

Annex 20 Appendix G Additional efficient costs of a small company model

December 2021

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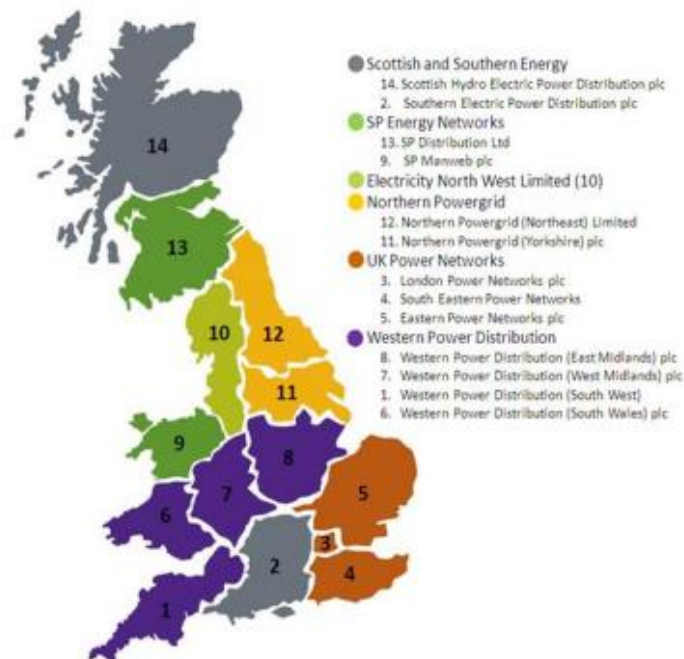
Introduction

We at Electricity North West are the only electricity distribution network operator (DNO) that operates in a single licensee area. We're proud of the essential role that we play and the investment we make locally and nationally to ensure we keep phones charged, TVs streaming and 2.4 million homes warm for our five million customers.

Our history traces back to being one of the 14 original Public Electricity Suppliers (PES) that were the subject of privatisation in the early 1990s. We hold a distribution licence for what was the North West Electricity Board Area known as 'NORWEB'. There has been much change since privatisation with some driven by business separation and/or legislative requirements that detached different aspects of the energy value chain, for example, energy supply from energy distribution, and others through industry consolidation where some distribution licenses have been joined into single groups for operating purposes.

At November 2021, and expected to continue within ED2, the electricity distribution companies that service all other licenced areas except ours are part of substantially bigger multi-licensee electricity distribution groups. For example, UK Power Networks (UKPN) sets out in its published draft business plan that it serves 29 percent of Great Britain's population and distributes 28 percent of all electricity through the three distribution license areas it manages as shown in Figure 1 below. Additionally, Western Power Distribution (WPD) has the largest number of licence areas within its DNO group with four geographically covering the South West, South Wales, East and West Midlands.

Figure 1: DNO licensee operating areas by Group



Our draft and final business plan includes (in Annex 26) a commissioned assessment by consultancy firm Economic Insight which identifies a range of benefits of a single licensee electricity DNO where the benefits also accrued to GB consumers. The benefits contained and evidenced in that report are a mixture of both our activities and business culture which flow from strategic direction and management, as well as those which are a function of our size and status as a single licensee DNO. It also evidences the benefit of having our single licensee operating model as an observable point in the sector.

We always strive to be as efficient as possible and we have a strong track record throughout RIIO-ED1 of leading levels of delivery performance for the outputs our customers need as well as being one of the most efficient DNOs as assessed at RIIO-ED1 final determination stage.

However, despite our efforts to be as efficient as possible, a single licensee that is also the smallest DNO group cannot achieve some of the benefits, in the form of lower costs, that larger DNO's comprising multiple licence areas can by virtue of structural factors of scale. This is 'particularly acute but not limited to activities where large DNO groups have access to structural efficiencies in areas such as IT, telecoms, finance, regulation, human resources and property costs. A single licensee will not have the same ability of a large DNO group to share these fixed costs of operation across multiple licensees. This means that even though the costs are required and are efficiently incurred by the single licensee, they will be higher. Given that efficiency is assessed on a comparative basis between the DNOs, these additional efficient costs must be recognised, and appropriate adjustments made in order for that comparison to be meaningful.

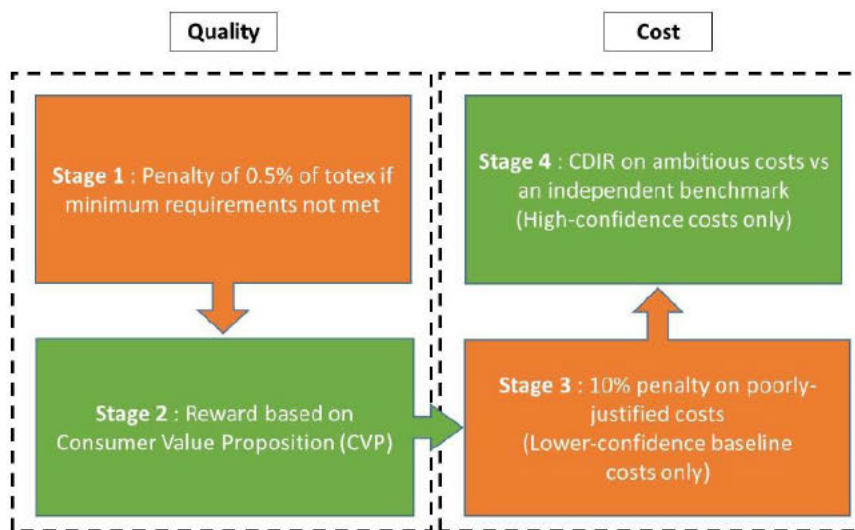
We have commissioned Oxera, a leading expert in the area of cost efficiency and productivity modelling with a strong track record of cost assessment and analysis gained not just in the UK, but on a pan-European basis. We asked them to assess whether there is an impact on the efficient level of costs for ourselves compared to large DNO groups by virtue of our size and single licensee status and, if found, to quantify through a range of techniques what company specific cost adjustment might be required in order for comparisons between our costs and those of other DNO groups within Ofgem's cost assessment framework to be meaningful. Oxera's independent expert assessment is provided below and has formed part of our business plan submission.

In summary, Oxera has concluded that there is a single licensee effect, noting that *"ENWL cannot make the same economies of scale savings on direct and indirect expenditure as larger DNO groups can"*. Oxera also concludes that *"If these economies of scale are not robustly accounted for (directly or indirectly) in Ofgem's cost assessment framework, [...] the resulting cost allowances could be biased against small DNO groups, such as ENWL"*.

We understand that cost assessment modelling and cost benchmarking is an important aspect of the business plan assessment process. In undertaking these assessment activities, it is crucial that costs compared are on a like for like basis so as not to skew the view of comparative efficiency. A company specific adjustment that addresses the issue identified by Oxera is, therefore, critical and necessary to ensure that our costs are comparable to those of the other large DNO groups.

We also note that Ofgem sets out in the business plan guidance how business plans will be assessed for a Business Plan Incentive Reward. Figure 2 below is taken from the Ofgem business plan guidance document.

Figure 2: Ofgem BPI assessment diagram



We expect that our ambitious plan will enable Ofgem to reveal effectively an annual fifteenth data point for understanding and modelling of the efficient cost benchmark, especially if an appropriate company specific cost adjustment is made to take account of the single licensee effect. We propose that this should feed into Ofgem’s consideration of a business plan reward.

In commissioning this project, we were conscious that cost assessment modelling is a highly specialised activity and that, if a single licensee effect was revealed, the results from modelling could present a range, rather than a clear single point answer, in terms of what company specific adjustment might be required. This has been the case in practise.

Oxera conclude that *“focusing on the TOTEX models, a reasonable lower end of the cost adjustment for ENWL could be █████ p.a. [per annum] with the upper end at █████ p.a. [per annum] [...] Using the same approach for the business support cost modelling, the reasonable range for a cost adjustment for ENWL could be █████ p.a. [per annum]”*¹

We are confident that the analysis undertaken by Oxera is comprehensive, using a number of modelling techniques which have been used both in the UK and across Europe for both regulators and companies, and that reliance can be placed on the range of values that Oxera has identified.

We have, therefore, carefully considered the work undertaken by Oxera and the evidence and analysis on which that cost adjustment range is based in order to select a point within that range for inclusion as a company specific adjustment in our final business plan.

We have included a company specific cost adjustment in our final business plan to take account of the single licensee effect of circa █████ per annum. We consider this to be a prudent estimate within the range estimated by Oxera, backed by our business view as well as the evidence provided, and is consistent with our aspiration to put an efficient and ambitious business plan together that is in consumers interests.

¹ Oxera has also derived an alternative range of █████ per annum and █████ per annum for TOTEX and business support expenditure, respectively. This is based on an alternative method of aggregating the individual estimates from the different modelling approaches.

We are happy to discuss with Ofgem any of the content included and the conclusions drawn in this document and welcome its detailed review as part of the review of our final business plan.

Full report [REDACTED] - Additional efficient costs of a small company model, Oxera, December 2021

The full report is provided after this point. [REDACTED]