

RIIO-GD2 Cost Assessment Working Group – Meeting 4

From: Ofgem

Date: 17th October
2018

Time: 10:00 – 15:00

Location: Ofgem, Glasgow

1. Present

Ofgem representatives;

Martin Siner

Tessa Hall

Callum Mayfield

Jonathan Farrier

Daniel Kyei

Teresa Romano

Nicole Weir

Stakeholder representatives;

Cadent

NGN

SGN

WWU

2. Introduction and recap of previous working group actions

2.1. Ofgem updated stakeholders on potential future activities (action 5 from the previous working group). Ofgem noted the view of some stakeholders that in RIIO-GD1 a significant proportion of the change in allowances from Initial to Final Proposals arose from misunderstandings. Ofgem confirmed their intention to continue to engage with GDNs in RIIO-GD2, which will reduce the potential for misunderstanding.

- 2.2. Ofgem confirmed that there will be more internal thought on the approach to assessing regional factors, but expected that they would be discussed early next year through the cost assessment working group.
- 2.3. Ofgem confirmed that they will circulate to the GDNs the updated baseline data that could be used to re-run the RIIO-GD1 regression models later this week or early next week. One stakeholder stated Ofgem needed to provide updated regression models to GDNs. This would enable GDNs to report to their engagement groups on their relative efficiency.
- 2.4. The group were informed that the presentation on non-regression activities due to be presented at this working group meeting will be moved to the next working group on the 15th November instead.
- 2.5. Ofgem confirmed that they will circulate information on SOC codes used in RIIO-GD1. Ofgem also highlighted that the SOC code information was collected for RIIO-GD1, but hasn't been updated since. The group was informed that in future, Ofgem may request the SOC code information on a yearly basis to keep this information up to date.

3. Upper Quartile approach and driving efficiency (Cadent)

- 3.1. The presentation began with a quote from the CMA that no benchmarking analysis will be perfect, and there will always be vulnerabilities and limitations in any approach, and then demonstrated the wide range of views of efficiency used by Ofgem at RIIO-GD1. There was also a discussion on the possible ways to determine how much weight to put on top-down and bottom-up regressions. Ofgem asked stakeholders for any suggested approaches to determine these weights, other than judgement. Several stakeholders raised the point that it depends on the relative confidence in the bottom-up and top-down approaches. It was noted that these working group meetings have highlighted several ideas for improvements to the bottom-up regressions, and there will be more years of useable data to inform decisions than in RIIO-GD1. It was

suggested by a stakeholder that for these reasons, there might in the future be a higher level of confidence in the bottom-up regressions, which could allow a higher weight to be applied to them. However the group also discussed the importance of the top-down approach, which can overcome structural, capitalisation and cost allocation issues. One stakeholder also noted that the fit (R^2) of the bottom-up regressions are lower than the top-down. These factors could justify a higher weighting on the top-down approaches.

- 3.2. Ofgem asked for views on the value of benchmarking using forecasts. One stakeholder stated that benchmarking should only be used for components that are broadly consistent over time, and that uncertainty mechanisms should be used for the components that are less consistent over time. Another stakeholder suggested that while there is an uncertain future, benchmarking of forecasts could still take place where GDNs have similar assumptions in their forecast data.
- 3.3. During the presentation slides on glide paths (ie catch up to the frontier), one stakeholder asked if this is related to the mechanism in RIIO-GD1 where companies are targeted to get to 75% of the upper quartile. Another stakeholder confirmed that this was the RIIO-GD1 IQI interpolation, which is a similar principle to a glide path.
- 3.4. Ofgem highlighted the example of Ofwat previously using the frontier rather than the upper quartile. One stakeholder informed the group that in this example, the frontier was reduced by 10% to account for uncertainty in the data, and there were also several criteria for circumstances in which a frontier would not be used.
- 3.5. It was discussed how a decision on the use of glide paths can't be made until Ofgem has information on the benchmarking approach, business plans, and whether IQI interpolation will be applied.

4. Ongoing efficiencies (Ofgem)

- 4.1. There was discussion over the RIIO-ED1 approach to setting ongoing efficiencies, and one stakeholder asked why Ofgem accepted the ongoing efficiency levels submitted in the business plans. A suggested reason was the similarity in values to Ofgem's ongoing efficiency assumptions for RIIO-GD1 and T1, based in large part on the EU KLEMS dataset.
- 4.2. There was some discussion on the EU KLEMS dataset. It was noted that the dataset had been updated, but that it no longer appeared to provide the Gross Output measure of Total Factor Productivity (TFP).

5. Data consistency

- 5.1. One stakeholder asked how inconsistencies in data reporting between GDNs would be resolved. Ofgem clarified that the intention is for any material inconsistencies to be resolved through the regulatory instructions and guidance (RIGs), and that historical regulatory reporting packs (RRPs) will be updated to ensure consistent data for RIIO-GD2 benchmarking. The RIIO-GD2 business plan data templates (BPDTs) and guidance will be linked to existing RIGs.
- 5.2. Another stakeholder asked how Ofgem will identify other inconsistencies, and if there will be a systematic process for this. Ofgem stated that this is an ongoing process, and that they will circulate a template for the GDNs to review and fill in. This should identify areas that will need to be reported differently in future, and should help highlight other areas of data reporting inconsistencies.
- 5.3. A stakeholder raised the point that Ofgem will need to ensure that any new data for RIIO-GD2 is reported consistently, and it was agreed that this could be discussed at the next working group. There was also a question raised about how stakeholders will report on the future of gas. Ofgem stated that they will work with the gas distribution policy team on this matter.

- 5.4. One stakeholder raised that it would be useful to understand how the Price Control Financial Model (PCFM) will link with the RRP's and the BPDTs. Ofgem informed the group that they have invited the RIIO Finance team to the next working group, as they might be able to contribute to discussions on these potential links with the PCFM.

6. CAWG 5 presentations

- 6.1. Ofgem outlined their expected timeline for the development of BPDTs for RIIO GD2. The intention is that Ofgem will highlight significant changes to the BPDTs in the December consultation document. Ofgem aim to formally share the development of the BPDTs and guidance in early 2019, and formally publish the BPDTs in mid-2019, possibly with or following the strategy decision.
- 6.2. There was a discussion on how the group should approach developing ideas on cost drivers in the following meetings. It was resolved that Ofgem should lead on the discussion on cost drivers. Ofgem then agreed to create a table that assesses RIIO-GD1 cost drivers against the principles of a good cost driver (discussed in CAWG meeting 3) This will form the starting point for discussion on cost drivers in the next meeting on the 15th November.

7. Alternative benchmarking approaches for regressions (WWU)

- 7.1. One stakeholder made the point that the decision on an appropriate benchmarking approach is always down to regulator's judgement.
- 7.2. Overall, stakeholders expressed interest in exploring alternative approaches to benchmarking for RIIO-GD2, however the group voiced several concerns about doing so. For example, one stakeholder raised that exploring the alternatives would take up significant time and resources. In addition to this, it was highlighted that there are risks associated with the alternative approaches discussed because they have never been used or tested for gas distribution in the UK. Another stakeholder suggested that

the alternative benchmarking approaches could potentially behave as “black boxes” that produce results with less transparency than the current method for RIIO-GD1.

7.3. In the presentation, it was stated that the number of data points has increased in terms of time series data since the start of RIIO-GD1, but the number of GDN companies remains the same, so there will still be limitations associated with the number of data points. There was a brief discussion around data limitations. Ofgem raised the point that there are pros and cons to each approach, but there will always be a limitation associated with the small number of data points, therefore this shouldn't be a reason to rule out considering alternative models that are typically used with larger datasets (e.g. Stochastic Frontier Analysis).

7.4. Ofgem informed the group that they have put out a tender for an independent academic advisor to support on benchmarking for RIIO-GD2.

8. Benchmarking Review findings (SGN)

8.1. During the presentation it was stated that forecast models in the RIIO-GD1 assessment produced more variable results than historical models. One stakeholder highlighted that this is directly linked to one of the points in the presentation on upper quartile and driving efficiency earlier in this meeting. Specifically, it backs up the point raised around how much variation there is in the rankings when using results based on forecast vs historical data (and when using top-down vs bottom-up regressions).

8.2. The presentation raised concerns over the cost driver used for repairs. It was suggested by one stakeholder that a cost driver for repairs should take into account the diameter bands in order to show the underlying efficiency. Other stakeholders agreed on this point.

8.3. In relation to the presentation slide on repex, one stakeholder argued that mains laid doesn't accurately reflect efficiency in repex, and that there could be better drivers for this. However, it was stated by one stakeholder that despite any issues with the repex

regression, once the allowances are set, all stakeholders are incentivised to be as efficient as possible.

8.4. The presentation stated that the repex bottom up models in RIIO-GD1 are not smoothed, but that this could be a solution to volatile repex efficiency scores. One stakeholder agreed that repex smoothing could be used to account for fixed overheads, such as project planning, which may materially impact a network's efficiency score in years with higher or lower workloads. One stakeholder suggested that smoothing may be more important than changing the cost driver for repex.

8.5. The presentation raised the idea that quality could be incorporated into regressions. It was stated that for example, a quality threshold could be used, i.e. the frontier performer should only be considered valid if they have delivered a quality service. Another stakeholder agreed with the suggestion of a quality threshold. One stakeholder suggested that we should identify specific areas where there are concerns over quality.

9. AOB

9.1. One stakeholder mentioned the need to further assess future energy scenarios, and the group discussed the current cross sector work looking into this. There was a discussion on the next steps of this work, and the consensus was that the onus is on the stakeholders to work out and agree thinking at a high level. Ofgem agreed to inform the group if this understanding is incorrect.