

Sector Specific Methodology Consultation response

Appendix 4: Response to Gas Distribution annex

March 2024



Contents

1	Introduction	3
2	Proposed RIIO-GD3 specific outputs and uncertainty mechanisms	3
3	RIIO-GD2 outputs and uncertainty mechanisms proposed for removal	11
4	Options for evolving our cost assessment approach for RIIO-GD3	11

1 Introduction

In this annex we set out our response to the questions in the Gas Distribution annex of the Sector Specific Methodology Consultation (SSMC) for RIIO-3.

We have responded to the questions by exception as we have a legitimate interest in the development of RIIO-3 as our consumers, stakeholders and shareholders could be significantly affected by the outcomes of this consultation. Where we have not responded to a question set out in the consultation, we have not included that question in this response document. We have not responded to questions where we have no direct comments to make or where the question is very specific to the sector in question.

Our response documents should be read cognisant of our key matters set out in our covering letter. The five key matters most important to Electricity North West, which have the biggest effect on our consumers are:

1. Undertaking separate, unfettered consideration of RIIO-ED3 is essential to enable electrification to achieve Net Zero;
2. Maintaining the stability of core regulatory principles in the face of significant change;
3. Ensuring that each sector has a financeable and investable framework calibrated to the requirements of that sector;
4. Protecting consumer interests by incentivising the behaviours consumers prioritise at the levels at which consumers value them; and,
5. Accelerating the levels of innovation and digitisation that will improve the affordability of delivering the Net Zero transition.

It is in this context that our response is limited to the development of RIIO-3 for Gas Transmission, Gas Distribution and Electricity Transmission only. We look forward to the process beginning for the RIIO-ED3 price control in a few months' time on an unfettered basis.

2 Proposed RIIO-GD3 specific outputs and uncertainty mechanisms

Question 6: What are your views on the options we have laid out for the heat policy re-opener, including whether this should be combined with other RIIO-3 net zero mechanisms?

As we refer to in questions OVQ4 and OVQ35 to OVQ38 in Appendix 1 of our response, we consider that the suite of Uncertainty Mechanisms (UMs) relating to Net Zero can be reduced for simplicity. The Heat Policy re-opener for gas can be removed and a new Net Zero re-opener be developed to be used to enable any adjustments needed as a result of the heat policy decision.

We consider this to be an optimal solution, as any Government decision on hydrogen for heating in 2026 will not only affect GDNs but also DNOs and other licensees as any decision on gas inevitably has implications for electricity. Using a Net Zero re-opener which is a cross-sector mechanism is therefore a better option than having separate mechanisms for each sector. To enable the Net Zero re-opener to work as required, revisions should be made to allow it to be both licensee and Authority triggered, rather than Authority only as in RIIO-2. Our support for a combined Net Zero re-opener is contingent on it becoming a licensee and Authority triggered UM as we do not think it is viable to remain as Authority only. The most appropriate time for licensee windows should also be considered in the context of RIIO-3.

With respect to the Net Zero and Re-opener Development Fund UIOLI allowance (NZARD), we note in chapter 8 of the Ofgem Overview document that this is proposed to continue to fund small Net Zero facilitation projects and early development work in RIIO-3 for the GT, ET and GD sectors. An equivalent UIOLI allowance was not granted to ED for RIIO-ED2, meaning there is disparity between the sectors without a clear rationale for this difference. We agree that this important UIOLI allowance should continue for RIIO-3 but that this should be extended to also include ED so that all sectors and their consumers are able to benefit from this work and none are unnecessarily excluded from the opportunity such a fund represents.

With respect to the Net Zero Pre-construction Works and Small Net Zero Projects Re-opener (NZASP), we consider that having multiple UMs for potentially similar purposes may cause unnecessary confusion and complexity. As this is for GD and GT companies only, we have limited awareness of how the re-opener has worked and been used, therefore have limited comments on its revision. We would add that the potential option for Ofgem of merging this with the broader Net Zero Re-opener merits further consideration and could be a way of streamlining the UMs whilst maintaining clarity on scope and purpose, though this would also require the need for the mechanism to be licensee triggered. We suggest that this is explored further during cross-sector working groups. Learnings from the application of pre-construction funding (PCF) in ASTI, or how the RIIO-ED2 West Coast of Cumbria UM has been designed (to allow an application for pre-construction, followed by full submission) could be relevant areas to review here.

There are a number of potential revisions to the Net Zero re-opener considered within the consultation, and we would support a full review of an appropriate mechanism that is able to accommodate changes driven by Net Zero targets and associated policies, heat policy decisions, the existing NZASP and potential changes driven by the RESP outputs. The design of this new re-opener should not be simply retro-fitted into the existing Net Zero re-opener and instead be designed based on the uncertainties it is aiming to address. Materiality, triggers and application windows should all be reviewed and put in place accordingly.

We note that paragraph 2.27 of the consultation document references a combined UM having an appropriate materiality threshold. Our position on materiality thresholds is that they should be considered both in the context of the sector and the nature of the uncertainty. Further, in setting any materiality threshold, the RIIO-GD3 package in the round needs to be reviewed and any common approach to materiality should not necessarily be adopted by default. In a lower return price control with potential for more reliance on uncertainty mechanisms or specific PCDs there is naturally much less flexibility for companies to respond as they have done previously to changing environments.

We do not support applying any materiality threshold to a mandated, compliance and/or legislative requirement outside of companies' control. This has largely been applied for RIIO-2, but there are some inconsistencies which should be corrected for RIIO-3.

In summary our position in this area is:

- Remove the heat policy re-opener.
- Retain the Net Zero and Re-opener Development Fund UIOLI allowance (NZARD) and extend its application to RIIO-ED3.
- Develop a new Net Zero re-opener which is able to manage uncertainties driven by Net Zero targets and related policies, including heat policy, RESP output.
- Materiality, licensee triggers and application windows should all be reviewed and put in place accordingly to ensure the new UM is viable.

- Consider incorporating the Net Zero Pre-construction Works and Small Net Zero Projects Re-opener (NZASP) with the newly developed Net Zero Re-opener with potential ability to build in streamlined pre-construction applications.

Question 7: What are your views on our proposed approach for managing uncertain costs relating to regional energy strategic planning?

We agree there is a requirement for a UM which can enable investment on the gas networks which are driven by the Regional Energy Strategic Planning (RESP) work.

The form of this UM is hard to comment on, or what is most appropriate given the timing and detailed design of the RESP outputs, and the RESP gas-specific capabilities being unclear. As a starting point the Net Zero re-opener could be an appropriate vehicle to use, however any changes to the Net Zero re-opener to accommodate such requirements should also be considered along with the potential other changes to this specific re-opener as set out elsewhere in the SSMC.

There are a number of potential revisions to the Net Zero re-opener considered within the consultation, and we would support a full review of an appropriate mechanism that is able to accommodate changes driven by Net Zero targets, heat policy decisions, the existing NZASP and potential changes driven by the RESP outputs. The design of this new re-opener should not be simply retro-fitted into the existing Net Zero re-opener and instead be designed based on the uncertainties it is aiming to address. Materiality, licensee triggers and windows should all be reviewed and put in place accordingly.

We continue to support the proposal that RESPs benefit will be driven by a whole system holistic consideration, and therefore having limited gas capability during RIIO-GD3 is not ideal.

The RESP and its input into RIIO-ED3 planning should be considered separately and any decision made for GD should not fetter any decision on the most appropriate uncertainty mechanism for ED in relation to RESP.

Question 21: What are your views on our proposal to retain the diversions and loss of development claims re-opener in RIIO-GD3, and whether all the cost areas are still uncertain in RIIO-GD3?

Our response to this question is specific to our experience as a DNO but will be of relevance for consideration by Ofgem in determining a position for RIIO-3. We would agree on retaining the re-opener and would note that the equivalent re-opener for RIIO-ED2 is the 'Wayleaves and Diversions' re-opener.

We note that diversions will always be required for several reasons including, but not limited to:

- Development
- Safety
- Notices to remove for aesthetic reasons; and
- We would also divert where it more economical and efficient to do so.

Development loss claims are an enduring uncertainty that we will continue to receive well into the future, with the volumes expected in the forecast a key issue of uncertainty. Development loss claims arise where it is not economical or efficient to divert our apparatus or simply where we have no viable alternative to divert. Development loss claims can also include an element of injurious

affection and sometimes diversions. This is particularly the case at the lower voltage apparatus where it may be more efficient and economical to divert.

With claims, we have many unknown and unquantifiable variables such as property values, proximity of the apparatus to property and what apparatus is on the land. This means that we cannot accurately calculate the overall cost of the claims or have foresight of these ahead of a future price control period. We also do not know at any given time what is going to be submitted and it is impractical to predict development loss claims as the evidence we have does not follow a forecastable pattern to enable us to predict volume and value (each is a case on its own).

There are similarities between the 'Wayleaves and Diversions' re-opener in ED and the equivalent for GD. The ED mechanism has a broadened scope covering diversions and development loss claims as well as all other injurious affection claims across our overhead and underground network.

Injurious affection claims are on our 132kV, EHV, HV and LV network (both overhead and underground) where our apparatus is located on residential (and sometimes) industrial or commercial land. To date we have received thousands of claims on our HV network and we are still receiving claims into RIIO-ED2 and are now starting to receive claims on our UG network. We anticipate circa 16,000 plus claims on the LV network alone though the actual realised volume of this is likely to still be uncertain.

Therefore, we support the retention of the GD mechanism for RIIO-3 and that the reasoning could be equally as appropriate for the ED specific mechanism into RIIO-ED3. This clearly should be subject to its own separate and unfettered process for RIIO-ED3 development set to commence in summer 2024.

Question 24: What are your views on our proposal to remove the Capital projects PCD in RIIO-GD3?

We agree with the removal of this PCD.

Furthermore, we support Ofgem as it seeks to rationalise and target the use of PCDs. We agree fundamentally with limiting PCDs to material areas where it is proportional. Our position is that as a default Ofgem should be looking to set out mechanistic PCDs, though where this cannot be developed or established, we recognise that in these very limited circumstances evaluative PCDs might be used.

Question 29: What are your views on our proposal for GDNs to develop individual and joint-GDN vulnerability strategies?

From our experience in ED, we would agree that an individual strategy is needed but we would question what additional benefit is delivered by a requirement for a joint vulnerability strategy. It is almost certain that individual strategies will consider collaborative or joint activities which are appropriate to the licensee involved and would expand beyond the sector.

Individual strategies are needed as the requirements of local stakeholders can differ, and we can see this even within our own operational area. Our experience within ED is that we have found that working with different DNOs on different issues has been effective and efficient and note this occurs without the requirement for a joint strategy to be developed. We do note that whilst some initiatives benefit from the involvement of other companies, they can sometimes be more challenging due to the number of participants which can slow progress.

We note the suggestion in paragraph 4.13 of the consultation document that the expectation to have and maintain vulnerability strategies is to be included within the VCMA governance document. We disagree and our position is that any mandated requirement to have such a strategy should be included in the licence itself, rather than within an associated document.

Question 30: Do you agree with our proposal to retain the RIIO-GD2 vulnerability minimum standards is sufficient to ensure customers in vulnerable situations are protected and treated fairly?

The standards look commensurate with those that apply to ED and therefore we would consider them appropriate.

Question 31: What are your views on our proposal to retain the use of the VCMA UIOLI allowance, on the alternative option to incentivise vulnerability through an ODI-F, and on which activities to support vulnerability could be funded through baseline allowances?

We believe that where services and activities are common and BAU, then these should be included in baseline allowances. For DNOs, these were developed through a series of baseline expectations which provided appropriate clarity for DNOs.

The consultation provides a good critique of the pros and cons of UIOLI versus an ODI-F. We note that an ODI-F was developed for DNOs for RIIO-ED2 but accept it is yet too early to ascertain whether it has been more successful or not over an UIOLI approach. We also welcome the precedence and process that Ofgem has demonstrated in considering the application of an existing mechanism to another sector but determining that it is not appropriate given the characteristics of GD specifically. It is important that Ofgem applies this to all policy and regulatory framework decisions helping to avoid the pitfalls of a one size fits all regulatory model. We look forward to RIIO-ED3 being developed on the same unfettered basis in due course.

Question 32: At what level should VCMA funding be set to ensure its effectiveness and sustainability, and what percentage should be ringfenced for collaborative projects?

On face value, the Ofgem proposal will represent a significant reduction in the services provided to vulnerable consumers.

The spend profile in Table 6 of the consultation shows a significant ramping up of the VCMA spend such that the forecast for 2025/26 is just under £60m. This spend in the last year of RIIO-GD2 is over 80% of the total spend for RIIO-GD3 and could result in a dramatic reduction in the following year, to about 25%.

However, if as mentioned in our response to question GDQ31, Ofgem intends that many of the initiatives instigated through the UIOLI mechanism become baseline services then the quantum of funding for new UIOLI initiatives may well be appropriate, although baseline ex-ante funding would need to be set accordingly.

Question 33: How should VCMA funding be allocated to ensure maximum impact for consumers in vulnerable situations?

We agree it would be more appropriate to allocate the funding based on the levels of vulnerability that each GDNs consumers experience.

The approach taken to set the PSR reach targets for DNOs for RIIO-ED2 could be utilised to develop a fairer allocation. In summary, this approach was developed by the Centre for Sustainable Energy, who took census data, allocated it by DNO area to calculate the potential number of people that could be considered to be eligible for the PSR register. The Centre for Sustainable Energy methodology converted the number of individuals from the census to households (as that is how the PSR is recorded) but either seem a better means to allocate the funding than the number of customers.

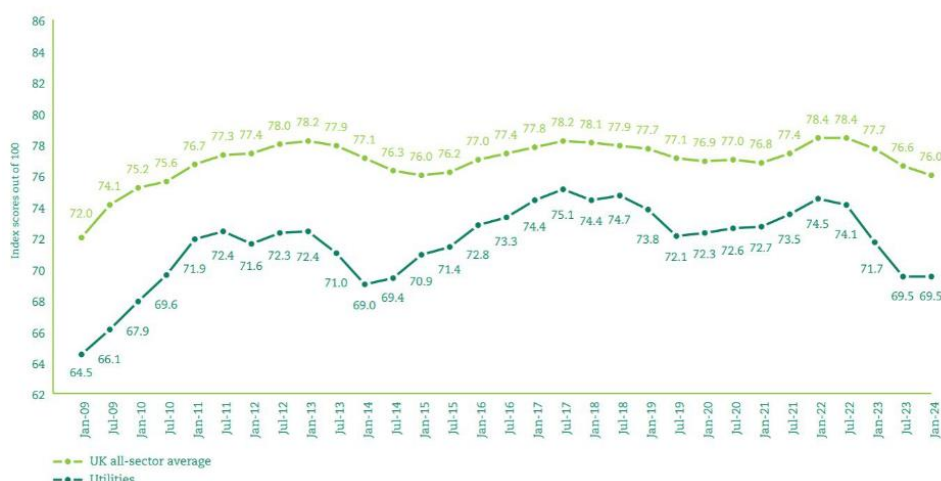
Question 34: How can learnings from VCMA projects better inform the GDNs' organisational approaches to consumer vulnerability?

As described above, we think learnings that have or could be considered BAU activities could be identified and funded through baseline allowances. This ensures a common and improved service is experienced by all vulnerable consumers, no matter where they live. It is important that the common expected baseline service and activities is set out upfront in the business plan guidance ahead of business plan submissions for RIIO-3. Failure to do so could render issues of cost and service disconnect in the cost assessment process undertaken by Ofgem. We set out our thoughts on this in more detail in response to the questions in section 4 of this response document.

Question 35: What are your views on the options we've set out to incentivise customer satisfaction during RIIO-GD2?

We believe that providing good customer service is a key objective for all network companies and that strong incentives help to drive the right behaviour. The most recent UK Customer Satisfaction Index published in January 2024 by The Institute of Customer Service shows a further drop in satisfaction both for utilities and across all sectors. This is important context for Ofgem to study when considering the incentive framework as delivering good results is increasingly difficult due to increasing customer expectations.

Satisfaction trends in the Utilities sector



We would point out that achieving excellent standards of customer service needs continued and considerable effort, focus and investment to maintain them and there is no guarantee that previous services will deliver the same satisfaction scores from customers in the future.

We therefore believe that positive incentives (i.e. rewards) should be made available for high levels of customer service. We also accept that with the use of appropriate deadbands for good performance then penalties for poor levels of customer satisfaction are also appropriate.

We note that for ED, for some time now, the three satisfaction surveys have had different weightings. These were changed to provide a greater emphasis on the connections survey which historically had the lowest results of the three. We believe that this same mechanism could be used to change the incentive properties for each of the three services for GDNs.

From a principle perspective, we believe that the starting point should be symmetrical incentive values. It is important that the concept of symmetry of incentive also considers the achievability of the upside as well as the risk exposure on the downside. Simple symmetry is meaningless if the downside exposure is too great for companies or if the upside is effectively unachievable. Therefore, symmetry should be in the context of achievability as well, with an assessment of probability of reward or penalty at the calibrated levels.

We think a move to a penalty only ODI-F would be detrimental for consumers as it creates a perverse incentive to only do enough rather than strive for the very best levels of customer service. We support the retention of rewards, subject to suitable targets being set.

Moving to relative targets would be a retrograde step. We have seen the benefits of having targets set in advance as this gives a firm basis when developing initiatives and evaluating the cost benefit of forecast improvements. Relative targets change the dynamic and reduce any potential collaboration which benefits consumers. We think this would work counter to many of the other initiatives covered above which deliberately encourage collaboration.

Question 36: What are your views on how the complaints metric can ensure customers' complaints are resolved quickly and effectively?

We support the use of static targets as this gives companies clarity on what performance they need to achieve in the price control period and this helps in assessing the cost benefit of new initiatives. Figure 8 in the consultation shows that the overall trend is improved performance in the complaints metric. The average has improved dramatically and therefore maintaining the target of five seems appropriate rather than averaging very different levels of performance across the two periods.

We would urge caution on any reporting of the number of complaints. This in effect creates a reputational incentive and potentially acts as a perverse incentive to not record complaints.

Our initial view is that adding additional periods brings unnecessary complexity and could create a perverse incentive. The weightings in the complaints metric means that a company needs to deal with the bulk of the complaints they receive with the D+1 period. For more complex complaints then they need more time and the metric works so that if they are not resolved with the D+31 period then the overall score is impacted. Having a shorter, arbitrary timeframe could result in companies seeking unreasonable customer resolution of a complaint to avoid the failing to meet the target at the detriment of the generality of consumers. This incentivises the wrong behaviour and ultimately would be more expensive for consumers.

In terms of reporting separately for customers on the PSR, it is not clear whether Ofgem is seeking visibility of all complaints from PSR customers or just those relating to their vulnerability.

Question 38: What are your views on our proposed options for the unplanned interruption ODI-F?

We do not have specific comments related to the proposals for the unplanned interruption ODI-F other than we note and support that the proposals set out in the consultation recognise the important principle of company specific adjustments to target setting are necessary. This is important where the cost assessment process does not include factors which relate to the performance or service standards that are achievable or have been achieved by the companies in the sector.

It is important to recognise that cost and service/performance are linked, and where cost assessment modelling does not account or control for service/performance/quality in its design then adjustments to the targets are needed to ensure that a false notional benchmark company is not created.

Question 39: What are your views on the options we have set out for the Collaborative Streetworks ODI-F?

This incentive is a bespoke incentive, and we support the principle of continuing regional incentives where benefit is derived from improvements. This is a tangential incentive in the same area of business activities as our own ENWL bespoke incentive Dig, Fix and Go and as such we support that our incentive should be continued on the same basis as the justification of Collaborative Streetworks as set out in the consultation document.

We can estimate the benefit to North West consumers of the Dig, Fix and Go incentive on projected performance for regulatory year 2023/2024 will be a reduction of, on average, 1.0 days of disruption per qualifying unplanned emergency streetworks activity for our consumers. This is the equivalent of circa 3900 days of disruption removed with an estimated monetary benefit of £20m to consumers based on the method we established as part of our ED2 business plan submission. Given this is only the first year of the incentive, we are cautiously optimistic that further improvements and benefits for our consumers can be made in the remainder of RIIO-ED2.

Question 41: What are your views on whether the specified streetworks costs re-opener is still needed in RIIO-GD3?

A Specified Streetworks costs re-opener should be retained within the regulatory framework for RIIO-3.

Many of the same uncertainties as in the RIIO-2 period remain, and whilst none of these triggering events have occurred to date based on our experience in ED, this does not mean that the risk of changes in the areas identified impacting on cost has been removed. For example, we are aware that the removal of Regulatory Position Statement 211 (RPS211) is still to be determined, including what additional activities that DNOs, network licensees and other operators are required to undertake as a consequence of its removal is still being discussed with the Environment Agency. Furthermore, the Department for Transport are looking at the wider rollout of lane rental which, should this occur, would create additional costs to DNOs and other network licensees. The risks are not realised to date and as such a re-opener with the same or expanded scope for RIIO-3 seems pertinent to protect consumers and companies from changes in requirements in this area.

3 RIIO-GD2 outputs and uncertainty mechanisms proposed for removal

Question 42: What are your views on our proposal to remove the Fuel Poor Network Extension Scheme in RIIO-GD3?

We agree that the FPNES should cease from RIIO-GD3 and the role of GDNs in the context of vulnerable customer support activities should be adjusted to reflect the change. We observe from the data provided in the consultation that its uptake is very much reducing year to year and note that if the trend continues then the scheme seems to be heading towards a natural conclusion by the start of GD3.

The consumer case for more natural gas heating and extending the distribution network, especially for vulnerable consumers would need to be very carefully assessed because in the medium term the FPNES risks inadvertently exposing those who benefit from it in the short term to the risks and potential cost they will need to share in for maintaining a less used infrastructure and eventually likely decommissioning costs for the gas distribution network.

Question 43: What are your views on our proposal to remove the consumer vulnerability ODI-R in RIIO-GD3?

The removal of the consumer vulnerability ODI-R and the changes to the metrics seem sensible.

Question 48: Should personalising welfare services continue to be supported under RIIO-3 and, if so, how should it be funded?

As outlined above in our responses to questions 31 and 32 our view is that welfare support should continue for RIIO-3 and anything that is considered BAU should be funded as baseline allowances.

4 Options for evolving our cost assessment approach for RIIO-GD3

We note that in the SSMC Ofgem state “We will not decide on our final approach to RIIO-GD3 assessment of efficient costs until after we have received final Business Plan submissions in December 2024, as Business Plan evidence may warrant a different approach” (Para 5.88). Whilst we understand the need to evolve or amend approaches when final data is received it is important that this is done with an established framework which is transparent and set out ahead of business plan submission. It is important for trust and legitimacy that wholesale or fundamental changes are avoided, and we would strongly suggest that if this does occur then consultation is undertaken. Our experience from RIIO-ED2 was that the cost assessment working groups continued right through to Final Determinations to discuss and iron out issues with cost assessment and we suggest this model is deployed for RIIO-GD3.

Question 50: What are your views on the potential advantages of using multiple totex regression models in RIIO-GD3?

We have responded to this question based on our experience from RIIO-ED2. We suggest that this is relevant for RIIO-GD3 and Ofgem should consider the learnings and context of this when making decisions for RIIO-GD3 policy.

As a principle we support the use of Totex benchmarking as part of the regulatory cost assessment toolkit but it is important that Ofgem is careful not to put undue weight on it as it tends to incentivise lowest cost and disregard quality of outcomes for consumers.

Generally, we would be concerned to observe the over-reliance on a single Totex model as the use of a single top-down Totex regression model to establish cost baselines is out of step with regulatory best practice. We firmly believe that it is impossible for any single Totex model to reflect the complexities of a network company's responsibilities, so would support the use of multiple Totex regression models. This is generally accepted with there being no single perfect econometric model. 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 [Ofwat] do not rely on a single model. Rather, we [Ofwat] use a diverse set of models, with different drivers and different levels of aggregation, in triangulation."*¹

This mirrors the RIIO-ED2 approach where Totex models were collectively limited to a 50 percent weighting with 3 different models developed. We are not necessarily suggesting a 50 percent weighting to Totex model at this stage, but rather that work is done to establish a robust modelling approach.

The development of the cost assessment framework for RIIO-ED2 represents a more holistic approach that considered both top-down and bottom-up regression models, including the consideration of middle models, as well as non-regression or disaggregated modelling where appropriate.

Totex models can be complemented through the use of disaggregated modelling techniques, such as including unit cost modelling where there are distinct costs and activities where cost trade-offs do not exist, and where justified differences between companies occur which cannot be explained or appropriately accounted for through cost drivers in econometric Totex regression models.

In essence, multiple models, and modelling methods, which are aggregated or triangulated should be considered to account for the inevitable and unavoidable imperfect assessment process and individual model imperfections.

Question 51: What alternative cost drivers and model specifications would you propose for early testing?

It is important that Ofgem considers all options in cost assessment modelling development and does not specify cost drivers to include or exclude too early in the development period. It is important that the context of the sector and drivers of costs are considered and tested thoroughly. The same applies for model specification.

The principles and tests for RIIO-ED2 were a useful guide to how to approach this for both cost drivers and model selection criteria. We summarise our view of these principles as below for both:

¹ Supplementary technical appendix: Econometric approach, pg.5, Ofwat, January 2019

Cost drivers:

- **Cost drivers that make economic and/or engineering sense:** It is important that the use of a cost driver can be explained, interpreted, understood as reasonable and relevant.
- **Are accurate and consistently measurable:** It is important that the data sets used have no issues of data inconsistency or where there are discrepancies in reporting between companies.
- **Relationship which is reasonably stable with the costs over time:** That incorporate as much relevant information as possible to be able to differentiate between costs which are explained by exogenous factors and costs by relative efficiency.
- **Largely beyond management control:** As far as is reasonably practicable given that most drivers are impacted by company decisions over the long term. This is to avoid distorting company incentives in ways which might be ultimately inefficient.

Model selection criteria:

- **Economic/technical justification:** Model specifications and results should have a clear economic/technical justification. This should also extend to being intuitive and make engineering sense. It is important to safeguard against any 'data mining' and it is important that this interacts with the robustness criterion. This should be done through statistical test which is critical to guard against overfitting of data. Issues of multicollinearity of similar cost drivers can also be avoided through appropriate statistical testing.
- **Transparency:** The data used, the results and ease of interpretation for stakeholders should be transparent. It should also include where data adjustments and or reallocations are made as well as the justification on how/why these changes are having to be made.
We would note that models can be transparent and at the same time complex out of necessity and the important part is the ability to explain and justify why the model has been selected. This should not rely on statistical testing results for the reasoning. Multiple model forms and methods can be combined in a way that is transparent to all stakeholders, if they are well understood and able to be articulated by the regulator. In the interests of transparency, all models should be published early in the process, along with all the information needed to fully understand, interpret, and recreate them.
- **Robustness:** Models do need to have statistical testing undertaken on them as well as sensitivity analysis on the underlying assumptions. Big changes and large ranges with regards to efficiency scores should give rise to concerns. Ofgem should not be blinded by statistical testing as a varied cost assessment toolkit considering a variety of models, methods and techniques that make economic and engineering sense are more important than overfitting models to suffice statistical testing criteria. The over reliance on statistical tests is a regulatory pitfall that should be avoided.

Question 52: What are your views on the potential of middle-up modelling in RIIO-GD3?

This primarily depends on how the categorisation within any middle-up modelling approach are determined as the cost drivers need to be appropriate for each category. It seems sensible to consider and test middle up models as part of RIIO-GD3 cost assessment development though this should be cognisant of the time available in the price review cycle.

We set out thoughts on how to consider costs for aggregation in response to question GDQ54.

Question 53: What are your views on the potential of disaggregated modelling in RIIO-GD3?

We believe that disaggregated analysis has an important role to play in network price reviews, but that analysis should reflect the activities that companies undertake rather than simply a measure of the size of the company.

From our experience comparing RIIO-ED1 Final Determinations to those for RIIO-ED2 there was a definite move in the disaggregated analysis from using median unit costs to using MEAV as the cost driver. For Electricity North West we estimate that 43% of our final allowance was associated with activity drivers where MEAV was used as the cost driver in the disaggregated analysis. This compares to 37% of costs which were associated with median unit cost analysis.

We recognise that there are problems with effective disaggregated analysis, particularly associated with the quality of data that is provided. Despite many years of regulatory reporting against specified RIGs it is still apparent that companies can report different activities on the same line of a table. If one company reports 'High-Volume Low-Cost' activities and another reports 'Low-Volume High-Cost' activities there will be significant differences in unit costs. Where those costs have been used in comparative analysis at price review, they have had significant unintended impacts on the outcome of those settlements.

We would like to see a thorough review of the data provided for disaggregated analysis to ensure that it is fit for purpose. We would hope that this would result in an improvement in the quality of the data collected rather than an increase in the volumes collected. There may even be scope for a reduction in the regulatory reporting burden. We see a significant benefit of Ofgem reviewing collected RRP data when it is received including asking relevant questions, undertaking comparisons between companies of the data submitted and then driving consistency in data sets on a continual basis. This would render the data collected as being more consistent and improve its use as inputs to future price controls.

As a component part of the disaggregated analysis, we would support the continued use of 'separate assessment' for Bespoke Activities and similar programmes.

Question 54: In your view, what is the most suitable configuration of cost activities for middle-up or disaggregated modelling, that once combined, could form a complete bottom-up assessment of totex?

Whilst we do not have fixed views on the suitability and configuration of cost activities for middle modelling in GD, we would offer the following in terms of principles to follow in considering costs for aggregation. It is important that Ofgem considers costs in respect of:

- **Complementary:** Can a strong technical/economic reason be established that activities or types of expenditure are complementary with a consistent set of cost drivers identified.
- **Trade-offs:** Are there trade-offs in expenditure that can be made between the different activities/areas considered for cost aggregation where benchmarking together will avoid biased efficiency results or create perverse incentives.
- **Boundary complexity:** Consider the complexity of the boundary of cost reporting and if it needs to be defined with more clarity to benchmark the cost aggregation.
- **Inaccurate/biased model risk:** Does the 'noise' in the data exist to a level that confidence in that data including certain types of expenditure within aggregated regressions would not lead to inaccurate model results or estimates that are difficult to interpret or justify on an engineering or economic basis.

Question 55: What do you think would be appropriate criteria for determining cost exclusions for RIIO-GD3?

Cost exclusions are important to ensure that cost assessment is undertaken adjusted for non-comparable costs ensuring that companies are benchmarked on a like for like basis. We do not propose a definitive criterion to determine cost exclusions however the types of costs as below should be considered for exclusion:

- The cost driver used cannot, or is not, a good explainer of the cost
- The cost is changing significantly in the nature between forecast and historical periods
- Low risk of allocation and cost boundary issues leading to impacts on modelling results
- Bespoke or only a minority number of companies incur the costs – such as unique investment programmes
- Costs which are not substitutable or complementary with other Totex costs (e.g. there are no cost trade-offs)
- Costs which are beyond management control (non-controllable)

For clarity, we support transparency on cost exclusions with clear and unambiguous criteria set out up front. It is important that the presumption is that a cost item or category is included in a Totex approach unless exclusion criterion or criteria are met.

Question 57: What are your views on the approach to regional factors for RIIO-GD3?

We note paragraph 5.59 “We [Ofgem] intend to continue to account for the regional factors of labour, urbanity, and sparsity in RIIO-GD3. We are open to alternative approaches that account for these differences, and we will look to revisit within-modelling approaches.”

It is important that any justification of regional factor(s) adjustment is revisited for RIIO-3 and retested for its appropriateness. Ofgem should not assume the reasoning for adjustments in RIIO-2 hold for RIIO-3. This important area would then be internally consistent with company specific adjustments which, even if they are enduring, require to be re-submitted and re-evidenced in new price control submissions.

Question 58: What are your views on the approach to company-specific factors for RIIO-GD3?

We continue to support the use of company-specific factors. We note that the criteria proposed are a continuation of RIIO-GD2 and we agree that the broad criteria set out appear appropriate. It is important and we would encourage that further detail around what evidence is required to suffice the criteria should be set out in the Business Plan Guidance documentation. This will support companies in considering any proposals and limiting these to those where they can meet the evidential requirement and a high bar that should be set by Ofgem.

We would note it is important that different company structures with regards specifically as grouped status is acknowledged as being outside of control of management. A decision to merge or de-merge is not entirely decided by an individual company and not entirely endogenous either with Ofgem having input through any merger and its impact on comparative regulation. Group size is more exogenous than it is endogenous, and there are significant benefits of differential company structures to Ofgem such as ENWL in ED as a single licensee operator.

Question 59: In your view, which cost areas will require separate technical assessment in RIIO-GD3?

We do not have specific views on this for RIIO-GD3 other than that the role of technical assessment and the engineering hub should be set out upfront and with clarity.

Question 60: What are your views on alternative technical assessment approaches for RIIO-GD3?

As set out in our response to GDQ59, it needs to be clear what the technical assessments are being used for and there needs to be clear communication between Cost and Output teams and Engineering teams to ensure internal consistency and application of assessment within Ofgem.

Question 62: Which separately assessed cost activities from RIIO-GD2 could potentially be included in totex benchmarking in RIIO-GD3?

It is important that any cost considered for inclusion with a Totex model or excluded are determined by a transparent and upfront set of criteria for this. We set out our views on this in response to GDQ55.

Question 63: What are your views on retaining the RIIO-GD2 pass-through cost items for RIIO-GD3?

We would support the continuing use of Pass Through for activities which are outside companies' control.

One area which we propose should be treated as pass-through are industry code costs and those arising from code reform programmes. RIIO-3 is a good time to review pass through of these items and it is important that the costs of these are pass-through representing the right outcome for consumers of the reforms and their aims.

Question 64: What are your views on suitable approaches to the disaggregation of totex allowances for RIIO-GD3?

We believe that the disaggregation of Totex allowances needs to be directly related to the disaggregated analysis undertaken by Ofgem. Our experience was that the approach adopted by Ofgem at RIIO-ED2 Final Determination of combining proportions of submitted costs and proportions of disaggregated assessments led to confusing messages at Final Determination. These were exacerbated by the Ofgem decision not to ask DNOs to forecast load costs based on a common scenario leading to significant diversity between submissions and disaggregated analysis. It is important in this context that Ofgem thinks carefully about its full end to end cost assessment process upfront including any method for disaggregation of allowances. This should be set out upfront and ahead of the business plan submission process.

We believe that the allowances should reflect the Ofgem assessment of the technical and financial aspects of the companies' submissions. To use an extreme example, a company could submit a programme of work which Ofgem deemed to be totally inappropriate, so disallowed all costs in the disaggregated analysis. If the same methodology as used at RIIO-ED2 was used, then the company would still be allocated an allowance for that work (a proportion of the total Totex equal to half the proportion of the costs of that activity in the company's submission). It would be very difficult to judge if this allowance had been spent effectively if it had been disallowed in the disaggregated analysis.

As we suggested to Ofgem following the Draft Determinations for RIIO-ED2, we would support the allocation of Totex in proportion to the outcomes of the disaggregated analysis.