ANNEX 29: FIXED COSTS OF SINGLE LICENSEE STATUS

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1. Executive Summary

Electricity North West is the only Distribution Network Operator (DNO) that is in an ownership structure that does not contain another DNO. As a consequence of this, we incur a level of fixed costs that is higher than other DNOs (because the other DNOs can share costs with companies in the same group).

We asked KPMG to analyse the level of fixed costs that a single licensee would incur above the level that would be expected of DNOs in an ownership group that included two DNOs. KPMG's report estimated that the fixed cost uplift which Electricity North West should be afforded relative to other DNOs as a result of its single licence status is £10.5m per year (2011-12 prices). We included this report in our July 2013 plan and are pleased that Ofgem recognised this as a "*well presented report*".

We used the results of KPMG's analysis in testing that our forecast costs represent an efficient level of costs for a single licensee group.

Ofgem's cost assessment analysis undertaken as part of its Fast Track decision did not take account of the fixed costs of being a single licensee. This resulted in the level of business support costs included in our July 2013 plan being assessed as being inefficient. Oxera has undertaken analysis for us that considers alternative assumptions within Ofgem's business support models. Oxera has also considered alternative modelling approaches such as regression analysis. This analysis demonstrates that Ofgem's assessment of our business support costs as part of its Fast Track decision was materially distorted by an inappropriate assumption regarding fixed cost normalisation; alternative models suggest materially higher modelled efficient costs for Electricity North West.

We also asked Oxera to assess whether it was possible to calculate the level of fixed costs by ownership group econometrically based on the data provided by DNOs in July 2013. Whilst the results of this analysis are not fully intuitive, possibly due to the small sample size used, they do disprove the hypothesis that fixed costs vary linearly by licensee, demonstrating that smaller companies incur a higher level of fixed costs.

Overall, we are confident that our plan offers excellent value for money for our customers and that the benefits in other parts of our plan outweigh these higher costs. Despite the inclusion of these costs our customers will pay some of the lowest prices for electricity distribution in Great Britain during the RIIO-ED1 period. Last year Ofgem assessed the total costs of each DNO's business plan and its analysis showed that our total costs are amongst the lowest of any DNO. This efficient cost base feeds directly into lower prices for our customers. Our leadership in our industry demonstrates that our customers benefit considerably from being served by Electricity North West. Electricity customers connected to our network receive some of the best quality of supply for some of the lowest costs of anywhere in the country. Their service is provided by an effective business focussed solely on the North West that has a proven track-record in innovation, enabling a rapid and effective response to any new challenge that might arise.

We accept that single licensee status is not an inherent characteristic and that it is possible that during the course of RIIO-ED1 our status could change. If we become part of an ownership structure that includes one or more other DNO licensee (either because our current owner purchases another licensee or because we are sold into a group that already includes a DNO licensee) we agree that an adjustment should be made to our cost baselines for fixed costs to ensure that any fixed cost allowance that we no longer need is returned to customers.

2. Ownership Structure of Licensees in Great Britain

The ownership structure of Distribution Network Operators is set out in the following figure and table:

1. Western Power Distribution: West Midlands (WMID)
2. Western Power Distribution: East Midlands (EMID)
3. Electricity North West Limited (ENWL)
4. Northern Powergrid (Northeast) Ltd (NPgN)
5. Northern Powergrid (Yorkshire) plc (NPgY)
6. Western Power Distribution: South Wales (SWALES)
7. Western Power Distribution: South West (SWEST)
8. UK Power Networks: London Power Networks (LPN)
9. UK Power Networks: South East Power Networks (SPN)
10. UK Power Networks: Eastern Power Networks (EPN)
11. Scottish Power Distribution Ltd (SPD)
12. Scottish Power Manweb plc (SPMW)
13. Scottish & Southern Energy: Scottish Hydro Electric Power Distribution (SHEPD)
14. Scottish & Southern Energy: Southern Electric Power Distribution (SEPD)

Group	Operating area	Licensees in ownership group
Electricity North West	North West	1
Northern Power Grid	North East	2
	Yorkshire	
Western Power Distribution	West Midlands	4
	East Midlands	
	South Wales	
	South West	
UK Power Networks	London	3
	South East	
	East	
Scottish Power	South Scotland	2
	Merseyside & North Wales	
Scottish and Southern Energy	North Scotland	2
	South	

Electricity North West is the only DNO that is in an ownership structure that does not contain another DNO.

3. Quantification of Fixed Costs Incurred by Licensees

3.1 Bottom Up of Level of Fixed Costs - KPMG

Analysis based on 14 licensees will not appropriately calculate the level of fixed costs that would be required for an efficient single licensee (because all other DNOs belong to ownership groups that include multiple DNOs).

We asked KPMG to analyse the level of fixed costs that a single licensee would incur above the level that would be expected of DNOs in an ownership group that included two DNOs. KPMG's report 'Estimating a fixed cost uplift allowance for RIIO-ED1' contains the results of its analysis. KPMG also tested whether any of the fixed costs could be diversified by outsourcing these activities. Its subsequent report 'Outsourcing suitability assessment' contains this analysis. KPMG's two reports can be found as Appendices 1 and 2 to this annex.

We included KPMG's reports in our July 2013 plan and are pleased that Ofgem recognised this work as "*a well presented report*".

In summary, KPMG undertook a bottom up approach to assessing how individual elements of our closely associated indirect and business support cost base would change if we were to double the size of our network. Its report identified fixed costs and semi variable costs (costs which are not fixed but would not change proportionately with the size of the network, equivalent to Ofgem's group-variable costs definition). It did not seek to identify the cost drivers associated with semi-variable costs. Where possible it cross referenced its analysis to academic research and management literature for evidence in relation to economies of scale that have been achieved. The following table summarises the results of KPMG's analysis.

2011-12 prices Net distribution		Single licensee group			2 licensee group		
		Fixed costs	Semi variable costs	Total fixed plus semi variable	Fixed costs	Semi variable costs	Total fixed plus semi variable
Closely Associated Indirects	Network design & engineering	0.8	1.1	1.9	0.8	1.2	2.0
	Engineering management and clerical support & Project management	0.5	0.6	1.1	0.5	0.8	1.3
	System Mapping	0.2	0.0	0.2	0.2	0.0	0.2
	Control Centre	1.4	0.0	1.4	1.4	0.0	1.4
	Call centre	1.0	0.0	1.0	1.0	0.0	1.0
	Stores	0.1	1.9	2.1	0.1	2.7	2.8
	Operational training	0.3	0.0	0.3	0.3	0.0	0.3
	Vehicles and transport	0.1	0.1	0.1	0.1	0.1	0.2
	Network policy	0.4	0.0	0.4	0.4	0.0	0.4
Business Support Indirects	HR and non-operational training	1.0	0.1	1.1	1.0	0.2	1.1
	Finance & Regulation	2.2	2.0	4.1	2.2	2.8	5.0
	CEO	1.4	0.0	1.4	1.4	0.0	1.4
	IT & telecoms (indirects only)	1.4	10.3	11.7	1.4	14.6	16.0
	Property (indirects only)	0.3	2.1	2.4	0.3	3.9	4.2
	Total	10.9	18.2	29.0	10.9	26.4	37.3

KPMG's analysis showed that the proportion of fixed and semi variable costs varied significantly between activities. Fixed and semi variable costs comprise more than 50% of the following activities: stores, network policy, HR and non-operational training, CEO, IT & Telecoms, Property.

		Fixed costs	Semi variable costs	Variable costs
Closely Associated Indirects	Network design & engineering	15%	20%	65%
	Engineering management and clerical support & Project management	3%	4%	93%
	System Mapping	13%	0%	87%
	Control Centre	37%	0%	63%
	Call centre	31%	0%	69%
	Stores	8%	92%	0%
	Operational training	4%	0%	96%
	Vehicles and transport	1%	1%	97%
	Network policy	100%	0%	0%
	Total	11%	8%	81%

Business Support Indirects	HR and non-operational training	52%	7%	41%
	Finance & Regulation	25%	23%	53%
	CEO	53%	0%	47%
	IT & telecoms (indirects only)	11%	81%	7%
	Property (indirects only)	9%	70%	21%
	Total	21%	50%	28%

KPMG's report estimated that the fixed cost uplift which Electricity North West should be afforded relative to other DNOs as a result of its single licence status is £10.5m per year, after adjustment for reductions that could potentially be achieved through outsourcing (2011-12 prices). The following table shows the fixed cost uplift identified by KPMG, by activity.

		KPMG estimate		Uplifted to 2012-13 prices	
		net distribution*	gross costs	net distribution	gross costs
		2011-12	2011-12	2012-13	2012-13
Closely Associated Indirects	Network design & engineering	0.8	0.8	0.9	0.9
	Engineering management and clerical support & Project management	0.4	0.4	0.4	0.4
	System Mapping	0.1	0.1	0.1	0.1
	Control Centre	0.7	0.7	0.7	0.7
	Call centre	0.5	0.5	0.5	0.5
	Stores	0.6	0.6	0.7	0.7
	Operational training	0.1	0.1	0.1	0.1
	Vehicles and transport	0.1	0.1	0.1	0.1
	Network policy	0.2	0.2	0.2	0.2
Business Support Indirects	HR and non-operational training	0.5	0.6	0.6	0.6
	Finance & Regulation	1.6	1.8	1.7	1.8
	CEO	0.7	0.7	0.7	0.8
	IT & telecoms (indirects only)	3.8	4.1	3.9	4.2
	Property (indirects only)	0.2	0.2	0.2	0.2
	Total	10.5	10.9	10.7	11.3

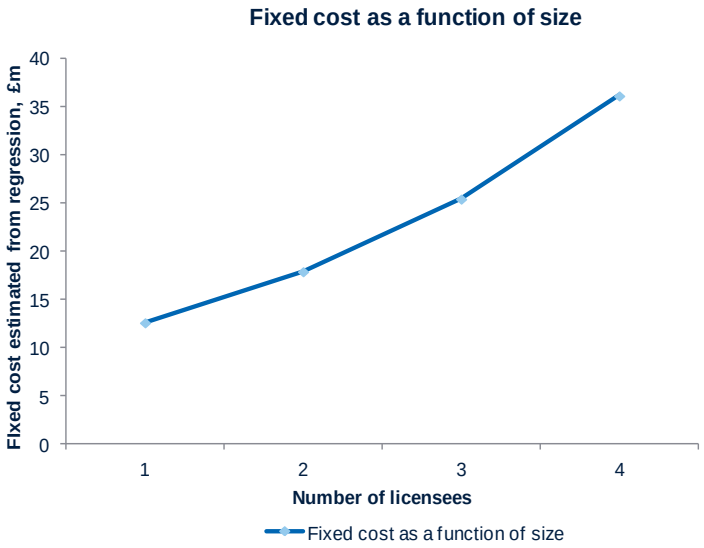
* Equivalent to 'Estimated Efficient Fixed Cost Uplift adjusted for non price control costs' in KPMG report

We used the results of KPMG's analysis in testing that our forecast costs represented an efficient level of costs for a single licensee group.

3.2 Econometric Assessment of Level of Fixed Costs - Oxera

We asked Oxera to test whether it was possible to assess the level of fixed costs incurred by companies of different sizes econometrically using a regression model containing the data submitted by DNOs in July 2013. The results of Oxera's analysis follow.

Ownership Group	Average Business Support Cost submitted over forecast (£m)	Average fixed cost estimated from the model (£m)
ENWL	36	12.6
NPG	42.1	17.9
SP	50	17.9
SSE	48.3	17.9
UKPN	91.9	25.4
WPD	105.3	36.1
Total	**373.6**	**127.7**



Oxera's results are somewhat counterintuitive as they suggest that more fixed costs are incurred in moving from a 3 DNO group to a 4 DNO group than is suggested between 2 and 3 DNO group. The opposite would be expected, particularly as the average size of WPD's 4 licensees is smaller than the average size of UKPN's licensees. This is possibly because of the small sample size involved and the fact that the sample includes only one single licensee, one 3 DNO group and one 4 DNO group. For this reason, we do not recommend that Ofgem uses econometric modelling to assess levels of fixed costs due to the sample size involved.

Using the fixed costs estimated from the regression model, Oxera tested the hypothesis whether fixed costs are proportional to the number of licensees operated by an ownership group. The hypothesis was rejected at the 1% level of significance. In other words, when the number of licensees increases from one to two, the fixed cost of the group increases by less than twice, demonstrating that smaller companies incur a higher level of fixed costs.

Further details of Oxera's analysis can be found in Appendix 3.

4. How Ofgem's Cost Assessment Analysis Considered Fixed Costs

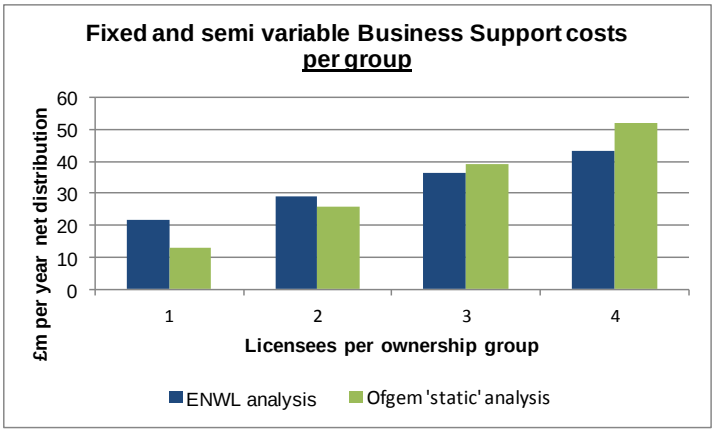
4.1 Business Support Analysis

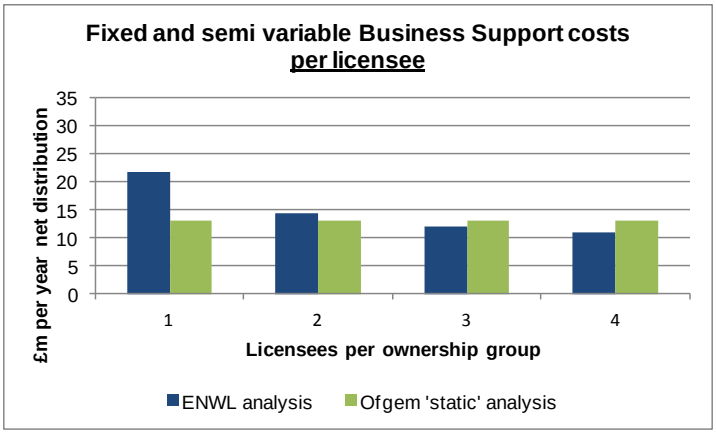
4.1.1 Ofgem's Approach

Ofgem's bottom up analysis of our proposed business support costs as part of its Fast Track decision suggested that efficient business support costs for Electricity North West are £177m (2012-13 prices, net distribution, eight year total, including real prices effects). Our plan included £255m of business support costs. Ofgem therefore suggested that our proposed business support costs were 44% higher than a modelled efficient level of costs.

As part of its analysis it made a normalisation adjustment to remove £13m per licensee from business support costs. In doing so, it effectively assumed that costs were fixed by licensee and no costs could be shared between companies.

The following graphs show how the level of fixed and semi variable costs removed in Ofgem's normalisation compare to the level identified in KPMG's analysis. We have extrapolated KPMG's analysis to show 3 and 4 licensee groups. It is clear that Ofgem's normalisation differs significantly from KPMG's and that at a licensee level (second graph), Ofgem's approach will particularly distort the efficiency results of single licensee groups.





4.1.2 Sensitivity Analysis of Ofgem's Approach

Ofgem's business support cost assessment model does not currently include a facility to remove different levels of fixed costs per group; it simply allows removal of the same value per licensee or per group.

We asked Oxera to undertake analysis to test the sensitivity of results of Ofgem's modelling to different assumptions in fixed cost normalisation, using the following scenarios:

- £13m per licensee – as in Ofgem's Fast Track analysis
- No fixed cost adjustment
- £23m per ownership group – twice KPMG's identified fixed cost uplift between a single and two DNO group

The results of Oxera's analysis show that Ofgem's business support analysis is hugely sensitive to its fixed cost assumptions, and that more appropriate assumptions would result in modelled efficient costs for Electricity North West being more than £77m higher.

Fixed costs - results

£m ED1 2012-13 prices		£13m per licensee (Ofgem)	No adjustment	£23m per Group
Static	Efficiency %	-47%	-24%	29%
	Allowance	184.5	190.8	261.7
Monte Carlo	Efficiency %	-25%	-22%	6%
	Allowance	184.9	192.8	262.1

Fixed costs - variance

£m ED1 2012-13 prices		£13m per licensee (Ofgem)	No adjustment	£23m per Group
Static	Efficiency %	N/A	23%	76%
	Allowance	N/A	6.2	77.2
Monte Carlo	Efficiency %	N/A	3%	31%
	Allowance	N/A	7.9	77.2

The detailed results of Oxera's analysis can be found in Appendix 4.

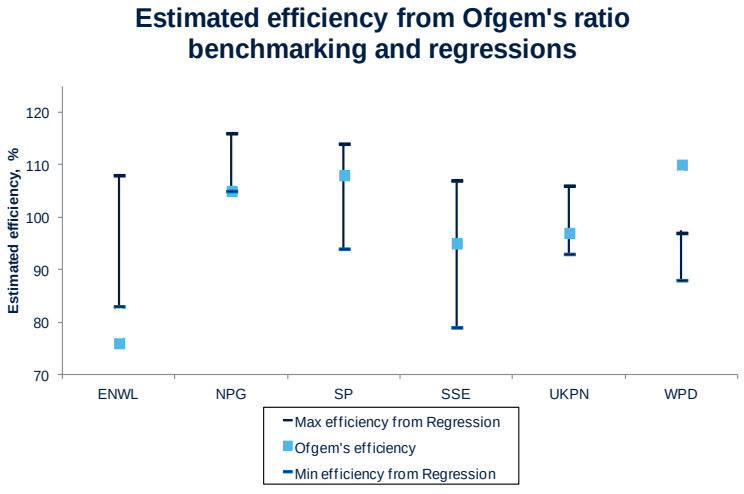
4.1.3 Alternative Regression Analysis

We asked Oxera to assess how the results from regression analysis differ from those of Ofgem's model.

Oxera developed a range of eight regressions based on combinations of

- Cost driver: Ofgem's Business Support composite and MEAV (driver for business support in Ofgem's activity drivers totex)
- Licensee and group based analysis
- Logarithms and levels

The results of its analysis are shown on the following graph.



In addition to demonstrating the sensitivity of results to the regression assumptions chosen, Oxera's results clearly demonstrate that the results obtained from Ofgem's model are outside of the range of results obtained from regression analysis.

Oxera's analysis included four ownership group based models. On average, these models suggest that Electricity North West's modelled efficient costs should be some £48m higher than Ofgem's analysis.

More details of Oxera's regression analysis can be found in Appendix 5.

4.1.4 Sensitivity Analysis to Ofgem's Approach

We asked Oxera to adapt Ofgem's business support model to allow a different level of fixed cost normalisation to be made depending on the number of licensees within the ownership group. Oxera used this model to remove a level of fixed costs determined econometrically via regression analysis, as described in section 3.2. If Ofgem had used this approach at its fast track decision the level of modelled fixed costs for Electricity North West would have been £25m higher.

Further details of Oxera's analysis can be found in Appendix 3.

4.1.5 Other Factors Affecting Ofgem's Assessment of our Business Support Costs

Ofgem's assessment of the efficiency of our business support costs is further distorted by three other issues:

- Analysis is distorted by Ofgem's removal of insurance costs from its models. This approach disadvantages companies such as Electricity North West that included very efficient forecasts of insurance costs.
- A spreadsheet error in Ofgem's business support model resulted in negative costs being modelled for some companies and artificially reducing benchmark costs. As this error affected all DNOs it was partially corrected via Ofgem's upper quartile translation.
- A spreadsheet error in Ofgem's aggregated cost assessment model resulted in the results from the business support model being inappropriately treated as gross costs. As this error affected all DNOs it was partially corrected via Ofgem's upper quartile translation.

Annex 14 provides more details of these issues.

4.1.6 Summary

We strongly believe that the evidence presented here demonstrates that Ofgem's assessment of our business support costs as part of its Fast Track decision was materially distorted by an inappropriate assumption regarding fixed cost normalisation. Different alternative modelling approaches inevitably suggest different results, but all suggest material increases to the level of efficient business support costs above that assumed by Ofgem.

4.2 Closely Associated Indirect Analysis

Ofgem's bottom up analysis of our proposed closely associated indirect costs as part of its Fast Track decision suggested that efficient closely associated indirect costs for Electricity North West are £370m (2012-13 prices, net distribution, eight year total, including real prices effects). Our plan included £336m of closely associated indirect costs. Ofgem therefore suggested that our proposed closely associated indirect costs were 9% lower than a modelled efficient level of costs, ie our costs forecasts are better than Ofgem's modelled costs.

Ofgem's assessment of closely associated indirects was generally based on regression by licensee. Ofgem included no group based regressions. We believe that it would be appropriate to incorporate group based regressions for those elements of cost that include substantial fixed and semi variable costs, such as network design & engineering, network policy, stores, control room and call centre, to ensure that account is taken of costs that can be shared between companies of the same group. Appendix 2 provides details of KPMG's assessment of fixed and semi variable costs associated with closely associated indirects.

4.3 Overall Sensitivity Analysis

Ofgem's published Fast Track assessment document 'Assessment of the RIIO-ED1 business plans' states that "*Whilst our central view does not include any adjustment for ENWL's view of 'fixed costs', our sensitivity analysis with 'fixed costs' included shows that ENWL is still above our overall fast-track cost assessment benchmark."* The report goes on the say that this sensitivity analysis was undertaken "*on the basis of ENWL's view of 'fixed costs*'".

Ofgem's overall cost assessment results, adjusted for monetisation of cost of equity and outputs, suggested that our costs were £77m above Ofgem's benchmark (8 year value, 2012-13 prices, net distribution). KPMG's view of equivalent annual fixed cost uplift, as included in our July 2013 plan, is £10.7m per year ie £85m over 8 years. We therefore do not understand how Ofgem has concluded that our costs are above its cost assessment benchmark when fixed costs are included.

We have repeatedly asked Ofgem to share its sensitivity analysis to allow us to understand how it reached this conclusion, but it has not shared the analysis with us. Without being able to review Ofgem's analysis, we can only assume that Ofgem made an error in how it undertook its fixed cost sensitivity.

4.4 Alternative Approaches For Assessing Slow Track Companies

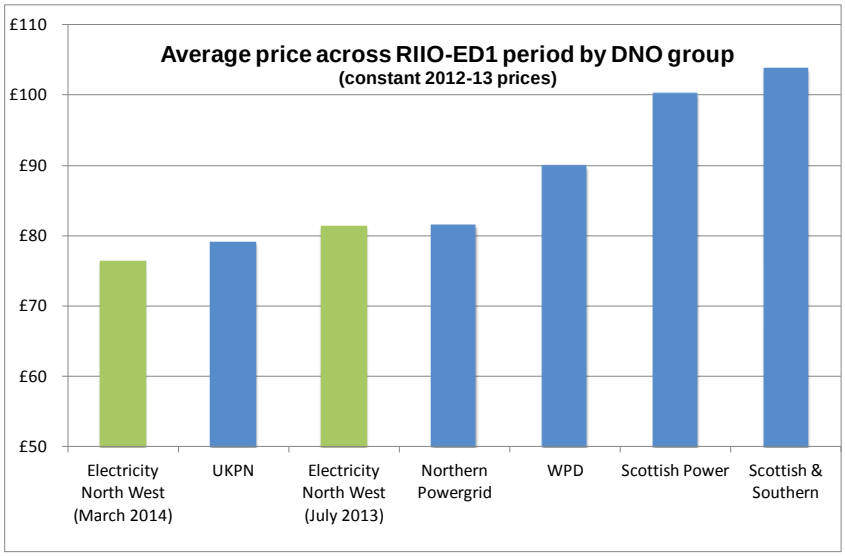
It is essential that Ofgem's cost assessment methodologies for business support indirects and closely associated indirects take account of the extent to which fixed costs can be shared by companies in the same ownership group. Annex 14 outlines in more detail our proposals for how cost assessment approach for Slow Track companies should be different to that used to assess Fast Track companies.

We note that the two largest DNO ownership groups, UK Power Networks and Western Power Distribution, have both proposed group-based cost assessment approaches for the assessment of some business support indirects and closely associated indirects. We believe that this adds further evidence to support both the fact that fixed costs can be shared by companies in larger groups and that the most appropriate cost assessment tools for these activities are those based on ownership group analysis.

5. Why It Is Appropriate For North West Customers To Pay For Fixed Costs

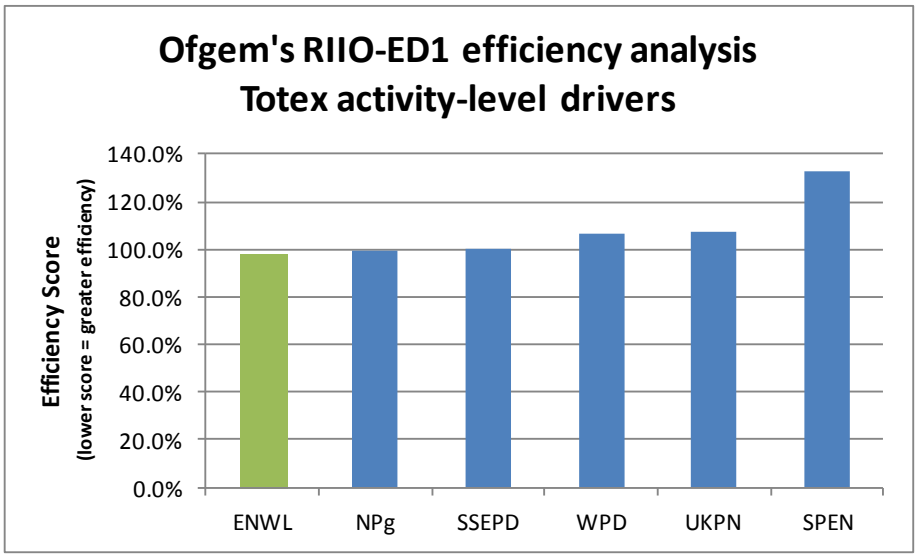
5.1 Providing Excellent Value for Money

Overall, we are confident that our plan offers excellent value for money for our customers and that the benefits in other parts of the plan outweigh these higher costs. Despite the inclusion of these costs our customers will pay some of the lowest prices for electricity distribution in Great Britain during the RIIO-ED1 period. We have compared the prices in our plan (using Ofgem's Plan-on-a-Page format) with the information available from all the other DNOs (Plan-on-a-Page) in July 2013 to produce the graph below.



Source: All DNOs plan on a page publications, July 2013

This shows that our prices were the second lowest of any DNO group and have reduced significantly. This is not a surprise as our base revenue is over £76m lower than in our previous business plan submission in July 2013. Last year Ofgem assessed the total costs of each DNO's business plan and its analysis showed that our total costs are amongst the lowest of any DNOs in Great Britain. This efficient cost base feeds directly into lower prices for our customers.



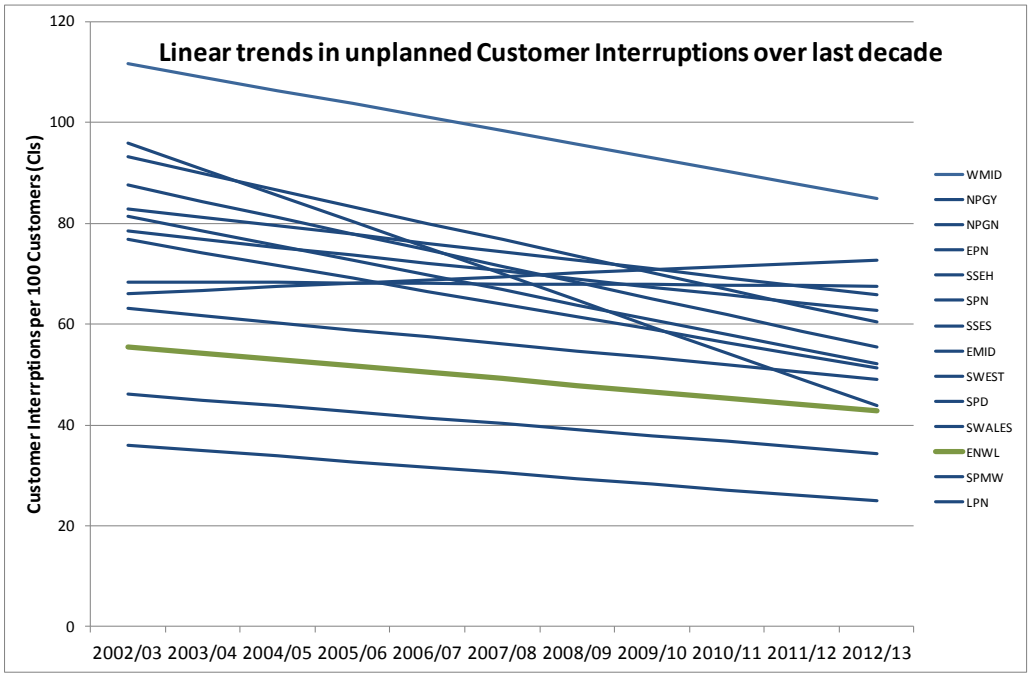
Source: Ofgem, RIIO-ED1 business plan expenditure assessment - methodology and results, December 2013

5.2 Benefits of Electricity North West

Electricity North West is entirely focused on delivering electricity to the five million people who live and work in the North West of England. We are not part of a larger corporate group, we do not get distracted by operations in any other parts of the energy supply chain. We simply concentrate on serving our customers in the best ways possible, day in and day out. We have always been leaders in some fields in our industry and since we separated from a larger corporate group in 2007 we have been steadily improving our performance in every aspect of our business.

5.2.1 Quality of Supply Leaders

The quality of supply experienced by customers connected to our network has consistently been one of the best in the country since privatisation and, since the introduction of standard measurement in 2002 has been shown to be consistently in the upper quartile. This means that over the last decade, the people in the North West have experienced some of the most infrequent and shortest power cuts in the whole of Great Britain. Our network is inherently resilient and we ensure it stays that way through efficient maintenance and asset renewal. Our performance has steadily improved as we have developed and implemented a wide variety of 'smart' technologies on the network including the deployment of widespread remote sensing and control, coupled with artificial intelligence and a self-healing capability into the control room.

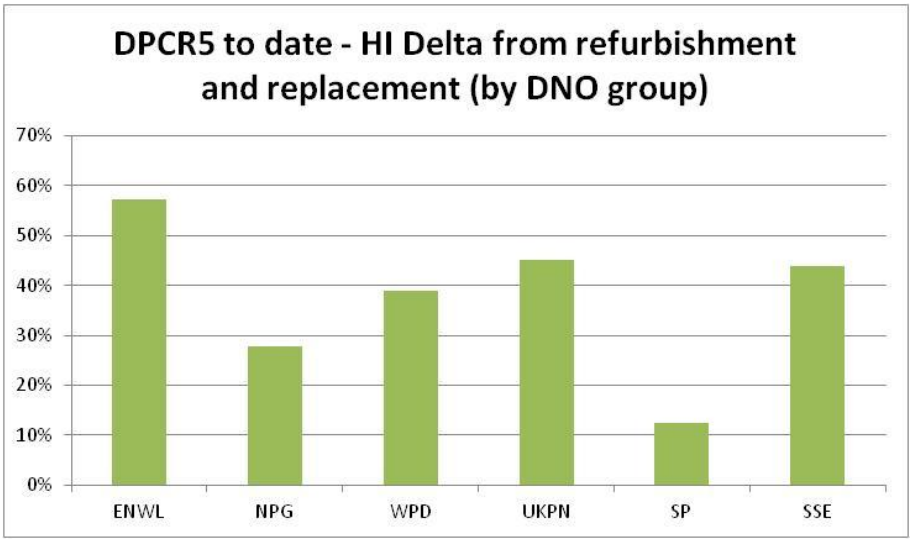


Source: Ofgem

5.2.2 Investment Delivery Leaders

Unsurprisingly for the birth place of the industrial revolution, the North West contains some of the oldest electricity network in the country. This could have presented a risk of more frequent power cuts as old assets fault or a high asset renewal bill to our customers. To manage this risk Electricity North West has developed world-leading asset management techniques and technologies to ensure we spend our customers' money as wisely as possible. These techniques determine the best things to do and in more recent years we have also demonstrated our leadership in the efficient delivery of these projects. This is now demonstrated by our leading performance against the output metrics looking at improvements in asset health that we have helped Ofgem introduce for the DPCR5 period. This shows that in the first two years of DPCR5, we delivered a higher proportion of our overall DPCR5 HI target than any other DNO group. The graph below shows that we are

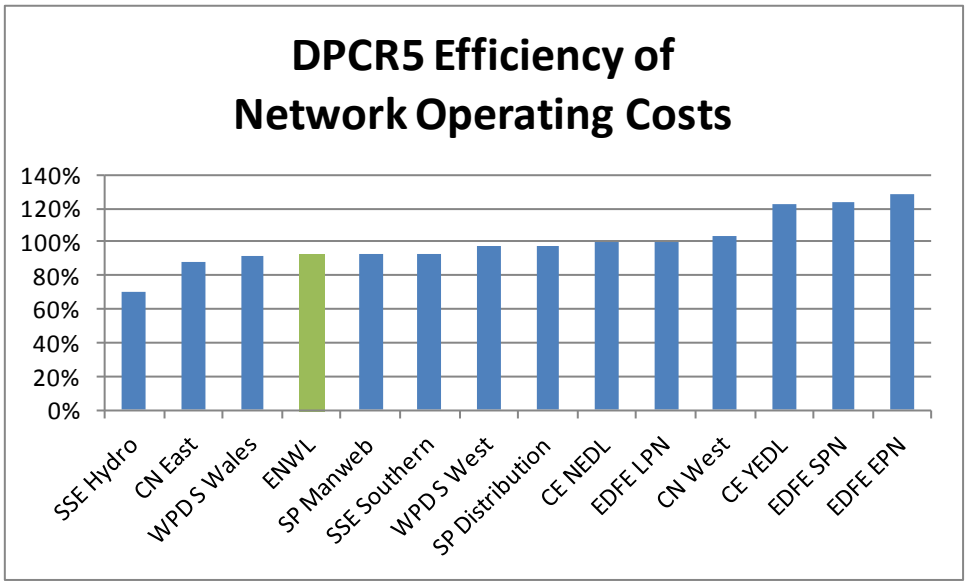
well ahead of scheduled having completed nearly 60% of our programme in the first two of the five year programme.



Source: Ofgem

5.2.3 Cost Reduction Leaders

In 2009, as Ofgem set the last price control review, we were rewarded as leaders in determining both the lowest unit costs of capital projects of any DNO in Great Britain and recognised as leaders in operational efficiency. We have continued to deliver efficiently for our customers and to set benchmarks for the whole industry. Ofgem's initial assessment of our previous business plan for the RIIO-ED1 period indicated that we remained a unit cost leader and an operating cost leader. Additionally, Ofgem's assessment shows that our total cost base is now one of the lowest of all DNOs.



Source: Ofgem, DPCR5 Final Proposals - Allowed revenue - Cost assessment appendix, December 2009

5.2.4 Innovation Leaders

We have achieved this performance for our customers not only by working harder, but also by working smarter. Electricity North West has developed a culture that encourages new ideas and new approaches. This has been inspired by the successes we have had in the asset management area and has been expanded to cover all areas of our business. Innovation drives our excellent quality of supply performance, our low unit costs and contractor costs, our tree-cutting leadership and our stakeholder engagement. Our strength in this area is perhaps best measured by our performance in Ofgem's Low Carbon Networks Fund innovation competition where we have been the only company to successfully win an un-conditional project award in each of the last three years.

Our innovative approach has been applied to the challenges facing our industry as we move to a low carbon economy. We are developing exciting new techniques and technologies to tackle these challenges that have significant benefit for our customers. These include our new Capacity To Customers (C_2C) Demand Side Response contracts and our Smart Street energy cost minimisation approach. As a result of our innovative approach, our customers have benefitted from the largest payback on innovation investment of any DNO (£133m benefit for £26m investment) and the largest smart grid discount in RIIO-ED1 plans of any DNO at over £82m.

Our leadership in our industry demonstrates that our customers benefit considerably from being served by Electricity North West. Electricity customers connected to our network receive some of the best quality of supply for some of the lowest costs of anywhere in the country. Their service is provided by an effective business focussed solely on the North West that has a proven track-record in innovation, enabling a rapid and effective response to any new challenge that might arise.

5.3 Our Role as a Comparator

In our industry, it is important to have a number of different owners and operators running the distribution businesses. This means that new ideas and approaches are developed by a good number of different management teams and enables their performance to be compared to identify and share best practice.

In its policy statement on mergers, Ofgem flags a number of issues associated with the benefits of different DNO groups. Ofgem states that:

> *"the number of independent groups within a sector brings significant benefits to consumers in terms of the ability it gives Ofgem to set effective price controls."*

By remaining independent from the other five DNO groups Electricity North West provides a valuable comparator that provides benefits to the people of the North West and to DNO customers across the country.

Ofgem lists a number of benefits of independent distribution companies, including:

- *"The more independent companies that we have to compare the more likely it is that one of them will reveal information that will allow us to set allowed revenues at an efficient level for all companies and/or that will support us in setting higher quality standards"*

- *"The more information that we have from independent sources then the more confident we can be in our cost assessment work meaning that we do not need to err on the side of caution"*
- *"These independent groups ... are compared against each other ... by investors and consumers as well. This creates competition between these management teams to become the leading performers in terms of efficiency and service quality. The more independent management teams there are competing to be the leading company the fiercer this competition is and consumers benefit from this through improvements being made more quickly than they otherwise would in the absence of that competition"*
- *"This is the essence of comparative regulation – Ofgem needs to use regulatory tools to try and replicate the competitive pressures that do not naturally exist in monopoly businesses. These competitive pressures are much stronger the more independent companies that we have in a sector"*
- *"Mergers ... may reduce the diversity in management approaches ... [and] the number of opinions/views within the sector which can be very useful for making progress in introducing new ideas or generally in policy development itself"*
- *"There are significant qualitative benefits where Ofgem is able to make comparisons between companies in terms of the ideas and policies that they are proposing"*
- *"There may be scope for a group that controls a significant share of the market to 'game' this benchmarking by allocating costs in a particular way between its licensees that maximises its total allowed revenues to the detriment of consumers"*
- *"There may also be issues of comparability between network groups if their scales vary significantly. A large group would also have a significant impact on any benchmarks that we set"*

5.4 Appropriateness of Including Fixed Costs in our Business Plan

Overall, we are confident that the benefits to north west customers of us remaining a single licensee and continuing to offer leading service for low costs, combined with the benefit to all customers in Great Britain of being an extra comparator that Ofgem will use to set stretching targets, more than outweighs the relatively small additional costs associated with being a single licensee. We therefore believe that our proposition for customers to fund the slightly higher costs in this area is well justified.

6. How Customers Will Be Protected From Any Change In Ownership Structure

We accept that single licensee status is not an inherent characteristic and that it is possible that during the course of RIIO-ED1 our status could change.

If we become part of an ownership structure that includes one or more other DNO licensee operating in Great Britain (either because our current owner purchases another licensee or because we are sold into a group that already includes a DNO licensee) we agree that an adjustment should be made to our cost baselines for fixed costs to ensure that any fixed cost allowance that we no longer need is returned to customers.

We propose to introduce a mechanism, to be set out in our distribution licence, to ensure that an appropriate adjustment can be made to our allowed costs. This adjustment would effectively reverse our baseline costs for all or part of the fixed costs that were assumed in our RIIO-ED1 baseline costs at Final Determination. Assuming that Ofgem accepts our proposal, this would be capped at either £10.7m pa (KPMG's identified fixed cost uplift) or the level of company specific adjustment made by Ofgem (if that amount is lower than £10.7m pa). We observe from data following in recent consolidations that it takes some time for savings to be made and propose that adjustments would be enacted from 12 months after the finalisation of any transaction that leads to us being part of a wider group. Any savings that we are able to make in the first 12 months following any transaction would be shared with customers via the routine efficiency sharing mechanism.

In order to ensure that any changes associated with this mechanism are predictable to suppliers and can therefore be passed through to customers, we propose that adjustments would be proposed and made at times set out for other uncertainty mechanisms in May 2019 and at the end of RIIO-ED1 period. These adjustments would take account of any transactions that occurred before those dates so that customers are fully compensated.

We will work with Ofgem to develop the required licence condition and associated financial handbook chapters and price control financial model modifications to achieve this. A draft licence condition is included as Appendix 6.

7. Conclusion

Electricity North West is the only Distribution Network Operator (DNO) that is in an ownership structure that does not contain another DNO. As a consequence of this, we incur a level of fixed costs that is higher than other DNOs (because the other DNOs can share costs with companies in the same group).

We have undertaken analysis, supported by KPMG, to assess the level of fixed costs that a single licensee would incur above the level that would be expected of DNOs in an ownership group that included two DNOs. KPMG's report estimated that the fixed cost uplift which Electricity North West should be afforded relative to other DNOs as a result of its single licence status is £10.5m per year (2011-12 prices).

Ofgem's cost assessment analysis undertaken as part of its Fast Track decision did not take account of the fixed costs of being a single licensee. This resulted in the level of business support costs included in our July 2013 plan being assessed as being inefficient.

We believe that Ofgem made an error in how it undertook its fixed cost sensitivity.

Oxera has undertaken analysis for us that considers alternative assumptions within Ofgem's business support models. Oxera has also considered alternative modelling approaches such as regression analysis. This analysis demonstrates that Ofgem's assessment of our business support costs as part of its Fast Track decision was materially distorted by an inappropriate assumption regarding fixed cost normalisation; alternative models suggest much higher modelled efficient costs for Electricity North West.

Oxera has also undertaken analysis, based on the data provided by DNOs in July 2013, that demonstrates that when the number of licensees increases from one to two, the fixed cost of the group increases by less than twice, demonstrating that smaller companies incur a higher level of fixed costs.

Our analysis suggests that Ofgem's analysis underestimated allowances for fixed costs by between £25m and £77m. Different alternative modelling approaches inevitably suggest different results, but all suggest material increases to the level of efficient business support costs above that assumed by Ofgem. The low end of this range on Oxera's econometric assessment of fixed costs that are somewhat counterintuitive and probably under-estimate fixed costs.

Overall, we are confident that the benefits to north west customers of us remaining a single licensee and continuing to offer leading service for low costs, combined with the benefit to all customers in Great Britain of being an extra comparator that Ofgem will use to set stretching targets, more than outweighs the relatively small addition costs associated with being a single licensee. We therefore believe that our proposition for customers to fund the slightly higher costs in this area is well justified.

We accept that single licensee status is not an inherent characteristic and that it is possible that during the course of RIIO-ED1 our status could change. If we become part of an ownership structure that includes one or more other DNO licensee we agree that an adjustment should be made to our cost baselines for fixed costs to ensure that any fixed cost allowance that we no longer need is returned to customers.

8. Appendices

The following documents are attached as appendices to this annex

Appendix 1 KPMG - Estimating a fixed cost uplift allowance for RIIO-ED1

Appendix 2 KPMG - Outsourcing suitability assessment

Appendix 3 Oxera - Econometric fixed cost estimation revised Monte Carlo ratios

Appendix 4 Oxera - Analysis of Business Support Costs

Appendix 5 Oxera - Business Support regression results

Appendix 6 Draft fixed cost adjustment licence condition

[These appendices contain commercially sensitive or personal information and have been redacted from public domain versions.]