electricity north west

Bringing energy to your door

Appendix 4: response to RIIO-2 Draft Determinations Gas Distribution Annex questions

September 2020

Contents

1 Overview

Electricity North West Limited (ENWL) serves part of the same customer base as two gas distribution companies, Cadent and Northern Gas Networks that operate in Electricity North West's distribution services area. We also interface with the Gas Distribution Networks (GDNs) via a number of industry fora, particularly those convened via the Energy Networks Association. Through these channels we share best practice regarding interfacing with consumers and how we deliver services. We have also reached out to the GDN's in our area as part of understanding if there are any whole system opportunities arising from their plans and to identify if there are any ED related requirements (e.g. electricity connections for local gas fuelled generators).

In addition to this business plan engagement activity, we have also undertaken a significant development in collaboration with Cadent to create decarbonisation pathways which effectively provide energy blueprints for our three key areas of Greater Manchester, Lancashire and Cumbria. These provide near to mid-term certainties around the future of energy supply and demand in order to inform decision-making and investment planning for the adoption of low carbon technologies (including solar PV and electric vehicles) as the North West transitions to a Net Zero future.

Our response to this annex focuses on those aspects where there is a potential consequential impact on the framework development for ED2, commencing in 2023.

Our comments relate to each of the sections of the consultation document, and specific questions have been answered by exception. We trust this response will assist Ofgem as it develops its thinking further.

2 Quality of service- setting outputs for RIIO-GD2

Meeting the needs of consumers and network users

We have not answered questions 1-7.

GDQ8. Do you agree with our proposed option to provide Cadent and SGN with consumer funding through totex baseline or a financial ODI reward for collaborative streetworks activities

Through our customer engagement as part of our business plan development for RIIO-ED2 we have found that the duration of street works, and street works in general are an area of priority for both customers and stakeholders. Therefore, the consideration of a financial incentive (ODI-F) to improve services to customers or baseline funding to deliver this is merited and we would support either approach in general.

That said, for clarity we seek not to influence the decisions that are made for individual companies, so our comments are limited to high-level policy points where these apply to individual sectors or the energy sector as a whole based on what the same customers and stakeholders are telling us as part of our ED2 engagement.

Deliver an environmentally sustainable network

We offer no comment to the bespoke EAP and AER proposals for GDNs as set out in the sector specific annex, our comments to the general approach to outputs can be found in section 3 of our response to the core document. We have some concerns that the DDs refer to common sector-wide measures without qualification that these do not apply to ED (though they may be considered) and that the decisions on the ED2 price control are not being made now, we would welcome more clarity being provided by Ofgem on this matter. It is likely also that all sectors will require bespoke items and considerations with regards to outputs.

Maintain a safe and resilient network

We offer no comment to output proposals for GDNs as set out in the sector specific annex as these are specific to that sector and unlikely to be applicable to ED, our comments to the general approach can be found in Q9 of our response to the core document. All sectors will likely require bespoke items and considerations as the energy sector develops and commits to how it will deliver and lead decarbonisation and Net Zero.

3 Cost of service- setting baseline allowances

Cost assessment and the setting of baseline allowances is key and an important aspect of the regulatory framework. The consequences of process or assessment failings will risk the key objectives and outcomes required of the short and long term including decarbonisation and Net Zero considering where the industry is on this pathway. Justification and evidence supporting positions and methods needs to be robust and we would urge that Ofgem errs on the side of caution rather than stretching what can be justified through the evidence it has gathered and established.

The ongoing PR19 referrals to the CMA should be a point of reference for Final Determinations and considered as part of the development of RIIO-ED2. Central proposed policy positions in Draft Determinations such as; issues of financing, ongoing productivity/efficiency assumptions, and the use of more stringent than upper quartile efficiency benchmarks are being reviewed as part of these appeals. It is important that policy positions as part of RIIO-2 are made mindful of the CMA views and findings, but independently of other sectors and considering the evidence and unique circumstances for RIIO-2 specifically and each company. The decarbonisation challenges as well as the transformative changes required are not inherently part of the water sector as they are in energy.

Approach to Cost Assessment

GDQ26. Do you agree with our proposal of using a top-down regression model?

We support the use of both top-down and bottom up regression models as well as non-regression or disaggregated modelling where appropriate. The targeted used of disaggregated modelling techniques could including unit cost modelling where there are distinct costs and activities where cost trade-offs do not exist and where legitimate differences between companies occur and can't be explained or appropriately accounted for through cost drivers in econometric regression models.

We offer no comment on the appropriateness of the modelling method for GD other than the use of a single top-down totex regression model to establish the majority of the cost baseline (c.84%) for the industry is out of step with regulatory practice in PR19 and that utilised in RIIO-ED1.

We understand that a number of alternative models have been tested but not used in the proposed assessment of costs for GD. It is generally accepted that there is no single perfect econometric model, and Ofwat concluded as part of the PR19 framework that:

"All models are subject to error and a degree of bias. In many instances, it is not possible to identify a single "preferred" econometric model that clearly prevails over all others. To mitigate risks of error and bias we do not rely on a single model. Rather, we use a diverse set of models, with different drivers and different levels of aggregation, in triangulation."[1]

In essence, multiple models which are aggregated or triangulated aims to account for this imperfect assessment process and individual model imperfections. Therefore, a single model covering 84% of the cost base would seem incoherent with this limitation, and when coupled with a more stringent benchmark, would suggest an increased level of accuracy or confidence of the assessment process that may not be justified. Modelling accuracy shouldn't be determined by statistical diagnostic tests alone such as the 'R^2' or the fit of the model. Models should make sense on both an economic and engineering basis or logic and both are as important when developing models that establish baselines for companies where trade-offs and cost substitutions exist.

A more stringent benchmark of the 85th percentile as compared to the upper quartile threshold that has been traditionally used would exacerbate any weakness of the single top-down regression model used for GD. Our experience is that a suite of models considering both top-down, bottom-up and disaggregated models (where appropriate) should be utilised in the assessment and establishment of baselines for companies and that this would represent good regulatory practice.

GDQ27. Do you agree with our proposed approach to benchmarking modelled costs at the 85th percentile?

We have provided our thoughts on the use of more stringent benchmarks in GDQ26, but we do not think that the use of 85th percentile should be the starting point. The use of a more stringent benchmark suggests a level of modelling accuracy that is unlikely to be supported by a single top-down totex regression model that covers the majority of the cost baseline. Further evidence of this is that in the CMAs redetermination of PR14 with regard to the Bristol Water review it used an average benchmark as the use of upper quartile benchmark may overstate inefficiency. This is particularly important where modelling is solely reliant on single methods and models and where these can't distinguish between modelling 'noise' and inefficiency.

The sector specific annex for GD also suggests that "it is reasonable to expect that all networks should be able to continue delivering efficiency improvements and achieve efficient performance over RIIO-GD2"[2] because "Overall for the GDNs, actual totex over the period 2013-14 to 2018-19 is on average 14% lower than RIIO-GD1 allowed costs"[3] as part of the justification for using an 85th percentile benchmark. Care should be taken in using such analysis to support the use of a more stringent benchmark. Efficiency delivery in the period of RIIO-1 will be due to a mixture of reasons and not because the benchmark used wasn't stringent enough. Interlinkages with other regulatory mechanisms such as the lowering of the totex incentive mechanism (TIM) will also change the dynamics and incentives for companies in RIIO-2. Any inferences on efficiency could only potentially be made by looking at unit costs, rather than just reductions on allowed GD1 costs and would need to reflect future work types too.

[1] Supplementary technical appendix: Econometric approach, pg.5, Ofwat, January 2019
[2] RIIO-2 Draft Determinations - Gas Distribution Annex, para.3.27, Ofgem
[3] Ibid.

GDQ28. Do you agree with our proposed approach to estimating embedded ongoing efficiency and values calculated?

We note that the proposals on ongoing efficiency are at the very top end of the plausible scale as assessed by CEPA. We also note that this aiming up is partly justified by the estimated impact of innovation funding, structure and characteristics of the monopoly industry companies operate in. Where the benefit of part of the existing framework is cited as evidence to support stronger measures as part of RIIO-2 this should be noted and collated to a central table to ensure and evidence that these benefits are not being double counted or assessed and built into other Ofgem evidence for mechanisms (e.g. allowed vs expected returns calculations).

Normalisation

GDQ29. Do you agree with our proposed pre-modelling normalisations?

We strongly believe the RIIO-ED2 framework needs to be considered on a standalone basis where proposed policy positions are established and justified for the ED sector specifically, distinct from GD/T2 therefore we comment that pre-modelling normalisations should be assessed and justified based on the sector being assessed and should not apply as a standard process by default.

Regression Analysis

GDQ30. Do you agree with the selected aggregation level, estimation technique and time period for our econometric modelling?

This should be read in conjunction with our answer to GDQ26. We support the use of both top-down and bottom up regression models as well as non-regression or disaggregated modelling where appropriate. The targeted use of disaggregated modelling techniques could include unit cost modelling where there are distinct costs and activities where cost trade-offs don't exist and where legitimate differences between companies occur and can't be explained or appropriately accounted for through cost drivers in econometric regression models.

We offer no comment on the estimation technique or time period other than these should be assessed and justified based on the sector being assessed and the characteristics of that sector such as the number of comparator points and observations. The process and methods for GD2 cost assessment shouldn't apply as a standard process by default to other sectors.

Non-regression costs

We have no comments on the process for GD2, treatment of non-regression costs should be sector specific and expect this to be consulted on separately for ED.

Technically assessed costs

We have no comments on the process for GD2, technically assessed costs should be sector specific and expect this to be consulted on separately for ED.

Disaggregation of allowances

GDQ41. Do you agree with our proposed disaggregation methodology?

The method for allocating costs through a disaggregation methodology should be developed in conjunction with companies as part of their sector specific consultation or RIIO-2 working groups. If such a method is needed for ED, we would urge that this is developed with the sectors and its stakeholders independently of the process established for GD and T.

BPI calculations

Our comments to the general approach for the BPI can be found in section 9 of our response to the core document. There should be substantial learning for Ofgem, companies, and stakeholders from the Draft Determinations process with regards to the assessment, application and process for the BPI. We urge that these are considered and implemented as part of a revised BPI for RIIO-ED2.

We have no comments on the process for GD2, so our comments are limited to high-level policy points where these apply to individual sectors or might be applied to the energy sector as a whole.

4 Uncertainty mechanism consultation questions

GDQ42. Do you have any views on our common UMs that haven't been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

In general, to effectively manage uncertainty within the RIIO-2 framework, ENWL support a limited number of targeted uncertainty mechanisms that are well defined and are clear to what risk or uncertainty they are to address in the period. We do not support macro or broad measures such as the mid-period review reopener deployed in ED1 as the broadness of the mechanism leads to a lack of clarity for companies and Ofgem about how, why and when these should be applied and assessed.

With ED2 starting 2 years after that of GD/T2 we believe that the level of uncertainty required to be managed should be less and therefore the approach taken for GD/T2 should not directly apply to ED2. Indeed, we have concerns where the DD refers to "Cross-sector uncertainty mechanisms" without qualification that these should or shouldn't apply to ED. We urge that uncertainty mechanisms and wider methods for managing uncertainty for ED be consulted on separately and independently of the DD through the ED2 SSMC. This should consider the impact on the level of uncertainty but not be limited to; the later start date for ED2, the differences of the challenges in ED compared to GD/T, and the lessons learned from the responses to the proposed package for managing uncertainty from this DD consultation.