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22nd August 2019

Dear RIIO Team,

ESPUG Comment on Ofgem's "RIIO-2 tools for cost assessment"

I am writing on behalf of ESP Utilities Group ("ESPUG") (comprising the licensed companies ES Pipelines Ltd, ESP Connections Ltd, ESP Networks Ltd, ESP Pipelines Ltd and ESP Electricity Ltd). We welcome the opportunity to respond to the "RIIO-2 tools for cost assessment" ('the consultation'), dated 28th June 2019.

ESPUG broadly welcomes Ofgem's approach for cost assessment. The estimating techniques presented are familiar, robust and their limitations well known. Their successful application will be based on the interpretation of the results. This is touched on in the model selection criteria relating to making "economic and/or engineering sense" (2.39 p15). We would suggest that this should be the primary principle in selecting the methodology. By applying this principle Ofgem can best interpret the findings of the econometric models and have the confidence to rule out certain results the models may produce.

We would note that efficiency is, to some extent, dynamic and requires a precise time frame to be investigated. Strategies used in one price control period may not always produce the same desired effect in others. The investment cycle is long and the payoffs may take years for some investments. This will be particularly important for networks that make tradeoffs between capital and operational expenditure for a given outcome. We would welcome further discussion on how the models intend to capture the dynamic aspects of efficiency.

Urbanity and sparsity are recognised by Ofgem in the consultation as driving differences between networks efficiency outside of management control. However, as pointed out, there is no obvious functional relationship between the two. This could lead to an efficiently run sparse network lagging behind an inefficiently run urban network. We are uncertain as to how this issue will be treated as it may well have a defining result in the control.

In choosing between models we would suggest a top down approach to costs. This is likely to have the advantage of comparing network performance as a whole. Using bottom up approaches described in the consultation may require a great deal of cost standardisation as a result of different ownership structures of the networks and strategies between them.

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Finally, we would expect as much transparency as possible in Ofgem's analysis. There are parties affected by the price control who need to understand the financial impact of the controls on their business such as large consumers, suppliers and independent gas networks.

More details are provided in the appendix of this letter.

If you wish to discuss any of the points raised in our response or have any queries, please contact me on 01372 587500.

I confirm that this letter may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Seb Eyre', with a large, stylized 'S' at the beginning.

Sebastian Eyre
Regulation Analyst

Appendix 1

Question 1: What model estimation options should be considered for our cost assessment and why?

The model options set out in the consultation paper are well known, tried and trusted methodologies with commonly understood limitations. We therefore do not have a strong preference for using any one of them.

Question 2: Do you agree with our proposed criteria for developing potential cost pools? If not, what additional criteria do you propose and why?

We agree with this general cost pool approach. We note there may be differences in network data, arising from differences in business cost allocation methodology, which might have an impact on the results. For example, the treatment of the charging of corporate functions in the networks, an area clearly under management control. There may also be issues with companies that have outsourced their work as the contractor's costs cannot easily be identified by Ofgem's models.

Question 3: Should we continue to use the Cobb-Douglas functional form? If not, why?

We agree with the proposal to continue using the Cobb-Douglas functional form. Its major strength is its ease of use and ability to produce a good empirical fit across data sets. The fact that it has limitations can be contained as they are well known and provide a degree of certainty in how to identify them.

Question 4: Do you agree with the proposed model selection criteria and model development phases?

We agree with the selection criteria and model development phases. We would emphasise the importance of the economic/technical criteria as they will be the only route to challenging the final models results.

Question 5: Should the cost driver of the totex regression model be determined by the cost drivers of the 'bottom-up' models, or should the totex regression model account for different explanatory variables? Why?

Top down regressions ultimately provide a blunt but powerful tool in terms of understanding what a network may do efficiently. Additionally, it has been argued that it can mitigate the risks that aggregating bottom-up regressions 'cherry pick' the best performing network across numerous performance categories. Also, disaggregated cost drivers may not always fully explain trade-offs made across activities. In this context we would suggest working on variable sets that capture the trade-offs that may have been made by a network.

Question 6: What could be appropriate cost drivers in middle-up models for opex, capex and repex? Why?

No comment.

Question 7: For which opex activities are there trade-offs that support the rationale for testing 'totex and opex plus' modelling?

No comment.

Question 8: Are there other particular costs that we should aggregate and test in our analysis?

No comment.

Question 9: Are there trade-offs between opex and capex activities that support the rationale for considering 'opex plus' modelling?

Where trade-offs can be made between capex and opex, they can be two-way. For example certain enhanced capex can reduce opex. Equally some increased opex can save or defer capex. In this context "opex plus" modelling must take into account this two-way relationship. It follows that agreement on what pooled costs in the model are considered to be complementary is critical to this approach.

Question 10: Which cost areas should be assessed using workload drivers as opposed to other cost drivers? Why?

No comment.

Question 11: Should repex (or some categories of repex) be excluded from our regression analysis and assessed using other techniques?

No comment.

Question 12: Are there other approaches to disaggregated benchmarking that we should consider?

We do not see any advantage in developing further disaggregated benchmarking approaches *per se*, but suggest there is agreement on the treatment and identification of costs within the existing suite of models.

Question 13: Should we assess business support costs at a group level in order to address cost allocations across companies within groups?

Yes, we think this will capture the differences between networks organisational structure.

Question 14: Which types of business support costs should be benchmarked, and how should they be benchmarked?

No comment.

Question 15: Which types of business support costs should be excluded from benchmarking?

No comment.

Question 16: How should we estimate and model the impact of regional factors?

Regional factors are important cost drivers for networks. They have long been acknowledged with electricity, gas and water price controls and so must be included in Ofgem's cost assessment.

We would support a proposal that adjusts for regional factors pre-modelling. This should naturally flow in the collection of cost data from the networks.

Question 17: Do you agree with the proposed criteria for justifying regional cost factors that we have outlined?

We support exploring within-model adjustments for network density.

Question 18: What RPEs should we account for, how should we gauge materiality, and what criteria should we use for index selection?

Real Price Effects are only relevant to the particular mix of goods and services a network needs to procure. It follows that it is up to the network to make the case for RPEs.

Question 19: What common input and expenditure categories are appropriate for structuring RPEs?

No comment.

Question 20: How should we identify an appropriate ongoing efficiency assumption?

In our view Table 7.2 of the consultation identifies the key indices relevant to understanding efficiency.

Question 21: How should we determine frontier shift?

We would suggest that over-relying on historical data may be an issue in predicting future performance. The frontier is clearly linked to the availability of technologies or management techniques that can be applied to networks to increase their efficiency. However, comparing the difference between actual and planned expenditure seems to be a reasonable proxy for determining the efficiency shift.

Question 22: Should we set the efficiency benchmark at the upper quartile level?

We suggest that using a glide path approach may be the most prudent method of setting the benchmark if the majority of networks are within a narrow band of performance.

Question 23: Are there types of expenditure that we should model using only historical or forecast data?

We would suggest that expenditure that is planned in advance and uses quotations would be suitable for aggregation in forecast data with most other kinds of data classed as requiring historical data.

Question 24: If we use a combination of aggregated and disaggregated modelling approaches, how should we determine the weight we apply to each?

In theory, the top down and bottom up approaches should give similar results. However, this may not happen in practice. We would suggest that using aggregated modelling approaches is likely to identify the general network efficiency as it does not suffer the problems of cost identification and classification.