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29 September 2014

A handwritten signature in black ink that reads "Dermot".

### THE PLACE OF HISTORICAL EFFICIENCY IN THE BENCHMARKING OF FUTURE COST ALLOWANCES AT ED1

At the Committee of the Authority meeting on 3 September we presented evidence demonstrating that when historical efficiency is taken into account, the implied efficiency target for Northern Powergrid is much harsher than the targets for the other DNOs.

We have determined the implied efficiency targets by assessing efficiency over the DPCR5 period (which for us averages 89.7% across the suite of models) and then adding to this the movement in costs between DPCR5 and ED1 (which for us is a 4.9% reduction).

The result for Northern Powergrid is, therefore, an implied efficiency target of 84.8%. This is the level of efficiency that the settlement in the Draft Determination would require us to achieve and it provides a meaningful sense check on whether we are being treated fairly.

When we met, you asked me to summarise in a sentence the concern that I have with that result. **Our concern is that we are being treated harshly because we are being expected to operate at a level of efficiency that is not being demanded of any other company.** That arises because the combination of (i) having an efficient starting point and (ii) being expected to deliver a cost reduction, does not arise for any other company. The other company with a similar efficiency score to Northern Powergrid is being allowed an increase in costs. Those companies that are being asked to operate with reduced costs are facing reductions that are commensurate with, or look generous compared to, their current levels of efficiency. In practical terms, the proposed cost allowances for Northern Powergrid are not realistic: we cannot deliver the enhanced outputs with the proposed cost base.

We have been in dialogue with your team on this issue and they have raised three concerns with our analysis:

- we have not used Ofgem's disaggregated model when modelling historical efficiency;
- our implied efficiency target does not factor in levels of outputs; and
- the ED1 cost allowances in the Draft Determination are similar to our actual DPCR5 spend.

We are able to answer all these challenges. I have set out below a summary of the response we have given to your team.

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### **The WPD disaggregated model**

Ofgem's disaggregated model would require a very significant amount of structural reconfiguration to produce historical results. This model is a collection of around 50 individual spreadsheets, and uses a range of assessment techniques. None of these individual models are set up to compare benchmarks to historical costs. In the time left available to us, we do not think it would be possible to run the Ofgem disaggregated model with historical data.

In any case, it is not necessary to undertake this task as there is a viable alternative. The WPD model also takes a disaggregated approach. It is based mainly on unit cost efficiency, using the historical results to determine the unit cost benchmark. While we agree with Ofgem that there are significant weaknesses to the model, ultimately it is the best (and only) ready-made model which is available to produce historical results on a disaggregated basis.

### **The implied efficiency target does not take account of outputs**

Setting aside the fact that the Ofgem cost assessment has not factored in outputs either, we can show that there is no evidence of an output gap in DPCR5. Using the full set of auditable RRP data that is available, we can show that we have spent 50% of our total DPCR5 planned expenditure in the first three years of the period. This is only slightly below the industry average, which is 53%. If we roll that forward to four years, admittedly not using audited data, we are at 78%.

We can unequivocally assure you that our outputs are being delivered in line with expectations for the DPCR5 period as a whole. Indeed we will have a modest over delivery of outputs relative to the levels we committed to at the DPCR5 settlement.

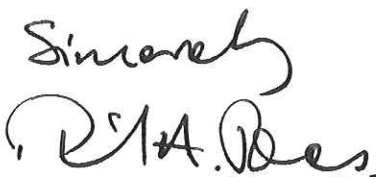
### **RIIO-ED1 allowances versus DPCR5 spend**

A simple comparison between ED1 cost allowances and DPCR5 actual spend does not take account of the additional outputs that DNOs are required to deliver during the ED1 period. We are proposing improvements in outputs across the board. Our forecast increase in costs relative to DPCR5 actuals is fully explained by the additional outputs that we are required to deliver in ED1; our like-for-like costs of running the network will actually fall.

### **Conclusion**

A sense check of the proposed cost allowances for ED1 in the light of the proposed outputs and existing levels of efficiency supports the view that Northern Powergrid is being treated harshly, to the tune of over £200m of unwarranted cost disallowances. We are disappointed that the Authority has allowed the process to develop without considering historical efficiency and the change in spending pattern and outputs the proposed settlements demand. The evidence points to a need for the Ofgem team to take account of the detailed justifications that we have proposed for our cost projections and make adjustments in order to establish a more workable outcome for Northern Powergrid.

I would, of course, be happy to discuss this if that would be helpful but I suspect that having covered it twice verbally and now having summarised it in this letter, our position will be clear to you.



Phil Jones  
Chief Executive