it intends to use this methodology as one of the principal ways it will assess past and forecast cost efficiency. We will continue to work with the industry and Ofgem to ensure the analysis can be robustly deployed in the short time available for fast-tracking decisions, to which it is ideally suited.

The total cost approach helps to inform an efficiency assessment based on both past and future expenditure.

103. As well as providing a view on the total volume of work being undertaken, total cost benchmarking may also be able to indicate where past expenditure is relevant. Because it can (and should) be conducted using both planned capital expenditure, and capital consumption, it has built in an internal cross check on whether future expenditure is appropriate in light of past investments.

104. The findings of this analysis could for example reveal situations where past high levels of expenditure (and so high levels of capital consumption) might suggest lower levels of expenditure are justified in future, or vice versa. Companies should then be able to take this into account in developing their plans for future expenditure.

105. As with all benchmarking results, the results from benchmarking using capital consumption should be used to inform a balanced efficiency judgement (rather than arrive at an answer mechanically). Additional care would need

to be taken in this case, since any mechanical implementation to ratchet capital consumption down to an 'efficient' level could amount to expropriating past investments, which would undermine one of the cornerstones of RAV based regulation.

The commitment to maintaining a high bar for company specific adjustments is also welcome.

106. Ofgem is right to state that there will be a high bar for company specific adjustments. Such adjustments can easily lack transparency or robust justification, and as such should be avoided unless there is a very clear and strong case supporting their inclusion.

107. Where a specific factor might warrant an adjustment, Ofgem should also assess its robustness as a cost driver. This is best undertaken by including it as a potential explanatory variable in regression analysis, so that all inter-relationships can be taken into account. If company specific adjustments are made at an 'off model' stage in assessment it is impossible to be certain that a robust cost driver has been identified.

The boost to the efficiency incentive rates will encourage innovation and cost control in a mature sector where further gains are challenging.

108. We support Ofgem's proposal to uplift the efficiency incentive rate range, when compared to the range used in DPCR5. There are three reasons for this.

109. Firstly, this proposal comes at a time when a higher incentive rate will pay dividends for the long term, given increasing expenditure on electricity networks both during ED1 and beyond, meaning that any new ways to sustainably reduce costs will have significant benefits over coming decades.

110. Secondly, it is also necessary because it is more difficult than ever to find efficiency savings in electricity distribution, over two decades after privatisation, when many of the easy efficiency gains have already been found.

111. Thirdly, we also support the proposal to place the efficiency incentive rate on a post-tax basis. If this were not the approach, it would result in the perverse outcome that companies in the gas distribution sector would face a stronger efficiency incentive than electricity distribution, even though they have been subject to comparative efficiency incentives for significantly less time, which (all else held constant) will mean on-going cost reductions are more challenging in electricity distribution.

Fast-tracked companies should be rewarded for setting the benchmark…

112. Ofgem has consulted on whether fast-tracked companies should be given a reward for achieving this status. Northern Powergrid believes that there should be significant rewards for such companies.

113. Firstly, these are likely to be the companies that set the benchmark against which the costs of other companies will be assessed. Provided their example is worthy of emulation, this process could create significant benefits for customers.

114. Secondly, those companies that have been fast-tracked are likely to have submitted the most challenging cost forecasts, and therefore beating the expenditure levels set out in their plan (while still delivering the associated outputs) can be assumed to be extremely challenging. In order for the best performing companies to be capable of achieving good returns on equity (potentially double digit, to balance the potential for poorly performing companies to achieve equity returns at the cost of debt), an adequate reward should be provided for having been fast-tracked.

115. Thirdly, fast-tracking under the RIIO framework also depends on an assessment of past performance, so the purpose of the fast-track is partly to reinforce and strengthen the incentives for long term good performance, across review periods (not just within them). It therefore makes sense to offer a significant reward for those companies that meet the very high

standard required and recognise the benefits that accrue to customers for such a forecast being brought forward voluntarily and pro-actively.

116. Given the significant benefits from companies achieving the standard required to be fast-tracked, the reward should be higher than the 2.5% of allowed expenditure mentioned in the consultation. Rewards of 4%-5% would be more appropriate.

117. There should also be a commitment that, in the unlikely event that a slow-tracked company receives an IQI assessment that grants it a larger reward, or an overall more favourable package, the fast-tracked company should also qualify for that amount. This would help maintain the strong incentives that Ofgem has had in place at DPCR4 and DPCR5 for companies to submit cost forecasts that are more challenging than Ofgem's own benchmarks (historically achieved by setting allowances at the level of the benchmark, not the company's forecast). As Ofgem notes in the Consultation, it is unlikely that companies will find themselves in this position, and as a result it would not represent a significant commitment, but would remove a valid concern of companies seeking to be fast-tracked.

…as should any company which submits a challenging forecast that Ofgem is able to use to reveal and capture efficiencies elsewhere in the sector.

118. Ofgem is right to set the bar very high for fast-tracking. The corollary of this is that there should be no shame in companies being assessed through the traditional slow track route.

119. Even where companies are not fast-tracked, perhaps for reasons unrelated to whether their forecasts are challenging, those that submit challenging forecasts should be rewarded for the information this provides Ofgem in assessing the costs of others. The proposed IQI calibration would not achieve this, as it is punitive across the board where Ofgem's benchmark is even slightly below a company's forecast, and experience from several price

control reviews has shown that the majority of companies would therefore expect a penalty through this mechanism.

120. Although the rewards should not be as high as for those companies which are fast-tracked, there should still be positive rewards for those companies which submit a forecast which Ofgem believes should be accepted with no adjustment. The 2.5% allowed for meeting this standard in DPCR5, and in the RIIO-GD1 review, would be more appropriate. It would also be perverse if companies in the gas distribution sector were to be provided with a more rewarding IQI settlement than electricity distribution, which has been subject to strong comparative efficiency incentives for significantly longer, making cost reductions more challenging.

The proposed approach to proportionate treatment is correct.

121. Fast-tracking decisions should not require wholesale revisions to the detail of a plan. We therefore agree with Ofgem's proposal to set out its fast-tracking proposals at the same time as its initial assessment, although we believe that the process should leave room for minor tweaks to plans when the big picture is right.

122. We also agree that well justified elements of slow-tracked plans should be treated proportionately.

Cost benefit analysis should also provide another useful appraisal tool.

123. We welcome the opportunity to develop cost benefit analysis with Ofgem. It represents another useful decision tool, since the formalised approach being developed should help clarify the rationale for taking certain courses of action rather than others.

124. Northern Powergrid supports the adoption of the Spackman approach with its 'real world' approach to valuing the capital costs of the DNOs responsible for implementing (and funding) the investments. Northern Powergrid also

supports the adoption of the Green Book recommended social time preference rate in discounting real costs and benefits.

125. Caution should, however, be adopted in accepting the results of analysis which depends on very long term benefits from specific investments (or classes of investments), because the impact of the low-carbon transition is a major unknown, and could mean the assets have a shortened useful life. This fits with Ofgem's recommendation that companies should consider the potential impact of uncertainty in establishing prospective benefits, and the fact that Ofgem considers there may be a requirement to limit the assumed economic life.

126. Through the development of cost benefit analysis, the industry and Ofgem should also work to understand areas where it may provide different answers from those that result from currently accepted decision making tools on areas of costs that are not discretionary in meeting obligations under the Electricity Act 1989 (the Act). Rigid implementation of the findings of the analysis would also constrain companies to a decision making framework that was developed for the public sector. The proposals in the Consultation imply that other factors or analysis could be used only in marginal situations.[5] This could be inappropriately restrictive, and should not be confirmed until a proper understanding of the results of this approach to cost benefit analysis is developed. And while we agree with Ofgem that benefit cost ratios could *help* prioritise projects where there are many with a positive NPV, this position should not be made more rigid.

127. Ofgem should also be cautious about specifying particular values to be used in such cost benefit exercises, where those values might relates to matters such as the value of a human life. Such parameters have their place in an informed process of cost benefit analysis, but they need to be used in a way that balances their methodological advantages alongside well-established conventions with respect to the tolerability of risk.

[5] The Consultation, Business plans and proportionate treatment document, paragraph 6.36.

128. Finally, cost benefit analysis should be applied to programmes of similar activities in cases where this is possible, rather than individual projects, in order to ensure that it remains proportionate as an assessment tool. If there are no significant distinguishing features between such projects, further disaggregation would be inappropriate. We also agree that there should also be a *de minimis* threshold below which cost benefit analysis is not expected, although companies should be allowed to undertake the analysis below this threshold where it would be helpful (for example in appraising an innovative pilot project). The standard *de minimis* threshold used for re-openers, of 1% of base demand revenues (after the application of the efficiency sharing factor on proposed costs) would be reasonably proportionate while ensuring consistency across different elements of the price control.

At the detailed level, companies should also have the freedom to structure their plans in the way that best suits their business.

129. Northern Powergrid believes that companies are best placed to determine the structure of their business plans to suit the needs of their varied stakeholders, which include diverse groups such network end-users, consumer bodies, energy supply businesses and DNO employees.

130. However, if there is a strong demand from stakeholders for consistency, Ofgem's proposed overarching structure strikes the right balance ensuring a measure of consistency without becoming unduly prescriptive.

131. There is no need for page limits on the executive summary, as DNOs should be capable of striking the right balance between detail and length, based on stakeholder feedback. Arbitrary limits may also not lead to the desired outcome, as it would be relatively easy to work within them without meeting the underlying stakeholder requirement for clear and easy to digest information. We believe that Ofgem has done enough to signal that long-winded executive summaries will not be viewed favourably in the fast-track assessment.

MANAGING UNCERTAINTY

Ofgem has identified the key new uncertainty mechanisms that are required.

132. As set out above in the section on facilitating low-carbon technologies, Ofgem has correctly identified that two new uncertainty mechanisms are required; one for low-carbon technologies and the other for smart meters.

The re-openers for rising and lateral mains and black start are no longer necessary.

133. Northern Powergrid support Ofgem's proposal to remove the rising and lateral mains re-openers, as it should now be possible to make allowance for these costs through business plans and the price control review, based on experience gained during the DPCR5 review period.

134. For black start batteries, removal of the re-opener will be possible provided that the black start national papers are completed on time. This will be necessary for exact requirements to be set out in business plans. If these papers are delayed, an alternative approach might be warranted.

We agree that the mid-period review of outputs should be tightly defined.

135. If the mid-period review were given too wide a scope, there is a risk that the price control could effectively collapse into two four year mini-review periods. This would undermine Ofgem's move to an eight year price control period as part of the RIIO framework.

136. We therefore agree with Ofgem that the mid-period review of outputs should be limited to clear changes in government policy or network user requirements that lead to changes in Ofgem output requirements (including the need for new outputs).

137. There is however one situation that we believe should potentially be covered by a mid-period review, but which might not be covered by Ofgem's existing wording. This situation is where an existing output measure is not properly

capturing consumer requirements (which could for instance be the case under the newly introduced time to connect incentive, due to potential unintended consequences that could arise depending on the design of the mechanism which is adopted). Any such ability to vary an incentive would have to be limited tightly to situations where customer requirements were manifestly not being delivered so as to avoid the potential that it could be perceived as a rebasing mechanism for incentive targets. Alternatively, if Ofgem prefers to keep this out of scope of the mid-period review in order to avoid any perceived potential for the scope to creep to other better understood and established incentives, a specific re-opener, or governance arrangements that allow for changes in how time to connect will be measured within the period, should be considered.

138. We also agree with Ofgem that:

- the mid-period review should not be used to adjust any other parameters, such as incentive mechanisms, allowed return or other price control parameters;
- any change to allowed revenues should be justified entirely by the change in outputs being implemented;
- there should be no changes to allowances on account of lower or higher costs of delivery for existing outputs being experienced by DNOs; and
- there should be no retrospective application of any changes made at the mid-period review, so as not to undermine regulatory certainty.

139. Finally, we note that in some circumstances a change in an existing output due to government policy could entail higher or lower volumes of delivery than built into the existing price control. In these cases, the additional volumes (or reduction) should be costed at the level being experienced at the time of the mid-period review. This would ensure that companies do not gain unexpected windfalls, or suffer penalties, relative to the position that they

could reasonably have expected to be in at the end of the price control period if there had been no mid-period review. Care will be needed to ensure that when this assessment is made there is no violation of the principle that there should be no changes to allowances because the outturn costs of meeting the outputs set at the start of the RIIO-ED1 period have turned out higher or lower than expected. This will need careful handling because delivery of the new outputs may have some impact on the costs of meeting existing outputs that may not be changing at all. At this point the costs of meeting the existing outputs will be different from the expected costs when the price control was set. Establishing the marginal impact of the change in outputs may require an assessment that is rather more subtle than a with/without assessment of the change in outputs and we recommend that further thought is given to this issue.

FINANCING DELIVERY

The credible range on the cost of equity, and approach to setting gearing, is welcomed.

140. The range on the cost of equity, from 6.0% to 7.2%, is a credible evaluation of the geared equity returns required by investors making decisions to invest in long term assets.

141. By setting this relatively narrow range at this stage in the review, and through the proposals recently made for RIIO-T1 and RIIO-GD1, Ofgem has provided the certainty necessary to underpin the continued elevated levels of investment that are being undertaken as part of the DPCR5 review.

142. Northern Powergrid believes that the approach set out for companies to demonstrate the cost of equity in their business plans is appropriate, being based on accepted financing theory in the form of the capital asset pricing model and various cross-checks.

143. The requirement placed upon companies to demonstrate the appropriate level of gearing using an assessment of risk exposure, scale of investment programmes, cash flow and financeability analysis is also appropriate. The RIIO-T1 and RIIO-GD1 processes have already clarified Ofgem's expectations in terms of the range for notional gearing, along with the evidence which can support it in business plans. Northern Powergrid therefore does not believe that additional guidance is required at the strategy decision stage of the RIIO-ED1 process, since at that point company business plans will still not be available.

144. Along with the rest of the sector, we also expect to continue working with Ofgem over the coming months to develop a relative risk framework that can be used to assess the electricity distribution in comparison to transmission and gas distribution.

The cost of debt index does not make allowance for issuance costs on an on-going basis…

145. Our analysis suggests that 25-30bps in addition to the chosen index is needed to account for the costs that are necessarily incurred when issuing debt.

146. The headroom Ofgem believed exists when it established and calibrated the policy is not apparent in our own costs.

147. We also believe that the evidence presented in the Consultation on the coupons at which debt has been issued misses two relevant factors. Firstly, Northern Powergrid's experience in issuing debt is that bonds trade at slightly cheaper rates than the rate actually achieved on sale of the bonds. Secondly, most bonds issued in the mid-2000s were 'wrapped', and so the analysis Ofgem presents reflects the credit strength of third parties which could only be acquired through significant payment. The fact that the so-called mono-line insurance has not survived as a business model underlines the extent to which those lower coupons (which were being paid for separately in any case) were not sustainable.

148. Overall this means that, once issuance costs are accounted for, network companies could only just match the index in the mid-2000s by taking advantage of an arbitrage opportunity that no long exists. To cover issuance costs on an on-going basis, 25-30 basis points on top of the index would be required.

…and fails to cover efficiently incurred past costs

149. The 10 year rolling index also makes no allowance for long term debt that was incurred efficiently during the 1990s.

150. Financing long term assets with long term debt makes sense for businesses that are recovering investments over 45 years, but the fall in prevailing interest rates, which was impossible to predict, means we are locked into paying interest rates at well above current market rates. Even if proper allowance is made for the costs of issuing debt on a rolling ten year basis (through addition of issuance costs on an on-going basis), the index will still not cover our actual long term cost of debt.

151. We do not believe that anyone contends that it is sensible to use a ten year trailing average of an index because that is the appropriate period over which DNOs should aim to finance their businesses in the debt markets. The reason that ten years has been chosen appears to be because the selected index does not reach far enough back in time to cover an appropriate financing period.

152. As long as the overall cost of debt allowance is broadly in line with the cost of debt truly being experienced by companies the debt index approach has some credibility as an uncertainty mechanism. But once it is manifestly out of line with reality it will be unsustainable as a regulatory tool, either because efficient companies will be unable to finance themselves, or because significant additional returns are being granted because of unpredictable long term changes in debt financing costs.

153. We appreciate that Ofgem regards the indexation of the cost of debt as a matter of settled policy following the RPI-X@20 review and the adoption of the RIIO model. However, we are not convinced that the Authority has understood the potential for significant misalignment if a company finances itself over a longer period than is implied by the chosen index.

154. As at January 2012, the debt that Northern Powergrid issued over 10 years ago had a nominal coupon over 200 basis points above the 10 year trailing average of the iBoxx index (before taking into account any issuance costs on this debt). Given the amount of this debt on the books, it would require an uplift of over 90 basis points on the cost of debt index to cover this shortfall, although this requirement would decline significantly from 2022 as these bonds start to mature.

155. Accordingly, we recommend that:

- in each year of the RIIO-ED1 period another year is added to the trailing average without losing a year from the beginning; and

- until a sufficiently long run of index data becomes available an adjustment should be made in recognition of the fact that the index does not yet cover an appropriate financing horizon for the businesses in question.

The potential change to the measurement of RPI will require careful unpicking if it is not to disrupt price control regulation seriously and undermine regulatory certainty.

156. As the Consultation notes, the Office for National Statistics (ONS) is currently consulting on potential changes to the retail price index (RPI) index.

157. If the RPI is effectively brought into line with the lower CPI index as a result of this consultation, then all those 'real' parameters that have been calibrated relative to historic RPI relationships will need to be increased by

an offsetting amount. This includes the cost of equity, cost of debt, and real price effects.

158. Failure to take this into account correctly would mean that allowances would be established that are too low to cover actual costs. More significantly, it would also add to regulatory risk, as it would be evidence that real terms price control regulation in the UK can be seriously undermined by the potential for further future changes to how inflation is measured.

Ofgem is correct to allow companies to justify asset lives transitional measures.

159. Ofgem's policy on the move to a 45 year life for new assets has been well signalled, and we are already planning on that basis.

160. Given the potential impact on company cashflows, we believe that Ofgem is correct to allow companies to request transitional arrangements as part of their business plans. Transition over a single period has effectively become the norm through the RIIO-T1 and GD1 reviews, although the Consultation is correct to allow for longer transition over more than one period (as has been allowed for Scottish Hydro Electricity Transmission Ltd in its RIIO-T1 settlement).

The DPCR5 pensions process has not been followed, with serious implications.

161. The Consultation asks for views on the process followed in the DPCR5 review of established pension deficit.

162. The process set out in the DPCR5 *Final proposals* has not been followed and the deviations are unacceptable.

163. In particular, the DPCR5 *Final proposals* established a two-stage review process where an initial 'high-level' review would be carried out by an expert independent body, the Government Actuary's Department (GAD). If that review indicated any cause for concern an 'in-depth' review would follow.

Only when that in-depth review had been carried out would there be any prospect of any deduction from the established deficit as at 31 March 2010 being made.

164. The GAD review that was carried out did not indicate any inefficiency in any of the schemes that were reviewed. That being the case, no in-depth review could properly be carried out consistently with commitments given by the Authority at DPCR5. Insofar as there has been any second stage review, no report has been issued justifying the deductions that Ofgem is currently proposing. We have been advised that for Ofgem to proceed on the basis of such a flawed process would be unlawful.

165. This unsatisfactory position must be urgently reviewed if it is not to undermine faith in future promises by the Authority to stand behind efficiently incurred pensions liabilities and the established deficit. Moreover, there is a danger that this issue will wrongly impact upon Ofgem's assessment of company business plans. The issue should therefore be taken outside the RIIO-ED1 process. We are confident that a proper assessment outside the RIIO-ED1 process will enable this matter to be resolved satisfactorily.

The retention of the DPCR5 tax framework is welcomed.

166. Northern Powergrid believes that the DPCR5 tax framework remains appropriate, and so the company welcomes Ofgem's proposal to retain it at RIIO-ED1. This includes the tax trigger mechanism, which remains a fair way of sharing with customers the benefits and disadvantages of any changes to taxation.

167. We note that there are proposed changes to detailed modelling, and believe that some of these may require a carefully managed transition between the old and new approaches in order to ensure they are equitable.

We are open to a revenue profile that smooths the impact of the price control.

168. Northern Powergrid has heard stakeholder concerns over charging volatility at price control boundaries loud and clear.

169. As signalled by the Consultation, the potential to smooth the impact of such price changes over the first few years of RIIO-ED1 should be explored in the event of any significant step changes. Using the cost of capital to discount any smoothing of revenues is appropriate and in line with established price control practice.