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*Dear Dermot*

### UPSIDES AND DOWNSIDES WITHIN THE DISAGGREGATED MODEL

When we met the Committee of the Authority on 4 September I spent some time on the question of the treatment of cost disallowances arising under the disaggregated cost model being used by Ofgem. I developed these points a little more when we met on 9 September and, having reflected on the further, I thought it might be useful if I provided you with a written explanation of our position. The points I will go on to explain bring into sharp relief some critical judgements that must be made about the nature of a price control review that sets out to be based on a well-justified business plan.

The issues raised here necessitate a consideration of some of the more detailed aspects of Ofgem's disaggregated modelling, but the key points are clear:

- The RIIO model centres on a well-justified business plan in which companies explain why their costs are necessary by reference to their outputs. Provided those plans are of sufficient quality, it follows that Ofgem must give more emphasis to considering the supporting justification than it has felt necessary in previous price control reviews.
- That said, the disaggregated model plays an important role in challenging the efficiency of a company in the detailed cost components that go to make up the total cost base.
- The fact that the model is so detailed means that there may be errors that favour companies as well as errors that are to their detriment.
- Ofgem is entitled to ask companies to justify the positives alongside the claims that improvements need to be made, to the extent that the company is seeking adjustments that tip the model into a net favourable result.

The starting point for my observations remains unchanged: Northern Powergrid's plan is found to be efficient by the two totex models (which indicate that we should receive a cost allowance that is ca.£120m more than our forecast) but, as things stand, the disaggregated model suggests disallowances totalling £148m. We are not surprised that the disaggregated model gives a view of our efficiency that is at variance with the view that comes from two totex models. Northern Powergrid has for a long time concentrated on the *total* efficiency of its activities: this concentration involves consideration of the trade-offs between possible solutions. It is in the nature of any disaggregated model that such trade-offs are not captured.

This outcome places Ofgem staff in the position of having to consider whether there is persuasive evidence to support their making adjustments to the outputs of the model to ensure that it is not falsely indicating inefficiency for a cost line that is in fact justified. The RIIO model places a great deal more emphasis on the quality of a company's plan than any previous network price control review. Ofgem has asked for justification of the costs proposed and, we

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believe, it has received a very high standard of submission from Northern Powergrid. Ofgem has deliberately moved towards an evidence-based review in RIIO and so it follows that any suggested disallowances (or upsides) must be explicitly considered in the light of the company's justification of its plan.

Consistent with this, we were told by Ofgem that, if a company can provide persuasive justification for its costs, then Ofgem would adjust the outputs of its models to reflect that persuasive justification. In Northern Powergrid's case, we have provided a very significant body of detailed justification that explains why £212m of the positive variances are supported by evidence and also why £224m of the disallowances suggested by the disaggregated modelling exercise should not flow through to the cost allowances. We have yet to receive any direct challenge to any of that evidence.

### **The proper role of the disaggregated model to challenge forecasts**

We accept that the disaggregated model has a proper place in your consideration of the efficiency of companies' plans. The disaggregated model indicates where a particular cost line is higher than the level forecast by the generality of DNOs (assuming a particular cost driver). That is itself not a proof of inefficiency that would warrant a disallowance; it is an indication that there is a question to answer and therefore the onus shifts at that point to the company to demonstrate that the particular cost in question is indeed efficient. Similarly, it is also obviously true that the model can indicate where a company has forecast lower costs than its peers and might deserve a higher allowance because it is particularly efficient. Again such an indication can arise as a result of real efficiency or due to the imperfections in the specification of the model.

In acknowledging that the model may confer unjustified benefits (upsides) as well as unjustified disallowances (downsides) I am far from suggesting that Ofgem can safely assume that the two effects will automatically cancel one another out and net to zero or even that the net result is fair. There would be no basis for such an assumption and I hope you will agree with me that Ofgem should strive to make each part of its assessment toolkit as robust as possible rather than rely on such unproven overall assumptions.

### **Upsides and downsides in the disaggregated model**

I have already explained that the evidence-based emphasis of the RIIO process means that we are entitled to expect to look properly at the evidence provided by a company that a given modelled disallowance is not a fair reflection of their situation. At some point, however, the practicalities of completing a price control review must come into play. We realise that Ofgem must find a way to balance the need to properly consider material evidence whilst working to a timetable.

In my experience, it is at this stage in the price control process that both sides of the debate start to make regular use of the phrase 'in the round'. So, I am not surprised that we have, in the last two weeks or so, been advised by members of your team that they think we must recognise that the cost assessment is made 'in the round'. I agree with that - but of course that does depend on what is meant by the phrase. If it means that any given component of the price control includes within it a number of pluses and minuses that net off to an aggregate position that can be shown to be sensible, then I agree.

However, if the phrase is used to mean that the Ofgem team should be entitled to make a disallowance on the strength of a cost modelling exercise without explicitly dealing with evidence that it has invited and that explains why the modelled result cannot be taken as indicative of inefficiency, then I do not agree that we should be expected to take things like that 'in the round'. As I said when we met, I think there is a sensible way to give some practical guidance to the teams on both sides at this stage in the review. In short, I think it is reasonable for Ofgem to expect a company to take the results of the disaggregated model 'in the round' to extent that the pluses and minuses broadly balance each other out or where they arrive at a net position that can be shown to be reasonable by reference to some other objective evidence. In other words, *to the extent that the upsides and downsides do not*



*balance, where the result is a net downside*, then I do not think Ofgem can expect a company to take that modelling result in the round *if* that company is also able to provide strong justification for costs that the model has suggested might be inefficient.

Using our case as an example:

- Assuming for the sake of this example that Ofgem continues with the undesirable distortion that arises from the application of ratchets to some parts of the benchmarking exercise to constrain a company to the lower of its forecast or the modelled outcome...
- ...then in its current form, the disaggregated model indicates net disallowances of £148m (the product of £402m of downside being partially offset by £254m of upside).
- The first thing to do is to correct for errors (£22m) and inconsistencies (£69m) in the net disallowances.
- That being the case, we would have a corrected net disallowance of £57m, (because there would now be £346m of downside being partially offset by £289m of upside).
- Up to the point of neutrality under the model (£57m in our case), where we can provide compelling justifications for costs that Ofgem is proposing to disallow, these adjustments should be made by Ofgem. As an aside, we need only consider the three most obvious cases of assets that do not properly fit into Ofgem's like-for-like modelling in order to justify the first £57m of adjustments.
- Once that neutral point is reached, we accept that for every further disallowance for which we seek a positive adjustment, not only must we provide a compelling case for the efficiency of that particular cost line, but we must also produce a compelling case for an equal amount of the total upside that the model has awarded us.
- Unless we can provide the upside justification we think Ofgem may pragmatically say that the pluses and minuses are assumed to offset one another and we should take the outcome in the round.

I gather that not all companies have acknowledged that upsides as well as downsides require justification if adjustments are to be made to the modelled outcome. We are able to justify large proportions of the upside that the model identifies. For example, we can demonstrate that we are especially efficient in our indirect costs, and indeed some of that evidence comes directly from Ofgem's own consultants. That being the case, it would seem fair to suggest that Ofgem should regard that upside as 'firm' and not try to suggest that we should take that upside 'in the round' with a number of other downside modelling results that we are able to justify as efficient by reference to the realities of our network.

We are still discussing these issues with your team and we hope these discussions will take this forward to a satisfactory conclusion. The disaggregated model has suggested that there are areas where the onus lies with us to provide justification. If Ofgem is either unwilling or unable to advance any good reason for rejecting the evidence we have provided then I do not think we can be expected to take the evidence of our efficiency off the table when, 'in the round', we are still losing from the process.

I would appreciate the opportunity to discuss this important matter with you in the near future. As I have said in another recent letter, I appreciate that time is at a premium and so hope that you will find it helpful to have my position set out in writing.



Phil Jones  
Chief Executive