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Dear David and Dermot

THE REGIONAL LABOUR ADJUSTMENTS DO NOT CORRESPOND WITH OFGEM'S POLICY INTENT

When Dermot and I met to discuss the Draft Determination on 9 September Dermot stressed that, whilst he was primarily in "listening mode", the two of you had agreed that the Final Determination would be settled in the light of evidence made available to Ofgem and that we should continue to raise our concerns with both of you and with your team. I confirmed that we would expect nothing else and will work hard to make sure that we present you with crisp, digestible summaries of the key issues that will, inevitably, require more detailed treatment at the working level. The issue of regional wage adjustments has reached a point where I feel I need to make you aware of the work that has been going on and is being shared with your team.

When I met Dermot, I indicated that my team had identified that, in addition to having received the smallest amount of qualitative adjustments made in favour of any of the companies in the slow-track assessment (including WPD), Northern Powergrid is also the company that suffers worst from the way that the Ofgem team has implemented regional labour adjustments. I did freely admit that simply being at the bottom of a league table is, in and of itself, not grounds for objection - someone has to be at the bottom. At that stage, I merely shared our headline result with Dermot and promised that once I had a better understanding of those concerns I would update you both if I felt that the analysis gave rise to a set of conclusions that warranted further consideration.

That work is now complete and our team is taking yours through the detailed analysis that such a complex issue necessitates. But it is clear that our findings are sufficiently important that you both need to be aware of them. In short there are two problems with the regional wage adjustments in Ofgem's Draft Determination:

1. Despite adopting the position that there is no evidence for regional wage differences outside London and the South East, the practical implications of the model that Ofgem is using means exactly the opposite. A spectrum of real wage adjustments has resulted from the complex calculations and Northern Powergrid is disadvantaged by the adjustment *relative to every other DNO*.
2. In any case, it is now clear to us that Ofgem has used datasets which are not fit for its purpose. The ONS data that Ofgem has used carries an explicit 'health-warning' on the fact that it will not provide 'like-for-like' comparisons between regions. Despite that,

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the data has been used without moderation and the results are London and South East weightings that are implausibly large (over 12% of totex in the case of London).

My team has now worked through the issues and we presented Chris Watts with a detailed slide-deck - setting out our evidence - at a meeting on 16 September. I have set out below a summary of that position and our conclusions (and I can provide you both with copies of the detailed analysis if that would be helpful).

Bottom-up application of regional wage adjustments

- The Draft Determination Ofgem assumes that there are different pay levels in three regions - London, the South East and the rest of the UK.
- Yet the regional labour adjustments reduce Northern Powergrid's cost allowances relative to *every other DNO* (please see Annex 1 for a breakdown of each DNO's regional wage adjustments relative to totex).
- This is driven by the bottom-up application of regional wage adjustments to hundreds of individual categories of costs based on individual DNO labour splits.
- This is inappropriate because:
 - the results will be driven in part by disparate allocation assumptions across DNOs; and
 - it weakens the incentives on DNOs to:
 - optimise across labour/capital boundaries; and
 - structure their operations optimally reflecting labour costs, since any gain could be removed from them by the benchmarking.
- This problem must be solved to restore Ofgem's overall policy intent of not applying differential wage adjustments for every region. A top-down method would serve to equalise the wage adjustment across the non-London, non-South East DNOs at the same level.

Failure to make like-for-like comparisons of wages

- The data the Draft Determination relies on is not fit for Ofgem's purpose: in fact, the ONS warns that regional comparisons using the dataset Ofgem relies upon may not be like-for-like. Our detailed analysis demonstrates that the data subsets Ofgem has placed substantial weight on are likely to suffer from significant bias because London and the South East have a higher concentration of more highly skilled and highly paid jobs than the rest of the country.
- The result, in Ofgem's models, is a set of implausibly large labour cost adjustments for companies operating in London and the South East, amounting to an increase relative to Northern Powergrid Northeast of over 12% of totex for operating in Greater London, 9% in the Seeboard region and 5% in the Southern region. This is equivalent to an allowed labour cost premium of 25% for staff that need to be based in London, 13% for those that need to be based in the Seeboard region and 9% in the Southern region.
- Ofgem should only allow a wage premium due to the effect of the cost of living on market wages for *identical* roles; not because certain regions have a much higher concentration of higher skill and higher pay roles.
- We have analysed more tightly defined occupations, with less scope for compositional skew, and on this basis there is strong evidence that:
 - a London premium exists (10%-15% on wages); but
 - there is either little or no South East premium (0%-5% on wages).

Conclusions

The solution is a simple top-down regional wage adjustment, based on a set percentage of a DNO's totex, which can then be allocated across individual costs lines. As the compositional effects of the data subsets may still introduce a London and South East bias, the bottom end of the ranges seen in occupations where there is relatively little scope for compositional bias should be adopted - resulting in a 10% London premium and no South East premium.

If Ofgem adopted this approach the result for the industry as a whole would be broadly neutral, since no change is necessary to the sum of the labour cost adjustments across DNOs, and since Ofgem's upper quartile at the industry level is designed to ensure the benchmarking results are aligned to a challenging level overall. But it would significantly affect the relativities across DNOs. It is little wonder that the benchmarking results in Ofgem's Draft Determination fail to reflect our actual established efficiency - since a major and unjustified cost-advantage has been inadvertently handed to DNOs operating in Greater London and the South East (relative to the costs pressures they actually face).

When we met with you and your colleagues on the Authority, I said that our assessment was that Northern Powergrid had been treated harshly relative to the other slow-track DNOs. At that time, I was referring to the facts that:

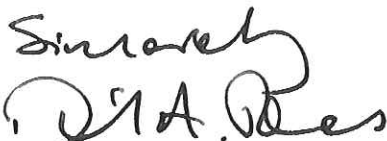
1. The combination of our current efficiency and the movement in cost allowances from DPCR5 to ED1 results in an implied level of efficiency that is harsher than any other settlement being contemplated in the Draft Determination.
2. Northern Powergrid has benefited from the smallest amount of qualitative adjustments in the disaggregated cost modelling, despite having submitted what has been regarded by many as the most clearly-articulated set of cost justifications.

Those points stand and remain unanswered by the Ofgem team.

This issue of inappropriate application of the regional wage adjustments is additive to that problem.

Also, since I met with Dermot, our modelling team has also discovered that Northern Powergrid is the second most adversely affected by Ofgem's use of ratchets in the disaggregated model. This modelling approach systematically works against companies that concentrate on optimising cost across the total cost portfolio - and it goes a long way to explain why the disaggregated modelling result for Northern Powergrid is so different from the other two models that Ofgem uses in its toolkit approach. We have shared this detail with the price control team, who have said they will consider the issue.

Taken together, all of these issues leave Northern Powergrid significantly harmed and disproportionately treated in a way that I did not fully appreciate when we met with the Authority. I would appreciate the opportunity to discuss the matter with you in person. Being mindful of the pressure on everyone's time, I thought it would be helpful to set out my concerns in writing ahead of a discussion.



Phil Jones
Chief Executive

Annex 1: Draft Determination Regional Wage Adjustments Relative To Totex

	Totex: submission	Regional labour adjustment	% totex	Relative to NPgN
LPN	1883	191	10.1%	+12.1%
SPN	1783	79	4.4%	+6.4%
SSES	2343	59	2.5%	+4.5%
EPN	2652	37	1.4%	+3.4%
EMID	1945	-23	-1.2%	+0.8%
WMID	1931	-24	-1.2%	+0.8%
SWEST	1582	-20	-1.3%	+0.7%
SWALES	1011	-13	-1.3%	+0.7%
SSEH	1170	-16	-1.4%	+0.6%
ENW	1794	-28	-1.6%	+0.4%
SPD	1496	-25	-1.7%	+0.3%
SPMW	1840	-31	-1.7%	+0.3%
NPgY	1725	-33	-1.9%	+0.1%
NPgN	1300	-26	-2.0%	+0.0%

Source: Northern Powergrid calculations based on Ofgem Draft Determination
Shared with Dermot Nolan on 9 September 2014