

## Cost Assessment Working Group – Meeting 10

From: Ofgem

Date: 24<sup>th</sup> July 2019

Time: 11am – 3:30pm

Location: Ofgem, Glasgow

### 1. Cost assessment working group terms of reference

1.1. Ofgem informed the group that they have updated the terms of reference for these cost assessment working groups (CAWG) to better reflect the current purpose of these meetings now that the draft business plans have been submitted. Ofgem outlined the proposed updates to the terms of reference, and the group were in agreement with these changes. Ofgem agreed to circulate the updated terms of reference to the group for comment before publishing them on the Ofgem website.

### 2. Tools for cost assessment consultation

2.1. Ofgem introduced the session by highlighting the intention to focus the discussion on the elements in the June cost consultation that had not been fully discussed at previous CAWGs, while still providing a general overview. The main topics of discussion were cost pooling, workload cost drivers and approaches to the assessment of regional factors.

2.2. The group discussed how to identify complementary types of expenditure for cost pooling. One stakeholder queried the statement in the presentation about testing year-on-year volatility, and how this could be used to identify complimentary areas of expenditure for cost pooling. Ofgem clarified that volatility could be caused by trade-offs, and the issue is how to make sure that costs are allocated to the right categories. Aggregating costs (eg repex) over a period, smoothing techniques, and qualitative assessment of CBAs were discussed as potential options to address volatility.

- 2.3. During a discussion on different cost pooling options, one stakeholder noted that taking multiple approaches is useful. They stated that although the totex model would be less precise in terms of cost drivers, it would provide a sense check to the overall analysis by mitigating the risks of taking a bottom-up approach only. Another stakeholder added that the degree of confidence in the models themselves is also important. Independently of this, the stakeholders agreed that a totex approach has the advantage of overcoming trade-off issues and is the only approach that can do so.
- 2.4. Options 2 (totex and disaggregated models) and 3 (totex and opex plus models) were then discussed. Ofgem stated that one of the reasons for considering Option 3 is the expectation of a lower degree of volatility in opex. Stakeholders pointed out that there might still be opex volatility due to weather conditions, but acknowledged that capex is generally more volatile in nature.
- 2.5. While discussing Option 4 (opex plus models), Ofgem asked the group for examples of non-opex activities that could be assessed together with opex. Relay after escape, Local Transmission System (LTS), and some aspects of reinforcement and repex were suggested. There was some discussion around the potential for repex to be excluded from regression analysis under some of the proposed pooling options. The stakeholders noted that despite repex being driven by work volumes, a regression approach could still be appropriate if it includes updated synthetic unit costs to account for differences in workload mix. Another stakeholder highlighted that repex has relatively predictable and consistent costs, and is therefore suitable for regression analysis.
- 2.6. One stakeholder pointed out that it is important not to create perverse incentives by excluding costs from models. On the other hand, including more costs into the opex plus model would make it more closely resemble a standard totex approach. Another stakeholder noted that it will be important to understand what cost drivers could be

used under different aggregation approaches. It was also raised by a stakeholder that the fact that Ofwat adopted an alternative cost pooling approach for water companies does not imply suitability for gas distribution, as the differences between the two sectors make it difficult to compare modelling approaches.

- 2.7. Overall, the stakeholders were open to see how different pooling approaches would work. It was suggested that it would be useful to start testing models with different pooling options and to discuss the results as a group. The group offered to provide feedback on Ofgem's initial thoughts on specific aggregation options, and suggested looking at some of the aggregation options proposed in previous working groups.
- 2.8. There was a discussion about the data Ofgem will use in testing models going forward. It was proposed that Ofgem use historical data for models to be presented in CAWGs. One stakeholder added that Ofgem should also consider using RIIO-GD1 forecasts because this data will be in the annual regulatory reporting packs which are shared between the GDNs. Ofgem confirmed that they would consider this suggestion to use RIIO-1 forecasts, but that models using the RIIO-GD2 forecast data in the draft BPDTs will not be presented as this information is confidential. One stakeholder highlighted that models only using historical data won't capture any big changes in costs for the next price control. One stakeholder added that the interactions of the models with the business plan incentive (BPI) will also need to be addressed, including in respect of the question on the use of historical v. forecasts data.
- 2.9. Ofgem highlighted several drawbacks and concerns with the use of workload drivers in regressions. One stakeholder asked for clarification on these concerns. Ofgem clarified that the fact that some costs are clearly driven by workload is not under discussion. However, the use of workload drivers might create endogeneity problems, as well as difficulties in the interpretation of coefficients when the composite scale variable (CSV) includes a mixture of scale and workload drivers. One stakeholder responded that

using a CSV with only scale drivers (as done in the tools for cost assessment consultation) might also be debatable in terms of interpretation. It was also noted that in RIIO-GD1 different approaches to determine CSV weights were proposed, but given the unreasonable results, Ofgem selected industry spend as the most appropriate option.

2.10. Ofgem presented the results of a few regression models on regional factors, including the use of a density variable as a way to account for urbanity and sparsity within the model itself (as opposed to ex-ante adjustments). Stakeholders commented that using population density as a proxy for urbanity and sparsity might be problematic, as it wouldn't necessarily match actual workload and would not capture the required level of complexity (eg properly account for particularly sparse/urban areas). It was suggested that Xoserve customer and pipe data, despite being very detailed, could offer useful insights and could be compared with what was done on sparsity in RIIO-GD1. Ofgem agreed to share the data used for the regression results presented and the models using the data.

2.11. Ofgem presented two options to set up the process for defining regional factors for RIIO-GD2. Stakeholders showed a general preference for using a future CAWG to discuss regional factors rather than a case-by-case assessment with no information shared between them. Independent of the final decision, stakeholders requested that Ofgem provide some notice before this process takes place. It was recognised that tackling regional factors at CAWGs before final business plans submissions in December would cause confidentiality issues. Nonetheless, stakeholders suggested that some topics, such as the use of consistent SOC codes, could still be discussed before December.

2.12. The session concluded with an overview of the cost consultation questions, which stimulated discussion around specific areas such as business support and

frontier shift. More specifically, stakeholders raised several potential issues to deal with while assessing business support costs, including the treatment of non-regulated activities, the choice between gross and net costs for benchmarking, the use of external benchmarks and issues with cherry picking.

2.13. In relation to the consultation question on frontier shift, one stakeholder asked why Ofgem is looking at frontier shift as a whole instead of identifying the two individual components (RPEs and ongoing efficiency). It was also highlighted that disentangling catch up and frontier shift might be impractical or even impossible, given managerial changes and past business decisions (eg on outsourcing). Ofgem noted its intention to assess both RPEs and ongoing efficiency, but also to look at outturn frontier shift using historical data, even if just as a sense check. Stakeholders pointed out that sharing ongoing work in this area before December 2019 could be useful, as long as the analysis focuses on historical data.

2.14. Finally, there was a discussion on the timing and content of the coming bilateral meetings. Ofgem clarified that, as it is not possible to provide any feedback on the recent draft business plan submissions, bilateral meetings will mainly focus on annual reporting.

### **3. Business plan data templates**

3.1. Ofgem provided an update on their timelines for the development of the final business plan data templates (BPDT). This included the plan to issue a working version of the BPDT to network companies in early August, with a two-week period for companies to provide comments. One stakeholder requested a longer period of around one month for them to comment on the BPDT because lots of staff are due to be on annual leave in this time. Other stakeholders stated that they may struggle to provide feedback in two-weeks for the same reason. Ofgem agreed to extend this response time to a three-week period.

- 3.2. Ofgem outlined their plan to amend the formula errors and re-publish the March 2019 draft BPDT and guidance, and that this template should be used for the October business plan submissions. Ofgem asked stakeholders for their views on this approach, and no concerns were raised.
- 3.3. Ofgem stated their intention to add a totex summary table to the BPDT pack, and suggested that this could exclude uncertain costs. One stakeholder queried the definition of 'uncertain costs' in this context, and Ofgem clarified that this would be the uncertainty mechanism costs. One stakeholder mentioned that uncertain costs should be captured in a way that matches the language used in the financial model on uncertainty mechanism costs. The discussion on uncertain costs highlighted that companies may treat uncertain costs differently (ie include them in baseline costs, or propose an uncertainty mechanism), so the BPDTs should capture the uncertain costs somewhere regardless of how they are being treated by the company. One stakeholder raised an additional point relating to cost adjustments that were made in previous years of RIIO-1 in several cases. They asked if historic data should be filled in with or without these adjustments, and highlighted the interaction with the financial model. Ofgem recognised the need to decide how best to capture and address these uncertain costs and historic cost adjustments, and to ensure the approach reconciles with the financial model.
- 3.4. The group discussed the potential for the BPDT to capture incremental and/or ambition costs. In relation to ambition costs, Ofgem suggested that it would be useful to know exactly what this ambition cost relates to, for example cost to deliver above a specific target or output. There were several suggestions from stakeholders of how incremental costs could be reported in the BPDT. For example, creating a new tab to show ambition and incremental costs for each activity. One stakeholder highlighted that in RIIO-GD1, the BPDT captured incremental costs year-on-year for opex, and

suggested that something like this could be replicated in RIIO-GD2 to capture incremental costs, and possibly uncertain costs too.

- 3.5. Ofgem asked the group for their views on whether cyber security costs should be captured in the BPDT. One stakeholder suggested that this may not be necessary if cyber security costs are submitted to Ofgem separately.
- 3.6. There was a discussion following on from the presentation on innovative methods of reducing risk led by SGN in CAWG 9. In particular, this discussion focussed on where CISBOT<sup>1</sup> costs and workload should be captured in the BPDT. The discussion identified current inconsistencies in how the networks report the costs and the workload. Ofgem concluded that CISBOT costs and workload should be split out and captured in the BPDT, but not necessarily as part of repex. It was agreed that more discussion is needed on how CISBOT costs will be assessed, and Ofgem stated that they will try to continue this discussion in the next asset management working group in August. One stakeholder reminded the group that there are multiple uses of CISBOT, and suggested that there will need to be clear guidance on where the costs go when CISBOT is used for different activities (eg camera surveys or internal pipe repairs).
- 3.7. The group discussed whether the BPDT could capture historic efficiency performance. One stakeholder argued that this is very difficult to do. They stated that this had been looked into before, and that the outcome was to compare the regression from GDPCR and RIIO-1. One stakeholder identified the link between this and an earlier discussion on frontier shift during the previous agenda item.
- 3.8. The group briefly discussed whether the input categories used in RIIO-GD1 for real price effects (RPE) are still relevant for RIIO-GD2. It was highlighted that this has been discussed in a previous CAWG in a presentation led by Cadent. Another

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<sup>1</sup> CISBOT is a remotely-operated robotic tool that can be used to inspect and repair cast iron joints.

stakeholder suggested that a useful follow on discussion from this would be to talk about which area of costs they should apply to.

#### **4. CAWG forward plan**

- 4.1. The group agreed that another working group could be arranged in October where Ofgem could present on some cost modelling work, and companies could bring some material on RPE eg SOC codes to the meeting for discussion.