

RIIO-ED2 Cost Assessment Working Group (CAWG) – 25th February 2020

From: Ofgem

Date: 25th February

Time: 10am to 4pm

Location:
London

1. Present

Ofgem
UK Power Networks (UKPN)
Western Power Distribution (WPD)
Northern Powergrid (NPG)
Scottish Power Energy Networks (SPEN)
Electricity North West (ENWL)
Scottish and Southern Energy Networks (SSEN)
Frontier Economics
Citizens Advice

2. Terms of Reference

2.1. Ofgem reviewed some of the key comments provided by the DNOs on the CAWG Terms of Reference (ToR). All comments will be considered and reflected in an updated ToR for the working group.

2.2. **Action: Ofgem to circulate updated ToR with tracked comments.**

3. Frontier Economics presentation on Ofgem at RPI-X@20, random effects and ED1 totex models

3.1. Frontier Economics gave a presentation on Totex benchmarking based on the RPI-X@20 and Total Cost benchmarking at RIIO-ED1 reports that were previously prepared for Ofgem. This included a review of the spectrum of options that exist ranging from 'Top Down' totex modelling, to 'Mid Model' opex plus modelling, to 'Bottom Up' granular disaggregated modelling.

3.2. Frontier Economics discussed 'Top Down' totex modelling, noting that this approach provided very pure incentives, but was blind to the more detailed input choices and provides no narrative to regulators on exactly why firms are efficient. At the opposite end of the spectrum, 'Bottom Up' granular disaggregated modelling, while the approach has risks relating to confusing, unintended, perverse incentives being created, it had the potential to yield more information to the regulator on why different DNOs might be efficient or otherwise.

3.3. Several DNOs commented on the importance of similar or aligned DNO investment cycles to the totex modelling and benchmarking process. Frontier Economics commented on the fact the networks electrified at the same time, and that DPCR5 was peak replacement period, and that previous assessments had indicated that there was no evidence to suggest the different DNOs were 'out of sync' with one another. Where

there is lack of commonality going forward, this may need to be assessed, noting that the fast track process in ED1 may have had an impact on this.

- 3.4. Frontier Economics continued by discussing the treatment of capital costs, outlining two approaches: benchmarking expenditure flows; or benchmarking opex + capital consumption. One DNO questioned whether to use the capital consumption approach, the data set required would have to match the length of the asset base. Frontier Economics responded that in the expenditure flows approach, it has been shown that 5 to 7 years of data is sufficient, but for capital consumption approach, ideally you would want data to match the regulatory asset life (45 years), while accepting that the early years have a lesser impact than the most recent years of data, due to depreciation.
- 3.5. Frontier Economics highlighted recommendations from the reports that thought Ofgem should focus on totex modelling, but also recommended that Ofgem used some 'mid models' as a validity check on business plans. ENWL questioned whether these 'mid models' would be used purely to sense check or whether they would feed into allowances. NPg commented on the approach in DPCR3 noting that opex was benchmarked and then sense checked with expert engineering views, resulting in some adjustments to some DNOs allowances for this cost activity.
- 3.6. UKPN commented on the risk of cherry picking if for example, a DNO performed well in four out of five models, would the fifth model just be discounted. Then if another DNO performed well in three out of the five models, would two of the models be discounted. Several DNOs commented on the use of several models and weightings in ED1, noting that setting out the weightings up front is at least transparent and fair.
- 3.7. NPg added that the model weightings used at Fast Track in ED1 was quite different from that which was set out in the Strategy Decision. Simplicity was key as far as NPg were concerned.
- 3.8. Frontier Economics highlighted the importance of a strong Business Plan Incentive (BPI) in the benchmarking of business plans. ENWL commented that understanding the framework and how rewards or penalties were achieved was just as important as the strength of the financial reward or penalty.
- 3.9. Frontier Economics discussed the use of modern equivalent asset value (MEAV) and network length as cost drivers, highlighting the incentive problems that arise with their use i.e. the bias towards capital, MEAV boosting expenditure. UKPN commented that in-period incentives should forego the risk of DNOs favouring capital expenditure and boosting MEAV, and will help set future price controls by revealing efficient cost. ENWL added that the dampening of in-period incentives would only exacerbate the question regarding MEAV as a cost driver.

4. SPEN presentation on totex models

- 4.1. SPEN presented on totex benchmarking, assessing the limitations with the RIIO-ED1 top-down totex modelling approach and the additional challenges for ED2 including the use of MEAV as a cost driver. SPEN commented the need to demonstrate that ED2 complexities are accounted for in model development.

- 4.2. SPEN presented results from their OLS Regression analysis that tested numerous regression models. In summary, SPEN outlined that the ED1 final determination model remained statistically robust with the addition of ED1 actuals, while noting that continuing with this approach does not address the limitations or the new challenges arising in ED2. Frontier Economics challenged the analysis, noting that assessing different models on the R squared term may not be the most appropriate comparator.

5. Ofgem overview of ED1 totex models

- 5.1. Ofgem provided an overview of the RIIO-ED1 totex models, noting that that the models have not been re-run yet, but that it is currently under consideration. UKPN commented on the impact of innovation on ongoing efficiency. ENWL added that there are two elements to ongoing efficiency, productivity and efficiency across UK and efficiency as a result of network innovations. Ofgem added that understanding what efficiencies and innovations were proposed in ED1 and how they played out throughout the price control will be important in the context of setting ED2. NPg highlighted that this tension itself could help to encourage engagement that balances the interests of different consumer groups.
- 5.2. NPg discussed reasons for going to the Competition & Markets Authority (CMA) on the Smart Grid Adjustment in ED1, citing issues with benchmarking of counterfactual 'non-costs' and why this distracts other incentives within the price control.

6. WPD presentation on Business Plan Incentive

- 6.1. WPD presented on the Business Plan Incentive (BPI) and cost assessment framework, first discussing the relationship between cost assessment and the BPI. WPD questioned the order of this decision making process, but Ofgem explained that the confidence assessments and BPI would be assessed as part of an overall confidence assessment approach. Further detail on the implementation, for the other three sectors, will be set out at Draft Determinations.
- 6.2. ENWL commented that not only should the BPI have a strong financial incentive associated with it to encourage ambitious, and challenging business plans, but that just as importantly, the BPI framework had to be clear and transparent, so that companies knew how to engage with it.
- 6.3. WPD commented on the previous statement from Ofgem in the Sector Specific Methodology Decision (SSMD) for the other three sectors, that to be eligible for a Stage 4 reward, the cost information must be useful to Ofgem in setting allowances, questioning how this would work for cost areas where Ofgem does not consider forecast costs, or where more weight is associated with historical costs.
- 6.4. WPD questioned whether Ofgem would use interpolation in the ED2 cost assessment framework. Ofgem noted that interpolation was not being considered for ED2 and that this was part of our framework decision to remove the Information Quality Incentive (IQI).
- 6.5. WPD questioned how Ofgem intended to apply rewards and penalties at the level of the company given the allocation of costs and confidence dependent incentive rate would apply at licensee level. Ofgem noted that each DNO should have a single confidence dependent incentive rate and that it is not the intention of the confidence

assessment or BPI to give separate licensees within a DNOs ownership, different totex incentive rates.

- 6.6. Ofgem noted while they were reviewing lessons learned from the implementation of the BPI in the other three sectors, there would have to be significant evidence to suggest that the environment in ED was sufficiently different to warrant a change in approach for the BPI in RIIO-ED2.

7. Review of regional and special factors in ED1

- 7.1. Given time constraints, this item was not discussed. WG attendees were invited to review the material presented in the slide deck, and it was agreed that this item could be picked up at future sessions.

8. How it all fits together – Cost Assessment principles for ED2

- 8.1. Given time constraints, this item was not discussed. WG attendees were invited to review the material presented in the slide deck, and it was agreed that this item could be picked up at future sessions.

9. Actions, Next steps, AOB

- 9.1. The next CAWG will be on 13th March in London.