RIIO-ED1 Cost Assessment Working Group:

Follow-up to 10 May meeting

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May 2012

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Areas for discussion

1. Views on work plan for Working Group
2. Regional Costs
3. Totex
4. Treatment of non-op capex
5. Allocation of Indirects to activities outside of the price control
6. Period over which costs to be submitted

1. Views on work plan

- Balance of needing to make progress vs establishing an assessment framework everyone has confidence in.
- Key questions:
  - What has to be within the assessment method, and what can be left to companies to justify within their plan?
  - Agree with decision to continue working group meetings to Feb 2013, however important to have clarity of priority issues and deadlines?

1. Views on work plan – pre and post-Strategy paper

Pre-strategy paper:

- Design for Totex model – costs, drivers and methods
- Identify primary assessment tools (i.e. regression, unit cost, expert review, company justification) for each cost category within
  - Network Investment
  - NOCs
  - CAIs
  - Business Support Costs
  - Non-op Capex
- Identify costs and drivers
- Identify any adjustments to be incorporated within models

Post-strategy paper:

- Finalise specification of cost bases, drivers and adjustments
- Build and test working models for Totex, disaggregated regressions and Unit Costs
- Finalise detail of:
  - Uncertainty mechanisms
  - Workforce renewal
  - Guaranteed standards
  - Scoping of expert review
  - Pensions
  - IQI

(Note: In many cases, dependency on other working groups to define principles)

2. Regional Costs –
DPCR5 experience

- Basic premise: Countless examples through government, industry etc of need to recognise regional variations in cost of living/costs of operation. Why would that not be present in electricity distribution?
- At DPCR5, UKPN presented a case for adjustments to reflect non-controllable variations in cost bases across the UK:
  - Internal labour and contractor costs
  - Working in an Urban environment
- Labour and Contractor cost adjustment was symmetrical reflecting the fact that all DNOs face different cost-of living related pressures – those below the average benefit!
- Urban adjustment was separated into two strands:
  - London-specific related to the unique infrastructure on the LPN network. e.g. cable tunnel network
  - Generic effects of heavily-urban working e.g. cost uplifts related to working out of hours, congestion, difficult site conditions etc
- Important to note:
  - UKPN was not the only 'beneficiary' of the above
  - The above adjustments were only made for Opex. Capex treatment was never revealed by Ofgem.

2. Regional Costs –
Looking forward

- UKPN would expect to see Regional Cost factors taken into account for both Opex and Capex
- UKPN Proposal:
  - UKPN will provide suggested adjustment factors for regional labour and contractor costs based on DPCR5 methodology
  - Recognise that many functions can be sited outside London, so propose that this allowance should only apply to direct resources + certain defined indirect roles e.g. field supervisors etc
  - Two options for Ofgem:
    - As in DPCR5, apply a specific adjustment to all DNO cost bases
    - A 'Greater London' adjustment for direct opex and capex – adjustment in proportion to customers within M25: LPN (100%), SPN (25%), EPN (23%) and SSES (15%) – Treatment of other DNOs at Ofgem's discretion.
  - These would need to be reflected in both Totex and disaggregated assessments, hence propose the following:
    - Simple single adjustment to Totex cost base
    - Detailed adjustments to all regressions, unit costs etc. will be required, however UKPN will ensure that the May 2013 business plan submission fully justifies the make up of its costs.
    - Responsibility falls on UKPN to justify size of adjustments
- Note: similar principle should apply to any other company which wishes to claim a company-specific adjustment.

3. Totex Benchmarking:
Views on WPD Proposal

- Initial impression is this does not constitute Total Cost Benchmarking – it is a bottom-up model
- The paper model will require considerable development to convert it into a ‘working’ model. Many of the drivers:
  - are not defined in a way that they can be used, and/or
  - are likely to be subject to debate, and/or
  - require data that is not currently provided/shared.

However…

- We would expect unit costs to be one of the tools deployed for detailed scrutiny of plans.
- UKPN, and doubtless other companies, use unit cost models for managing particular key areas of expenditure.
- UKPN proposal: Working Group should focus on deciding which cost categories lend themselves to the use of unit costs and define those measures (see slide 4).

3. Totex Benchmarking:
Joint work on Totex model

- UKPN, Northern Powergrid and Scottish Power have agreed to commission a joint piece of work to build a Totex model
- Proposed timeline (subject to discussion with selected provider):
  - Tender issue w/c 21/5
  - Presentations w/c 11/6
  - Commence work w/c 18/6
  - Interim Design report i.e. defined cost base, drivers and methods (inc. confirmation of feasibility) complete by 30/7
  - Model delivered, tested and documented by 31/10
- Question: How does IQI interact with Totex?

4. Treatment of non-op Capex

- DPCR5 treatment:
  - Non-op capex assessed using a 10 year average (DPCR4 + DPCR5 forecast) added into analysis of relevant cost categories
  - Vehicles & Transport (opex + capex) and Small Tools & Equipment capex were apportioned across the Network Investment and NOCs cost categories
  - IT non-op capex was assessed as part of the Expert Review

- UKPN proposal for RIIO-ED1:
  - All non-Op capex to be included in Totex
  - Following principles of well-justified business plan, Ofgem need to allow each company to justify their expenditure hence we would not favour apportioning of costs across other categories.
  - For comparative purposes,
    - ‘lumpiness’ to be dealt with by averaging actuals/forecasts over DPCR5 and ED1 periods.
    - Apply simple metrics, alongside assessment of policy:
      - Average STE capex/direct FTEs + maintenance/replacement policy
      - Average vehicle capex/direct FTEs (for those companies purchasing vehicles) + replacement policy
  - Smart-metering/Low Carbon-related IT expenditure to be separated out from IT non-op capex – purely assessed in line with company justification

5. Allocation of Indirects to Connections

- WPD have circulated their analysis re Indirects allocated to Connections and Excluded Services, showing a variation in the proportions (17%-31%)
- UKPN view:
  - Every company has a different mix of Direct Activities i.e. proportion of Directs which are Connections, ranges from 14% for WPD S Wales and 35% for SSEH
  - Within Connections, each company displays a different mix of metered vs unmetered, voltage levels, sole vs shared use etc
  - The scale of the Connections activity will in itself have an impact on the allocation of Indirect – a larger Connections activity may well have more dedicated resource and hence is less reliant on apportionment when it comes to allocating costs to Connections.
  - This leads to the conclusion that Indirects should be benchmarked in relation to Gross direct activity, rather than attempting to normalise allocations between companies.

6. Period of cost submission and implications for assessment

- UKPN will prepare a detailed forecast for the remainder of DPCR5 and ED1, together with a high-level forecast for ED2
- Totex or highly aggregated analysis can utilise DPCR5, ED1 and ED2 analysis, although Ofgem may wish to cross-check this against DPCR5 and ED1 only.
- Disaggregated analysis should only include DPCR5 and ED1 periods, due to uncertainty of ED2 period.