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

RPEs AND SMART GRID SAVINGS: OFGEM'S APPROACHES TO UNCERTAINTY ARE ILL-CONCEIVED

When we met the Committee of the Authority on 4 September our presentation on RPEs concentrated on the errors in Ofgem's calculation of the starting point. In particular, we explained that there were errors and inconsistencies that ranged from the use of inappropriate indices to the failure to apply the specialist labour premium in 2014-15 and 2015-16. Correcting these errors would give a starting point that was in line with the CMA and with the most ambitious of the DNOs' forecasts.

In contrast with the assessment of the starting point, we have no fundamental disagreement with Ofgem on the slope of the line going forward. We would argue for a different number, but we accept that there is plenty of scope for reasonable people to disagree about something like this and we certainly do not think that the Ofgem proposal is outside the range of such a difference of opinion.

We have shared our detailed analysis with your teams and my purpose in writing this letter is not to reiterate those points. Rather I want to touch on the aspect of the RPE debate that we did not concentrate on in our presentation: the uncertainty mechanism that you are consulting on in parallel with your consultation on the Draft Determination.

In short we are fundamentally opposed to this novelty and we are very surprised to find that the Authority has come to think that it has any merit whatsoever because:

- we do not think that it is necessary;
- it cannot be implemented in a way that is consistent with the RIIO principles; and in any case
- there simply is no index or basket of indices that can act as a reliable proxy for DNOs' RPEs.

Even more important is the basic principle of incentive regulation that Ofgem sets an ex ante cost allowance and leaves that risk with the companies to manage. If one were to take the indexation proposal to its logical conclusion, one might as well link individual cost components of our cost base to particular indices (e.g. cable to the London Metal Exchange index). That is impractical across an asset so diverse, and would itself have questionable incentive properties, even if it were possible.

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However, we think that the uncertainty mechanism being proposed is even worse because the civil servants' search for a surrogate is bound to fail and, if implemented, it will leave us in the position where the uncertainty mechanism is likely to inflict more uncertainty on us than the ex ante allowance. In other words, apart from distorting one of the most important incentives in the RIIO package, the cure is very likely to be worse than the problem.

We find this to be particularly odd because Ofgem has been content to rely on benchmarking of plans in order to establish its view of appropriate future costs in the vast majority of the cost base. It has not made the case for departing from this approach in the two particular cases - RPEs and smart grid savings - where it thinks civil servants can do better than the DNOs' forecasts.

It is ironic that whilst the RPEs intervention has resulted in a proposal for an unsuitable uncertainty mechanism, the smart grids intervention has resulted in a simple disallowance where a carefully designed uncertainty mechanism might well be appropriate (instead of Ofgem proposing a huge reduction in the forecast costs of the entire sector on the basis of a civil servant's view -or rather guess - of the future). And yet, if Ofgem is concerned that there are savings available that are not reflected in our plans, it is possible to incentivise the revelation of those savings in the early years of the ED1 period, conduct a mid-period review, and make any adjustment (if justified) for the later years. I shall write separately to you on the issue of smart benefits, but suffice it to say at this point that we see the two issues of RPEs and smart benefits as suffering from the same underlying problem of civil servant over-ride.

These points have been developed in a more detailed letter that we sent to Maxine. I think the points I have raised are straightforward, but I would be happy to discuss them with you when we next meet.



Phil Jones
Chief Executive