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Dear Maxine

Consultation on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators

This letter and its two appendices are the response from Northern Powergrid Holdings Company and its subsidiaries Northern Powergrid (Northeast) Ltd and Northern Powergrid (Yorkshire) plc to Ofgem's letter entitled *Consultation on the treatment of real price effects for RIIO-ED1 slow-track electricity distribution network operators* (the Consultation).

The Consultation raises a legitimate question about whether the mechanics of the electricity distribution price control mechanism can be improved by the introduction of an uncertainty mechanism for real price effects (RPEs). In essence, it seeks to understand whether the benefits of introducing such a mechanism would outweigh the costs, and introduces a legitimate framework within which to consider the question.

In short, it is not possible to design a mechanism which performs well on Ofgem's criteria.

- The basket of indices currently proposed has demonstrably failed to match the cost pressures faced by the sector in recent years. While these indices might maintain incentives to minimise cost at the same level as an ex-ante settlement, they would add significant additional risk to the settlement and so raise the cost of capital as well as creating additional costs for consumers associated with higher price volatility.
- It may be possible to devise an alternative basket which does not create additional risk. But this would require direct measurement and use of data on the cost pressures actually experienced by the sector. Mechanistically updating cost allowances based on this information may significantly weaken incentives on the sector to minimise cost.

The only option which can therefore recommend itself to Ofgem is a fixed ex ante allowance, properly calibrated to reflect the cost pressures faced by the sector.

Yours sincerely

John France
Regulation director

APPENDIX 1 – RESPONSES TO QUESTIONS

1. Do you think these criteria are appropriate and sufficient? If not, please explain why and justify any alternative assessment criteria.

The criteria are both appropriate and sufficient. All of the relevant factors can be accounted for under at least one of the criteria.

2. Which of the RPE approaches (including the current approach of a fixed ex ante allowance, or any not explicitly discussed in this consultation) do you favour and why? Please justify with reference to the criteria.

Northern Powergrid favours a properly estimated fixed ex ante allowance (i.e. a higher fixed allowance than the one proposed in the draft determination).

It is not possible to design an RPE uncertainty mechanism which lowers risk faced by the sector while at the same time maintaining strong incentives to minimise costs. In light of this, and the fact all uncertainty mechanisms would introduce a cost to consumers in the form of additional charging volatility, Ofgem should not implement an uncertainty mechanism.

We set out further details of our assessment (using Ofgem's criteria) of the mechanism proposed in the consultation, and a potential alternative, in appendix 2.

3. If we use indexation with a deadband, at what value should the thresholds be set?

If it were possible to design an index that would track DNO sector costs accurately without damaging incentives to manage costs, there would be no reason for a deadband.

However, this is not the case. The deadband should therefore be set at 100% of costs, and a properly estimated fixed ex ante allowance should be provided.

4. If we use indexation, do you think the proposed indices are appropriate? If not please justify alternatives.

The two labour indices should be replaced with a benchmarked view of DNO pay settlements on an annual basis in order to accurately reflect the cost pressures faced by DNOs.

If external benchmarks are to be used, the currently proposed indices are probably the most appropriate indices that are available for use in normal economic conditions (though not in those conditions experienced in the last few years). However, the weights placed on specialist labour should be adjusted to reflect the actual labour mix employed by DNOs based on occupational SOC codes 21, 31, 52 and 53.

5. Do you think that using a single mechanism covering all cost types is more appropriate than multiple mechanisms? If you think multiple mechanisms would be appropriate please justify which one you think should apply to each cost type.

Since a single mechanism can be structured to be broadly equivalent to multiple mechanisms there is no clear reason why multiple mechanisms should be used.

APPENDIX 2 – ASSESSMENT OF UNCERTAINTY MECHANISMS AGAINST THE CRITERIA

The approaches to calculating RPEs set out in the uncertainty mechanism consultation and the draft determination are both reasonable for estimating long term trends in RPEs.

However, both suffer from serious flaws that mean 'actual' estimated RPEs can diverge significantly from those experienced by the sector. This problem is particularly acute for labour RPEs. External benchmarks for labour RPEs can for example be affected by structural shifts in the economy. ONS analysis confirms that pay rises for all employees have been affected by this issue since the 2008 recession.[1] The approach used by the Competition Commission for NIE would result in a significantly less negative estimate of the composite RPE in 2013-14 and 2014-15, principally because Ofgem's basket of indices has seriously mis-measured recent actual RPEs (and short term forecasts) for the labour needed in conducting electricity distribution activities.

Therefore, when applied to the estimation of actual RPEs, the two approaches perform poorly on the unintended consequences and exposure to risk criteria. Overall the uncertainty mechanism proposed in the consultation would create a greater likelihood of allowances diverging from actual cost pressure compared to a fixed ex ante allowance. It would therefore add to risk faced by debt and equity holders and raise the cost of financing the sector.

These issues could be remedied by implementing an annual benchmarked approach to the pay settlements agreed by the sector, since labour is a large proportion of a DNO's costs and this is the area where external benchmarks are likely to be subject to the worst measurement error.

However, if this adjustment is made to the RPE mechanism, it would suffer another serious weakness, since an annual exercise of benchmarking pay deals may significantly weaken management incentives for companies to secure the lowest possible pay deals.[2]

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1 ONS, December 2013, Annual Survey of Hours and Earnings, 2013 Provisional Results, page 25

2 This concern does not apply to benchmarking pay deals to determine RPEs that have already been realised in order to set a fixed ex ante allowance–it is the regular, repeated, nature of the exercise which could weaken incentives, while a one-off benchmarking exercise would maintain strong incentives.