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Dear Jonathan

RIIO-2 tools for Cost Assessment Consultation

This response is from National Grid Gas (NGG) and National Grid Electricity Transmission (NGET) Transmission Owner. The response summarises our views on the areas of the RIIO-2 tools for cost assessment consultation that are directly relevant to our Transmission businesses; we set out our detailed view in the attached appendix.

We recognise the role of cost assessment in determining the efficient level of costs to enable us and other network companies to maintain safe and reliable networks and meet our other commitments to consumers in RIIO-T2. In order to deliver this it is critical for Ofgem to balance view of cost efficiency with value for consumers.

Robust cost assessment is dependent on having good quality, meaningful and consistent data to analyse. We are concerned that the Business Plan Data Table formats are significantly different to RRP table format in key areas of the plan and in some instances will require significant assumptions being applied to the data to meet table requirements. This increases the risk of incorrect conclusions being drawn from the data, resulting in totex allowances that are not based on efficient levels of costs.

We support the use of benchmarking analysis in gaining an important and insightful tool for assessing the cost of repeatable activities that are comparable across different businesses, however too simplistic an approach can result in underfunding of Business Suport activities, such as in RIIO-T1. Particular caution should be taken in areas such as IT costs, where comparability of costs is lower between companies due to differences in type and volume of activities they support, and are subject to change over time. In assessing costs Ofgem should consider both a cost efficiency view such as that provided by ratio benchmarking and evidence from companies justifying areas where costs are higher because they have invested to drive long-term value for consumers or wider society benefit to ensure the right balance is struck between efficiency and service delivery.

We do not support an approach to embed observed historic frontier shift into future frontier shift expectations. This approach deviates from incentive based regulation by presupposing the frontier shift for RIIO-T2 and setting it in advance of the price control period. This will result in more cautious decisions from companies to avoid losses and consequently in lower levels of innovation and consumer benefit both in RIIO-T2 and future price controls.

In addition, this approach assumes that historic observed frontier shift is the best predictor of future frontier shift. There are a number of reasons that this assumption is flawed, for example lack of comparability in regulatory framework and other conditions that support the level of ongoing efficiency achieved.

If you have any queries about this response please contact me.

Kind regards

Darren Pettifer

[by email]

Head of Regulatory Finance

Appendix 1 – Detailed Consultation Question Responses

Q1-13: Not answered

Q14: Should we assess business support costs at a group level in order to address cost allocations across companies within groups?
Where it is appropriate for business support costs to be assessed through a benchmarking approach, we are supportive of this assessment at a group level.

Like many businesses, we operate a shared services model where teams within functions perform services for all of the members of our group of companies. We have a robust method for allocating costs to each company within the group, which is reviewed by Ofgem annually. We would therefore expect the results of Business Support benchmarking to be consistent whether at the group or company level, however cost assessment at group level would be consistent with our operating model.

We do not support adjusting business support benchmarks for fixed costs. The role of cost benchmarking is to support the setting of allowances for a notionally efficient company and this should not be impacted by the size of the company. Such an adjustment could result in windfall gains or losses to companies.

The calculation of such adjustment may involve Ofgem making arbitrary judgements, will add complexity and reduce transparency of this cost assessment. A simpler and more transparent alternative to adjustment at the is use external benchmark datasets, with access to a range of company sizes, and select comparator companies of similar size to the network company.

We do not support the resetting of allowances mid-price control period following a purchase or divestment. Doing so would risk disincentivising companies from transacting when it may be in the long-term interest of consumers to drive efficiencies.

Q15: Which types of business support costs should be benchmarked, and how should they be benchmarked?
We support the use of benchmarking in assessing most business support costs. Benchmarking is a cost effective way of assessing costs of activities that are repeatable, comparable between companies and relatively immaterial in value. Benchmarking provides a helpful data point in assessing TO business support costs in particular as econometric cost assessment is not viable due to the small number of networks and high variability in size of network.

However, we believe the approach adopted by Ofgem in setting RIIO-T1 allowances was too simplistic focussing solely on cost efficiency, rather than overall value and not fully adjusting for limitations in the benchmarking data. Analysis published in this consultation shows that no sector was able to manage its business support costs within the allowances set by Ofgem set for the first four years of RIIO-T1, with a trend for increasing business support costs in Electricity Transmission and Gas Transmission sectors across that period.

In assessing business support costs for RIIO-T2 allowances, Ofgem should consider evidence from network companies that justifies cost forecasts that may be higher than the upper quartile efficient cost threshold, such as the cost of value-add activities that deliver long-term value for consumers, i.e. HR activities that support the diversity, productivity, and wellbeing of employees in the business, or the role that CEO and group management functions play in our corporate social responsibility activities.

Ofgem should also provide network companies with the opportunity to submit evidence to support differences from benchmark because of differences with comparator groups. The nature of such differences will depend on the nature of comparator group chosen, but could include;

- Differences in level or nature of risks faced by business, and therefore activities needed by business support costs to manage those risks, for example the higher risk of cyber threat that transmission networks face (due to the higher impact of a cyber attack on a national, rather than regional, network) requiring more investment in IT systems and expertise to mitigate this risk

- Differences in size and complexity of company impacting level of support needed, for example larger organisations needing a more sophisticated level of HR support in line with legislative requirements

- Other one off explanatory factors, for example the need for regulated companies to have a Regulation function and perform regulatory reporting activities in addition to general statutory reporting duties

We agree with the proposed normalisations for non-operational capex spend to normalise for different policies around property and IT expenditure; this is particularly relevant with the move to cloud hosted IT solutions in place of traditional built solutions, which are treated as opex costs rather than capex. However, these adjustments do not normalise for the extent to which companies have strategically invested in their business support functions to deliver efficiencies in their direct business costs, for example the implementation of IT systems to automate manual processes or better manage data, avoiding cost in the direct business. Ofgem should consider evidence from companies that justify where higher business support costs are a result of such strategic decisions aimed at delivering value in other areas of the business plan.

We note the consideration by ECA of the pros and cons of different comparator group sources of benchmarking data. Our view is summarised in table 1 below. Whilst all three comparator groups require normalisations of some nature, given the limited number of transmission companies we believe external comparator groups provide the best comparability for size, complexity and potential economies of scale. Given that business support costs are more related to non-sector specific drivers (such as size of company, number of people, level of spend), we do not think that the associated limitation in potential cost drivers related to network metrics is important.

This consultation does not specifically address the assessment of high cost confidence (in determining Totex Incentive Mechanism sharing factor, or Business Plan Incentive award). We have assumed that, consistent with their decision in the sector specific methodology consultation (para 11.36 and 11.37) that Ofgem will consider other independent benchmarking evidence in assessing their confidence of business support costs for calculation of sharing factor and business plan incentive.

Table 1: Pros and cons of using different comparator groups for Business Support benchmarking

Comparator group	Pros	Cons
Transmission sector	• Data readily available • RRP RIGs would provide higher certainty of comparability of cost categories (apples and apples) • Scope to use a wider range of cost metrics in analysis	• Insufficient data points, time series data is not sufficiently independent to provide additional data points • High variability in size of transmission companies would limit cost comparability, requiring more cost justifications and reducing cost/time benefits of benchmarking • Only provides insight into observable efficiency
Cross sectoral regulated	• Data readily available • RRP RIGs would provide higher certainty of comparability of cost categories (apples and apples) • Some scope to use a variety of cost metrics in analysis	• High variability in size and risk across companies would limit cost comparability, requiring cost justifications • Only provides insight into observable efficiency
External	• Access to wider group of sectors and companies, can adjust for size/economies of scale through selection of comparators • Provides access to notional efficiency if comparator group includes data from competitive industries • Provides insight into best practice effectiveness from other sectors	• Requires use of proprietary datasets • Requires adjustment for regulatory activities not undertaken by competitive industries, or which are difficult to map • Fewer cost metrics available but deemed to be low impact for Business Support costs which are not strongly related to sector specific metrics

Q16: Which types of business support costs should be excluded from benchmarking?
We believe that the materiality of IT costs, combined with their complexity and level of change over time means that cost assessment should not be solely based on benchmarking.
At any given time, IT costs will reflect a combination of the number of systems being supported, the complexity of those systems, the level of availability needed for those systems and the efficiency of expenditure. Further investment in IT systems over a given period may result in increased IT capex and opex costs, supporting savings or avoided costs elsewhere in the business. Consistent with the approach in RIIO-T1, IT costs should be assessed from a combination of historic trend analysis and normalised benchmarks (for business as usual costs) plus assessment of IT investments and their associated impact on future business support costs by consultancy.

Ofgem should adopt an approach consistent with RIIO-T1 and not benchmark insurance premium costs or health and safety costs. Insurance premiums will vary by the level of risk that the business faces in a given time period and its risk appetite. for those reasons, historic insurance premium data will not give an informed view of the efficient future cost of insurance. We are supportive of a consultant review of projected premiums.

In assessing costs related to health and safety activities a cost efficiency benchmarking approach risks setting costs at a level that does not adequately fund the level of risk and standard of safety committed to by the company.

Q17: Not answered

Q18: What RPEs should we account for, how should we gauge materiality, and what criteria should we use for index selection?
RPEs should be accounted for where significant differences are seen between CPIH and associated indices to better align allowances with input prices as they change over the period of the price control.

Materiality should primarily be assessed by the long-term deviation of indices to CPIH. However, it is important to consider the impact of volatility in some commodity driven indices where a long-term average if deemed immaterial at a point in time may cause material future changes in input prices. An alternative approach is to establish the totex value at risk from real price effects as a proportion of total spend for each network and spend category.

Indices should be selected based on their alignment to networks input prices, longevity and their isolation from networks influence. We agree with the criteria groups proposed by CEPA in the frontier shift final report as appropriate measures for indices.

Q19: What common input and expenditure categories are appropriate for structuring RPEs?
The expenditure categories align to how networks report costs though the current RRP and the RIIO-T2 business plan data tables and are still an appropriate and practical level at which to apply real price effects.

The input categories used in RIIO-T1 allow for correlation between underlying indices and input costs. Cutting the RIIO-T2 data into these categories will be a manual activity as they do not align to how we currently capture data or report in our regulatory accounts. However, we have been able to create a method which allows for a high-level classification of our costs into these categories.

Q20: How should we identify an appropriate ongoing efficiency assumption?
We are supportive of the use of data sources such as EU KLEMS to determine the ongoing efficiency assumption for RIIO-T2, in conjunction with more company specific context.

The purpose of an ongoing efficiency challenge is to ensure unit costs remain at the most efficient level throughout the price control to mimic competitive forces. Companies are already incentivised to innovate and reveal the new efficient frontier through the business plan incentive and totex incentive mechanisms. Presupposing the result of these activities will result in more cautious decisions from companies to avoid losses and consequently in lower levels of innovation and consumer benefit both in RIIO-T2 and future price controls.

In determining ongoing efficiency assumptions, historic data sets such as EU KLEMS as well as more forward looking and UK focussed sources such as Bank of England forecasts should be considered, as recommended by CEPA in their report. This is particularly relevant given the recent trend of lower productivity which is not fully reflected in long run historic averages.

Ofgem should also allow for individual companies to have different ongoing efficiency assumptions within the range identified from analysis of external datasets. For example, a company with costs at the efficient frontier and with high cost certainty should have a lower ongoing efficiency expectation than companies where cost confidence is lower. Setting a consistent ongoing efficient assumption across plans that differ in efficiency evidence and cost confidence risk setting allowances at below the efficient level, in some cases.

It is important that Ofgem applies productivity estimates to business plans in a way that is consistent with the treatment of RPEs. As highlighted in the CEPA report, failing to do so could result in a higher implied ongoing efficiency in cost areas where RPEs are deemed immaterial.

Q21: How should we determine frontier shift?
We do not support the proposal to use T1 observed frontier shift in determining RIIO-T2 frontier shift. The proposal has a number of flaws:

- It ignores the one-off additional impact on frontier shift attributable to the move to full totex incentivisation in RIIO-T1 – recognised in Ofwat's determination of ongoing efficiency expectations in PR19
- It assumes framework changes between RIIO-T1 and RIIO-T2 will have no impact on frontier shift, such as the level of totex sharing factor, Uncertainty Mechanisms and indexation, introduction of Returns Adjustment Mechanism and a shorter price control duration
- It assumes the conditions for innovation are consistent within the company between the two periods; the type and nature of activities in RIIO-T2 may not support similar levels of efficiency
- It implies that companies who have seen risk outturn in RIIO-T1 would receive a corresponding additional allowance

END