

## RIIO-ED2 Cost Assessment Working Group (CAWG) – 27<sup>th</sup> March 2020

From: Ofgem

Date: 27<sup>th</sup> March

Time: 10am to 1pm

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)

- 1.1. WPD noted that a couple of actions from CAWG-3 had not been transposed to the Action Log. One of the actions was for Ofgem to re-circulate the Terms of Reference (ToR), and the second was for UKPN and Ofgem to share views / calculations on BPI scenario. Both actions to be included in updated action log.

### 2. Ofgem presentation on Productivity and Frontier Shift

- 2.1. Ofgem ran through the slides on productivity and frontier shift. WPD asked what interlinkages there were with ongoing efficiency and the rest of price control. Ofgem highlighted innovation funding and the link with RPEs.
- 2.2. NPG encouraged Ofgem to look at actual ED1 costs to see cost trends over time and use this in support of assumptions and approaches for RIIO-2.
- 2.3. ENWL posed the risk of double-counting of innovation if Ofgem were looking more widely at national productivity, which should capture innovation.
- 2.4. There was general discussion on Michael Pollock's work on productivity. This work highlighted that productivity had increased significantly with the introduction of outputs as part of RIIO, outstripping the productivity growth of the rest of the country.

### 3. WPD presentation on Ongoing Productivity Growth

- 3.1. WPD presented slides on ongoing productivity growth. ENWL made the point that the Production Possibility Frontier (PPF) is not as pure as it is depicted in the slides, because of the UQ efficiency assessment, and that perhaps it is more accurate to characterise it as the Production Possibility Upper Quartile (PPUQ). WPD agreed, stating that it was not possible to know the frontier, but that the challenge was to set the threshold as close to the frontier as possible.
- 3.2. There was discussion on the assessment approach to ongoing efficiency. The Gas Distribution (GD) sector BPDs have stripped out RPEs. For ED1, efficiency was embedded in each individual cost table, but ongoing efficiency was also reported

separately. NPG asked if Ofgem would do the same for ED2. ENWL stated that this would be driven by the method of cost assessment, with WPD adding that the SSMD suggested the assessment approach would be aligned to input cost categories, not expenditure categories or activity areas.

- 3.3. The interaction with RPEs was discussed. WPD noted that in the Transmission and GD sectors, the view was that ongoing efficiency would offset RPEs. NPG made the point that the driving factor for real wage increase is productivity growth, so at the highest level ongoing efficiency was fundamentally linked to RPEs. WPD asked whether the alignment would be as concrete at a disaggregated level. NPG responded that the two had to be interpreted as interlinked, and must be looked at together.
- 3.4. On the emerging RIIO-2 framework, WPD stated that Transmission and GD price controls were used as a cross-check for ED1. WPD asked if there were any interactions between ongoing efficiency assumptions and the Business Plan confidence assessment. WPD also asked when and where Ofgem would apply an efficiency assessment, why Ofgem had proposed to exclude the energy sector from the EU KELMs dataset, and how multiple sources of information might be aligned. Ofgem commented that the Sector Specific Methodology Consultation (SSMC) would look to address a number of these questions.
- 3.5. Ofgem also noted that the Electricity Distribution (ED) sector would not be bound by decisions made by the other sectors. Ofgem added that while the draft determinations for the other sectors was important, all relevant options for this sector would be consulted on in the SSMD in the Summer. ENWL highlighted the value in getting sight of some of these decisions or options as early as possible. Ofgem agreed, and noted that, if possible, a session could be held to review some of these decisions, options, directions of travel etc.
- 3.6. **Action: Ofgem to work with the other sectors and legal to identify if and when a session could be held to review any draft SSMD decisions, with CAWG stakeholders.**

## 4. Ofgem presentation on Real Price Effects (RPEs) and Indexation

- 4.1. Ofgem presented slides on Real Price Effects (RPEs) and Indexation, first reviewing the approach in ED1 and looking at the different criteria used to assess the different proposals. Some of the key criteria for assessment included, exposure to risk, impact on incentives, and complexity and unintended consequences. ENWL commented on the assessment criteria, noting that it appeared to represent a robust approach and could be considered as the basis for assessing proposals for ED2.
- 4.2. Ofgem continued by reviewing the RIIO-2 Framework Decision document, that confirmed that where possible, uncertain costs would be indexed, including for labour and construction cost inflation. Ofgem reviewed some principles from the RIIO-2 tools for cost assessment document, including the intention to place strong emphasis on the materiality of RPE claims and to impose a high evidential bar to ensure appropriateness. NPG challenged this principle, noting that inflationary uplift was not only due to price lifts but also due to productivity, and that on this basis how could Ofgem apply a high bar for RPE adjustments, but not for ongoing efficiency?

- 4.3. Ofgem noted another principle from the RIIIO-2 tools for cost assessment document, which stated that we would expect companies to propose indices for any proposed RPEs, along with evidence to support their use in indexation and justification for their selection over alternatives. WPD challenged this principle arguing that if the indices were not appropriate in ED1 why would they be appropriate for ED2. NPG added that DNOs didn't think there was an index which captured the cost pressures on DNOs, and that Ofgem would accept. Thus relying on DNOs to suggest an appropriate index was not the right approach.
- 4.4. Ofgem noted the strong challenge and views put forward and will aim to capture these views as well as the learnings from the other sectors draft determinations, in the SSMC.
- 4.5. **Action: Ofgem to re-run some of the ED1 models and share some analysis of the actual costs against ex-ante allowances for RPEs for RIIIO-1.**

## 5. Ofgem review of feedback received on Regional and Special Factors

- 5.1. Ofgem presented slides on regional and company-specific adjustments. On the approach to GD2, it was highlighted that GDNs could respond to other GDNs' requests for company-specific factors.
- 5.2. NPG questioned how a GDN could respond to other GDNs' claims for company-specific factors, given the asymmetry of information between network companies when it comes to their regional or company-specific factors. Cadent Gas, for example, had a confidential annex about regional factors in its business plan submission.
- 5.3. NPG further indicated that, with the asymmetry of information, there was no incentive for network companies to attempt to expose weaknesses in other DNOs' submissions.
- 5.4. WPD noted that a similar discussion had taken place for PR19 in the water sector. WPD also asked Ofgem whether GDNs had commented on each other's company specific factors submissions. Ofgem replied that it believed that all of the company submissions had been shared during a GD CAWG meeting.
- 5.5. SSEN highlighted that the key point was for Ofgem to clarify the allocation of costs to higher and lower confidence costs, as well as the implications for the Business Plan Incentive assessment. NPG called for an incentive on company-specific claims, to avoid this process being a 'one-way belt' for DNOs.
- 5.6. Ofgem gave an overview of the approach taken by Ofwat for setting regional and company-specific factors in PR19. NPG pointed out that water companies who believed their regional adjustments were not picked up in econometric modelling could still submit individual adjustment claims.
- 5.7. ENWL added that many companies had withdrawn their claims after their draft submissions, following feedback from Ofwat. Action: NPG and WPD to double-check whether Thames Water had submitted any company-specific claims to Ofwat for PR19.
- 5.8. NPG also questioned the effectiveness of incentive mechanisms designed to limit the number of individual company-specific claims made by network companies - particularly having this as a factor for fast-track assessment in ED1. NPG argued that

DNOs knew in advance whether they would be fast-tracked or not, and so submitted their claims anyway.

## **6. UKPN presentation on Regional and Special Factors**

- 6.1. UKPN presented slides on regional and company-specific factors, giving an overview of the NERA and Arcadis study on the cost of providing utility services in London. This study was commissioned by UKPN, Cadent Gas, Scotia Gas Networks and Thames Water, and is publicly available online.
- 6.2. UKPN argued that it is impossible for a statistical model to capture all elements affecting costs, and advocated an individual assessment for some cost adjustments.
- 6.3. UKPN outlined the company-specific factors that the study looked into for London. They include the nature of the streets, permitting & traffic management, transport & logistics, network configuration, labour costs and high operational property costs.
- 6.4. NPG challenged UKPN on the London-specific factors presented. NPG pointed out that no factors which could reduce costs were included, and enquired on the weight given to the proportion of employees based in London in the wage adjustment presented. More generally, NPG warned against the lack of balance in adjustment claims. Ofgem echoed that a full understanding of all the factors affecting costs was necessary for adjustments claims to be accepted.
- 6.5. UKPN showed the modelling results with and without the London-specific factors used in the study. UKPN concluded that its ED1 allowance did not capture the full extent of regional adjustments needed for London. NPG challenged UKPN on the validity of the results, pointing out the financial incentive to show high cost adjustments for London-based utilities.
- 6.6. Ofgem thanked the DNOs for their contribution to the debate. ENWL finished by stating that there existed a trade-off between a simplified modelling environment for cost-assessment and another more complex one which tries to take all regional/company-specific factors into account - similar to Ofwat's approach. In the latter, a high bar for exceptionality must be introduced, ENWL added.

## **7. Actions, Next steps, AOB**

- 7.1. ENWL asked Ofgem when lessons learnt from the other sectors' draft determinations would be available to be discussed with the working group. Ofgem replied that internal discussions where necessary with the GD team, to assess if any areas could be flagged to stakeholders earlier than the draft determination publications.
- 7.2. Ofgem reminded the working group that the next CAWG session would cover uncertainty mechanisms and 'how everything fits together. NPG volunteered to present on uncertainty mechanisms. Action: NPG to present on uncertainty mechanisms in CAWG 6.
- 7.3. Ofgem asked DNOs to get in touch if they wished to present in the next CAWG meeting. Ofgem will try to limit future sessions to 3 hours, and welcomed feedback on this.

- 7.4. NPG asked Ofgem for updates about the ENA letter sent last year on the smart metering roll-out. NPG stressed that Covid-19 made this issue even more pressing. Ofgem the licence modifications were being drafted, but that it was not aware of recent updates from BEIS on this issue.