

98 Aketon Road
Castleford
West Yorkshire
WF10 5DS

email - andy.jenkins@northernpowergrid.com

Joanna Campbell
Ofgem
9 Milbank
London
SW1P 3GE

Our Ref:

Your Ref:

29 October 2013

Dear Joanna

The timing of a decision on electricity distribution networks' revenue for 2015-16 - consultation response

This letter gives Northern Powergrid's response to the consultation, on behalf of Northern Powergrid (Northeast) Limited and Northern Powergrid (Yorkshire) plc.

We welcome Ofgem's review of the benefits of making an earlier than proposed decision on the revenue that will be recovered by electricity distribution network operators (DNOs) in 2015-16. The transparency and predictability of use of system (UoS) charges is a key issue for suppliers and this is a clear message that we have received through working closely with suppliers via our on-going stakeholder engagement activities.

Energy suppliers are a very important stakeholder group and we are continuing to work with all stakeholders to better understand their issues/concerns and to evaluate the feasibility and scope of any potential solutions. Suppliers have told us that, if they knew our charges further in advance, they would face lower risk and be able to charge customers less overall. Northern Powergrid has tried to address some of these concerns via the governance arrangements under the distribution connection and use of system agreement (DCUSA) by raising a change proposal (DCP178 - 'Notification period for change to use of system charges') that attempts to change the notice period in DCUSA for finalising tariffs from 40 days to 15 months so that energy suppliers have more time in which to reflect final network charges in their tariffs.

We recognise the previous work that Ofgem undertook to identify improvements in mitigating network charging volatility arising from the price control framework and we supported the proposals. However, that work did not specifically address changes in revenues resulting from

NORTHERN POWERGRID

is the trading name of Northern Powergrid (Northeast) Ltd (Registered No: 2906593) and Northern Powergrid (Yorkshire) plc (Registered No: 4112320)

Registered Office: Lloyds Court, 78 Grey Street, Newcastle upon Tyne NE1 6AF. Registered in England and Wales.

If you would like an audio copy of this letter or a copy in large type, Braille or another language, please call 0800 169 7602

www.northernpowergrid.com

the transition from one price control to another which is one of the concerns that suppliers have raised.

In the consultation paper, Ofgem has identified three options that could be adopted for locking down the RIIO-ED1 first year revenues earlier than currently planned, namely:

- Option (a): This reflects the current RIIO-ED1 review process and results in revenue for all DNOs being finalised at final determination scheduled for November 2014;
- Option (b): For slow-tracked DNOs' 2015-16 revenue would be finalised at the slow-tracked draft determination scheduled for July 2014. For fast-tracked DNOs 2015-16 revenue would be finalised at the fast-track final determination scheduled for February 2014; and
- Option (c): All 14 DNOs' 2015-16 revenue would be notified as part of Ofgem's decision following this consultation. This is the earliest opportunity at which Ofgem could make a decision on 2015-16 revenue. Each DNO's revenue would therefore be based on its 2 July 2013 business plan submission rather than any re-submitted plans (if these are required) or Ofgem's assessment of those plans.

Northern Powergrid would not object to an early lockdown of the first year revenues provided that we were net present value (NPV) neutral to any true-up mechanism and that it would be reconciled in a timely way. In deciding on the most appropriate notification period a key consideration needs to be the timing of when energy suppliers enter into contract negotiations with end users, and we understand that new supply contracts typically commence in October. On balance we believe that option (b) would be the most appropriate solution, as the revenues will be based on a more accurate and robust set of assumptions that will have been informed by Ofgem's assessment of each DNO's business plan. This should result in revenues that will be more closely aligned to those that would be set under the status quo and facilitate smaller adjustments via the true-up mechanism in 2016-17.

Appendix 1 provides a detailed response to all of the questions raised in the consultation.

I trust this provides you with sufficient information at this time to further Ofgem's thinking; if you have any further questions regarding the above, or if you would like to arrange a meeting to discuss the content of this letter, please do not hesitate to contact me.

Yours Sincerely

Andy Jenkins

Andy Jenkins

Head of Network Trading

Appendix 1 - responses to specific questions

1. Please provide any relevant information to improve our analysis of the benefit of each option including (if available):

- (i) information on the risk premium included in contracts offered to consumers; and
- (ii) the expected reduction in the risk premium an additional 4 months (option (b)) and an additional 11 months (option (c)) would provide.

Please specify if you wish any data provided to remain confidential.

We note this question is directed at suppliers - whilst we understand that suppliers build some risk premiums into their charges we have no visibility of the magnitude of the adjustment and the resulting impact on consumer prices.

2. Do you have any views on the potential costs we have identified? Do you consider there to be other costs we have not identified?

One of the costs associated with a change to the status quo is the increase in risk that will be faced by electricity distribution companies associated with setting 2015-16 levels before Ofgem has taken a final decision.

It is difficult to quantify the risk at this time as it is uncertain what the magnitude of the difference in revenues under options (b) or (c) will be compared to the revenue under option (a). However, if our understanding of the options is correct, option (b) is likely to deliver an outcome that is more closely aligned to the revenues that would result from the baseline option (a).

That said, provided that any true-up mechanism is implemented consistently with the standard approach to revenue profiling used when price controls are set, and that it would be reconciled in a timely way, Northern Powergrid would not object to an early lockdown of the first-year revenues. We note that the approach to adjusting values for the passage of time in price controls can vary significantly depending on the context, but that when profiling revenues between years when setting price controls the weighted average cost of capital being set in that price control is used.

3. What is your preferred treatment of deferred revenue? Please explain your reasoning.

We appreciate that there is the potential for either a positive, or negative, true-up of deferred revenues as a result of introducing an earlier than proposed decision on the revenue that will be recovered by electricity distribution network operators (DNOs) in 2015-16. The consultation considers three options, namely:

- 1) all deferred revenue could be recovered in 2016-17;
- 2) deferred revenue could be spread over the remaining 7 years of RIIO-ED1; and

- 3) deferred revenue could be recovered in 2016-17 unless it breached a specified threshold in which case the remainder would be spread over future years.

We agree with Ofgem's evaluation that option 1 has the benefit of being the simplest approach to implement. Our stakeholder engagement activity has indicated that predictability in the year-ahead allowed revenues, and the resultant charges, is more important to suppliers than the magnitude of any future price changes (i.e. if suppliers know what is coming then they can factor it into their pricing arrangements and contract negotiations).

4. If you prefer option 3 for deferring revenue, what do you consider an appropriate threshold? Please explain your reasoning.

N/A - our preference is to adopt option 1.

5. Do you have any views on our initial assessment of each option?

We agree that there needs to be a balance in the price control review process between providing information to stakeholders as early as possible while allowing the appropriate time to consider and undertake diligence on DNOs' business plan proposals to ensure that they provide value for money for consumers.

An informed decision needs to be made based on: the evaluation of the business plans; the benefits of early notification; and the timing of supplier contract negotiations with end users. Overall option (b) appears to provide the most appropriate balance of the above factors, given where we are in the overall price control review process.

In addition, in one of our research exercises we undertook whilst developing our business plan, we offered customers a notional £10 of Northern Powergrid spend and asked what they thought we should spend it on. More than 30%, the largest group, wanted the money handed back to customers; and each time we've asked, cost control and cost efficiency have been at the top of our stakeholders' lists. This further supports option (b) as the cost to consumers of managing the impact on their cash-flow is likely to be lower than under option (c).

6. Which option do you consider will drive the greatest benefit to consumers? Please support this view with analysis of the costs and benefits.

This is difficult to quantify in the absence of more detail on the amount of any risk premium that suppliers may build into their charges to consumers. That said, as described above, option (b) appears to provide the most appropriate balance for providing an informed decision taking into account an evaluation of the business plans; the benefits of early notification; and the timing of supplier contract negotiations with end users. It is also likely to carry lower costs to consumers since the cost of managing the impact on their cash-flow is likely to be lower than under option (c), as the outcome is likely to be more closely aligned to the final price control outcome.

7. Do you have any views on the relative complexity of option (b) and (c)?

We do not see any difference in the level of complexity of option (b) or (c); they both have the same intent, the only difference being the timing of the notification.