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RIIO-2 Team
Network Price Controls
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Dear RIIO-2 team,

This letter sets out Northern Powergrid's response to the questions on the ESO finance model that Ofgem published as part of the T2 and GD2 methodology decision, where we can offer some relevant views.

ESQ1: We think that model 1 (with a RAV element, as opposed to pure fast money, and where an externally-set totex capitalisation rate is applied) is likely to better facilitate the twin objectives of:

1. maintaining strong incentives on the ESO (since the shareholder would have more at stake); and
2. supporting financeability (since a return on the RAV would provide free cash flow).

With no RAV element the overall cost to consumers of meeting these objectives may be higher.

ESQ2: An additional return (or margin) will be needed. It is definitionally the case that a downside regulatory or political risk (compared to a scenario where there is no such risk) will reduce expected returns. An additional return will help maintain expected returns at levels that investors would require. The level of risk would need to be evaluated, and then WACC (or margin) would need to be set higher than it would otherwise be to offset this risk. If this risk is not recognised and allowed for the costs of operating the business would not be covered.

We offer no response to ESQ 3-4 which relate only to ESO working capital facilities and their availability.

ESQ5: Whether downside incentive penalties are in place or not, the ESO will be exposed to downside regulatory and political risks. For example, the potential regulatory fines that the ESO is exposed to, like the ones Ofgem can levy under the Electricity Act 1989 and Competition Act 1998, are significant. It will therefore be necessary to consider and address the issue of downside risk and the financial resilience of the ESO irrespective of whether the price control incentives contain a downside element. Given these issues need to be addressed regardless of the incentive package, we think there would be little additional cost from an incentive package that contains downside as well as upside. Such a package would have the benefit of strengthening shareholder pressure on management over performance, compared to an incentive package with no downside.

Yours sincerely

Keith Noble-Nesbitt
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