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3 September 2015

Dear Rupika

**National Grid's response to Ofgem's minded-to
Position for the Fuel Poor Network Extension Scheme**

Please find enclosed National Grid's response to your letter dated 5 August 2015, Ofgem's consultation on the minded-to position for the Fuel Poor Network Extension Scheme. In our response we have answered your two specific questions and also added some supplementary comments to seek further clarification on your proposals.

1. Do you agree with our assessment of revised connections target for the GDNs for the scheme?

National Grid can confirm the RIIO-GD1 revised total targets for volumes are consistent with what has been submitted. However, our commitment to delivering additional volumes was on the understanding we would receive an equitable allowance to do the work. We do not agree that the proposed allowance will allow us to meet our ambition to support fuel poor customers.

2. Do you agree with our assessment of the additional allowed expenditure for the GDNs to facilitate additional connections under the scheme?

National Grid is keen to deliver additional fuel poor connections, however, at this point we are not able to agree with the assessment for additional allowed expenditure.

Basis of cost analysis

We understand Ofgem's use of an efficient unit cost for each connection based on an upper quartile approach. However, we do not understand why only 2013/14 has been used as the benchmark, when there are two years of RIIO-GD1 RRP data now available, as well as the GDN's independent forecasts. We would welcome an approach which blended at least the latest two years of cost data, and also analysis of how this compares with the original RIIO-GD1 values and methodology.

Community v One Off Fuel Poor Connection costs

It appears that in deriving the unit cost, Ofgem has used a weighted average unit cost for both community connections and one-off connections. National Grid does not believe this approach is appropriate, for a number of reasons:

- The unit cost for a community connection is significantly different to a one-off connection due to the mains extension, and the increased overhead of managing a large project and its coordination with in-house works and associated organisations.
- Each GDN will have a different mix of community connections and one-off connections.
- We believe National Grid has a very different mix of community to one-off connections when compared to the other GDNs.
- National Grid's proposal to increase volumes overall by 5.7% is weighted heavily towards community connections. A 32% increase in community connections is offset by a small reduction (-0.2%) in one-off connections.

The table below summarises National Grid's proposed increase in volumes:

<u>Community</u>	Revised	RIIO		%
<i>Volumes</i>	Forecast	target	Variance	change
East	2,980	1,280	1,700	
London	-	-	-	
North West	2,155	2,560	(405)	
West Midlands	3,294	2,560	734	
	<u>8,429</u>	<u>6,400</u>	<u>2,029</u>	<u>31.7%</u>

<u>One-off</u>	Revised	RIIO		%
<i>Volumes</i>	Forecast	target	Variance	change
East	9,066	8,800	266	
London	2,880	2,880	-	
North West	11,175	10,770	405	
West Midlands	5,072	5,800	(728)	
	<u>28,193</u>	<u>28,250</u>	<u>(57)</u>	<u>-0.2%</u>

<u>Combined</u>	Forecast	RIIO		%
<i>Volumes</i>	Forecast	target	Variance	change
East	12,046	10,080	1,966	
London	2,880	2,880	-	
North West	13,330	13,330	-	
West Midlands	8,360	8,360	-	
	<u>36,616</u>	<u>34,650</u>	<u>1,966</u>	<u>5.7%</u>

Using the information we have provided in our regulatory submissions you can see how the unit costs differ from the more complex community connections and the more straightforward one off connections.

Based on our experience in the first two years of RIIO, the cost of more complex community connections are 33% higher on average than one-off connections, and can vary significantly from project to project. We would also note that a GDN is obliged to connect any project where the unit cost, net of any customer contribution, is at or below the relevant fuel poor voucher value e.g. £1,972 in the East of England. Up to this cost, efficiently incurred, will still be a valid project and satisfy the self funding criteria.

In earlier correspondence we noted that increasing the target number of connections for communities will further increase the differential. The more connections we deliver, the harder it becomes in time and effort, to first find the schemes, and then install the connections, which are likely to become increasingly complex. Recognising there will be higher costs associated with higher volumes in our recent submission we increased the unit rate for these schemes by 10% compared to the RIIO final proposals allowance (i.e. for the avoidance of doubt the higher rate only applies to the higher volumes in each network). This increase was based on our most recent experience of fuel poor connection costs, and reported to Ofgem.

National Grid is unable to deliver the additional volumes for the incremental allowance expenditure Ofgem has included within their publication (£2.3m). Our calculations suggest £4.5m is required ('14/15 prices) to deliver the additional work. This equates to £2,016 unit cost for each additional community connection (an average across EE and WM), which is still below the fuel poor voucher value.

National Grid is keen to carry out additional Fuel Poor connections, and continue the work we have done to connect whole communities. To support this, we would urge Ofgem to not create an incentive to focus primarily on one off fuel poor connections, and benchmark community connection cost separately from one offs, capped by the appropriate fuel poor voucher value. Such an approach would also need to be applied to future district heating costs, as these should also be benchmarked separately to recognise the significant differences.

The minded to approach creates a significant shortfall and would not provide the funds necessary to connect the additional fuel poor communities we have forecast. This makes it very hard for us to commit to the additional volumes we all want to pursue.

Other comments / clarifications

Re: Clarity on treatment of first 2-3 years of RIIO-GD1

The review process to date has requested the GDNs to reforecast costs and volumes from April 2016 onwards, when the proposed changes to the scheme take effect. We are therefore assuming that the proposed incremental costs and volumes have no bearing on any decision as to the efficiently incurred costs between 2013/14 and 2015/16 inclusive. We would welcome a discussion on this, if we are incorrect in making this assumption.

Re: decision not to allow further re-forecasting opportunity

National Grid previously indicated that given the uncertainty around government funding in future years it is still difficult to accurately forecast future volumes, and subsequently we requested an opportunity to formally re-forecast volumes again at a later date. We understand and accept Ofgem's position and the constraints of Special Condition 3F, and also recognise Ofgem have somewhat mitigated this with the over/under incentive mechanism. However, we believe it is important to flag up the risk this creates in our delivering the outputs. External factors, which may include changes to the level of funding that is available, could significantly affect our ability to deliver these outputs. Of course, additional funding in this space would not be an issue. We are more concerned if there is a continued tightening of local council budgets which could further constrain funding for in house capital measures, especially if no further additional funding is forthcoming at government level. This could have a negative impact on future numbers of Fuel Poor connections and this in effect would be out of our control.

Re: District Heating

We expressed in previous correspondence our thoughts on the possible opportunity to explore district heating as a route to accessing high density fuel poor communities.

National Grid would appreciate further clarity as soon as possible on Ofgem's vision for how district heating costs will be regulated and the voucher mechanism operate. Ofgem's minded position is to allow efficient costs; could Ofgem elaborate on how this will be tested?

At present, we are unclear whether a Fuel Poor voucher will be available for each household, rather than per connection as is currently the case and which constrains take-up. We would appreciate if Ofgem could clarify how they see this working. Is it for instance, aligned to our proposal of capping the connection cost based on the number of households multiplied by domestic Fuel Poor voucher level?

Re: Connections on IGT network

We are disappointed the joint GDN/IGT proposal has not been endorsed by Ofgem. Our proposal established a consistent, robust and practical process, and removed the barriers of funding certainty for IGTs and GDNs. National Grid does not agree that we should be accountable for reviewing the efficient costs of a third party doing work on their own network. It is entirely inappropriate for one licensee to act as a pseudo regulator in assessing another licensee's activities. Particularly as the licensees are competing in the connections market. It is also an important principle that the GDNs and IGTs are treated consistently e.g. timing, value of remuneration and efficiency drivers.

We believe the GDNs should be remunerated fully (up to the CSEP point) for connections on the IGT network and this mechanism should be as close to real time as possible for both IGTs and GDNs. We believe there is a key principle at stake here: A GDN should not have any significant costs or associated risks imposed on it directly by the policies, plans, actions and strategies of an IGT. With this in mind, and the strong desire by all to facilitate as many IGT fuel poor connections as possible, we struggle to understand why Ofgem are unable to accept the proposal agreed by the IGTs and the GDNs.

The minded to proposal places two significant risks on each GDN. Firstly, the risk that payments to IGTs, when reviewed by Ofgem at the end of a price control as proposed, may be discounted. Secondly, the short term cash-flow risk from having to fund IGT voucher payments, which IGTs would have no obligation to forecast at all, let alone accurately. The suggestion that each GDN should establish a robust fuel poor planning and forecasting mechanism with each IGT could be seen as anti-competitive i.e. sharing information between competing organisations and/or abusing a dominant market position.

We do not accept that National Grid should bear any risk for work being carried out by another business on their own assets. It is not appropriate for National Grid to both, bear this risk and also to finance the activity of another company. We ask Ofgem to reconsider their position on this area and seek an equitable agreement with the GDNs and IGTs before publishing their final conclusions. Our strong preference would be to a simple pass through mechanism, as we see no reason to expose the GDNs to the risks described above. Should the existing miscellaneous pass through mechanism be unacceptable then we see no reason why the existing reopener window in May 2018 could not be used, when other uncertain costs will need to be agreed and passed on to customers. This would avoid a long term log up of costs and then the associated cost of capital for the additional years being passed onto customers, when there is known industry price change due, which will see a movement in transportation fees.

National Grid remains committed to our Fuel Poor ambition and we ask you to consider the concerns and questions we have raised before concluding your review. We would welcome discussing the issues raised in this response with you at the earliest opportunity.

Yours sincerely



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