Minutes

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Making a positive difference
for energy consumers

Cost Assessment Working Group – Meeting 8		
From: Ofgem	Date: 11th April 2019 Time: 10am – 3pm	Location: Glasgow

1. Business Plan Data Template (BPDT) discussion

1.1. Ofgem stated that they are considering carrying out a consultation on the templates in Summer, and that the responses to this will feed into the final BPDTs which they plan to issue in September 2019. Ofgem confirmed that they do not intend to make changes to the templates before then.

1.2. The discussion moved onto the draft RIIO-GD2 BPDTs that were published on 29th March. Ofgem stated that they won't produce a list of areas that companies are exempt from completing for July. As per the guidance from the RIIO-2 Challenge Group, companies should fill in what they can, and note what data isn't available and why, and the level of data assurance that has taken place.

1.3. One stakeholder asked if Ofgem expect all data in the July BPDT submission to have been through the full DAG process. Ofgem clarified that full data assurance should be carried out where possible, but they understand that companies may not be able to do this for all of the draft data. Companies should do what is reasonable by July and be clear on what assurance has been carried out. Ofgem clarified that they do expect some changes in the data between the draft July submission and the final BPDT submission.

1.4. One stakeholder asked if there is any concern that GDNs may complete the BPDTs differently. Ofgem stated they expect differences will be minor and that this would be consistent with RIIO-GD1 because there were some inconsistencies in the amount of

data submitted in the BPDTs between GDNs, and some of these differences are due to differences in company systems and processes.

1.5. The group discussed the repex BPDT tables as this is one area where GDNs have raised that it will be difficult to provide data, or in some cases they can't provide the data. There was some discussion on specific data requirements, however the group agreed to set up a call between Ofgem and two individuals from each company to discuss the repex BPDT tables in more detail (eg purpose of the data requests, difficulties in providing it, and whether the data would be better supplied in a subsequent Supplementary Question).

1.6. There was a discussion on reinstatement costs, with one stakeholder stating that this information can't be provided at the level of disaggregation asked for. There was a suggestion from a stakeholder that for the split of reinstatement costs, supplementary questions to gather this information would be more suitable, giving GDNs time to discuss it with contractors. Ofgem stated that the use of supplementary questions could be useful in general for the BPDTs, in a similar way to the supplementary questions for the annual reporting of RIIO-GD1.

1.7. Stakeholders stated that it would also be useful to set up calls to discuss the opex and capex draft BPDT tables.

1.8. Ofgem agreed to hold bilateral meetings with GDNs to discuss the contents of the BPDTs if it would helpful.

1.9. Ofgem noted that the data requested for Business Support activities was different to that provided in the Gas Distribution RRP, because Ofgem wanted the ability to benchmark across energy sectors, rather than only using GDN data.

1.10. One stakeholder asked how to deal with any errors in the formulas of the draft BPDTs. Ofgem asked for companies to let them know of any errors, and to note down amendments in the changes log in the BPDT file. One stakeholder asked if the BPDTs

will need updating after the 2018/19 RRP is submitted at the end of July. Ofgem confirmed that the draft BPDT won't need amending with the new yearly figures, but that the 2018/19 figures should be used in the final RIIO-GD2 BPDT submission later in the year.

2. Modelling approach

2.1. Ofgem presented high level criteria for model selection, and one stakeholder suggested that secondary drivers should also be considered.

2.2. In response to the model evaluation part of the presentation, the group discussed the issue of models' consistency with policy. The group highlighted this consistency with policy as a high-priority criterion for model evaluation. One stakeholder pointed out that the model should drive the policy, not the other way round. Ofgem's academic advisor noted that in the water sector, Ofwat used this consistency criterion to account for quality in the models.

2.3. The group were in agreement on the desirability of stability, but also if model results were moving significantly, it was key to understand why. One stakeholder questioned how a robust model and a good fit is defined. The group discussed this query, referring to R^2 values and other statistical criteria, but the group didn't reach one clear definition.

2.4. Ofgem asked stakeholders for ideas on alternative approaches to combining different levels of models. One stakeholder stated that this might depend on the level of confidence in the individual models. Another stakeholder suggested that the mid-level analysis (ie opex and capex) could be reconsidered in RIIO-GD2 to provide an additional view on efficient costs. It was proposed by a stakeholder that a different cost categorisation for the mid-level models could be used, although some of the group questioned the usefulness of this proposal, partly due to the differences in contracting strategies between companies.

2.5. A stakeholder suggested that it would be useful to have further discussion on the approach to regional factors in the near future. The group expressed interest in discussing the materiality thresholds for companies' cost claims. One stakeholder suggested to start the discussion after draft Business Plan submission, as the Business Plans will include information on regional factors.

3. Alternative Modelling Techniques

3.1. Ofgem's academic advisor presented two potential alternative modelling techniques: data envelopment analysis (DEA) and stochastic frontier analysis (SFA). It was noted that DEA is a mathematical optimisation model which does not determine whether inputs and outputs are statistically significant. Its optimisation process applies weights (including potentially zero weights and different weights to each company) to variables and 'attempts to view firms in the best possible light'. However, DEA is less transparent than a cost function. Stakeholders acknowledged the limitations of applying DEA in network regulation (ie due to limited data and complexity).

3.2. It was noted that SFA could perhaps be more applicable than DEA, however its benefits could be overstated in the regulatory context. SFA makes a specific assumption of non-correlation between error and regressors in order to decompose the error term into inefficiency and random noise. SFA is better with larger data samples and relies more on robust data. Stakeholders acknowledged that SFA could also be a candidate modelling technique, and is a potentially useful area of work to explore further.

4. Totex regression

4.1. Much of the totex presentation was covered in the previous presentations and discussions, so there was very little discussion for this session. It was stated by a stakeholder that there were a number of exclusions made to the RIIO-GD1 totex regression, and that these were sensible exclusions.

5. Repex regression

5.1. One stakeholder highlighted that the reported repex costs are not the true costs of carrying out the work due to under/overspend sharing mechanisms in contracts. Consequently, in the case of underspend, underlying costs are lower, and in the case of overspend, underlying costs are higher.

5.2. There was a discussion on the slides showing repex costs as compared to network length, and it was noted by a stakeholder that they don't take account of the actual work done. It was suggested that it would be useful to look into cost per workload replaced instead of network length.

5.3. The group discussed whether regional factor adjustments should be incorporated when updating synthetic unit costs. There was no clear consensus on this discussion, and it was identified as something for Ofgem to consider.

5.4. There was a discussion over whether to update the repex synthetic costs for RIIO-GD1 actuals. It was noted that non-domestic services had a lower unit cost in GD1 than used in the synthetic. It was suggested that this may be due to the lower level of Tier 3 replacement in GD1 than previously, with Tier 3 non-domestic services typically being significantly more costly than those of lower Tiers.

5.5. A stakeholder noted that service relays after escape incur notably higher costs than relays associated with mains replacement activity, and suggested that these costs could have a material impact on the regression result.

5.6. Apart from services, the value of updating the synthetic for GD1 actuals was questioned by Ofgem, in the context of GDNs using allocation to apportion costs between mains diameter bands. It was stated that there was far less apportionment of costs over the larger diameter bands, which potentially implied that the regression may be more accurate if more up-to-date synthetic unit costs were used.

5.7. In a discussion on how costs are allocated in certain areas of repex, one stakeholder stated that the allocation methodology can be found in the data assurance and guidance (DAG) methodology statements produced by the network companies as part of the DAG process. It was highlighted that these statements will be replicated for the RIIO-GD2 BPDTs in due course.

6. Connections regression

6.1. The group asked for clarification on how regional factors were applied in the presented analysis. WWU explained that the analysis shown in their presentation included regional factors that were applied based on the assumed split of labour, contractors etc. taken from the capitalised overheads table in the RRPs, which are different for each company.

7. Mains reinforcement regression

7.1. The group discussed the use of net or gross costs for this regression. One stakeholder stated that net costs were used in RIIO-GD1, but there was no clear justification given for this at the time. They suggested that there is an opportunity to change this to gross costs for RIIO-GD2. It was stated by one stakeholder that the difference between using gross or net here is not very material, but that gross costs is the logical choice, and would align with the connections regression which uses gross costs. There was agreement from all stakeholders that gross costs should be used instead of net costs in the mains reinforcement regression.

7.2. Ofgem identified that there needs to be more clarity on how reinforcement work is reported in this category and in capitalised repex. One stakeholder highlighted that there was a supplementary question on this area of the annual regulatory reporting packs (RRP) recently.

7.3. In response to the analysis shown in the presentation, one stakeholder highlighted that the five year regressions have better R^2 values than the single year regressions, and suggested that this may be due to projects that span multiple years.

7.4. It was highlighted that the Ofgem regression work for mains reinforcement differs to the analysis presented here. The group identified a possible explanation for this; that normalisations for regional factors and the London Intermediate Pressure reinforcement project were made in this analysis, but not in the Ofgem analysis. It was suggested that the London Intermediate Pressure project significantly affected the quality of the model as it was material, very high cost per km, and not representative of the vast majority of reinforcement works.

8. Summary

8.1. In relation to regional factors and RPEs, Ofgem informed the group that they intend to include considerations and evaluation of options for the approach to assessing regional factors and indexing RPEs in the cost assessment summer consultation paper.

8.2. In terms of timelines, Ofgem stated that they aim to publish the cost assessment paper at the end of June before draft Business Plans come in, however there is no set date yet. Ofgem stated that the cost assessment paper is another stage in the consultation in the run up to Draft Determinations, and they don't intend to publish a separate decision on this consultation.

8.3. Ofgem advised that they were in the process of engaging external Consultants to assist with their work on Cost Assessment.

8.4. The group discussed potential topics for the next CAWG meeting on 9th May. The provisional agenda is published on the Ofgem website[1].

[1] Ofgem, RIIO-GD2 Working groups (https://www.ofgem.gov.uk/publications-and-updates/riio-gd2-working-groups)