

RIIO-ED2 Cost Assessment Working Group (CAWG) – 8th April 2020

From: Ofgem

Date: 8th April

Time: 10am to 1pm

Location:
Teleconference

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. Ofgem asked if there were any comments on the updated actions log that had been distributed. UKPN noted that there were still some outstanding actions against them, and that they would look to address this in the next week.

2. NPG presentation on Uncertainty Mechanisms

- 2.1. NPG went through their slides on Uncertainty Mechanisms (UMs). NPG stated that UMs need to work as a holistic package and that their benefits should outweigh their costs. They presented a taxonomy of ED1 UMs, and asked members whether there were any categories missing from the list. ENWL suggested that smart meters and link boxes were hybrid UMs, where there were both ex-ante allowances and adjustments for uncertainty. There was a discussion on the Return Adjustment Mechanism (RAM), which NPG considered as a global UM operating across the price control.
- 2.2. Members highlighted non-licensee specific mechanisms not included in NPG's slides. UKPN stated that the ED1 Worst Served Customers (WSC) use it or lose it allowance should be included, while Diversions could perhaps be treated in the same way as connections as it is driven by similar factors. WPD flagged the discussion from the SRRWG around Telecoms Operational IT and how the BPDts should be designed to capture ex-ante forecasts.
- 2.3. UKPN suggested that the NOMs under/over-delivery mechanism was another UM. Ofgem noted the work with DEFRA and BEIS on PCBs. All DNOs agreed that there should be an LCT mechanism to better accommodate the low carbon transition, although there were different views on its design.
- 2.4. There was then a discussion on whether UMs would be designed prior to Business Plan submission, akin to ED1 where the strategy consultation gave a good idea on the direction of travel.
- 2.5. **Action: Ofgem to circulate a template for DNOs to provide their views on UMs for ED2 by 24th April.**

2.6. WPD noted that the BP guidance for the other 3 sectors gives companies the freedom to put forward bespoke UMs, and asked if Ofgem's position had changed on this for ED2.

2.7. Action: Ofgem to add agenda item on bespoke Ums at next CAWG.

3. WPD presentation on how it all fits together

- 3.1. WPD presented a schematic representation of 'how it all fits together' for ED2 cost assessment, highlighting where decisions would be necessary. WPD flagged that the schematic was a representation of the Ofgem process based on previous publications, not necessarily reflecting WPD's view.
- 3.2. On the business plan submission stage, WPD stated that the design of the data tables was a key decision yet to be made. WPD asked whether cost forecasts would embed RPEs and ongoing efficiency assumptions.
- 3.3. WPD mentioned that useful insights could be obtained directly from the raw data submitted by DNOs; for example, to inform on DNO outliers and whether special adjustments would be needed. Certain data points might be removed, as not to skew a 'reasonable' view of costs in the assessment. Exclusions should be considered, such as pass-through costs or other costs falling outside of the price control.
- 3.4. NPG pointed out that totex disaggregation could simply have high and lower-confidence costs as two cost categories. NPG stated that cost adjustments and normalisations requested by companies should by definition fall within the lower-confidence category of costs, as these adjustment requests are one-way requests between the DNO and Ofgem.
- 3.5. UKPN added that the existence of multiple guidance documents meant that some costs could reasonably be labelled under different categories by DNOs. Ofgem replied that business plan guidance would be sent as early as possible in the cost assessment process to provide clarity.
- 3.6. WPD listed a number of questions and comments on raw data analysis for cost assessment:
 - What is the relative balance between totex/ disaggregated/ middle modelling?
 - Further discussion is needed on the separate assessment for special factors and regional adjustments.
 - What will the uncertainty mechanisms be? How will they work in practice?
 - How will RPEs and ongoing efficiency assumptions be applied?
 - Where are they applied in the modelling process?
 - Do ongoing efficiency considerations apply to all cost areas? What would the exclusions be?
 - Are ongoing efficiencies embedded in the DNOs' cost forecasts, or applied separately? ENWL warned of the risk of double counting.
 - Is there a role to play for third party inputs in the design of the relevant indices?

3.7. On box 2 of the schematic 'high/ lower-confidence assessment', WPD argued that the use of totex benchmarking made it difficult to work backwards through BPDTs down to what DNOs were expected to deliver. NPG disagreed with WPD's view, saying that working backwards through a category by category table was not difficult. However, NPG noted that cost areas with uncertainty mechanisms, or areas such as NARMS, would require more thoughts.

- WPD's concern was that Ofgem had to monitor the delivery of outputs against costs set activity by activity, which was challenging.
- Ofgem agreed that uncertainty mechanisms would require further scrutiny, and stated that a consistent approach would be sensible.

3.8. WPD and Ofgem asked working group participants for views on where innovation and competition fitted in the cost assessment process. Last, WPD summarised all the key decision points identified for ED2 cost assessment, and asked for feedback on whether any decisions had been left out.

4. ENWL presentation on how it all fits together

4.1. ENWL presented a number of schematics on 'how the cost assessment framework fits together'. ENWL noted that the diagrams highlight the areas of choice and summarised the discussions that have been held in previous working groups. ENWL outlined the ED1 cost assessment process and focused on the following areas:

- Data and inputs
- Totex modelling
- Disaggregation and individual modelling
- Adjustments and cost exclusions including
- Outputs and allowance aggregation

4.2. ENWL noted that a triangulated assessment was carried out in ED1, with an Upper Quartile (UQ) adjustment applied. Real Price Effects (RPEs) and Smart Grid adjustments were applied afterwards which flowed into the Information Quality Incentive (IQI) finally calculating the Totex allowance at the end of the process.

4.3. For RIIO-ED2, ENWL presented on three potential modelling options:

- Indicative totex modelling approach
- Indicative disaggregated approach
- Indicative hybrid modelling approach

4.4. For option one, ENWL noted that external drivers were added and suggested that an increase of complexity may be required. NPg noted as demonstrated in Ofwat's PR19 review, that special factors can be assessed econometrically within the modelling regressions. SSE argued that there were a number of special factors and that they might not necessarily fit within the econometric models. NPg reiterated the view that company specific factors had no comparators and should be deemed as lower-confidence cost categories, though, SSE suggested that past price controls as a comparator.

4.5. ENWL continued and presented the potential ED2 disaggregated approach and noted that cost exclusions might still be required under this option. For option three, ENWL

outlined that some of the targeted costs excluded could still be assessed econometrically, but should have a separate model with justification to why it's treated separately.

- 4.6. ENWL suggested that it would be useful to have similar schematics for ED2 when the Ofgem view was finalised. UKPN questioned whether Ofgem had determined the level of disaggregation required in the BPDTs. In addition, NPg noted the practicality of completing data tables where some tables might not be used in the Cost Assessment process. Ofgem stated that the models will be determined post consultation and will not have this information prior to the first draft of the BPDTs. Ofgem acknowledged the balance between unnecessary reporting and limiting reporting.

Ofgem review of CAWG priorities

- 4.7. Ofgem showed the list of priorities that had been drafted during the first CAWG meeting, and asked DNOs for written feedback in order to review these priorities.

5. Ofgem presentation on Scenarios and Forecasting

- 5.1. Ofgem presented two opposite approaches to scenarios and forecasting:

- One where DNOs would suggest their own forecasting assumptions
- The other where Ofgem would provide general assumptions for DNOs to use for forecasting

- 5.2. WPD highlighted the need to understand how successful scenario and forecasting approaches had been in GD2. WPD also pointed out that a range of scenarios could be developed in addition to a common scenario for all DNOs.

- 5.3. Ofgem indicated that scenarios and forecasting would be discussed in more detail during future CAWG meetings. UKPN pointed that the key area of discussion was core baseline scenario development for DNOs, which Ofgem agreed with.

- 5.4. NPG, ENWL and UKPN discussed the role of CAWG in policy development, such as with the LCT mechanism. They agreed that the CAWG should take outcomes of policy decisions, and work out how to implement them in practice.

6. Actions, Next steps, AOB

- 6.1. UKPN, Ofgem, NPG and ENWL discussed core baseline scenario development. UKPN and NPG stressed that forecasting approaches will have a big impact on cost associated with uncertainty mechanisms. ENWL questioned whether the CAWG was appropriate to discuss these issues. UKPN clarified that the CAWG's role was to work out the parameters of core baseline scenarios, should they go forward, as they will inform BPDT development.
- 6.2. The next CAWG meeting will be on 28 April, and will cover CBA, EJPs and uncertainty mechanisms, with potentially a session on scenarios and forecasting.