

RIIO-GD2 Cost Assessment Working Group – Meeting 3

From: Ofgem

Date: 26th September
2018

Location: Ofgem, London

Time: 10:00 – 15:00

1. Present

Ofgem representatives;

Martin Siner

Tessa Hall

Jonathan Farrier

Daniel Kyei

Teresa Romano

Nicole Weir

Stakeholder representatives;

Cadent

NGN

SGN

WWU

2. Introduction

2.1. Ofgem introduced the agenda for the meeting, and provided a recap of the actions from the previous CAWG meeting. Stakeholders confirmed that they were not aware of any additional actions from the last meeting.

3. Some principles for cost assessment (Ofgem)

3.1. There was a discussion over the aspects of a good cost driver. One stakeholder agreed with the presentation point that states a good cost driver should be beyond the control of the network company, but they suggested that this is difficult to achieve in practice,

a point on which there was general agreement. Another stakeholder raised concern over this point, and stated that there may be variables within composite scale variables (CSVs) that could be manipulated by the network companies. Another stated that intuition and influence were the most important factors in considering cost drivers.

- 3.2. There was discussion on what makes a good cost driver specifically for the topdown regression, with the three options being a high level approach with one or two drivers, a bottom-up approach using drivers from the disaggregated activities, and an approach using a workload driver from each of opex, capex and repex. One stakeholder stated that, in an ideal world, the topdown totex regression would use a different CSV from the bottom up regression to provide an independent "sense check" to the bottom up approach.
- 3.3. One stakeholder raised the point that the topdown regression is meant to provide a directional tool, with disaggregated analysis used to reach a more informed view. Other stakeholders stated that totex is more than just a directional tool. One stakeholder highlighted the cost allocation issues with disaggregated bottom up regressions. They mentioned examples of "end to end" processes that feed into several cost areas, and stated that there is variation in how network companies allocate the costs. Another stakeholder stated that the totex regression approach was developed as a solution to issues associated with the bottom up regression model, including cost allocation and cherry picking. They went on to argue that to use the totex regression as a secondary approach to bottom up would be a backwards step. There was general agreement from stakeholders on this point.
- 3.4. The group discussed cost adjustments, and in particular there was debate about how to treat provisions and accruals in benchmarking. It came to attention that there is a grey area between accruals and provisions. One stakeholder informed the group that

they have a particularly large accrual release in the 2017/18 reporting year of RIIO-GD1, which had been accrued in a prior price control period. Some other stakeholders suggested that this particular case should be classed as a provision rather than an accrual, and should be treated as such and normalised out.

3.5. There was a discussion over how long smoothing adjustments should take place for.

One stakeholder mentioned several examples of smoothing adjustments from RIIO-1 that have been applied for different lengths of time. Ofgem's response to this was that these decisions would have been made on a case by case basis.

3.6. Stakeholders raised that they would find it useful if Ofgem could share their early iterations of new regression models for RIIO-GD2. It was mentioned that during RIIO-GD1, the models were only shared with network companies at Initial Proposals, although there had been sharing of some cost assessment data (e.g. MEAV) prior to this. Stakeholders would ideally like to be engaged before initial proposals. Ofgem don't currently have a forward program with dates for the RIIO-GD2 regression model development, but Ofgem agreed to update stakeholders when decisions have been made on this matter.

4. Regional factors (Cadent)

4.1. In relation to the RIIO-1 labour regional factor, there was some debate around which ONS ASHE data SOC codes were used. Ofgem stated that they will look into the use of SOC codes in RIIO-GD1 and in the context of RIIO-GD2.

4.2. There was some debate around the concepts of zero-sum adjustments. One stakeholder stated that they are able to accept the idea that labour could be a zero-sum adjustment because they are applied around the national average. However, they were opposed to the idea of zero-sum adjustments for other regional factors such as sparsity and urbanity. Ofgem raised concern over regional factors that are applied as an adjustment in one direction from an average, and it was mentioned that Ofwat

were criticised by the Competition and Markets Authority for one-directional 'regional factors' in PR14, although this in the context of totex models with no workload drivers, which is different to the Ofgem RIIO-GD1 approach.

- 4.3. The group discussed the RIIO-GD1 urbanity regional factor. Several stakeholders argued that for RIIO-GD2, elements of urbanity could be applied to other cities in addition to London. There was also a criticism of the way that the urbanity adjustment was applied in RIIO-GD1. It was suggested that the urbanity adjustment could be applied based on the proportion of workload in the zone where the urbanity regional factor applies (e.g. inside the M25) rather than the proportion of the population inside this defined zone.
- 4.4. Other regional factors used in RIIO-GD1 were also briefly discussed by the group. The sparsity regional factor was identified as being driven largely by travel times and meeting the emergency response requirement. Stakeholders questioned whether the calculation could be carried out at a lower level than Local Authority areas. There was some confusion within the group over what the reinstatement regional factor includes. It was stated that it is similar to urbanity, but covers different costs. The discussion highlighted that reinstatement includes cost of material and transport. One stakeholder mentioned that it would be useful to have some clear metrics on regional factors to be able to compare regions.
- 4.5. It was proposed by a stakeholder that the CAWG could be used as a forum to consider regional factor claims. Stakeholders were in general agreement that this would be a good place to discuss regional factor claims and would provide an opportunity for claims to be debated and amended before submission. However, it was noted that different stakeholders would be at different stages in the process of developing regional factor claims, and this could impact the debate. Ofgem acknowledged that

stakeholders see value in this suggestion, and stated that they will provide an update on how to take this matter forward to the next working group.

5. Model structure and cost assessment approach (WWU)

- 5.1. The group discussed the use of forecast and historical data in relation to the RIIO-GD1 approach and options for RIIO-GD2. One stakeholder suggested that the weighting of historical and forecast costs in cost assessment should be assessed on a case by case basis. This point was backed up using an example of vehicle fleets; it is expected that there will be a transition to more electric vehicles, and in this case, the historical costs will be a poor indicator of the future. Other stakeholders agreed that there are several cost areas that will likely undergo significant shifts in cost profile between RIIO-1 and RIIO-2.
- 5.2. It was suggested by a stakeholder that the discussions on model structure and cost assessment approach also need to consider any cost areas that might be better suited to non-regression analysis. Ofgem agreed that non-regressed cost items should be discussed at a future working group, and stated that it is something that is being looked at by Ofgem.
- 5.3. A stakeholder suggested that the use of forecasts in the regression analysis does not need to be mechanistic. One option is not to use them at all (ie. use historical regression results to extrapolate predictions). On the other hand, forecasts could be used when the past is not a good predictor of the future. Ofgem pointed out that using forecasts might lead to distortions in companies' incentives. One stakeholder highlighted the importance of understanding what is driving change.

6. Next steps / AOB

- 6.1. A question was raised about the information on the working groups that will be published online. Ofgem clarified that non-attributable meeting summary notes will be produced for each CAWG meeting, and that they will be circulated to stakeholders for

comment before being published on the Ofgem website. Ofgem also clarified that presentations from the meetings will be published online, along with some information on upcoming topics to be discussed at future CAWGs.