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Dear Mick

Introduction of RIIO Accounts – further consultation on licence modification

Thank you for giving us the opportunity to comment on the consultation on the proposed licence modification to introduce a requirement for licensed network operators (NWOs) to prepare and publish RIIO Accounts.

The current timetable for the introduction of RIIO Accounts was established with the target of introducing RIIO Accounts for the 2017/18 regulatory year. In order to achieve this ambition, the timetable contained the risk that the licence modification would be issued prior to Ofgem receiving feedback on the implementation issues arising from the NWOs conducting a “dry run” of the activity required to prepare RIIO Accounts and this work being reviewed by the auditors. This risk has materialised and fundamental issues have been raised which Ofgem should recognise such that implementation of the proposed licence modification should, at least, be deferred pending consideration of these issues. We provide further details below.

Issues arising from audit feedback at an industry level

Since Ofgem’s consultation was issued on 8 November 2017, feedback received from the audit firms has raised a number of significant issues which mean that progressing with the RIIO Accounts licence modification in its current form would be ill advised.

The audit feedback was presented at the Ofgem workshop on 17 November 2017 and followed the “dry run” activity undertaken by the NWOs and audit firms this year, in line with Ofgem’s timetable. That feedback outlined a number of serious issues:

- The Ofgem Regulatory Financial Reporting Standard (ORFRS) is principles-based and, therefore, open to interpretation (such as the enduring value adjustment). Where standards are principles-based (such as UK GAAP), guidance notes are usually issued, which provide details on how to interpret those principles and examples of that interpretation. There will

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not be consistent application of the ORFRS without this practical guidance. *This missing guidance needs to be developed;*

- Certain balances in the RIIO Accounts (such as RAV and revenue) come from Ofgem's models and, therefore, are not auditable. Consequently, the auditors will need Ofgem to provide confirmation of these balances so that the auditors are able to rely on that information and on Ofgem's associated representations regarding that information. *Consequently, a list of balances requiring assurance by Ofgem should be compiled and provided to Ofgem for this purpose; and*
- Form of Audit Report – *until the above two points are addressed it would not be possible for the auditors to provide a "fairly presents" opinion, i.e. for 2017/18.* As a potential solution Deloitte has suggested that each NWO could develop a published methodology statement showing how it had interpreted the ORFRS in preparing the RIIO Accounts. The auditors would then provide an audit opinion based on whether the RIIO Accounts had been "prepared in accordance with" the published methodology statement. Having prepared the first sets of RIIO Accounts, the NWOs would have to review these statements with Ofgem to arrive at a common methodology, thereby providing the guidance and examples that are currently missing. If this suggestion was adopted for the 2017/18 regulatory year, the discussion on a common methodology could only begin after September 2018, so the next two years of RIIO Accounts would have to be audited on an "prepared in accordance with" basis rather than a "fairly presents" basis.

The ORFRS does not currently support obtaining an audit opinion on a "fairly presents" basis. As much of the form and content of the RIIO Accounts has been driven by the desire to obtain this form of opinion, rather than an opinion on a "prepared in accordance with" basis, this would be a good opportunity for Ofgem to take stock and consider the costs and benefits of placing the obligation on the NWOs to prepare RIIO Accounts.

In our previous consultation responses we have questioned the value to customers of the "fairly presents" audit opinion and have suggested that the information investors require could be achieved rather more effectively by Ofgem simply extending the PCFM to include a RAV and a properly prepared RORE.

Ofgem's original impact assessment¹ contained the following statement on costs and benefits:

"Costs and benefits

6.16. We expect our proposal for RIIO accounts will have a broadly neutral effect on the regulatory compliance costs borne by NWOs (and so ultimately consumers). It is possible there will be some savings if the introduction of RIIO accounts means that other regulatory reporting can be reduced in future. We consider that there could be significant financial benefits for consumers in the long run if our proposals successfully improve transparency for investors and reduce perceptions of risk so that financing costs can be more efficiently incurred. In any case, we do not consider that there would be any impact on the distribution of costs amongst stakeholders."

¹ Ofgem's RIIO Accounts: Consultation on our proposed framework document dated 14 November 2015

At the time Ofgem published the impact assessment, it was envisaged that the RIIO Accounts would be relatively concise, with a focus on presenting key measures of performance under the regulatory framework. This has not proved to be the case and the requirements now run to many tens of pages of information, similar to a set of statutory accounts, and the predicted costs of auditing the RIIO Accounts is now several millions of pounds for the NWOs. There will also be substantial internal resource costs that the NWOs will have to dedicate to the preparation of RIIO Accounts. It is no longer the case that introduction of RIIO Accounts will be cost neutral or that the NWOs will be able to make savings in other regulatory reporting areas. In addition, it is not clear to us who will actually read the significant quantity of information required to be included in the RIIO Accounts and, therefore, it does not seem sensible to impose this cost on consumers without further, considered assessment.

The risk assessment predicted significant financial benefits, if the proposals were successful in improving transparency for investors and in reducing the perceptions of risk so financing costs could be more efficiently incurred. This prediction is unproven and requires further consideration. The NWOs are already incentivised through the price control regime to incur financing costs efficiently and, therefore, to provide the information investors require in order to raise new debt and equity at the best possible rates.

Ofgem should ask itself why such an incentive is not sufficient to encourage the NWOs to provide whatever providers of finance require for them to be satisfied that they understand and have confidence in the sector and its regulatory arrangements.

Proposed licence modification

Our preference is for Ofgem to defer the proposed licence modification to allow a robust cost benefit analysis to be undertaken based on the current proposals for RIIO Accounts and for the audit requirements to be better understood, such that the NWOs are not required to produce RIIO Accounts for the 2017/18 regulatory year. This would not necessarily stop further progress being made (if Ofgem determines that the benefits case remains proven) in developing the ORFRS or production of RIIO Accounts by the NWOs on an informal “dry-run” basis and, therefore, would not necessarily lead to a delay in the achievement of a “fairly presents” audit opinion, if that is still the preferred outcome.

If Ofgem wishes to go ahead with making the licence modification now, the audit requirement should be changed to a “prepared in accordance with” basis in order to avoid qualified audit opinions being given, which would achieve nothing in terms of realising the perceived benefits from RIIO Accounts for consumers. Even if RIIO Accounts are audited on a “prepared in accordance with” basis, we remain concerned that publication of the methodology statements could create more uncertainty in the regulatory regime if the NWOs’ interpretations of the ORFRS differs from each other.

For either basis of audit opinion, it seems that Ofgem would need to be prepared to confirm the validity of various balances to the audit firms, the extent of which may need to be described in the licence condition. Consequently, it would be preferable to progress with further “dry-run” activity in the 2017/18 regulatory year and firmly establish these requirements first, rather than introduce a formal licence condition under which there would be too much risk of the NWOs obtaining audit

opinions at significant overall cost, which would confuse rather than provide assurance on regulatory performance for investors/stakeholders.

The licence modification, as currently drafted, allows amendment of the ORFRS to be made as late as the last day of the regulatory year in respect of which RIIO Accounts are prepared. In order to allow a reasonable amount of planning time for both NWOs and auditors, this should be changed to 31 December in the regulatory year in respect of which the RIIO Accounts are prepared.

There are some areas of the ORFRS where we feel that further guidance is required but we will provide this feedback separately.

Finally, we must comment upon the Proposed Regulatory Corporate Governance Statement Principles (RCGS). This draft is fundamentally flawed as it strays into matters of governance that Ofgem cannot determine. The regulatory regime has been designed carefully so that Ofgem regulates the licensee. It does not regulate those who own a licensee; nor even the directors of a licensee. It is not appropriate for Ofgem to direct that companies or directors should have a particular 'business model' – or indeed any 'business model' - and Ofgem should not require companies to promote a particular view of how well the regulatory regime is working to protect customers. Ofgem should, as a general principle, keep out of company governance and leave this to shareholders.

Consultation questions

We have attached Ofgem's completed questionnaire template and have also provided feedback on the proposed licence condition on the basis of Ofgem seeking a "fairly presents" opinion. However, as should be clear from our comments above, we do not believe this basis of opinion should be pursued at this stage.

Conclusion

The development of RIIO Accounts and the associated ORFRS and RCGS is a complex project and we feel that it is better for the interests of consumers to take longer to get it right and to ensure the costs that will be incurred are justified.

Yours sincerely



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