

RIIO-ED2 Cost Assessment Working Group (CAWG) – 13th March 2020

From: Ofgem

Date: 13th March

Time: 10am to 3pm

Location:
London

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)

1. SPEN Presentation outlining of DNO RAG assessment of ED1 disaggregated models

- 1.1. SPEN presented the consolidated view from DNOs of the different tables/disaggregated models. The intention was to build a sense of prioritisation for the models, establishing what models should be reviewed first.
- 1.2. Most of the reinforcement models fell into the red category (requiring the most attention). NPG noted that the models flagged as red cover around 30% of the cost base for ED1, and the majority of the rest the models were classed as amber, highlighting that the majority of the price control needs some attention.
- 1.3. For primary reinforcement, there was a common theme around how flexibility would be addressed in ED2. NPG argued that it would be damaging to other incentives if flexibility was assessed separately from other expenditure, and that everything should be assessed holistically, under totex. It was also asked whether Ofgem would be updating the unit costs, with Ofgem confirming that this was still on the table and the debate would be opened through the Sector Specific Methodology Consultation (SSMC).
- 1.4. There was debate around whether allowances for flexibility should be set on a given proportion of reinforcement activities/expenditure. Noting that there were further questions around a) what would happen if actual levels of delivery were different from the proportion assumed when setting allowances, and b) does this become misleading if the focus was on unit cost of delivery, rather than the total cost of meeting low carbon needs.
- 1.5. UKPN raised a point around current reporting and the visibility available at the moment, and a parallel question around the role of NARMs in relation to asset replacement unit cost analysis (the two will need to be linked/decoupled effectively).

WPD pointed out that we will need to be careful not to 'benchmark out' the mechanics of the amount of capacity released at different points on the network.

- 1.6. On secondary reinforcement, one DNO commented that it will be important to identify anticipatory investment and whether it will need to be presented as something that goes over/above firm capacity. For operational IT, we may need to consider alternative drivers to MEAV (modern equivalent asset value). One DNO commented that one option would be to use customer numbers, to stop this being an asset-centric solution. In terms of the costs associated with DSO transition and/or cyber resilience, there remains a question of how this will be assessed, noting that there is likely to be a distinction between DNO and DSO Operational IT costs.
- 1.7. This lead to a wider question on the areas of totex that could be carved out for DSO separation. One option discussed, was to carve out a simple percentage of all costs associated with DSO, raising an important questions around the activities that DNOs are undertaking now to reduce the costs of DSO-type activities.
- 1.8. One DNO commented that for losses and/or environmental reporting, we will need to take into account legislative changes (such as the arrangements around PCBs) and how these are treated.
- 1.9. In terms of diversions, it was noted that the current table was fairly reactive to customer need on the network, so cost assessment would need to take that into consideration. This also meant that forecast data may be more applicable than historical data in RIIO-ED2.
- 1.10. **Action: UKPN to pull together thoughts on how the diversions table could be modified to better reflect future arrangements.**
- 1.11. The refurbishment tables were discussed, and it was noted that this was an area in which there was a lack of consistency of units across the categories, making it difficult to carry out a robust cost assessment. This area will need to be developed in order to provide a split between SDI and non-SDI work.
- 1.12. Next up was Quality of Supply (QoS) and one of the comments was around the need to reflect the policy position that is taken (i.e. whether this work is DNO funded or customer funded). It was noted that, if this area becomes Distribution Use of System (DUoS) funded, then the reported costs may need to be further disaggregated.
- 1.13. Non Operational Capex (property) was discussed, and it was noted that this was another area in which there may need to be a DNO/DSO split of costs, the detail of which will depend on the property policy of the individual DNOs.
- 1.14. One issue identified for Civil works, was the way in which standard units were defined. One of the DNOs commented that it could be worth re-running the ED1 models with updated data and to review the results.
- 1.15. **Action: SPEN to re-run the civil works model with ED1 data, and share results via email by 27th March.**

- 1.16. Several DNOs questioned whether Vehicles and Transport, both the CAI and Non Op Capex elements, should be assessed together. Noting that there may be a need to be consider the impact of local authority policies.
- 1.17. The majority of DNOs agreed that several tables/modes were in a good position for ED2, with only some minor adjustments required. These included; Asset Replacement (where we will need to consider activities driven by NARM); Legal and Safety (while noting that different types of activities included in the tables give scope for DNOs to add specific programmes, meaning the activities may not be comparable); and Connections (where it was questioned whether the use of historical information was appropriate to assess future work activities).

2. Ofgem presentation on GD2 disaggregated models

- 2.1. Ofgem gave a presentation on the disaggregated models that were used for setting allowances in RIIO-GD1 and an overview of the approach for RIIO-2 (GD2). Ofgem explained that there were seven bottom-up disaggregated models used in GD1. Ofgem continued by explaining that in setting allowances in GD1 the seven bottom-up models were combined with an overall top-down totex model. Noting that this totex model did include some bottom-up regression activities.
- 2.2. Ofgem discussed cost pooling, an approach, which could be considered middle-up modelling, somewhere between top-down and bottom-up modelling. Some of the key considerations under this approach included:
- Grouping together complimentary activities that staff jointly undertake such as emergency and repairs.
 - Capex and Opex trade-offs.
 - Cost boundaries and the different reporting and treatment of Capex and Opex costs.
 - Grouping of models of differing maturity and robustness to one another, resulting in an overall lowering of the strength of the model.
- 2.3. ENWL commented that in ED1, a large proportion of the models used were for Capex, and questioned how Capex was dealt with in GD. Ofgem noted that some of the logic behind this was following on from Ofwat's approach which, effectively, excluded lumpy Capex. While there are some Capex elements in some of the cost pools, Capex generally sits outside of the regression. Instead, Capex was dealt with by undertaking a bottom-up review of those costs and adding them back in at the end. Ofgem also noted the difference between the two sectors, GD and ED, and that Capex was quite small in GD. ENWL commented that the outlined approach made sense, but reiterated the point that ED and GD were not like-for-like.

3. ENWL presentation on middle models

- 3.1. ENWL gave a presentation on middle modelling, as an approach sitting in-between Totex and disaggregated models. ENWL pointed out that middle modelling (also called

'bottom up Totex') attempts to overcome the limitations of both disaggregated and Totex approaches.

3.2. ENWL suggested that there were two main ways to conduct middle modelling:

- Either run regressions for each cost area, resulting in multiple models,
- Or generate an aggregated composite variable made up of the different cost drivers, and apply it to a single regression model (which was the option undertaken in ED1)

3.3. ENWL highlighted that composite variables could lead to a simple regression model, but note that there is significant complexity in building a suitable variable. One of the main issues is in determining the weight to give to the underlying cost drivers to build the composite variable. ENWL suggested that middle modelling could be used in a few different ways in ED2. It could be the primary model used for cost assessment, it could be weighted to form part of the cost assessment, or it could be used to sense check the results of other modelling approaches.

3.4. NPG and ENWL discussed the role which middle modelling had played in ED1. NPG pointed out that the composite variable in ED1 relied on MEAV at 70%, so it was a major cost driver in the approach. NPG and ENWL also discussed slicing up the cost base in a different way to the usual cost structure, for example pooling costs by voltage level. ENWL indicated that DPCR5 RIGs did not allow for this in ED1 modelling, however this could be a potential approach for ED2.

4. ENWL/WPD presentation on Ofwat's PR19

4.1. ENWL and WPD gave a joint presentation on Ofwat's 2019 Price Review (PR19). The presentation provided an overview of PR19 and context about the framework for the water sector as a whole. WPD and ENWL discussed Ofwat's treatment of assessment costs including aggregation and costs outside of core modelling.

4.2. WPD mentioned that Ofwat set seven price controls across the whole water industry including retail. WPD mentioned that the cost assessment was a collaborative process and supported by consultants and academic advisors. ENWL and WPD noted that in PR19 there were five main cost models, which include two water resource models, one treated water distribution model and two wholesale water models.

4.3. WPD and ENWL noted that Ofwat split Totex into base costs and enhancement costs. Where, base costs (BOTEX) were the costs associated with maintaining operations, assets and performance, and enhancement costs were those costs used to improve / add to the network. WPD and ENWL noted that both cost categories were assessed separately with different cost assessment techniques and approaches.

4.4. WPD discussed the impact of productivity and frontier shift, noting this was an area that was under particular scrutiny during the cost assessment process. Some DNOs suggested the model was flawed and produced spurious results. WPD and ENWL pointed out that a number of water companies challenged this issue, arguing that Ofwat's artificial frontier was unattainable. This resulted in significant movements in cost assessment methodology from Draft and Final Determinations.

- 4.5. Several DNOs questioned how stakeholder input would be factored into the process. WPD commented that RIIO-2 had an enhanced engagement process and questioned how net zero costs would be treated as licensees have different authorities with varying legislative requirements. NPG pointed out that local authorities have revenue raising powers and price controls should not be the method to pay for local efforts to decarbonise. Ofgem stated that this issue is being discussed in the Overarching working group (OAWG) and that we will need to insure issues raised within this group (CAWG) were fed into policy discussions.

5. NPG presentation on disaggregated models

- 5.1. NPG presented a set of slides looking at whether the ED1 disaggregated models were fit for purpose for ED2.
- 5.2. NPG stated that the models used in ED1 were very granular:
- Only three models covered more than 5% of the cost base.
 - Models covered 42 cost areas and thousands of individual benchmarks.
- 5.3. NPG commented that regression and ratio models can promote efficiency, provided cost drivers are appropriate, and that they can promote transparency and have proportionate data needs. NPG continued noting that highly disaggregated models require major resource input.
- 5.4. NPG stated that allowances should be set based on totex regressions. One of their key points was that licensees can handle uncertainty, with the largest uncertainty faced being the pathway to net-zero. NPG argued that disaggregated model assessment can lead to distortions because it does not account for business plan differences, and that qualitative adjustments made line-by-line within models lack transparency. As such, their view was that ED1 disaggregated models were not fit for purpose as a starting point for ED2.
- 5.5. NPG stated that if Ofgem were to use disaggregated modelling for ED2, it should use much higher cost groupings that capture complementary and substitutable costs. ENWL asked what the higher-level cost groupings look like, pointing out that the current RIGs data structure might limit the ability to do exciting versions of disaggregating modelling, simply because the data does not allow it.
- 5.6. UKPN asked whether Ofgem would use NARMs in the disaggregating assessment, and for benchmarking. Ofgem's response was that everything is on the table at this stage, but that it was unlikely that we would solely rely on NARMs for cost assessment, instead it was but one of the tools in the toolbox.
- 5.7. There was a discussion on whether/when Ofgem would share with DNOs the models they were intending to use. NPG pointed out that the RIIO handbook states that Ofgem would not give the DNOs models before BPDT submission. UKPN argued that DNOs should be informed of the types of models being used before BPDT submission.

- 5.8. **Action: NPG to provide further detail on the size of cost-pots covered by Ofwat's disaggregated benchmarking of the parts of the water sector value chain that include networks.**

6. Actions, Next steps, AOB

- 6.1. The next CAWG will be on 27th March and will be teleconference only.