

**Appendix – Responses to specific questions from Ofgem Consultation on RIIO-2 Draft Determinations for Electricity and Gas Transmission (ET and GT) and Gas Distribution (GD)**

**Core Questions**

→ **Q1.** What role should Groups play during the price control period and what type of output should Groups be asked to deliver? Who should be the recipients of these outputs (companies, Ofgem and/or stakeholders)?

WPD is supportive of CEG's and UG's being retained by all companies during RIIO-2. It will not be necessary for all members to be retained and groups to continue in the exact same form as they comprised in the Business Plan development stage – smaller groups focussing on core expertise would be most appropriate. Groups can be expensive to run so this will ensure a balance of value for money to consumers while retaining the critical expertise needed to continue to provide valuable oversight of company performance on behalf of consumers. Given that the make-up of each Group was decided by each individual Chair and the company, there is currently disparity between the number and types of members and the expertise areas covered. It would be welcomed if greater commonality could be achieved in the groups that are retained during RIIO-2. There should also be consistency in the frequency with which groups meet, to ensure the scrutiny and oversight provided by each group is comparable. WPD is of the view that groups should be responsible for scrutinising the delivery of the Business Plan outputs and deliverables – providing assurance to customers and Ofgem that this is taking place and flagging any concerns. In addition, Groups can have a role in raising areas of emerging consumer priority to companies, to be addressed during the period, ensuring companies do not focus solely on the commitments set out in the business plan.

→ **Q2.** What role should Groups take with respect to scrutinising new investment proposals which are developed through the uncertainty mechanisms?

As above. We consider the role for uncertainty mechanisms in RIIO-2 should be limited and not overused. Assuming the limited use then as long as all Groups retain the comparable member expertise, knowledge and experience levels, then it would be appropriate for CEGs to scrutinise investment proposals developed via uncertainty mechanisms. The Group's oversight can provide additional assurance to Ofgem to aid their decision making in this area, giving confidence that proposals put forward have been independently reviewed and potentially endorsed ahead of submission. This should focus on ensuring that relevant stakeholder engagement has taken place and is responded to.

→ **Q3.** What value would there be in asking Groups to publish a customer-centric annual report, reviewing the performance of the company on their business plan commitments?

There is the risk of duplication if companies themselves will be required to publish annual performance reports to enable wider stakeholders to track their delivery progress against their plans. Rather than a separate annual report from the Groups, it would be more appropriate for the Groups to scrutinise the company reports (and

underlying performance) ahead of publication. Groups could then provide a statement to be carried alongside that core report, flagging areas of satisfaction/agreement and any areas of concern.

For ESO this would be useful to feed into the assessment of the incentive scheme.

**→ Q4. What value would there be in providing for continuity of Groups (albeit with refresh to membership as necessary) in light of Ofgem commencing preparations for RIIO-3 by 2023?**

There is significant value in retaining Groups throughout RIIO-2 as they fulfil an important role in challenging and scrutinising company plans and performance/operations, thereby raising overall standards of performance and ambition, to the benefit of wider customers. However, this needs to be balanced with a consideration of value for money and therefore retaining smaller but effective Groups for each company would be best. WPD is supportive of groups being retained on a per company basis. However there needs to be an acknowledgment that their capabilities will therefore stretch to reviewing benchmarking data made available to them, but they will not be capable of conducting this sector-wide benchmarking themselves. If Ofgem has a requirement for stakeholder input into sector-wide benchmarking then this will require a sector-wide group, such as Ofgem's Challenge Group, or perhaps the formation of a central group comprising the Chair plus one or two relevant members from each company-specific CEG.

Given that the draft determinations have significant components that rely on ex-post assessments and potential re-openers, likely to be towards the end of the RIIO-2 period, this potentially back-loads some key decisions with significant consumer impacts. WPD is therefore supportive of CEGs carrying out enduring scrutiny and review throughout RIIO-2, so that Ofgem will have a continual, independent view of what companies are delivering and have independent scrutiny on the cases for triggering re-openers. If Groups are to be retained Ofgem must be able to demonstrate to wider consumers that they deliver clear value for money; this can be achieved if Group feedback will be used as a vital considered factor by Ofgem in these decision making processes at the backend of the price control period.

**→ Q5. Will the combination of the two proposed Licence Obligations support the delivery of a digitalised energy system and maximise the value of data to consumers?**

The Digitalisation Strategy and Action Plan licence conditions will provide a standardised approach to the production of Digitalisation Strategies in terms of updates and review periods. An understanding of the detail required within both the Strategy and Action Plan updates would be useful to inform the requirements of the Licence Condition to enable benchmarking between organisations and to ensure the expectations of Ofgem are met.

A Licence Condition focussed on ensuring compliance with the Data Best Practice guidance will support a common industry approach to data and be a useful mechanism to move towards a standardised approach to data. The information to data also proposes that guidance on how to manage a data triage process and a request for data that is currently not available externally; a common approach / set of guidance for these processes would provide significant value to consumers and stakeholders when accessing data from multiple organisations. Understanding how compliance with the

Licence Condition will be measured to determine an organisation is or is not compliant is required to understand the full impact and benefit.

**→ Q6. Do you agree with our proposed frequency for publication of updates to the digitalisation strategy and the digitalisation action plan, respectively?**

Yes. Having a review period of every two years for the Strategy is sensible and provides a reasonable time for strategy level updates. The Action Plan is proposed to be updated every six months; this provides a reasonable period of time to deliver developments and implement them to report on progress and new developments within that period based on stakeholder engagement and need.

**→ Q7. What kinds of data do you think should comply with the data best practice guidance to maximise benefits to consumers through better use of data?**

All datasets should comply with the data Business Plan Guidance as far as is practicable. The 12 principles encourage a common approach to data management, access and on-going engagement, which is complimentary and supportive to our approach. The maturity of our data and data access aligned to the Business Plan Guidance will evolve over time and the requirements should be reflective of this maturity through the price control period and demonstrating tangible improvements for all data throughout should be the focus.

**→ Q8. Do you agree that the Groups could have an enduring role to work with the companies to monitor progress and ensure they deliver the commitments in their engagement strategies?**

Yes. See answers to questions 1-4 above. In addition, it must be stressed that Groups were not formed with the knowledge or capacity to conduct sector-wide benchmarking. They will therefore be capable of monitoring progress and ensuring companies deliver the commitments in their engagement strategies. However, they will not be well placed to assess the extent to which companies are showing ambitions over and above this, and whether they are adequately monitoring and adopting best practice from other companies and sectors. This will require an appropriate, independent Ofgem-appointed panel such as that formed as part of the stakeholder engagement incentive in RIIO-1.

**→ Q9. Do you agree with our proposal to accept the proposals for an ODI-R for BCF and the other proposals set out above as EAP commitments and to require progress on them to be reported as part of the AER?**

No comment.

**→ Q10. Do you agree with our proposed RPEs allowances? Please specifically consider our proposed cost structures, assessment of materiality, and choice of indices in your answer.**

WPD offers the following comments with regard to the proposed RPE allowances. These comments reflect our understanding with respect to the running of the Gas Distribution,

Gas Transmission and Electricity Transmission for RIIO-2 and do not preclude our position with regard to any proposed RPE allowances in RIIO-ED2.

### **Cost structures**

Ofgem's propose "to apply the...RPEs to the cost structure set out in our [Ofgem's] cost assessment tools consultation in June 2019 and our SSMD"<sup>1</sup>. WPD understand from the RIIO-2 Tools for Cost Assessment Consultation that Ofgem intend to use "average (notional) cost structures"<sup>2</sup>. WPD disagree with the use of an average notional cost structure in the setting of RPEs.

Average notional cost structures may provide excessive allowances to some network companies for some inputs and provide insufficient allowances to other network companies for the same or other inputs. Firstly, this will generate an inequitable outcome; especially where network companies have sufficiently evidenced that the wedge between the input price and CPIH is efficient – e.g. direct labour costs are higher than CPIH, but are demonstrably efficient (i.e. wages are not artificially high). Some networks will under-recoup efficient costs whilst others will be over-funded for efficient and / or inefficient costs. Secondly, this may dis-incentivise networks to reallocate resources in response to changes in the relative price of inputs, creating a sub-optimal behaviour. Whilst use of an average notional cost structure avoids rewarding potentially inefficiently resourced networks, it also penalises efficiently resourced networks (see also WPD response to the RIIO-2 Tools for Cost Assessment Consultation<sup>3</sup>).

In particular application to ED, WPD has previously emphasised that this sector is going through significant change and therefore the use of notional structures in ED may be even less appropriate. As stated in WPD's responses to the RIIO-2 Tools for Cost Assessment Consultation<sup>4</sup> and to Ofgem's RIIO-2 Sector Specific Methodology Consultation<sup>5</sup>: "Through the RIIO-2 work to date, Ofgem has stated the industry is going through a period of significant change. As such the use of notional cost structures in RIIO-ED2 may well be less relevant with companies taking different approaches to insourcing and outsourcing for example, along with more significant changes with networks taking different solutions to network problems for example DSOs implementing different capex/opex solutions to constraint issues."

In light of the above, WPD recommends that RPEs be set on basis of actual cost structures, in line with the approach in the GT and ET sectors<sup>6</sup>.

WPD agree with Ofgem's proposal to update cost structures at "Final Determinations to reflect our [Ofgem's] final views of the cost structures associated with company cost allowances, rather than those based on company cost forecasts"<sup>7</sup>. Can Ofgem clarify how this will work in practice. For example, will Ofgem take the ex-ante allowances then re-work on a pro-rata basis each networks' respective cost split of direct labour, contractors, materials etc. As Ofgem have disallowed some of networks' submitted costs and activities, therefore the mix of inputs required to deliver what has been allowed ex-ante will more than likely differ to the mix of inputs submitted by network companies in their BPDs.

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<sup>1</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 45, para. 5.22

<sup>2</sup> Ofgem (June 2019) RIIO-2 tools for cost assessment, p. 63, para. 7.10

<sup>3</sup> WPD (August 2019) response to the RIIO-2 Tools for Cost Assessment Consultation, Q19, p. 10

<sup>4</sup> WPD (August 2019) response to the RIIO-2 Tools for Cost Assessment Consultation, Q19, p. 10

<sup>5</sup> WPD (2019) Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation, p. 63

<sup>6</sup> appreciating that there is not opportunity to take a meaningful average of cost structures in these sectors due to the number of data observations

<sup>7</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 45, para. 5.22

Whilst WPD agrees with the setting of cost structures based on FD allowances (albeit not on an average basis – see WPD’s comments above), Ofgem need to be aware that the structure of inputs used to deliver RIIO-2 commitments and activities may differ to that identified by Ofgem at FD (and indeed that set out by networks in BPDts). This reflects the totex framework; i.e. that network companies are not held to how they deliver activities as per BPDts, they should choose the mix of inputs, balance of opex/capex solutions and best available technology to deliver solutions efficiently at the point of delivery. Therefore the cost structure associated with individual network companies may differ in any one year of RIIO-2 compared to ex-ante. Therefore, Ofgem will need to design the AIP RPE true-up mechanism to account for not only for difference in any identified price index compared to CPIH, actual compared to index, but also difference in outturn cost structure compared to ex-ante.

Ofgem has delayed assessment of a number of cost and activity areas until mid-price control via Uncertainty Mechanisms (UMs). As such these costs have not been allowed for ex-ante and therefore will not enter into any ex-ante allowances provided or associated AIP true-up. Forecast costs allowed for in RIIO-2 UMs will also need to be assessed for RPEs. A UM simply delays the cost assessment process until a point at which costs are more certain; the associated costs like at ex-ante may be subject to cost pressures, e.g. relating to direct labour, contractors, materials, etc. As more costs are being assessed via UMs, there is more risk that the price uncertainties and the associated costs of this (i.e. the CPIH-input price wedge) will not be acknowledged. Furthermore, in RIIO-1, Ofgem have been active in applying ongoing efficiency assumption in ED1 re-openers, but have made no equivalent consideration of RPEs. Can Ofgem confirm that they will consider such RPEs in the same way as for ex-ante and using the same price indices to provide allowances.

In addition to the above comments, can Ofgem please clarify the source of information used to inform the cost structures in the Draft Determination. The RIIO-2 Draft Determinations - Core Document sets out that Ofgem have “*used CEPA’s calculated cost shares...*”<sup>8</sup>, however the CEPA analysis<sup>9</sup> says they have used cost structure information provided by Ofgem. This is inconsistent.

### **Assessment of Materiality**

WPD are comfortable with the proposed approach for assessment of materiality in GD/T2.

### **Choice of Indices**

No response provided in reference to Gas Distribution and other sectors. WPD does not expect roll-forward of RIIO-1 indices, as has been proposed for GD, to be precedence setting for ED without due sector-specific consultation.

### **Additional Comments**

In addition, WPD offer the following comments with regard to the Gas Distribution, Gas Transmission and Electricity Transmission RPE proposal, as below.

Table 4 of the RIIO-2 Draft Determination Core Document<sup>10</sup> sets out the weights applied to the indices where more than one index has been used to inform the input price movements for a particular input. Equal weight is applied to each index. Ofgem do not justify this decision. Can Ofgem please clarify? WPD consider that the weights could be more reflective of the sub-categories of inputs network companies actually use. For

<sup>8</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 45, para. 5.22

<sup>9</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.9

<sup>10</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 46

example, do GDNs really have perfect 25% split of labour across the four labour indices identified in Table 4? It is not clear how this has been allocated.

Ofgem need to consider the impact of COVID as far as possible in advance of FD with respect to ex-ante allowance setting and forecasting of indices. It is not unforeseeable that network companies will still be facing the impacts of COVID at the end of this year. Whilst the true-up mechanism via the AIP will iron this out, it is important up front to get this as accurate as possible to avoid volatility in customer bills.

The FOCOS Index (used for material opex costs) will not be updated by RICS<sup>11</sup>, the provider. Ofgem / CEPA need to consider this when it comes to true-ups against an price index that will no longer be updated for RIIO-2 price control period it is being considered for.

It is noted that in the RIIO-2 Tools for Cost Assessment Consultation<sup>12</sup>, the input categories cited as an example from GD1 were: direct labour, contract labour, materials, plant and equipment, transport, and other. It is observed that the BPDTs for GD, GT and ET and associated RPE allowances provided in the RIIO-2 Draft Determination are provided for the input categories general labour and specialist labour. CEPA too acknowledges this change<sup>13</sup>. It is not clear or justified why this decision has been taken or how labour can be identified across these two categories. Please can Ofgem set out how they have mapped from a direct/contract split of labour to general/specialist in the setting of GD2 ex-ante allowances for RPEs.

The RIIO-2 Draft Determination Core Document does not provide sight of the proposed cost structures for comment. It is not clear how Table 4 and Table 5 have been informed or how the former feeds into the latter. Furthermore it is not clear how Ofgem intend to run the annual RPE true-up process via the AIP. Can Ofgem please clarify?

**→ Q11. Do you agree with our proposed ongoing efficiency challenge and its scope?**

WPD offers the following comments with regard to the proposed ongoing efficiency challenge and its scope. These comments reflect our understanding with respect to the running of the Gas Distribution, Gas Transmission and Electricity Transmission for RIIO-2 and do not preclude our position with regard to any proposed ongoing efficiency challenge in RIIO-ED2.

**EU KLEMS - Choice of sector**

Ofgem determine an ongoing efficiency challenge through, in the large part, consulting EU KLEMS data on outturn productivity for two sample groups: *“weighted average of all industries; and unweighted average of four industries selected by Ofgem in RIIO-1 as being of particular relevance for the activities carried out by energy networks”*<sup>14</sup>.

WPD agrees with having two sample groups, reflecting that productivities in energy networks can be both sector-specific by origin and come from the wider economy. This reflects our response to the RIIO-2 Tools for Cost Assessment<sup>15</sup> in which we set out our agreement.

<sup>11</sup> RICS, <https://www.rics.org/uk/products/data-products/bcis-construction/public-sector-price-cost-indices/> [Accessed 03/08/2020]

<sup>12</sup> P. 63-64, para. 7.11

<sup>13</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.41

<sup>14</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.5

<sup>15</sup> Q20, p.11



It is understood, as set out above, that the latter sample is intended to reflect “activities carried out by energy networks”<sup>16</sup>. This sample is made up of the following EU KLEMS sectors: “Construction, Wholesale and retail trade: repair of motor vehicles and motorcycles, transportation and storage; financial and insurance activities”<sup>17</sup>. Given Ofgem’s intention for the selected industries to mirror energy network activities, as a non-exhaustive list of examples, it is not clear why:

- Each of these sectors have been included and the justification for each
- The EU KLEMS sector ‘Electricity, gas, steam and air conditioning supply’ has not been included or even considered (even if subsequently dismissed with due justification) from this analysis. Neither CEPA nor Ofgem reference this sector, which WPD considers an oversight as it has direct read across to the activities of energy networks in WPD’s view. WPD consider that sole reliance on the productivity index for the ‘Electricity, gas, steam and air conditioning supply’ sector may not be appropriate as it would be self-fulfilling, however this sector could reasonably be incorporated with appropriate weighting into the second sample group.
- Furthermore, WPD consider inclusion of the EU KLEMS sector ‘Electricity, gas, steam and air conditioning supply’ in the ongoing productivity analysis a more effective way of capturing energy sector specific contributions to energy sector productivity than the proposed DD approach to include a 0.2% additional efficiency challenge to that implied by the EU KLEMS analysis to reflect the returns from innovation. WPD comment on this further below.

Ofgem / CEPA arrive at the above two sample groups from the following five initial sample groups<sup>18</sup>:

- 1) Construction
- 2) Unweighted average selected industries (Construction, Wholesale and retail trade: repair of motor vehicles and motorcycles, transportation and storage; financial and insurance activities; manufacturing)
- 3) Unweighted average selected industries\*** (Construction, Wholesale and retail trade: repair of motor vehicles and motorcycles, transportation and storage; financial and insurance activities)
- 4) Unweighted average all industries (exc. real estate, public admin, education, health and social services)
- 5) Weighted average all industries** (exc. real estate, public admin, education, health and social services)\*

The two bold, asterixed samples were used to inform CEPA/Ofgem’s analysis.

It is not clear why CEPA/Ofgem chose the asterixed samples over others. Please can Ofgem confirm the rationale for this decision.

Sample 5) is a weighted version of sample 4). It is not clear why Ofgem did not run scenario / sensitivities of weights on samples 1), 2) and 3) also. WPD recommend these also be considered. In principle, WPD would expect that a weighted version of sample 3 (with inclusion of the ‘Electricity, gas, steam and air conditioning supply’ sector) would be a better alternative than the current unweighted equivalent. The

<sup>16</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.5

<sup>17</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.9

<sup>18</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.12-13, Table 2.1

weights should be informed by the percentage contribution that each EU KLEMS sector has on a typical energy network's activity<sup>19</sup>.

It is understood the weights for Sample 5 are constructed based on "*the proportion of VA at current basic prices or the proportion of GO at current basic prices*"<sup>20</sup>. It is not clear how this has been constructed or the rationale for the approach. Can Ofgem clarify. Reflecting the above response, it is WPD's view that Ofgem should consider an alternative weighting which weights the sectors in the all industries sample based upon the contribution each sector has on energy networks. WPD considers that this approach will most fully capture productivities in the energy network from the wider economy sources.

## **EU KLEMS – Choice of Time Period**

Ofgem / CEPA base the EU KLEMS analysis and ongoing efficiency challenge set in the DD on the time period 1997-2016. CEPA also consider a shorter time period of 2006-2016. CEPA set out that the second time period "*would be consistent with seeing the slow productivity growth since the global financial crisis as representing a structural break in the economy-wide potential for productivity improvements. Under this view, more weight should be put on the most recent business cycle information and less on previous business cycles – whereas using the full time period of 1997-2016 puts equal weight on the last two business cycles.*"<sup>21</sup>

WPD considers a short time period is more appropriate because it reflects the latest available information. The most recent past is the best indicator of the future; especially given the level of economic wide change. The ED sector in particular has not only been experiencing change from and as part of the wider economy, but also via a number of sector-specific changes, including the development of DSO functionality and working towards net zero targets. It is irrefutable that the economy as a whole, including energy networks, has undergone a substantial change as a result of the 2008 financial crisis; it is a commonly agreed fact in the literature of reputable institutions that productivity post the financial crisis has not returned to pre-crisis levels and may not do given an observed structural shift in the economy<sup>22</sup>.

It is not clear why Ofgem has decided against using a short time period, given the above evidence that the UK economy has undergone a structural shift and as such information prior to 2008 bears little insight to the current state of the economy, yet alone expectations of what the future state of the economy might look like. WPD is unconvinced by the conclusion reached by CEPA in reference to a structural break that "*It is not clear to us that the evidence exists for such a strong assumption at this stage when it is challenging to confidently identify a structural break in long-term productivity growth*"<sup>23</sup>. Can Ofgem clarify justify their decision. It is observed in Table 2.2 and Table 2.3 in the CEPA report<sup>24</sup> that the outturn productivity values are typically lower, sometimes negative, for the time period 2006-2016 than for 1997-2016 period for most of the five sector samples consulted.

<sup>19</sup> I.e. As a hypothetical example, Transportation and Storage might represent 8% of the economy, however what is important is the linkages that the Transportation and Storage sector has on energy networks, which as a percentage of all the economy wide links that impact energy networks, could be higher (e.g. 11%) or similarly lower.

<sup>20</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.56

<sup>21</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.13

<sup>22</sup> As indeed CEPA acknowledge: CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.16

<sup>23</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.37

<sup>24</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.15



## **Innovations bolt-on**

It is not clear why Ofgem / CEPA have sought to apply an innovation bolt-on to the more standard ongoing efficiency analysis using EU KLEMS outturn data which is an agreed upon procedure in regulatory economics and regulatory price controls. This is double counting. The two samples of sectors Ofgem/CEPA consider for EU KLEMS outturn data consider firstly the economy as a whole and secondly sectors reflecting the activities carried out by network companies. If Ofgem are in any doubt that either of these sample sectors does not fully account for within sector productivity gains, WPD recommend that Ofgem consider inclusion of the 'Electricity, gas, steam and air conditioning supply' sector into the samples as a superior alternative to an innovation bolt-on. See WPD's response above.

It is not clear how Ofgem/CEPA have calculated or justified that the innovation bolt-on should be 0.2%<sup>25</sup>. Despite CEPA identifying that they *"have not yet identified robust evidence for establishing a firm quantitative relationship between innovation funding and the scope for frontier efficiency improvements in the energy network sector"*<sup>26</sup>, they provide an estimate of 0.2% per annum in their report.

Investigation of this innovation bolt-on appears at best a poor attempt by Ofgem to justify a higher ongoing efficiency challenge to network companies in the face of what is, from a regulators perspective, a disappointing message for productivity when consulting EU KLEMS outturn data (especially when more recent data is consulted) and forecasts from reputable organisations alone. WPD reiterate our view set out in our RIIO-2 Tools for Cost Assessment Consultation response<sup>27</sup>: "WPD raises concern regarding Ofgem adopting a cherry-picking approach of trying to find new and additional measures to inform a composite / triangulated view of ongoing efficiency (as has recently been attempted by Ofwat at PR19) on the basis that the EU KLEMS implied efficiency challenge is disappointing from a regulatory perspective of setting a challenging efficiency target. Present analysis by reputed organisations clearly sets out that ongoing efficiency is disappointing and this reflects the general state of the economy, prevailing political climate and the impacts that economic / political events since the 2008 recession have had on R&D investment as well as the propensity of private and equivalently public sector organisations across the economy, whom in the face of the aforementioned events have no doubt reduced their risk appetite, to embracing new technologies and innovations."

Mirroring the above, it appears this innovation bolt-on is taken directly from the pages of PR19 and Ofwat's efforts to justify a productivity challenge completely out of canter with current economic observations through exploring returns to the PR19 totex outcomes framework.

As highlighted by Frontier Economics in their critique of Ofwat's PR19 approach<sup>28</sup>, in summary *"it is not at all clear why the kinds of regulatory innovation that Ofwat is talking about – totex and outcome regulation – should lead to reduction in recurring expenditures; rather, there is a respectable argument that Ofwat's incentives will typically lead to companies incurring higher ongoing expenditures in the short term as part of a drive towards whole-life cost optimisation"*. WPD considers this argument completely valid to RIIO-2 and energy networks.

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<sup>25</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, section "Impact of innovation funding on ongoing efficiency assumption"

<sup>26</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.35

<sup>27</sup> Q20, p. 10

<sup>28</sup> Frontier Economics (2019) A REVIEW OF OFWAT'S PR19 APPROACH TO ESTIMATING FRONTIER SHIFT, p.3

Furthermore, not all innovation is focused on projects the end goal of which is to deliver efficiencies on how current activities are done. For example a significant proportion of innovations in the ED sector are more exploratory by nature and concern areas including future networks and DSO. By its very nature innovation is often associated with zero-returns, for example due to ideas that upon development are not commercially viable. Ofgem need to be clear in their distinction between different types of innovation, crucially those which can and cannot be associated with delivery of efficiency gains.

It is not clear why separate analysis of the innovative/incentive framework of regulators requires specific attention, any more so than any other driver of ongoing productivity, such as technological developments. Innovation is just one component of the overall package concerning how network companies seek to deliver efficiencies.

### **Forecasting Ongoing Productivity (Includes BoE / OBR forecasts)**

Both the Bank of England (BoE) and the Office for Budget Responsibility (OBR) provide forward looking forecasts of productivity. CEPA, in their report, summarise the latest forecasts (at the time of writing) provided by these institutions including commentary, for example with regard to the post-financial crisis 'productivity puzzle': the observation that productivity levels have not returned to the pre-2008 crisis levels.

Ofgem's draft determination position<sup>29</sup> is that they "*do not wish to place significant weight*" on the forecasts and insights of the BoE and OBR. CEPA suggest that based on insight from the BoE and OBR that this would support a slight increase in the ongoing efficiency challenge for opex and a slight decrease in the ongoing efficiency challenge for capex, using the EU KLEMS analysis and resulting ongoing efficiency range as the base case<sup>30</sup>. Despite Ofgem's above position with regard to the use of BoE and OBR forecasts, Ofgem chose to take the upper of the ongoing efficiency range for both opex and capex/replex (Core Doc, Ofgem, para. 5.36, p. 48). WPD considers that greater weight should be placed on the forecasts and insights from both the BoE and OBR for the reasons set out below.

Both the BoE and OBR are highly reputed institutions and their forecasts are developed through consulting a number of independent forecasts. As such it is WPD's view that this approach represents a more robust, cross-referenced and triangulated view of the future than any simple extrapolation of EU KLEMS outturn information. CEPA use the productivity forecasts from the BoE and OBR to "*support a higher top-end of the range for the ongoing efficiency challenge for opex, and a lower value for capex/replex*"<sup>31</sup> from their own extrapolation of the EU KLEMS information, rather than assessing the forecasts as a separate and independent source.

Ofgem further comment that "*In the context of a rising trend in longer term productivity forecasts, we do not wish to place significant weight on such economy-wide and short-term forecasts, as network companies are not exposed to these short-term risks (to volume and revenue) as their comparators in the wider economy and are better able to withstand any short-term shocks.*"<sup>32</sup>

WPD disagrees with the context of a rising trend in longer term productivity forecasts. Consulting insights from the BoE, OBR or the many negative productivity figures sighted

<sup>29</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 48, para. 5.39

<sup>30</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p. 36

<sup>31</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p. 6

<sup>32</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 48, para. 5.39

in the EU KLEMS analysis provided by Ofgem's own consultants<sup>33</sup> would suggest, even confirm, otherwise. Please can Ofgem substantiate this insight with evidence. The plausibility of Ofgem's assessment becomes ever more questionable as one considers the increasingly likelihood of the short-medium term post financial crisis productivity figures becoming long term, a likelihood increased by the COVID pandemic. Ofgem also need to consider what impact the UK's exit from EU will have, following conclusion of the transition period.

Network companies are exposed to the wider economy, as WPD sets out in our response to Q20 of the RIIO-2 Tools for cost assessment consultation<sup>34</sup>. In the above justification Ofgem is saying that with respect to BoE and OBR information on productivity that network companies are not exposed to the wider economy, and yet with regard to Ofgem's own choice of sample sectors to use in the EU KLEMS information on productivity they have chosen as one of the two sample sectors, one "unweight of all industries", which presumably reflects an acknowledgement that economy wide productivities can and do impact on energy networks. This is inconsistent. Recent experience of the COVID pandemic would strongly suggest that network companies are exposed to economy wide short term risks (to volume and revenue). Indeed, Ofgem acknowledged this through confirming activity and volume reductions in the lockdown period.

As a point of principle surely forecasts (e.g. from BoE and OBR), even if considered short term by Ofgem, are a better indicator of long term forecasts, rather than out of date outturn historical data (1997-2016, EU KLEMS)?

Linking to WPD's response on the choice of time period used in the EU KLEMS analysis, Ofgem needs to give greater consideration to the recent financial crisis and observations of negative productivity and the apparent engraining of such observations into the longer term. Furthermore, it is imperative that Ofgem gives consideration to the impact of COVID and the UK's exit from the EU on the medium-long term productivity forecasts ahead of FD.

### **Level of ongoing efficiency challenge**

WPD are of the position that the ongoing efficiency challenge set out in Ofgem's DD is unreasonably and unjustifiably high. WPD provide the following comments:

Ofgem has chosen to take the higher point of CEPA's ongoing efficiency ranges<sup>35</sup>. This is inconsistent with CEPA's own approach to developing those ranges from the constituent sector samples as CEPA took the midpoint<sup>36</sup>. WPD recommend Ofgem take the midpoint from a perspective of consistency and to provide some alleviation to the fact that there will inevitably be measurement error within the method and range quoted.

After dismissing the forecasts of the BoE and OBR, Ofgem<sup>37</sup> subsequently set out reasons why they believe the EU KLEMS dataset will under-estimate the scope for efficiency gains in regulated sectors.

- a. *"Network companies [are] less exposed to negative shocks"*. WPD set out above our view for why this is not the case

<sup>33</sup> Table 2.2. and 2.3, in particular those productivity measures considering the shorter more recent time period: CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.15

<sup>34</sup> P. 10

<sup>35</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 48, para. 5.36

<sup>36</sup> CEPA (May 2020) RIIO-GD2 and T2: Cost Assessment – Frontier shift methodology paper, p.33, Table 3.1

<sup>37</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Core Document, p. 50, para. 5.42

- b. *"Lack of competitive pressure means management should be able to focus on driving higher efficiency gains"*. WPD disagree with this justification in theory and practice. Standard economic theory would suggest that less competition would provide weak incentives for management to drive efficiency gains as inefficiencies can be funded through customers who have no alternative provider. In theory and practice, it is the existence of regulation that creates these absent competitive pressures to be efficient.
- c. WPD disagree with Ofgem's justifications for why the EU KLEMS dataset will under-estimate the scope for efficiency gains in regulated sectors.

In Para 5.43 of the GD DD Core Document, Ofgem propose to apply ongoing efficiency to all of totex<sup>38</sup>, which is consistent with Ofwat's position in PR19 FD. WPD disagree with this position and we have previously stated to Ofgem: "An ongoing productivity challenge should not be applied to cost categories / activity areas that are beyond the control of management / infancy areas that are still maturing, etc."<sup>39</sup> Street work fees for the granting of permits and lane rental is one example that is relevant to network companies, including those in ED. WPD agrees that Ofgem should continue to consider this "default" position<sup>40</sup> including whether any areas should be exempt. Ofgem may also need to further consider how they have classified costs as controllable and non-controllable and what is included in totex.

### **Applying the Ongoing Efficiency Challenge**

It is not clear to WPD how Ofgem has applied the ongoing efficiency challenge as per the method set out in the Step by Step Guide to Cost Assessment on ongoing efficiency<sup>41</sup>. Can Ofgem clarify the approach, in particular:

- a. The implied adjustment factor referenced in para. 1.74. Is this related to the disaggregation methodology of totex allowances to an activity level as set out in Gas Distribution Annex, p. 117-118, para. 3.157-3.159?
- b. If there is a typo in para 1.75 such that "catch up efficiency challenge" should actually read "ongoing efficiency challenge"?
- c. Given the above, why Ofgem consider it appropriate that the ongoing efficiency challenge be applied evenly to totex, given that there may be areas where network companies are unable to drive efficiencies because they are beyond management control (see WPD's above comment) or that no further efficiencies in that particular area can be realised due to some other constraining factor.
- d. Why Ofgem has considered the need to understand application of the ongoing efficiency challenge at a disaggregate level, given the draft determination position to set allowances at a totex level? WPD would broadly consider that where ongoing efficiencies are delivered is at the discretion of management.

### **→ Q12. Do you agree with our proposed common approach for re-openers?**

WPD considers that these need to be sector specific, but has concern that over-use adds uncertainty to planning.

### **→ Q13. Do you agree with our proposals on a materiality threshold, a financial incentive, a 'foreseeable' criterion, and who should trigger and make the application?**

<sup>38</sup> This is comparable to Ofwat's position in PR19 Final Determination

<sup>39</sup> WPD Presentation to the ED2 CAWG (20 March 2020) Ongoing Productivity Growth

<sup>40</sup> Ofgem (July 2020) RIIIO-2 Draft Determinations - Core Document, p. 50, footnote (50) to para. 5.43

<sup>41</sup> p. 21 para 1.74-1.76

No comment.

**→ Q14. Do you consider that two application windows, or annual application windows, are more appropriate, and should these be in January or May?**

It is currently unclear how the process would work for these application windows, and what Ofgem's assessment criteria would be. More detail is required to facilitate an informed discussion around this proposal.

**→ Q15. Do you consider that the RIIO-1 electricity distribution licences should be amended to include the CAM, or wait until in 2023 at the start of their next price control?**

WPD considers that this consultation is not the appropriate forum in which to ask this question, as this is a RIIO-ED1/ED2 question.

In broad terms, WPD considers the principles of the CAM to be generally agreeable. Through not setting a materiality threshold limit and requiring participants in the CAM to be in agreement, this should promote a collaborative environment to build on more economic whole system solutions. Two set windows within the price control should be sufficient, recognising that this might continue as a biennial window to extend through ED2/T3 overlap. Establishing similar mechanisms for ED alongside ET, GT and GD seems sensible, to maximise the chance of successful whole system outcomes.

Not only can the actions of one network company impact other network companies in the same or other energy sectors, but furthermore network company actions can also be impacted by system operator actions, and vice-versa. Whilst tangible benefits for system operation cost reduction through investment on network assets (Transmission or Distribution) can be picked up through NOA processes, system operation cost reduction benefits arising from distribution system operator actions are not readily assessed or valued. ESO-led competition is being introduced. The CAM could present another opportunity for this cross-licensee revenue adjustment to be delivered and to provide more certainty where DNOs would otherwise receive revenue through DRS.

**→ Q16. Do you agree with our proposed re-opener windows for cyber resilience OT and IT, and our proposal to require all licensees to provide an updated Cyber Resilience OT and IT Plan at the beginning of RIIO-2?**

No. This should be undertaken through ex ante funding. WPD is already incurring these costs in ED1 to be compliant with NIS. Cyber Resilience OT and IT Plans require certainty of funding. As RIIO-2 is only a five year price control there is sufficient certainty for Ofgem to be able to assess and fund these plans through ex ante funding. Ofgem has currently provided no clear indication on timing duration of windows or further development of the proposal, and these costs should be included in baseline allowances.

**→ Q17. Do you agree with our proposal for the Non-operational IT and Telecoms capex re-opener?**

As above, no. This should be undertaken through ex ante funding. WPD is already incurring these costs in ED1 to be compliant with NIS. Cyber Resilience OT and IT Plans required certainty of funding. As RIIO-2 is only a five year price control there is sufficient certainty for Ofgem to be able to assess and fund these plans through ex ante funding. Ofgem has currently provided no clear on timing duration of windows or further development of the proposal, and these costs should be included in baseline allowances.

**→ Q18. Do you agree with our approach to using a re-opener mechanism for changes to government physical security policy?**

Ofgem's proposed approach does not provide sufficient explanation of how this would work as a re-opener in isolation to other required changes to physical site security. As a short, five year price control, there is sufficient certainty for Ofgem to *ex ante* fund as base line costs. If Government policy changes significantly, this should be recovered through the RIIO-3 price control.

**→ Q19. Do you agree with our approach regarding legislation, policy and standards?**

The introduction of NIS is a good example of what could happen with changes in policy that drives significant costs to businesses that they have not been able to recover, as it is not considered a legislation change. Through NIS, transmission and distribution networks have been required to implement cyber plans and reinforcements that were unforeseen at the commencement of RIIO-1. As NIS is not considered a legislation change, these costs would not be accounted for through Ofgem's proposed approach, despite being introduced and required by government.

**→ Q20. Do you agree with our overall approach to meeting Net Zero at lowest cost to consumers? Specifically, do you agree with our approach to fund known and justified Net Zero investment needs in the baseline, and to use uncertainty mechanisms to provide funding in-period for Net Zero investment when the need becomes clearer?**

WPD is concerned that the Draft Determinations excessively focus on achieving short-term (within the 5-year period) price reductions at the expense of medium and long term benefits. An incentive based regime should deliver lasting benefits to consumers – including long term efficiency, sustained increases in service levels and quality, and investment in networks capable of delivering the infrastructure needed for a Net Zero economy. We consider Ofgem's proposals risk the opposite.

**→ Q21. Do you think the package of cross sector and sector-specific UMs provides the appropriate balance to ensure there is sufficient flexibility and coverage to facilitate the potential need for additional Net Zero funding during RIIO-2?**

Please see response to Q20. We consider the role for uncertainty mechanisms in RIIO-2 should be limited and not overused. The overuse of uncertainty mechanism could results in delays to essential projects, further exacerbated by delays in supply chain given the delayed decisions. Whilst the use of uncertainty mechanisms can be seen as a benefit to solving some problems the full impact of leaving significant elements of the price control to uncertainty mechanisms must be fully considered.



**→ Q22. Do you have any views on our proposed approach to a Net Zero re-opener?**

See Q.20. The proposed package incurs significant risk of leading to zero ambition from companies.

**→ Q23. Do you agree with our proposals for the RIIO-2 Strategic Innovation Fund?**

Yes. WPD considers that ad hoc calls on themes is a good idea. The process should be managed by an external specialist body rather than Ofgem. We support combining calls with other public sector funding calls and direct third party access to the SIF competition if possible.

**→ Q24. Do you have any comments on the additional issues that we seek to consider over the coming year ahead of introducing the Strategic Innovation Fund?**

Since SIF will be set by specific themes and only available for projects that cannot be funded by NIA (and under £5m) the impact on NIA allowances needs to be considered. WPD would expect the allowance may need to be increased to ensure sub-£5m projects previously funded through NIC or LCNF Tier 2 can be delivered.

**→ Q25. Do you agree with our approach to benchmarking RIIO-2 NIA requests against RIIO-1 NIA funding?**

No. The benchmarking should take into account sub-£5m NIC spend in addition to NIA. The extension of NIA funding to cover customer vulnerability projects should also be assessed in order that these projects do not detract from projects delivering net-zero.

**→ Q26. Do you agree with our proposal that all companies' NIA funding should be conditional on the introduction of an improved reporting framework?**

Yes. WPD already produces a suite of reports over and above that required by governance. We also run our own NIA call for proposals each year to ensure we engage with potential partners ahead of projects being registered. Ongoing engagements for future, current and past projects is achieved at a Programme level through our regular "Balancing Act" events.

**→ Q27. What are your thoughts on our proposals to strengthen the RIIO-2 NIA framework?**

WPD agrees with the proposals, but they should not be unnecessarily prescriptive or extensive. We suggest companies already have sufficient incentives to ensure projects are delivered and communicated well (broad measures and reputational). Ofgem has sufficient powers to disallow funding ex-post for poorly delivered projects.

→ **Q28. Do you have any additional suggestions for quality assurance measures that could be introduced to ensure the robustness of RIIO-2 NIA projects?**

NIA (and NIC/other innovation funding) projects are already subject to QA. The projects and programme are regularly assessed by internal and external audit functions. The proposed ENA benefits reporting will add further scrutiny.

→ **Q29. Do you agree with our proposals to allow network companies and the ESO to carry over any unspent NIA funds from the final year of RIIO-1 into the first year of RIIO-2?**

Yes. Early indication of similar treatment for ED companies would help ensure the NIA programme remains as effective as possible. Else larger multiyear projects may not be registered.

→ **Q30. Do you agree with our proposal that all work relating to data as part of innovation projects funded via the NIA and SIF will be expected to follow Data Best Practice?**

See answer to Q7. Yes, this will provide increased value and visibility for data as part of innovation projects. WPD already makes available all project data and (as part of ongoing Digitalisation works) is currently planning to migrate the data to our Energy Data Hub to make it easier to access and better catalogued.

→ **Q31. Do you agree with our proposed position on late competition?**

Any decision taken on early and late competition for T2/GD2 must not set a precedent for ED2. WPD has previously responded to RIIO-2 consultations highlighting that early and late competition would not be relevant for ED2.

→ **Q32. Do you agree with our proposed approach on early competition?**

No comment.

→ **Q33. Do you agree with our view that SHET, SPT, SGN and WWU passed all of the Minimum Requirements, and as such are considered to have passed Stage 1 of the BPI?**

Stage 1 is Ofgem's assessment and so Ofgem needs to be able to assure itself the correct decision has been made.

→ **Q34. Do you agree with our rationale for why NGET and NGGT should be considered to have failed Stage 1 of the BPI?**

Stage 1 is Ofgem's assessment and so Ofgem needs to be able to assure itself the correct decision has been made.

→ **Q35. Do you agree with our rationale for why Cadent and NGN are considered to have passed Stage 1 of the BPI?**

Stage 1 is Ofgem's assessment and so Ofgem needs to be able to assure itself the correct decision has been made.

**→ Q36. Do you agree with our overall approach regarding treatment of CVP proposals?**

WPD agrees with need for CVP proposals and inclusion in plans. Ofgem must provide more guidance and ensure this is carefully considered.

**→ Q37. Do you agree with our proposed clawback mechanism to treat received CVP rewards?**

These should be considered as Totex in the round. It is important that Ofgem considers the RIIO-2 package in the round rather than piecemeal.

**→ Q38. Do you have any views on the interlinkages explained throughout this chapter?**

No comment.

**→ Q39. Are there other interlinkages within our RIIO-2 package that you think are relevant to the three pillars identified in this chapter?**

It is important that Ofgem considers the RIIO-2 package in the round rather than piecemeal.

**→ Q40. Do you have any views on our proposal to include a statement of policy in Final Determinations that in appropriate circumstances, we will carry out a post appeals review and potentially revisit wider aspects of RIIO-2 in the event of a successful appeal to the CMA that had material knock on consequences for the price control settlement?**

As per WPD's Response to Ofgem's RIIO-2 Sector Specific response in March 2019, the consequences of an appeal made to the Competition and Markets Authority should remain self-contained to the scope of the appeal.

If there are any consequential issues associated with the area being considered in an appeal then these should be incorporated within appeals proceedings. There should not be any post appeal adjustments for areas of the price control not considered during the appeal.

The appeal itself should consider maintaining a coherent regulatory settlement and therefore it is inappropriate for Ofgem to carry out additional adjustments to the price control arrangements not covered by the appeal.

The impact of any successful appeal should not be extended to any other licensee, unless that licensee has been specifically identified as potentially being impacted by an

appeal. This will allow the potentially affected licensee to be involved in the appeals process, providing any supporting evidence necessary. It is wholly unacceptable for a licensee to be affected by an appeal, where it has not been directly involved with the appeals process.

**→ Q41. Do you have any views on the proposed pre-action correspondence, including on the proposed timing for sending such to Ofgem?**

No comment.

**→ Q42. Do you think we need specific mechanisms in RIIO-2 to manage the potential longer-term impacts of COVID-19? If yes, what might these mechanisms be?**

From a Cost Assessment perspective, WPD recommend Ofgem given consideration to a true-up mechanism for ongoing productivity. Whilst there is a RIIO-2 mechanism for RPEs, WPD considers a mirroring true-mechanism is required for ongoing productivity. WPD sets out the justification below.

It is plausible that the RPE wedge between CPIH and input prices (or indices that proxy for input prices) may increase due to the potential longer-term impacts of COVID-19. The annual true-up mechanism proposed for RIIO-2 will mean that any differences in the outturn wedge between input prices (or indices that proxy for input prices) will be trued-up such that neither customers nor network companies will be out of pocket as a result of COVID-related or other sources of input price pressures.

It is also plausible that outturn ongoing productivity may be less than forecast ex-ante due to the potential longer-term impacts of COVID-19. For example, a decrease in the productivity of works completed in the road for repairs and maintenance (R&M) activity may be expected as it will take longer to complete dig and lay works whilst ensuring compliance with social distancing. In this respect, it is expected that COVID is to have a longer term impact via changing the way we work. However, in contrast to RPEs, there is no comparable mechanism in RIIO-2 to true up differences in productivity compared to forecast. Whilst network companies will be insulated against changes in RPEs due to COVID they will not be for changes in productivity.

It is important that Ofgem consider this, given RPEs and ongoing productivity assumptions are considered different sides of the same coin and given just how impactful the COVID-19 could be on the long term landscape for RIIO-2.

## **Regulatory Finance Questions**

### **Allowed return on debt questions**

**→ FQ1. Do you agree with our approach to estimating efficient debt costs and setting allowances for debt costs?**

We agree that it is not appropriate to include ED expected sector debt costs in Ofgem's current calibration exercise, given that this could imply a debt allowance calibration for the ED sector, when Ofgem is not yet at a stage where it can consider the financeability of the ED notional efficient operator for RIIO-2.

**→ FQ2. Do you agree with our proposal to use the iBoxx GBP Utilities 10yr+ index rather than a combination of iBoxx GBP A and BBB 10yr + non-financial indices?**

Any financeability assessment performed by Ofgem should be based on the ratings of the companies represented by the index. The iBoxx Utilities Index current rating is around A/BBB, but if Ofgem use this index throughout RIIO-2, companies will then have the risk of the index rating improving over the RIIO-2 period.<sup>42</sup> This will be particularly relevant as the RIIO-2 settlement is likely to have a negative impact on ratings due to the financeability issues it raises.

We also note Ofgem's comments in paragraph 2.65 "We have accepted possible under-provision for cost of debt index calibrations in the past. For example, at ED1 draft determinations we indicated that our modelling at that stage suggested potential under-provision. However, for that determination we were comfortable that this resulted from some conservatism in assumptions for the cost of new debt and that any remaining under-provision would be balanced by the headroom in the cost of equity estimate" Given the unprecedented reduction to Cost of Equity allowances Ofgem is proposing for RIIO-2, and in light of Ofgem's duties in relation to financeability, it should be clear that under-provision for the Cost of Debt in RIIO-2 is not acceptable.<sup>43</sup>

**→ FQ3. Do you agree with our proposal that the RAV growth profile of SHET continues to be materially different to other networks and therefore warrants continuation of a bespoke RAV weighted allowance calculation?**

No comment.

**→ FQ4. Do you have any views on the model to implement equity indexation, as published alongside this document, (the "WACC allowance model.xlsx") or on the annual update process?**

Given the importance of the cost of equity being calculated robustly and the fact that investments in the network industries are long-lived, we consider that there should be stability in the cost of equity applied. Accordingly, when setting the cost of equity it is important that a long-term perspective is adopted. WPD continues to believe that, while the cost of equity is largely outside management control and forms a material proportion of the company's total costs, it does not vary sufficiently annually such that Ofgem is unable to set a reasonable cost of equity allowance for the whole RIIO-2 price control period.<sup>44</sup> The cost of equity is not as volatile as individual parameters that form the calculation and indeed there is constancy in the TMR over time. As such, we see no reason to index the cost of equity annually. Moreover, consumers would potentially suffer from greater volatility in prices if the cost of equity is indexed.

<sup>42</sup> NERA's slides for ENA meeting: *Ofgem's Draft Determination: Key issues for Cost of Debt Allowance*, 14 July 2020

<sup>43</sup> WPD's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution, 14 March 2019

<sup>44</sup> WPD response to Ofgem's framework consultation, March 2018.

We note Ofgem's statement "We propose to retain some discretion during RIIO-2 to refine the calculation in light of difficulties estimating CPIH-real gilts using market data, as reflected in a recent HM Treasury consultation." The inclusion of such uncertainty over the calibration of such a key element of the price control package has a significant impact on regulatory risk for companies, and does not appear to be an improvement from the stability of a cost of equity set on an ex-ante basis.

### Equity beta questions

**→ FQ5. In light of RIIO-2 Draft Determinations and Ofwat's final determinations for PR19, do you believe that energy networks will hold similar systematic risk during RIIO-2 to water networks during PR19?**

The energy networks will have a far greater level of systematic risk than the water networks during RIIO-2 and beyond. The degree of change required by the energy networks and the future challenges are far greater in energy, as we look to significantly decarbonise and move towards a net zero economy. Significant investment will be required and, at present, there are many known unknowns that will have to be addressed in order to achieve the net zero aim. With this brings increased risk, which has to be factored in in order to meet this objective.

**→ FQ6. Is there evidence of a material difference in systematic risk between: a) RIIO-1 and RIIO-2, b) distribution and transmission networks, c) gas transmission and electricity transmission, d) gas and electricity?**

Ofgem is proposing large-scale revisions. We find this surprising given the success of RIIO-1 [as outlined above]. In WPD's view, the current RIIO-GD2/T2 proposals ignore the benefits RIIO-1 has provided.<sup>45</sup> The RIIO-1 price control includes a strong incentive package that facilitates positive performance from network companies and directly benefits consumers. However, Ofgem's proposals for RIIO-2 include a penalty heavy "incentive" package, with the reward for high performing companies primarily being limited to the avoidance of a penalty.

Such large-scale revisions also raise real risks for consumers. Ofgem rightly emphasises the importance of regulation being stable and predictable, since regulatory risk (in particular where it is asymmetric in nature) will increase the cost of capital. Given that energy networks are capital intensive, any such increases in the cost of capital can be expected to lead to higher prices to the detriment of consumers.

In our view Ofgem's RIIO-2 proposals do not provide a logical and predictable continuation of RIIO-1 which is especially of concern given the changing technological and market environment in which companies are operating. This changing environment creates investment challenges. In this context, Ofgem's proposed step changes in RIIO-2 to investment incentives, such as the cut in the cost of capital, the restructuring of outputs and weakening of outperformance rewards, seriously challenge companies' abilities to respond to these changing demands with appropriate investment.

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<sup>45</sup> WPD Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.



As highlighted in FQ5 above the level of risk in the energy sector will increase. With the move from carbon-based products more emphasis is being put on electricity to achieve the net zero target - therefore increasing systematic risk. To achieve the Government goals on carbon the focus will be predominantly on end users and therefore more focus on distribution. To achieve the required green recovery more weight than ever will be placed on the ED companies to deliver and therefore for the companies the risk will be significantly increased.

## **Step-2 implied cost of equity consultation questions**

### **→ FQ7. Do you have any views on how we should consider further the gearing impact on beta and cost of capital estimates?**

We remain of the view that Ofgem should fully consider its statutory duty to ensure the financing of licensees. Ofgem appears to regard a financeability test as a trigger for action by shareholders, rather than a critical cross check of whether the expected cost of equity is sufficient.<sup>46</sup> We do not consider it appropriate that, when the outcome of Ofgem's financeability tests show insufficient headroom, the result is an expectation that shareholders will provide a further equity injection, rather than Ofgem adjusting the cost of capital to ensure that financeability tests are met at 60%, the headline level of gearing Ofgem has maintained from the sector specific methodology consultation in March 2018, and indeed from RIIO-1 for NGET.

### **→ FQ8. Do you agree with our interpretation of cross-checks?**

As regards the so-called "cross-checks", none of these provide a robust basis to verify Ofgem's conclusions on the cost of equity. As Ofgem itself recognises, MARs are dominated by investors' long-term expectations well beyond the next price control. Furthermore, transaction prices for privately held shares are affected by a control premium, or even a "winner's curse" in a bidding process,<sup>47</sup> whilst MARs for publicly listed utility companies are volatile and premiums seen over the 2015-2017 period have disappeared.<sup>48</sup>

Another "cross check" deployed by Ofgem are projected rates of return used by investment managers when marketing financial products. Oxera's report for the ENA "Rates of return used by investment managers"<sup>49</sup> explains why TMR forecasts published by investment managers, and forecast assumptions prescribed by the FCA for the purposes of marketing retail financial products, will understate the expected market returns.

Ofgem's main "cross check" appears to be the equity Internal Rate of Return (IRR) for winning bidders in the OFTO competitions. Here Ofgem looks at firstly the decline in expected equity returns from OFTO bidders, and secondly at the current expected level

<sup>46</sup> WPD's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.

<sup>47</sup> UKRN, "Estimating the cost of capital for implementation of price controls by UK Regulators", Appendix J, March 2018.

<sup>48</sup> "RIIO-2 Sector Specific Methodology", Ofgem, December 2018, Finance Annex, Figure 11.

<sup>49</sup> Oxera, "Review of RIIO-2 finance issues: Rates of return used by investment managers", March 2019.

of return. Ofgem calculates that there has been a three-percentage point decline in the cost of equity for these projects from 2011 to 2018.<sup>50</sup>

This decline, however, should not necessarily be taken as evidence of the decline in the cost of equity of markets generally nor energy networks in particular. It can equally be interpreted as investors becoming comfortable in their understanding of the mechanics and risks of OFTO investments. Given the structural differences in the ED, GD and T companies compared with OFTOs, along with the different legacy nature of the businesses, this is not a like for like comparison.

Ofgem calculates that the latest 2017-20 OFTO projects (only three) appear to be yielding an average post-tax nominal equity IRR of 7.0%, and concludes this supports Ofgem's CAPM range of 6-7% post tax nominal cost of equity (i.e. 3-4% RPI real). The first point to make is that 7.0% is nevertheless above Ofgem's proposed mid point for Step 1 cost of equity of 6.44% (nominal).<sup>51</sup> Furthermore, when we look at the average discount rates used by OFTO-investing infrastructure funds to value their infrastructure investments we see that 7.0% is the low end of a range extending up to 7.9% or, in the case of 3i Infrastructure, up to 10.2%.<sup>65</sup> However, even this low end is of questionable relevance. In the case of BBGI SICAV Ofgem's quoted discount figure of 7.2% is the low end of a range from 7.2-9.5% with a weighted average of 7.45%. Ofgem argues that OFTO investments should be relatively low risk within these funds (especially in the case of 3i Infrastructure), but there is no evidence to support this as infrastructure itself tends to be regarded as a low risk long-term investment. It follows that these discount rates of 7.2-10.2% support a real RPI post-tax cost of equity of 4.0-6.9%, compared to Ofgem's range of 3-4%.

More fundamentally, WPD questions the legitimacy of these funds as benchmarks of equity risk in energy networks more generally. As Ofgem itself recognises, all the infrastructure funds listed are closed end funds. Closed end funds have a limited investment horizon that will typically be shorter than the generality of investors in energy networks. Current interest rate yield curves show an expectation that rates will rise reaching a peak in 15-20 years. It is to be expected, therefore, that these closed end funds will use a lower discount rate than would be appropriate to investors in the generality of energy networks.

In any case, financeability is the most reliable cost of equity cross-check that Ofgem has at its disposal. This metric should take centre stage in verifying the CAPM estimate, or at least determining where in the wide range of CAPM possibilities Ofgem's determined cost of equity should lie.<sup>52</sup>

### **Step-3 allowed return on equity consultation questions**

**→ FQ9. What is your view on the overall in-the-round assessment of allowed returns to equity? Is our judgement of 3.95% at 60% notional gearing reflective of the combined analysis through Steps 1, 2, and 3?**

Please refer to sections 5 and 6 of the annex to our cover letter.

<sup>50</sup> "RIIO-2 Sector Specific Methodology", Ofgem, December 2018, Finance Annex, Figure 14.

<sup>51</sup> Finance Annex, Table 24.

<sup>52</sup> WPD's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019

The arbitrary 0.25% AR/ER adjustment is inappropriate – see FQ10. In relation to the base cost of equity there needs to be recognition that we are seeing the greatest change in the energy sector for a generation. As this change is dynamic, the level of risk also increases. The level of investment required to achieve the Government aims will also increase and the combination of both increases needs to be recognised within the allowed return on equity.

**→ FQ10. What is your view on the expected outperformance estimate of 0.25% at 60% notional gearing? Do you recommend alternative analysis techniques or do you have suggested improvements to the analytical files published alongside this consultation?**

Please refer to sections 5 and 6 of the annex to our cover letter.

Ofgem is the only UK regulator to adjust the Allowed Return (AR) on equity down by 25 basis points below the Expected Return (ER) by arguing that there is a systematic expectation by investors that they will be able to outperform the allowed cost of equity by this margin. We maintain that any adjustment from the ER to the AR is invalid in a well-designed price control determination. Moreover, in any incentive-based regime, the ability to achieve higher returns are required to reward efficiency, innovation and the delivery of outputs, with more demanding targets consequently being set in subsequent price controls.

It is also not at all clear how the ER/AR adjustment should be calibrated. Making an arbitrary adjustment based on possible outperformance in previous regulatory periods is inappropriate since RIIO-2 will make changes to the regulatory regime in a way that will affect expectations.<sup>53</sup>

**→ FQ11. What is your view on an ex-post adjustment for baseline equity returns? Is there an alternative mechanism or implementation approach that you think could better meet our stated objectives? Do you have specific views on averaging, pooling or suggested simplifications?**

We note that Ofgem's proposed ex-post top up, if 0.25% outperformance (at 60% gearing) doesn't materialise, will be implemented on a sector basis, using average (not weighted average) returns, excluding debt performance, tax performance and Business Plan Incentive. The outcome of this may then mean that, even if a company or companies do not outperform, but still achieve their targets, if the sector outperforms on average the company will not receive this true up, and the AvE adjustment will still be applied. This further compounds the inequity of this mechanism which, given the differing Totex: RAV ratios of companies during RIIO-2, will affect some companies to a greater extent than others, as previously highlighted in the report. If Ofgem insists on the inclusion of an AvE adjustment, any true up should be on a company specific basis. Further, we would like to understand whether and how Ofgem has included the long term impact of the dampening of incentives to outperform, both as a result of the AvE adjustment and the introduction of RAMs, in its Impact Assessment.

<sup>53</sup> WPD's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.

## Financeability questions

### → FQ12. Do you agree with our approach to assessing financeability?

We remain of the view that Ofgem should fully consider its statutory duty to ensure the financing of licensees.<sup>54</sup> Ofgem appears to regard a financeability test as a trigger for action by shareholders, rather than a critical cross check of whether the expected cost of equity is sufficient.

In the short term, financeability risks are masked by Ofgem's decision to move from RPI to CPIH indexation of the regulatory asset value (RAV), since this will increase current revenues and reduce future revenues. However, this move is a one-off cash flow benefit that will dwindle over time with lower RAV growth. The underlying issue is that in the long-term a 3.7% (ET) and 3.95% (GT and GD) CPIH real cost of equity may challenge companies' current investment grade credit ratings.

### → FQ13. Do you agree with our approach to determining notional gearing for each notional company?

We do not consider it appropriate that, when the outcome of Ofgem's financeability tests show insufficient headroom, there is an expectation that shareholders will provide a further equity injection, rather than Ofgem adjusting the cost of capital to ensure that financeability tests are met at 60%, the headline level of gearing Ofgem has maintained from the sector specific methodology consultation in March 2018, and indeed from RIIO-1 for NGET.

### → FQ14. Do you have any evidence that would suggest we should consider adjusting our notional company financing assumptions due to the impact of COVID-19?

WPD sets out above the potential of the ratings of companies within the iBoxx utilities index to diverge from the rating of the notional company used in Ofgem's financeability assessment for RIIO-2 over time. This is particularly likely if there is a 'flight to quality' in times of economic uncertainty, with the index then no longer representing the embedded cost of debt of RIIO-2 companies. It is essential that Ofgem acknowledges this and ensures there is sufficient headroom in any financeability assessment.

## Corporation tax questions

### → FQ15. Do you agree with our proposal to pursue Option A?

Yes.

### → FQ16. Do you agree with our proposals to roll forward capital allowance balances and to make allocation and allowance rates Variable Values in the RIIO-2 PCFM?

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<sup>54</sup> WPD's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.

Yes.

**→ FQ17. Do you agree with the proposed additional protections? In particular:**

The provision of a tax reconciliation would be a significant and time consuming task, with a substantial amount of reconciling items. Given that the CT600 is not required to be filed with HMRC until 12 months after the period end, we agree that any reconciliation would be provided in the year following the end of the regulatory year it relates to. WPD also considers that the RFPR commentary document may not be the appropriate place for discussion of reconciling items – this could be an extremely detailed and technical analysis. Further, if any reconciliation is to be introduced, WPD would value the opportunity to contribute to development of the format for this reconciliation; note that we have already provided an example to Ofgem to aid this process. Any template should be very clearly specified with detailed instructions.

**→ FQ17. a) do you have any views on a materiality threshold for the tax reconciliation? Do you think that the "deadband" used in RIIO-1 is an appropriate threshold to use?**

Given that the impact of type A tax trigger events now flows directly through to revenues, it is now less likely that there will be trigger events and tax trigger deadband will be activated. In light of this, and the fact that any tax reconciliation involves inputs from multiple sources and price bases (e.g. revenue return (nominal prices uplifted with RPI and RPIF), CT600 (nominal prices), PCFM (12/13 prices)) and which may be stated to varying decimal places, it would therefore seem logical for materiality thresholds, including that for the tax review, to be aligned across the price control, at 1% of base revenue.

**→ FQ17. b) Do you have any views on our proposals to retain the Tax Trigger and Tax Clawback mechanisms from RIIO-1?**

We understand that the Tax Trigger deadband will now only operate for type B items and we welcome this simplification. In addition we agree that, where Ofgem is reducing notional gearing levels in RIIO-2, it is important that Ofgem should allow some headroom by gradually reducing notional gearing levels for the purposes of the tax clawback calculation.

**→ FQ17. c) Do you have any views on the proposed process for the Tax Review?**

We underline Ofgem's statement there will be legitimate and significant differences between notional and actual tax costs and the existence of these alone should not prompt Ofgem to trigger a review.

**→ FQ17. d) Do you have any views on the proposed board assurance statement?**

We do not object in principle to the provision of a board assurance letter, although we question whether it is required given that any submissions to Ofgem will already have been through the Data Assurance process. If Ofgem requires any assurance over tax information provided, we propose a return to the submission to Ofgem of a copy of the Senior Accounting Officer certifications provided to HMRC, as previously provided alongside the RRP submissions, plus submission of NWOs' published tax strategy documents.

### **Return adjustment mechanism questions**

#### **→ FQ18. Do you agree with our proposal to introduce a symmetrical RAMs mechanism as described above?**

As WPD has previously stated, we consider that any RAMs mechanism will reduce incentives for the sector to outperform.<sup>55</sup> Further, we would like to understand whether and how Ofgem has included the long term impact of the dampening of incentives to outperform, both as a result of the AvE adjustment and the introduction of RAMs, in its Impact Assessment. However, if Ofgem insists on introducing a RAM, we agree this should be symmetrical and company specific, and welcome the simplification from earlier iterations.

#### **→ FQ19. Do you agree with our proposal to introduce a single threshold level of 300 basis points either side of the baseline allowed return on equity?**

Any potential threshold needs to be set at a fair level, and needs to be reflective of the risk and therefore the appropriate level of return. If the return on equity is correctly calibrated and the recognition of incentives appropriately targeted then the basis should become self-regulating.

A greater understanding of how the 300 bps has been calculated may enable a more specific conclusion as to its appropriateness, without this its use and scale cannot be fully assessed. It is questionable how such a threshold should apply across all companies, across all sectors given the range of proposals submitted by companies on behalf of their customers.

#### **→ FQ20. Do you have any other comments on our proposals for RAMs in RIIO-2?**

As per WPD's response to Ofgem's RIIO-2 Sector Specific Methodology consultation in March 2019, we still consider that RAMs will dull incentives. This is because they penalise the combined impact of improved efficiency, innovation, and output performance on companies' returns.

We remain surprised that Ofgem is proposing to introduce RAMs at this time. In RIIO-1 much of the perceived over-performance in respect to underspend is associated with RPEs, which is not evident in the electricity distribution sector. Ofgem indicates that

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<sup>55</sup> WPD's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.



RIIO-2 will introduce indexation of these effects and thus will largely remove this source of forecasting error. Furthermore, in the electricity distribution sector much of the current underspend appears to be simply a delay in spend on the part of UKPN. This further reduces any potential case for any form of RAMs.

As Ofgem is choosing to introduce RAMs, companies should be rewarded for absolute (Class 1) and not relative (Class 2) performance. An absolute incentive target allows companies to make investments based on more certainty as to the likely returns. Investors are ultimately interested in absolute return, or relative return compared to the total investment market in which they could potentially invest. They are not primarily interested in relative return compared to peers within a part of the UK energy network sector. The lack of such certainty on absolute returns may easily undermine the investment case by increasing risk, and also raising the underlying cost of equity in these networks.

**→ FQ21. Do you agree with our proposal to implement CPIH inflation?**

We have two concerns with this immediate switch. Firstly, Ofgem has not provided any assurance in its proposals that this switch will indeed be NPV-neutral with respect to true-ups between RPI and CPIH forecasts and indexation.

Secondly, the cash flow benefit from a notionally higher CPIH WACC compared to an RPI WACC provides only a short to medium term easing of financing constraints that will dwindle over time with lower RAV growth – providing even less cash to service debt in the long term. The underlying issue is that in the long-term a 3.7% (ET) and 3.95% (GT and GD) CPIH real cost of equity could challenge companies' current credit ratings.<sup>56</sup>

**→ FQ22. Do you agree with our proposals, including the policy alignment for GT and GD, and to recover backlog depreciation for GT RAV additions (2002 to 2021) over 20 years from the start of RIIO-2?**

No comment.

**→ FQ23. Do you agree with our proposed assumptions for capitalisation rates?**

We agree that capitalisation rates should, where possible, reflect accounting distinctions. However, flexibility around capitalisation rates may be one option to improve financeability. Further, WPD considers that all Totex capitalisation rates should be set ex-ante. Any ex-post adjustment would add considerable complexity and uncertainty to the RIIO-2 settlement; companies would not be able to have a view of performance during the price control and any ex-post true up would result in confusing restatements of values – RAV, RoRE etc. at the end of RIIO-2 – this does not seem acceptable for stakeholders or from a rating perspective. Further, any discussions around RIIO-3 would not have a full picture of performance until any ex-post adjustment was finalised.

**→ FQ24. For one or more of the aggregations of totex we display in Table 40, should we update rates ex-post to reflect reported outturn proportions for capex and opex?**

<sup>56</sup> WPD's Response to Ofgem's RIIO-2 Sector Specific Methodology Consultation Western Power Distribution; 14th March 2019.

We urge Ofgem to set Totex capitalisation rates ex-ante. Any ex-post adjustment would add considerable complexity and uncertainty to the RIIO-2 settlement; companies would not be able to have a view of performance during the price control and any ex-post true up would result in confusing restatements of values – RAV, RoRE etc. at the end of RIIO-2 – this does not seem acceptable for stakeholders or from a rating perspective. Further, any discussions around RIIO-3 would not have a full picture of performance until any ex-post adjustment was finalised.

### **RAV opening balance questions**

→ **FQ25. Do you agree with our proposal to use the closing RIIO-1 RAV balances as opening balances for RIIO-2?**

Yes.

→ **FQ26. Do you agree with our proposal to use estimated opening RIIO-2 balances until we have finalised the closing RIIO-1 RAV balances?**

Yes.

### **RIIO-1 close-out questions**

→ **FQ27. Do you agree with the three categories of adjustments outlined below?**

Yes, although it is unclear whether all ED1 legacy adjustments will be captured by these three categories as methodologies/updates have not yet been fully consulted on (e.g. Street works logging up mechanism; changes to Smart Meter methodologies in light of the extended time frame).

→ **FQ28. Do you agree with our approach in using estimated values for closeout adjustments until we are able to close out the RIIO-1 price controls?**

Yes.

### **Disposal of assets questions**

→ **FQ29. Do you agree that proceeds from the disposal of assets during RIIO-2 should be netted-off against totex from the year in which the proceeds occur?**

Yes - this is already the case for ED1.

→ **FQ30. Do you agree that we should carry out a review where an asset is transferred to a holding company and then subsequently sold to a third party?**

No comment.

### **Time value of money questions**

→ **FQ31. Do you agree with our proposal to apply one interest rate to revisions to PCFM inputs and charging errors, based on a short-term cost of debt?**

No - this is a shift from an accepted regulatory approach that has existed for some time.

→ **FQ32. Do you agree with the margin-based approach, and the methodology used to calculate a margin of 110bps?**

No - this approach adds additional complexity and reliance on a further external variable.

→ **FQ33. Do you have any reason why the marginal cost of capital for revisions to PCFM inputs and charging errors should remain distinct from each other, or why WACC may remain a more appropriate time value of money for a particular subset of prior year adjustments?**

WACC continues to remain the appropriate uplift to compensate licensees where there has been a delay in revenues. Ofgem's proposal is an unsignalled departure from established regulatory practice. The use of the WACC ensures neutrality for companies between receiving revenues in one time period or another. If WACC is deemed to be a company's cost of capital, it follows that companies should be compensated for any delay in revenue being received at the WACC. Further, it is a mis-characterisation to describe the difference between allowed and recovered revenues as a charging error; differences may arise for various reasons, for example the £5 rebate several years ago, or from differences between forecast and actual outturn demand.

### **Revenue forecasting questions**

→ **FQ34. Do you agree with our proposal to include forecasts for most PCFM variable values for the purposes of the AIP?**

WPD does not object to the introduction of the inclusion of forecast values in the PCFM in principle. However, we have concerns that this approach will increase complexity and will take a significant amount of time and effort to achieve and to ensure correct operation. Given the relatively late stage Ofgem is at in the RIIO-G2 and T2 process, we

question whether this is achievable in time to be introduced for RIIO-2, and the correct area of focus for Ofgem in the coming months. We also agree in principle that companies could provide forecast values, however it is important that these are provided on a reasonable endeavours, rather than a best endeavours, basis.

**→ FQ35. Considering re-openers as set out in these Draft Determinations, do you agree with our proposal to exclude them from any forecasting? If not, please submit specific examples or analysis of the potential materiality of actual spend versus initial allowances.**

It would seem appropriate to exclude reopeners until the outcome is directed by Ofgem. However, this would rely upon licensees receiving appropriate Time Value of Money uplifts on revenues once directed to reflect delays in receiving revenue streams.

**→ FQ36. Do you agree that additional reporting on executive pay/remuneration and dividend policies will help to improve the legitimacy and transparency of a company's performance under the price control?**

WPD does not support additional narrative around executive remuneration. A requirement to disclose personal data/information for publication is not one that Ofgem can impose and also conflicts with requirements in respect of good corporate governance and the disclosure of directors' remuneration set by Parliament, the FCA and any exchange on which a company's securities are listed.

Information is already provided in the Statutory Financial Statements, for those companies which are required to disclose such information, where it is subject to external audit and presented in a common way across the UK. Any information provided to Ofgem would not be subject to the same reporting standards. Note that some licensees are not currently required to report such information in their Statutory Financial Statements. Further, as a principle, Ofgem should not aim to micro-manage all cost sub-categories as it is for the DNO to determine how to meet its obligations as efficiently as possible within the envelope of its allowed costs. Similarly, information on forecast dividends is commercially sensitive and is not currently a requirement set by either the Statutory Financial Statements or the Regulatory Accounts, as previously required by Ofgem.

## **Base Revenue definition and ODI cap/collar questions**

**→ FQ37. Do you agree with the proposed definition of Base Revenue?**

For consistency with RIIO-ED1, it would seem more appropriate to keep tax allowance within the Base Revenue definition; this is a key part of the price control package and does not depend upon or vary significantly with, targets being achieved; i.e. it is a base component. Further, for ED the underlying pass through amounts are already included in Base Revenue in ED1 and it is only any true-up amounts to this which are outside it. The Draft Determinations document states that Core DARTs will comprise Pension Deficit amounts; for clarity this should be Pension Deficit Repair Allowance amounts. Further, it is unclear where any Revenue Profiling adjustments, currently within ED1 Base Revenue, would be included. We agree that Legacy amounts may be better outside

the Base Revenue definition as these may vary depending upon performance (i.e. not a base component).

**→ FQ38. Do you agree with the proposal to fix the values used for ODI caps and collars at final determinations?**

In a well calibrated price control the need for caps and collars should be limited, primarily around new initiatives where the outcome is very unclear. Where caps and collars are deemed as required it is appropriate to fix ODI caps and collars on an ex-ante basis to avoid complexity and ensure clarity around the parameters.

## **Electricity System Operator Questions**

**→ ESOQ1. Do you agree with our proposal to incorporate EMR into the ESO's wider outputs incentives scheme?**

No comment.

**→ ESOQ2. Do you agree that it is appropriate to maintain the ring-fence between the EMR DB and ESO in its current form?**

No comment.

**→ ESOQ3. Do you agree we should regulate system restoration costs in a consistent manner to other external balancing costs?**

Yes. Consistent treatment of all balancing and operational services is important.

**→ ESOQ4. Do you agree with our approach to setting up-front performance expectations?**

Yes. Being clear on what are baseline expectations and what exceed these is important if the ESO are to be able to justify the work to exceed the baseline.

**→ ESOQ5. Do you agree that a financial reward or penalty should be determined every two-years, to align with the period over which we set expectations, costs and outputs?**

Yes. It will match with the commitments made in the ESO business plan.

**→ ESOQ6. Do you agree with our proposed approach to within-scheme feedback, including the timings and approach to performance panel sessions?**

Yes. Allows timely feedback to ESO to allow for improvements to be made.

→ **ESOQ7. Do you agree with our proposed evaluation criteria for RIIO-2?**

Yes. A more structured approach to the evaluation criteria will allow the ESO to link their investment to reward under the incentive.

→ **ESOQ8. Do you agree with our proposals on the incentive scheme value?**

Yes. Agree with the proposals and the need for a greater upside incentive to drive performance and stretching ambition.

**Outputs consultation questions**

→ **ESOQ9. Do you think that our proposals will capture the full scope of minimum obligations/standards associated with the ESO's Business Plan activities?**

Yes.

→ **ESOQ10. Do you agree with our proposed changes to the ESO Roles Framework guidance?**

Yes. The proposed changes provide a better separation of activities.

→ **ESOQ11. Do you agree with our grading of the ESO's RIIO-2 aims and Delivery Schedule for 2021-23?**

In general, yes, although given the speed that developments are taking place being very specific is a challenge for the ESO.

→ **ESOQ12. What are the priorities for the ESO to achieve by March 2023 to exceed your expectations?**

Closer working with DSOs on integration of markets and products to ensure that flexible resources available to the ESO are accessible by DSOs and vice versa.

→ **ESOQ13. Do you agree that these are the right performance metrics to assess ESO's performance?**

Yes.

→ **ESOQ14. Do you agree that these benchmarks are sufficiently challenging?**

Yes.



→ **ESOQ15. Do you have any comments on the revised methodologies we have proposed (in Appendix 3) for assessing ESO's performance on balancing costs and forecasting?**

No.

→ **ESOQ16. Do you agree with our proposals for measuring stakeholder satisfaction?**

Overall, WPD welcomes the introduction of satisfaction surveys for stakeholders, to enable a robust, quantifiable comparison between companies. It is sensible to base targets on the average of revealed performance. The application model established with ED for the survey components of the Broad Measure of Customer Satisfaction would be a good model to adopt. However the selection of a starting point target of 7.5/10 raises concerns about the conversely extremely high targets set for customer satisfaction in the gas sector. While the sectors differ the principle and approach to satisfaction measurement should be the same. It is therefore difficult to align the fact that satisfaction in the GD sector, that would dramatically outstrip the upper satisfaction target for ESO (therefore representing a view of what 'good' looks like), can result in significant fines. In both sectors we are supportive that rewards should only be achieved by companies delivering frontier, stretching performance. However the concern is that companies should not be fined for performance that is so far above the top performers across all UK plc, as revealed by results from the Institute of Customer Service. For example, it is difficult to reconcile that ESO can be set a target to achieve of 7.5/10, whilst gas companies will face fines for satisfaction scores that fall below 9.37 for unplanned interruptions.

In addition, it is vital that companies are incentivised to pursue innovation and ambition in the way we engage and respond to the needs of stakeholders. The current SECV incentive within ED has successfully achieved this leading to a wide range of positive outcomes for stakeholders and consumers that would not otherwise have been achieved. To solely focus on measuring satisfaction risks failing to encourage the ESO to focus on new service types and ambitious outcomes, instead focussing only on those areas captured by the survey scope.

→ **ESOQ17. Do you agree with proposed approach to tracking plan benefits?**

Yes, the regularly reported evidence appears appropriate to track delivery of the Business Plans aims and ambitions.

→ **ESOQ18. Do you agree with our suggested areas for regularly reported evidence?**

Yes.

## **Costs consultation questions**

→ **ESOQ19. Do you agree with our overall approach to cost regulation for the ESO?**

Yes, it is appropriate for the ESO.

→ **ESOQ20-30.**

No comment.

→ **ESOQ31. Do you agree that ESO's NIA funding should be subject to the condition that all projects must involve partnership with other network companies, third party innovators and/or academics?**

No. We would imagine that some innovation funding may be appropriate for exclusively internal projects within the ESO. However the overall spend for their NIA programme should be predominantly with partners. WPD would also expect that ESO would not lead projects which predominantly involve DER assets on a DNO system. Such projects should be led by the relevant DNO with ESO as a partner.

**Uncertainty consultation questions**

→ **ESOQ32. Do you believe our price control design is sufficiently flexible to account for uncertainty? Are there any relevant foreseeable future uncertainties which we have not identified here?**

Yes the price control design is sufficiently flexible for uncertainty.

→ **ESOQ33. Do you have any views on whether we should introduce a different funding approach or uncertainty mechanism to account for the risk of material changes to the ESO's revenue collection role? Do you have any views on how this should be designed?**

No comment.

**Other areas consultation questions**

→ **ESOQ34. Do you agree with our assessment that the current approach, with the ESO's IT provided by National Grid Group is not appropriate for the future? Have we identified the correct concerns with the current model?**

No comment.

→ **ESOQ35. Do you agree that the ESO needs full control of its IT provision? Are there other options that you think are preferable?**

Given the central position of the ESO it is important that the ESO has control over the delivery of IT projects.

→ **ESOQ36. Do you have a view on the proposed timing of implementing IT autonomy?**

No comment.

→ **ESOQ37. Do you agree with our position that the ESO should recover its internal costs based on actual spend within year? Do you believe this change would create any new information/forecasting needs to allow industry to anticipate and manage this?**

No comment.

→ **ESOQ38. Do you have views on whether the NIA and other ESO pass-through items should be recovered via TNUOS or BSUOS?**

BSUOS seems a more appropriate mechanism for the ESO.

→ **ESOQ39. Where or how can the ESO's existing reporting requirements be streamlined?**

No comment.

→ **ESOQ40. Do the proposed timings for the BP2 process provide sufficient time for the ESO to develop and refine a robust plan, stakeholders to contribute to this and Ofgem to undertake the necessary assessment and decision making?**

No comment.

### **3. Electricity Transmission Questions**

→ **ETQ1-8.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

→ **ETQ9. Do you have any views on our overall approach to setting totex allowances?**

At a high level, WPD agree with the overall approach to setting totex allowances which provides balance between costs and activities that are common amongst the three networks and bespoke assessment for costs and activities that are more unique to each respective network.

However, based on the current Draft Determinations we have concerns about how much totex could be subject to the proposed uncertainty mechanisms. The scale of the Ums could hinder the ability of network companies to plan and adequately resource for the longer term leading to higher costs overall.

Care should be taken as to the relevance of the past in informing an assessment of future costs. Where Ofgem have sought to benchmark costs, WPD would question whether a sample of three networks is sufficient to provide a meaningful benchmark.

→ **ETQ10-13.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

#### **4. NGET Questions**

→ **Q1-5.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

→ **Q6. Do you agree with our proposed approach to facilitating NGET's transition to an EV fleet?**

Yes. If Ofgem considers the industry as leading the way and setting a good example in the transition to EVs, it is vital that this is supported through the price control.

→ **Q7-20.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

#### **5. SPT Questions**

→ **SPTQ1-18.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

## 6. SHET Questions

### → Q1-4.

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

## 7. Gas Transmission Questions

### → Q1-3.

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

## 8. NGGT Questions

### → NGGTQ1-39.

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

## 9. Gas Distribution Sector Questions

### → GDQ1. Do you have any views on our common outputs that haven't been covered through any of the specific consultation questions set out elsewhere in this chapter? If so, please set them out, making clear which output you are referring to.

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

### → GDQ2. What are your views on the reporting metrics we have proposed for the consumer vulnerability ODI-R?

WPD is supportive of the inclusion of an incentive in this area. However, given that there is currently a wide range in the performance of network companies and disparity in the ways outcomes/targets are delivered against, it is important that Ofgem continues to drive high levels of ambition and innovation. The metrics mentioned and the nature of a reputational only incentive risk limiting the scope of ambition to minimum performance levels, unlike frontier ambition and performance that is driven by

a financial incentive (as has been demonstrated by the top performers in the SECV incentive in RIIO-ED1).

Rather than an annual showcase event, we feel Ofgem should require GDNs to submit overviews of their work, with a process to be defined by Ofgem to assess performance (we would recommend an external, expert judging panel as is used in the SECV incentive). This would ensure best practice is recognised and rewarded, and ensures the best outcomes are achieved and rewarded, not just any outcomes.

WPD strongly advocate the need for incentives to be financial, not just reputational in this area. The current incentive model for stakeholder engagement in GD and ED demonstrates that this is a highly successful way to incentivise improved performance. Ofgem's own feedback at this annual incentive scheme continues to highlight that there has been a significant step-change in the approach of companies in this area as a result of the financial incentive structure. Ofgem's assessment of companies, and associated rewards achieved, has helped to drive up standards in an area where outcomes and benefits for customers can be largely qualitative. However, there remains some way to go and there is currently a significant disparity in the different performance levels of companies in relation to addressing consumer vulnerability. Citizens Advice Scotland's recent policy paper 'Pylons, Pipes and People: Energy networks in Scotland and their changing role with consumers' concluded that the gap in service provision for vulnerable customers is dramatically different depending on where you live in the country. It is difficult to see how an annual showcase event as part of a reputational incentive will address this 'post code lottery' in any way. The introduction of a financial incentive would help to tackle the considerable differences in effort made by companies and the quality of outcomes achieved. A reputational incentive alone is unlikely to drive this same rate of improvement, given that there will be limited consequences for companies that fail to aim for the most ambitious innovation and maximum value outputs.

**→ GDQ3. What are your views on the design of the annual showcase events, including whether they should be held at a national or regional level?**

National level events on a rotating host basis (much like the model used for the LCNF conferences in ED) would be a preferred model. However, as per the answer to GDQ1 above, we are concerned that an annual showcase event will not drive the correct behaviours and levels of ambition and innovation needed to drive the best possible outcomes for customers.

**→ GDQ4. Do you agree with our position to change the FPNES from a PCD to a capped volume driver?**

Yes.

**→ GDQ5-25.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

**Approach to Cost Assessment Consultation Questions**



→ **GDQ26. Do you agree with our proposal of using a top-down regression model?**

Whilst WPD do not wish to comment on the cost drivers used to inform the top-down regression model as these are GD specific, we raise the following concerns:

WPD disagrees with the use of a top-down model as the main and only method of assessing 84% of GD costs.

Top-down models provide a very limited line of sight between the sources of efficiency and inefficiency, be that to Ofgem, network companies, stakeholders and customers. As an information tool it is therefore limited and may restrict future planning, monitoring and understanding by all parties which may detriment the actual delivery of future efficiency gains. Whilst a top-down model can inform a view of overall efficiency, it neither tells Ofgem or network companies where the sources of inefficiency and efficiency are, or how the former might help drive long term improvement for subsequent controls / allowance setting (i.e. it provides no information on where or how big the efficiency gap is in respective areas).

Sole reliance on a top-down model may breed long term inefficiency, as Ofgem will be limited in future price controls to assess efficiency movements at an activity level over a sufficient a length of time for it to be informative.

Ofgem have chosen to assess 84% of costs using a single method. WPD is not convinced that this is optimal. Under a toolkit approach, if more than one tool can be used to assess costs and create a triangulated view, this will be more robust than reliance on a single method. Whilst Ofgem have set out that they have used this toolkit approach by running a series of disaggregate models, Ofgem decide only to use a top-down model to inform draft allowances on the basis that the disaggregated models generated similar results. It is not clear why Ofgem have disregarded the disaggregate models instead of the alternatives of combining the results of both model sets (aggregate and disaggregate), or simply using the disaggregate models to inform allowances. In summary, Ofgem use a single method of assessment which is not aligned to the principles of triangulation or improving credibility, robustness and transparency through a multi-method approach.

Whilst Ofgem seek to justify that the proposed top-down model presents the best of both worlds, top down and bottom-up, the CSV driver whilst informed by identified disaggregate costs drivers, does not enable interpretation or understanding of the causal relationship between any one of the disaggregate drivers on costs (e.g. it is not possible to understand the impact of a 1% change in cost driver x will have on totex, i.e. the elasticity, due to bundled inclusion in a CSV). WPD raised this concern in our response to the Tools for Cost Assessment Consultation, in answer to question 5 (p. 6).

Whilst Ofgem set out in para 3.60 (Draft Determination Gas Distribution, p. 95) that some of the disaggregate models "*were not proven to be statistically robust*", Ofgem need to consider both sides of the coin: that is that at a disaggregate level some of the totex drivers are insignificant, whilst at totex level some of the disaggregate drivers become insignificant<sup>57</sup>. Use of a single model formed from a bottom-up CSV might overlook the latter point and as such having a balance of both a top-down and bottom-up method, appropriately weighted, may present the best of both worlds.

<sup>57</sup> See also WPD's response to the RIIO-2 Tools for Cost Assessment Consultation (August 2019), Question 5, p.5

Colloquially speaking it is not clear why Ofgem has 'chosen to put all their eggs in one basket', especially when that basket is mis-specified. This top-down approach places considerable weight on the robustness of Ofgem's econometric models. However, we are concerned that several issues make the results potentially unreliable. The dataset used contains only 104 observations, based on a mixture of actual and business plan forecasts, for the eight GDNs. With such few datapoints, the estimates of the parameters in the models are likely to be imprecise, but more importantly the limited sample size - particularly only eight GDNs - calls into question the robustness of the results on individual company efficiency. After reviewing econometric modelling of comparative efficiency between GD companies we several detailed and technical questions and critiques around Ofgem's approach. There would be benefit in carrying out an independent review of the statistical robustness of the model estimation; how reliable are the estimations of the individual company efficiencies implied by the chosen model? Broadly there will be four areas of interest: (i) Adjustments made to the "raw" totex data (e.g. exclusions, adjustments for factor costs); (ii) Construction of the econometric dataset (e.g. the CSV – Composite Scale Variable cost driver); (iii) The econometric estimation techniques used (e.g. Ordinary Least Squares regression vs. more advanced techniques such as Stochastic Frontier regressions); and (iv).

Robustness of the model specification – are there alternative plausible specifications that may give different results? The GD2 SBSG Annex sets out that the current proposed model fails the RESET test<sup>58</sup> (Table 3, p. 15). The findings are likely to imply omitted variables and / or incorrect functional form in the model, which is not an acceptable result. A correct functional form in respect of the CSV variable is absolutely critical in order to estimate unbiased relative efficiency, otherwise either larger or smaller than average companies would be either penalised or rewarded. Triangulating findings from more than one assessment approach helps to mitigate the measurement and modelling errors of any one of the constituent approaches. WPD recommends not only that the top-down model be reconsidered (see response to Question 27) but also that it be combined with disaggregate modelling, appropriately weighted.

Top down models do not make use of all the available information. Ofgem cites (Draft Determination, p. 86, para. 325) the "*extensive data collation undertaken via BPDTs submissions*" which is not made use of. In the ED2 CAWG and ED2 BPDT sub-group of the CAWG, WPD have communicated the need for data collation in the ED2 BPDT's to be proportionate and reflect the required level of information Ofgem need to make the price control assessment. Whilst the use of a single top-down model in the draft determination of GD2 should not preclude the nature of assessment in ED2, it serves as a timely reminder for ED2 planning for a proportionate and needs-based approach to data collation. Furthermore and as set out in our response to Question GDQ41 of this consultation, top-down models do not readily support line of sight between modelled allowances and what DNOs are actually expected to deliver and at what cost.

In addition, WPD raises the following concerns:

1. Ofgem needs to be mindful that an ex-ante cost assessment approach will create inconsistent application of cost assessment throughout the price control. Uncertainty mechanisms (UMs), by considering discrete packages of work activities and costs naturally lend themselves to disaggregate cost assessment. Ofgem are also proposing that a significant proportion of costs in RIIO-GD1 are to be assessed via UMs, which will, by design, have to be assessed on a different, inconsistent, basis to the ex-ante approach.

<sup>58</sup> The RESET (REgression Specification Error Test) is designed to detect omitted variables and incorrect functional form.

Furthermore, where some costs are to be assessed both at ex-ante and via a UM, Ofgem will not be able to cross-check the assessment of efficient costs due to different methods.

2. Top down models can tend to associate inefficiency with underspend, which can be at the cost of service quality, performance and non-delivery. The absence of disaggregated models to balance the incentive framework and ensure delivery at an activity level may make the balance of trade-offs of underspend more appealing to network companies.

It is not clear how Ofgem have arrived at the top-down model, for example in terms of the process of considering a range of alternatives and selecting the most appropriate model or models based upon a prior agreed upon criteria. Ofgem do not appear to follow the 'general to specific' approach to cost driver and model selection as is academic and regulatory best practice. This mirrors our response to the Tools for Cost Assessment Consultation (Q5, p.5).

**→ GDQ27. Do you agree with our proposed approach to benchmarking modelled costs at the 85th percentile?**

WPD disagrees with the proposed approach to benchmarking modelled costs at the 85<sup>th</sup> percentile.

Ofgem cite that they have "delivered improved comparability across GDNs"<sup>59</sup> through the use of adjustments and regional factors and that this has presumably given Ofgem greater confidence in their modelling results. However by reviewing the adjustments made by Ofgem<sup>60</sup>, it is not clear how any of these adjustments have improved the modelling upon which the benchmark is derived, such that a higher benchmark is justified compared to the same comparable adjustments at RIIO-GD1:

- *Exclusions* – Ofgem apply cost exclusions<sup>61</sup> not dissimilar to the RIIO-1 exclusions and therefore cannot be cited as justification for the increased benchmark.
- *Volume related adjustments* – seeks to align other changes made to costs.
- *Reclassifications* – these adjustments have no impact at totex level upon which 84% of costs have been determined on for RIIO-GD2 DD and so reclassifications cannot be the attributable adjust for the increased challenge.
- *Non-regression and technical assessment* – an adjustment for costs that have been separately assessed, so this adjustment cannot be responsible for the increased challenge
- *Regional factors* – Regional factors were used at RIIO-1 and in a comparable approach to RIIO-2. It is not clear therefore how accommodating for regional factors this time round again would substantiate a catch-up efficiency challenge 10 percentage points higher than in the previous control.

Ofgem appears to retrospectively justify a 75<sup>th</sup> percentile benchmark at GD1 due to poor data (para 3.25 of the RIIO-2 Draft Determinations - Gas Distribution Annex)<sup>62</sup>. However, WPD understands that a 75<sup>th</sup> percentile benchmark has applied in regulatory economics and regulatory price controls for a variety of reasons including on the basis

<sup>59</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 87, para. 3.25

<sup>60</sup> Ofgem (July 2020) RIIO-GD2: Step-by-Step Guide to Cost Assessment, p.3, para 1.8

<sup>61</sup> including reclassification of some costs from controllable to non-controllable, capex projects for separate assessment, pass through and costs to be subject to UMs

<sup>62</sup> Ofgem (July 2020), p. 87

of non-perfect regression models with respect to choice and availability of cost drivers<sup>63</sup>, omitted variables, measurement and model specification errors and noise. It is unclear how Ofgem can be certain that any of these factors have less impact in the GD2 model compared to the GD1 models. In proposing an 85<sup>th</sup> percentile benchmark Ofgem is suggesting that they have a better model and have a better executed totex cost driver to explain differences in GDNs operations and costs:

- It is inconsistent with regulatory precedence;
- Ofgem have taken an especially hard-line position to the setting on an 85<sup>th</sup> percentile benchmark given they are relying on a single model to inform draft allowances (see WPD's response to GDQ26).
- With Ofgem's total dependence on top-down econometric models for GD, it is of concern that Ofgem has – without clear justification – selected an 85<sup>th</sup> percentile efficiency benchmark (an increase from the 75<sup>th</sup> percentile previously used in RIIO-GD1 and also used by Ofwat for PR1964).
- The lower the confidence in the robustness of the model (specification and estimation), the lower should be the efficiency percentile to avoid penalising firms that may erroneously appear inefficient due only to model error – particularly error in model functional specification error with respect to the CSV. We have already noted (see WPD's response to GDQ26) that the totex model proposed in the SBSG Annex (Table 3, p. 15) fails the RESET test, a test for model mis-specification
- With only 8 networks, and four companies, the 85<sup>th</sup> percentile will be even more sensitive to an apparent outlying performance by one of the companies caused only by data or model specification issues and not representative of achievable efficiency across all companies.
- In fact, there is no theoretical underpinning for the choice of the 85<sup>th</sup> (or any) percentile in the context of the ordinary least squares ("OLS") estimated regression models used by Ofgem. At best the model residuals only give relative efficiency scores.<sup>65</sup>

Ofgem justify that at GD1, network companies have so far outperformed cost allowances when a 75<sup>th</sup> percentile was set<sup>66</sup>. There is no guarantee however that GDNs can repeat this for the next price control however. Whilst WPD is not in a position to comment on any underspends in gas distribution, WPD makes the following observations:

- It is unlikely that underspends are due to percentile being set at the wrong place
- At ED1 most cost assessment took place at the median<sup>67</sup>. The more stretching 75<sup>th</sup> percentile challenge was placed on costs assessed via regression analysis to reflect network activities where Ofgem had a high number of data observations more data points, whereas unit cost analysis typically drew a median benchmark.

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<sup>63</sup> and proxies in the absence of actual cost drivers

<sup>64</sup> Ofwat, PR19 Final Determinations, December 2019 (updated April 2020), pp.13.

<sup>65</sup> If Ofgem wish to justify actual (as opposed to relative) efficiency scores it would need to rely on a Stochastic Frontier Regression (SFR) using a Maximum Likelihood (ML) estimation, where the model residuals are decomposed into model error and actual inefficiency. These models rely on very restrictive assumptions, but the fact that in this case the OLS, GLS and ML estimates give similar results suggests these assumptions may be valid.

<sup>66</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 87, para. 3.26

<sup>67</sup> Broadly speaking the majority of costs were assessed against a median benchmark (typically where this was assessed via a unit cost or ratio benchmarking approach) with only costs being assessed via regression being subject to a 75<sup>th</sup> percentile challenge

Ofgem justifies the increased catch-up efficiency benchmark based on the observation that its proposed GD2 Draft Determination totex model has a negative coefficient on the historical time trend<sup>68</sup>. The Draft Determination proposed totex model should not be used as justification given the model does not meet the RESET test (see also WPD's response to GDQ26). The RESET test is designed to detect omitted variables and incorrect functional form. Omitted variables and incorrect function form can cause the coefficients on variables in the mis-specified model to be inaccurate, both in sign and magnitude, as a result.

Ofgem, in citing this as evidence, is using the two types of efficiency inconsistently: benchmarking or catch-up efficiency and ongoing efficiency. Econometric regression analysis in application to price controls has typically taken the format of an expenditure assessment which seeks to explain variations in companies' expenditure through variations in observable and controllable cost drivers<sup>69</sup>. The residual variation in companies' expenditure not explained through variation in the cost drivers is, rightly or wrongly, wholly or partially, efficiency as captured by the error term<sup>70</sup>. That is the error term captures the benchmarking or catch-up efficiency. Whilst examination of the coefficient on a time trend variable may provide some insight into unobserved factors which vary with time that can explain variations in expenditure, which may or may not relate to drivers affecting ongoing efficiency (e.g. technology), this is unrelated to the catch-up efficiency error term. Therefore, for Ofgem to cite a negative coefficient on the historical time trend in their model as justification for a harder catch-up efficiency benchmarking challenge is invalid.

Finally, Ofgem appear to justify that an 85<sup>th</sup> percentile benchmark is appropriate as it only imposes an extra 2% cost challenge to those GDNs below the benchmark<sup>71</sup>. However, the combination of 85th percentile for catch-up efficiency combined with a 1.2% capex and a 1.4% opex ongoing efficiency challenge per annum creates an exceptionally challenging draft determination position from Ofgem for all except one or two companies that are setting the benchmark based on Ofgem's draft determination analysis. For example, prior to the application of the ongoing efficiency challenge, setting the benchmark at an 85<sup>th</sup> percentile puts Cadent with a c. 15% catch-up efficiency challenge to the benchmark. Comparison of the submitted totex post pre-modelling adjustments, with the proposed benchmarking efficiency adjustments, implies the following approximation with regard to the cost catch-up efficiency faced by GDNs:

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<sup>68</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 87, para. 3.27

<sup>69</sup> Or appropriate proxies

<sup>70</sup> When an OLS estimation technique is used, as has been for the RIIO-GD2 draft determinations

<sup>71</sup> i.e. those playing catch-up

Figure 1 - Benchmarking efficiency challenge as proportion of submitted totex post pre-modelling adjustments by GDN, £m 18/19 prices

Network company	GDN	Submitted totex post pre-modelling adjustments	Benchmarking efficiency	Benchmarking efficiency as proportion of submitted totex post pre-modelling adjustments
Source		Table 17 and 18, GD DD	Table 18, GD DD	
Cadent	EoE	£1,577	-£195	-12.4%
	Lon	£1,394	-£210	-15.1%
	NW	£1,127	-£78	-6.9%
	WM	£896	-£59	-6.6%
NGN	NGN	£1,080	£61	5.6%
SGN	Sc	£945	£4	0.4%
	So	£1,931	-£53	-2.7%
WWU	WWU	£1,086	-£49	-4.5%
Total		<b>£10,806</b>	<b>£10,806</b>	

**→ GDQ28. Do you agree with our proposed approach to estimating embedded ongoing efficiency and values calculated?**

WPD provides the following comments and observations with respect to the proposed approach to estimating embedded ongoing efficiency and values calculated:

It is not clear from the Gas Distribution Annex<sup>72</sup> whether Ofgem have used modelling inputs provided by GDNs net of or inclusive of efficiency assumptions (catch-up and / or ongoing). Can Ofgem confirm the nature of the cost taken from the GDN BPDTs as used in the cost assessment process (for each of modelled regress costs, modelled non-regressed costs, technical assessment). Clarity is required on this to inform the appropriateness of the approach as noted below.

If the model inputs used are inclusive of efficiency assumptions then all of the cost assessment will not have been done on a like-for-like basis. As Ofgem set out<sup>73</sup>, GDNs have assumed different ongoing efficiency challenges and some have embedded challenge in their costs which vary to the ongoing efficiency challenge respectively communicated (i.e. presumably including a degree of catch-up also).

Based on the above, it is WPD's view that cost assessment should be done post application of any catch-up efficiency but before (net) of any ongoing efficiency. This reflects that the purpose of the cost assessment models, be that modelled regress costs, modelled non-regressed costs or technical assessment is to assess relative catch-up efficiency. It is important then that model inputs include any GDN assumptions on catch-up efficiency as this reflects the respective networks' commitment to improve their relative efficiency performance than would otherwise be the case if the modelling inputs were net of catch-up efficiency assumptions.

<sup>72</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex

<sup>73</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 89, para. 3.35



Ofgem set out their view that *"By selecting a top-down econometric model that uses information from both RIIO-GD1 and RIIO-GD2, we acknowledge that our view of modelled efficient costs and technically assessed costs is likely to have captured a level of embedded ongoing efficiency within it"*<sup>74</sup>. Ofgem are suggesting that the selection of a top down model to assess the *regressed* modelled costs using actual and forecasts costs, will mean that *all costs*<sup>75</sup>, including those assessed by non-regression modelling techniques also capture a level of embedded ongoing efficiency within it. WPD consider that selection of a top-down model in the regressed modelled costs would have no bearing on the level of embedded ongoing efficiency in costs assessed via alternative means, e.g. non-regressed models or technical assessment. WPD does however agree that if cost assessment methods (regression, non-regression, technical assessment) use information from both RIIO-GD1 and RIIO-GD2 this will capture a level of embedded ongoing efficiency within it, however only where the model inputs are inclusive of an ongoing efficiency challenge (see above comment). WPD agree with the second sentence of paragraph 3.33<sup>76</sup>. WPD consider that inclusion of GD2 information in the cost assessment models, only where the nature of the GD2 inputs is inclusive of GDN's respective ongoing efficiency assumptions, will the models capture a level of embedded ongoing efficiency.

With regard to Ofgem's proposed approach to estimating embedded ongoing efficiency. Ofgem set out that they *"propose to estimate the embedded ongoing efficiency in our view of proposed costs using a blended average of the values the GDNs provide in their BPDT"*<sup>77</sup>. Ofgem are therefore proposing to use ongoing efficiency assumptions provided by GDNs to inform an estimate of embedded ongoing efficiency, however Ofgem are not proposed to using ongoing efficiency assumptions provided by GDNs to inform the overall ongoing efficiency assumption (Ofgem set out elsewhere they will use analysis EU KLEMS data in the main part to inform this). This is inconsistent. Why rely on GDN input for part of the analysis but not all? WPD would like to take this opportunity to remind Ofgem that at ED1 Ofgem allowed DNOs own ongoing efficiency assumptions as these broadly aligned with the results of Ofgem's own analysis<sup>78</sup>.

It is not clear from para 3.36 and Table 20 of the Gas Distribution Annex<sup>79</sup> how Ofgem have estimated the embedded ongoing efficiency. Ofgem sets out that the approach *"is based on taking a simple average of ongoing efficiency over the RIIO-GD2 period across GDNs"*, however the results in the average row of Table 20 are of an order of magnitude different to the ongoing efficiency assumptions provided by GDNs as summarised in para 3.35. Can Ofgem please clarify.

Given Ofgem also note in para 3.35 that *"Companies also submitted ongoing efficiencies incorporated or "embedded" in their forecast costs, which in some cases varied from values"* of ongoing efficiency cited elsewhere in the GDNs' submissions, can Ofgem clarify exactly which BPDT values Ofgem have used to create the *"blended average of the values the GDNs"* provided as referred to in para 3.36. Given this observation, WPD are concerned that inputs to the average have not be drawn on a like-for-like basis from companies' submissions.

<sup>74</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p.88, para. 3.33

<sup>75</sup> As modelled costs includes both regressed and non-regressed costs

<sup>76</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 88

<sup>77</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p.89, para. 3.36

<sup>78</sup> Ofgem (November 2014) RIIO-ED1: Final determinations for the slow-track electricity distribution companies; Business plan expenditure assessment p. 158, para 12.49-12.50

<sup>79</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 88

Taking the section on 'Ongoing efficiency adjustment' in totality<sup>80</sup>, it appears to WPD, without explicit statement by Ofgem, that Ofgem have taken GDN cost information inclusive of ongoing efficiency as inputs to the cost assessment models and then in acknowledgement of a degree of embedded ongoing efficiency within in, sought to carve out the shortfall to the ongoing efficiency challenge Ofgem have interpreted from the EU KLEMS (CEPA) analysis. Can Ofgem please confirm.

This seems to overcomplicate the process and creates unnecessary additional steps. As set out above the cost assessment process will not be on a like-for-like basis.

This approach takes a divergence to regulatory precedence; cost assessment models have typically taken cost inputs exclusive of ongoing efficiency assumptions a) because network companies typically forecast different levels in their BPDTs and b) because cost assessment typically holds the economic assumption of being short term, i.e. that one or more factors of production is fixed. I.e. catch-up efficiency is about DNOs realising allocative and productivity efficiencies to achieve the frontier; ongoing efficiency is about how in the long term that frontier moves out due to factors affecting all network companies as a whole (i.e. at a sector or wider level). If so, Ofgem have used cost inputs to the models which include GDN specific assumptions on ongoing efficiency, and yet when Ofgem seek to back-estimate the level of embedded ongoing efficiency in the models this is done on a GDN average basis. This is inconsistent.

This means that for most GDNs, Ofgem's approach either over-estimates or under-estimates the level of embedded ongoing efficiency GDNs have actually put in their cost forecasts, relative to the sector average and therefore will correspondingly also under-estimate or over-estimate respectively, the shortfall (additional challenge) each GDN faces.

It is unclear why is Ofgem comfortable to take GDNs' forecasts (GD2) of ongoing efficiency to apportion out was is already deemed embedded, but not to use GDNs' forecasts of ongoing efficiency outright.

## **Normalisation Consultation Questions**

### **→ GDQ29. Do you agree with our proposed pre-modelling normalisations?**

In paras 3.38 to 3.54 Ofgem sets out its proposed pre-modelling normalisations with respect to:

- 1) Regional factors and company-specific factors
- 2) Other adjustments

Each are considered in turn below:

### **Regional factors and company-specific factors**

WPD notes some positives of Ofgem's approach to regional factors<sup>81</sup>, of making adjustments pre-modelling and then adding them back in, insofar as the regional factor is controlled for prior to the running of regression analysis and is therefore accounted for in the determination of efficient costs (which affects all companies).

<sup>80</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 88-89

<sup>81</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 90, para. 3.39

It is not clear if Ofgem has considered within model adjustment to regional factors, i.e. using a cost driver to capture each regional factor (labour, urbanity, sparsity) separately. This may be a more favourable alternative as it also provides information as to the statistical relationship (through the coefficient) between the regional factor and costs, which cannot be determined from undertaking pre-modelling adjustments. This is important because it can then be understood if the regional factor actually has a statistically significant impact on costs, in much the same way that any other cost driver is tested for statistical significance. It is not clear<sup>82</sup> that Ofgem have actually tested whether the proposed regional factors have a statistically significant impact on totex at GD2, rather this has been taken as de-facto without testing the hypothesis.

WPD's preference in the RIIO-2 Tools for Cost Assessment consultation<sup>83</sup> response was for regional factors to be controlled for via an in-model cost driver, where regression models are specifically discussed. Through already having calculated pre-modelling adjustment, Ofgem should have all the required information to create cost drivers that capture the regional factor.

It is not clear if and how Ofgem have controlled for regional factors in the non-regressed modelled costs or the technical assessment<sup>84</sup>. There is no reason why regional variation in labour, urbanity or sparsity would only affect costs assessed in the regression model. Can Ofgem please clarify.

WPD considers the proposed regional factors of labour, urbanity and sparsity are appropriate for GD, without acknowledging sector specifics. WPD considers these regional factors may also be relevant to ED, however comment, in reference to para. 3.41<sup>85</sup> that:

- Urbanity impacts may affect more than simply reinstatement opex activities
- Sparsity impacts may affect more than simply emergency and repair activities

In the SBSG Annex Ofgem only provided details on calculation of labour and sparsity regional factor. Ofgem do not provide details of how the urbanity regional factor is calculated, however Table 10 does set out Ofgem's results by cost activity area for where an urbanity reinstatement and separately an urbanity productivity regional factors are relevant<sup>86</sup>.

WPD has no comments with regard to company specific factors as these are company and sector specific.

## **Other adjustments**

WPD agrees with the adjustments made to historical costs in order to provide comparability of assessment when using both GD1 and GD2 data to inform the cost assessment. Ofgem need to be mindful also that any adjustments made to costs to enable consistency over time, also needs to be mirrored with corresponding activity / volume adjustments. We request that Ofgem clarifies this.

Mirroring the above, with regard to the adjustments to forecast costs made, Ofgem also needs to be mindful that any forecast costs removed, e.g. because they relate to a bespoke output or for other reasons, that Ofgem may also need to remove the

<sup>82</sup> from the Gas Distribution Annex

<sup>83</sup> WPD (August 2019) response to the RIIO-2 Tools for Cost Assessment Consultation, Q16, p. 8

<sup>84</sup> Based upon WPD's reading of the Gas Distribution Annex

<sup>85</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 90-91

<sup>86</sup> Ofgem (2020) RIIO-GD2: Step-by-Step Guide to Cost Assessment, Table 10, p. 29

corresponding volumes and activities, such that any cost assessment (both for the removed and retained portion) is undertaken on a like-for-like basis.

Ofgem notes that they have removed costs associated with proposed bespoke PCDs.<sup>87</sup> Can Ofgem clarify how these have been cost assessed? Understanding treatment of these costs is especially pertinent given their bespoke nature, which may not lend itself to benchmarking?

WPD considers there may be greater scope for the removal of forecast costs and activities / volumes from the cost assessment approach where it is evident that networks are putting forward levels of service or output commitments that go above and beyond those seen elsewhere in the sector. Doing so will further ensure that cost assessment is done on a like-for-like basis without penalising ambitious, high delivery networks for striving to do more, especially where this is supported by customer research. Ofgem need to give more thought to the alignment of performance in cost assessment and performance in service quality delivery and outputs and the inevitable cost-quality trade-offs that the current non-quality adjustment cost assessment framework incentivises network companies to take.

Again, with regard to the reclassification of costs, Ofgem needs to be mindful that corresponding treatment is also made to volumes / activities such that cost assessment takes place on a like-for-like basis.

WPD make no comment on the loss of meterwork adjustment as this is sector specific.

## Model Selection Consultation Questions

### → GDQ30. Do you agree with the selected aggregation level, estimation technique and time period for our econometric modelling?

WPD provides the following comments with regard to the selected aggregation level, estimation technique and time period with regard to Ofgem's econometric modelling. It should be noted that whilst these comments are provided in relation to the Gas Distribution Sector, they do not preclude WPD's position with regard to ED.

With regard to WPD's view on the selected aggregation level, please see our response to question GDQ26.

WPD is comfortable with the use of an Ordinary Least Squares (OLS) estimation technique, in the acknowledgement that Ofgem have "*checked the robustness of the totex model by estimating it via both RE and SFA*"<sup>88</sup>.

Ofgem sets out the alternative time period samples ran and justify that "*in terms of model fit and estimated coefficient, the performance of the totex model was very similar across the different periods*"<sup>89</sup>. Whilst Ofgem do not provide the results of the alternative models ran in the SBSG Annex, on the basis of the justification provided WPD is broadly comfortable with the time period chosen.

<sup>87</sup> Ofgem (July 2020) RIIIO-2 Draft Determinations - Gas Distribution Annex, p. 103, para. 3.90

<sup>88</sup> Ofgem (2020) RIIIO-GD2: Step-by-Step Guide to Cost Assessment, p.7, para. 1.27

<sup>89</sup> Ofgem (2020) RIIIO-GD2: Step-by-Step Guide to Cost Assessment, p.5, para. 1.20-1.21

Ofgem's proposed totex model fails the Ramsey RESET test<sup>90</sup>. Can Ofgem confirm if the same model ran using different time period also failed the RESET test?

With regard to ED, it might be envisaged that a purely forward looking would be most appropriate given the significant changes the sector is witnessing and driving, such that the relevance of historical data might be a limiting factor if included in models, especially if a structural break is apparent.

In addition, WPD provide the following comments with regard to other aspects of the econometric modelling:

In our response to question GDQ26, WPD sets out our high level thoughts with regard to the use of CSVs in econometric modelling. WPD is not able to provide further response on the particular make-up of the CSV proposed for the GD econometric model, however can provide the below more 'general' comments with regard to the use of a bottom-up CSV. The construct of a CSV as a single variable built up from the cost drivers of disaggregate activity model, as explained below.

Firstly, it does not lend itself easily to the incorporation of other cost drivers not directly linked to any one particular disaggregate activity, for example regional factors. WPD sets out the merits of controlling for regional factors through within model adjustments, i.e. a cost driver controlling for each regional factor, in our response to question GDQ29, insofar as it can inform as to whether the hypothesised regional factor actually has a statistically significant impact on costs. It is not clear how a regional factor cost driver could be incorporated or interpreted within a CSV. WPD do however considered that costs drivers, separate to the CSV, might be an option.

Secondly, it overlooks the fact that cost drivers of disaggregate costs may not be statistically significant drivers of costs at a totex level. Furthermore reliance of a bottom-up CSV as a the driver of totex costs might mean the totex model suffers from omitted variable bias relative to cost drivers that are statistically significant at a totex level but not at disaggregate level. This relates to WPD comments provided in question GDQ26 and also WPD's response to the RIIO-2 Tools for Cost Assessment Consultation (August 2019), Q5, p.5.

It appears that Ofgem's proposed selection of an aggregate level, of a top down model, is perhaps ill-fitted to Ofgem's wider needs in the RIIO-2 cost assessment framework. For example the ring-fencing of costs and deliverables associated with bespoke outputs, means that with a single totex model, Ofgem have to back-solve the totex allowances to provide a view of the corresponding disaggregate allowances for PCD deliverables. This is creating an additional step in the process, which could be simplified and with improved transparency through the setting of allowances at a disaggregate level via disaggregate models. Please also see WPD's response to question GDQ41.

**→ GDQ31. Do you believe we should take into consideration revised cost information for the remainder of GD1 including 2019-20 (actuals) and 2020-21 (forecast)?**

It is WPD's expectation that Ofgem should consider and include the revised cost information for 19/20 actuals, as this will be the lastest received information. WPD would be cautious in the use of any revised 20/21 forecasts as, at the time of writing,

<sup>90</sup> Ofgem (2020) RIIO-GD2: Step-by-Step Guide to Cost Assessment, p.15, Table 3

there could be a lot of uncertainty as to how 20/21 outturns compared to forecast, for example with second wave and/or localised lockdowns relating to COVID-19.

→ **GDQ32-37.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

**Non-regression Costs Consultation Question**

→ **GDQ38. Do you agree with our assessment of non-regression costs and our proposed adjustments?**

WPD agrees that assessing the efficiency of costs in some activity areas is not appropriate via regression techniques. WPD provides no response with regard to which cost activity areas Ofgem have chosen to assess via non-regression means with respect to gas distribution or the appropriateness of non-regression method chosen.

Ofgem sets out that the non-regressed modelled costs combined with the regressed modelled costs are subject to the benchmarking efficiency challenge<sup>91</sup>. WPD raises a general concern that an efficiency challenge should only be applied to cost and activity areas where the driving of efficiencies is within management control. Whilst WPD are not able to comment on this with respect to GD specific activities, as an example from ED, our awareness of the street works policy arena informs us that with respect to fees chargeable by Highway Authorities (HAs) for permit schemes and lane rental, these fees are beyond the control of management. HAs levy different fees and street work undertakers are not in a position to influence the fee setting process<sup>92</sup>, therefore it is not appropriate to subject this cost area to a benchmarking efficiency challenge. This is just one example, there may be others.

WPD provide no response with regard to the specific non-regressed activities mentioned of MOBs, Repex diversions, Smart metering, Land remediation, SIU opex and Growth governors, however we do provide the following comments with respect to street works:

- a) WPD agree with Ofgem's Draft Determination proposed approach to assess street work costs based *"on each network's own average streetworks costs in RIIO-GD1 (between 2016-17 and 2019-20)"*. WPD agree with the justification for this approach *"Since networks face varying exposures to chargeable permit and lane rental schemes"* and the exclusion of the early years of RIIO-GD1 from the assessment *"because costs were more volatile when permit schemes were less common"*<sup>93</sup>. This mirrors our recent response to the SSWC RIIO-ED1 close-out methodology consultation<sup>94</sup>. Whilst these comments do not preclude WPD's position with respect to ED sector, WPD take this opportunity to emphasise the need for consistent treatment and cost assessment across controls, given the

<sup>91</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 109, para. 3.109

<sup>92</sup> WPD (July 2020) WPD Response to the RIIO-ED1 Closeout Methodology Consultation – Specified Street Works Costs, p. 4, para. 1.9a

<sup>93</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 110, para. 3.125

<sup>94</sup> WPD (July 2020) WPD Response to the RIIO-ED1 Closeout Methodology Consultation – Specified Street Works Costs



prevailing street works policy facing networks in both sectors is exactly the same.

WPD agrees with Ofgem's position and justification on street work penalties, however we disagree with Ofgem's Draft Determination decision to disallow lane rental avoidance charges<sup>95</sup>. Whilst there are currently no lane rental schemes in WPD's licence areas, it is understood that the costs associated with undertaking works in the road where a lane rental scheme is in operation are expensive (e.g. daily chargeable fees of up to £2500, without considering any condition or admin charges) and that network companies may be able to deliver the same works more cost-efficiently through changing their ways of working and not incurring the lane rental charges, e.g. by working out of hours. Whilst the network company has avoided the c. £2500 lane rental charge, other costs have been efficiently incurred.

### **Technically Assessed Costs Consultation Questions**

#### **→ GDQ39. Do you agree with areas selected for technical assessment?**

No response provided in reference to Gas Distribution. Any decision for GD should not pre-determine Ofgem's decision making for ED without sector specific consultation.

#### **→ GDQ40. Do you agree with our proposed approach?**

No response provided in reference to Gas Distribution. Any decision for GD should not pre-determine Ofgem's decision making for ED without sector specific consultation. WPD do however agree that the 8% of costs assessed via technical engineering assessment should not be subject to the benchmarking efficiency challenge.<sup>96</sup>

### **Technically Assessed Costs Consultation Questions**

#### **→ GDQ41. Do you agree with our proposed disaggregation methodology?**

Please also see WPD's response to GDQ30. WPD considers that Ofgem has created an additional unnecessary and over-complicated step in the proposed Draft Determination cost assessment framework and that a more disaggregate assessment, either fully or in complement to an aggregate approach, would mitigate the need for any proposed disaggregation methodology.

Ofgem set out that the disaggregation of allowances "*is required for the setting of PCDs*"<sup>97</sup>. WPD considers that having a disaggregated view of allowances is imperative for all activities such that Ofgem, networks, customers and stakeholders have transparency with regard to the full terms of the price control. WPD has set out the importance of this in our contribution to ED2 CAWG discussions<sup>98</sup>. WPD emphasised and reiterate here the importance of having line of sight from allowed costs to the associated activities and volumes at a disaggregate level, noting that at ED1 this was not the case with the results that DNOs were not clear on which activities and which costs had been cut from the plan by Ofgem. This then makes in-period monitoring

<sup>95</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 112, para. 3.127, 2<sup>nd</sup> bullet

<sup>96</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 114, para. 3.142

<sup>97</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 117, para. 3.157

<sup>98</sup> ED2 CAWG6 – 8<sup>th</sup> April 2020, WPD presentation: How it all fits together?

harder as there is no well-defined reference point which may have adverse effects on incentives and network behaviour. If Ofgem continue to only focus on the disaggregation of allowances for the setting of PCDs the same above issues will prevail with respect to the remaining non-PCD funded pot.

WPD raises the following specific concerns with the disaggregation methodology: Step 1 determines an average reduction to submitted totex.<sup>99</sup> WPD would expect the ratio between proposed totex allowance and submitted totex to vary by activity. Ofgem however, in applying the same ratio are oversimplify the process, such that at a disaggregate level Ofgem is likely to be giving some activity areas more allowance than submitted and vice versa, despite the overarching assessment is that all DNOs have had totex cuts overall<sup>100</sup>.

It is important that Ofgem clarifies if the scaling comparison of proposed totex allowance to submitted allowance is done as per GDN's BPDT submissions, or as per Ofgem's view post normalisations and adjustments, as this ratio could be quite different. The latter would be WPD's preferred method (if a disaggregation method is required at all) to give better line of sight as to what GDNs are still expected to deliver and at what cost.

Ofgem's disaggregation methodology concerns the disaggregation of cost allowances only.<sup>101</sup> Ofgem also need to give thought to what associated activity levels and deliverables based on this methodology they are expecting GDNs to deliver. Step 2 of the method only implicitly captures the workload volumes, which is sufficient for developing the weights but does not give line of sight of what has to be delivered.<sup>102</sup> This will inevitably require some sense checking such that portions of projects or portions of volumes, which are by definition non-deliverable, are required.

## **Uncertainty Mechanisms consultation questions**

### **→ GDQ42-45.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

### **→ GDQ46. What are your views on our consultation position to address bespoke decarbonisation of heat re-openers through our proposed innovation stimulus, Net Zero and Heat Policy re-opener mechanisms?**

Hydrogen remains a relatively new fuel source with use in gas networks restricted to innovation and test projects. The extension of learning and trial through innovation is the best way to develop this fuel through to BAU development. It must be noted that hydrogen production varies in its contribution to the decarbonisation goal, with Green Hydrogen produced through electrolysis using renewable generation offering the best decarbonisation outcome. Other hydrogen production methods have their own carbon impacts.

### **→ GDQ47-51.**

<sup>99</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 118, para. 3.159

<sup>100</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 5, Table 1

<sup>101</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 117-118, paras. 3.157-3.159

<sup>102</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 118, para. 3.159

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

**→ GDQ52. Do you agree with our proposal to continue with a smart meter rollout re-opener?**

Yes. Ofgem is looking at a 2.5% intervention rate which WPD considers low based on experience in the electricity sector. WPD wonders if there are less gas issues with regulators, leading to the lower volumes than we see for cutouts? Within the WPD area the intervention rate is around 4.6%.

**→ GDQ53. Do you agree with our proposal to continue with a common streetworks re-opener?**

WPD agrees with Ofgem's proposal to continue with a common street works re-opener, however raises the concerns noted below.

Ofgem set out that some GDNs included other additional street works costs such as hazardous waste / excavation disposal or reinstatement liabilities<sup>103</sup>. WPD agrees that network companies are likely to face these additional street works costs in RII0-2.

It is not clear what Ofgem's draft determination position is with respect to these. Ofgem have not provided any justification as to why this couldn't be part of the same re-opener. Can Ofgem please clarify.

Ofgem should be mindful that not all of these additional costs will necessarily be introduced by Highways Authorities, but rather may be the remit of other bodies, such as DfT or EA. WPD recommend that the wording for the scope of the re-opener in the summary table for the street works re-opener consultation position be revised to reflect this.<sup>104</sup>

It is not clear where in RII0-2, or via what mechanism, Ofgem intends to assess costs associated with clean air zones. Can Ofgem please clarify.

WPD observes that in neither the ex-ante assessment<sup>105</sup> nor the proposed GD2 re-opener assessment<sup>106</sup> is the need for 12 months of cost data<sup>107</sup> an evidence requirement for a respective licences' costs to be eligible for assessment, ex-ante or re-opener, made explicit. Can Ofgem please clarify. For example, there is no mention in para 4.83<sup>108</sup>, concerning the GD2 re-opener evidence requirements, for the provision of 12 months of cost data at the licensee level, however WPD are aware this has been a fundamental clause in the ED1 re-opener and is likely to be a key feature of the ED1 close-out mechanism.

<sup>103</sup> Ofgem (July 2020) RII0-2 Draft Determinations - Gas Distribution Annex, p. 145, para. 4.79

<sup>104</sup> Ofgem (July 2020) RII0-2 Draft Determinations - Gas Distribution Annex, p. 146

<sup>105</sup> Ofgem (July 2020) RII0-2 Draft Determinations - Gas Distribution Annex, p. 111-112, para. 3.124-3.127

<sup>106</sup> Ofgem (July 2020) RII0-2 Draft Determinations - Gas Distribution Annex, p. 145-147, para. 4.78-4.83

<sup>107</sup> E.g. at a licensee level

<sup>108</sup> Ofgem (July 2020) RII0-2 Draft Determinations - Gas Distribution Annex, p. 147

The summary table for the street works re-opener sets out Ofgem's consultation position with regard to timing of the re-opener window that GDNs have one opportunity to trigger in January 2022.<sup>109</sup>

WPD anticipates that uncertainty in costs, especially regarding lane rental and other addition costs, will remain in January 2022. WPD especially considers this to be the case if Ofgem require GDNs to provide 12 months of cost data as network companies will then need to have certainty of schemes and costs by January 2021. WPD recommends that Ofgem consider either delaying the re-opener until further into the price control and/or establishing a second window. Ofgem should also give consideration to a possible GD2 street works close-out mechanism.

If the above single window of January 2022 is directly transferred to ED2 and Ofgem retain the requirement for DNOs to provide 12 months of cost data at a licensee level from the ED1 re-opener, Ofgem needs to consider the following with regard to the requirement for 12 months of cost data and how this may shape the timing and scope of future funding mechanisms, as developed below.

DNOs are due to submit their RIIO-ED2 plans on 1st July 2021. It is important, for consistency, if Ofgem retain the requirement for DNOs to provide 12 months of cost data for ED2 ex-ante assessment, that this requirement is applied on the same basis as the ED1 re-opener, i.e. at a licensee level. If the requirement for the provision of 12 months of cost data is applied at a Highway Authority (HA), not licensee, level this will mean the costs associated with any permit schemes yet to go live by 1st July 2020 (to satisfy the 12 months of actual cost data requirement) will be unfunded. This will result in different treatment of DNOs in allowance setting purely due to differences in the timing of the roll-out of schemes by HAs, which is beyond the control of DNOs. This consideration is valid equally in application to permit schemes as well as lane rental schemes.

Alternatively, if the GD2 re-opener scheme design is transferred to ED2 as a single re-opener window within the first year of the price control (2024) and Ofgem interpret a "new permit" scheme as one which went live within the respective price control, then DNOs will not only have to bear the costs of permit schemes which go live post July 2020 (see above comment), but will also have to bear the costs incurred associated with those same permit schemes in ED2. Can Ofgem clarify what is meant by a "new permit" scheme.

In light of the above, Ofgem should consider delaying and / or creating a second window in the ED2 timetable for the assessment of street work costs.

As both the ex-ante assessment and re-opener assessment considers the same bucket of costs and policy framework, WPD recommend, for line of sight, that the same method of assessment is used in the GD2 re-opener as has been used in the ex-ante assessment.

## **10. Cadent Questions**

### **→ Cadent Q1-6.**

<sup>109</sup> Ofgem (July 2020) RIIO-2 Draft Determinations - Gas Distribution Annex, p. 146

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

## **11. NGN Questions**

### **→ NGNQ1-9.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

## **12. SGN Questions**

### **→ SGN Q1-9.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

## **13. WWU Questions**

### **→ WWU1-7.**

Please refer to our response to Core Questions and WPD's cover letter and adjoining annex. Beyond these broad points, no further comment.

## **14. NARM Questions**

### **→ NARMQ1. Do you agree with our proposals on the scope of work within each of the NARM Funding Categories and on the associated funding arrangements?**

#### ***NARM Funding Categories***

It is appropriate to set clear distinctions between asset categories and interventions that fall under NARMs and those that do not.

Paragraph 3.3 is unclear. It states that the four categories are NARM Funding Categories, but category B is for non-NARM assets (so technically not a NARM category). Also the bullets provided in section 3.3 do not make it clear whether categories A2 and A3 relate specifically to NARM asset categories or also relate to non-NARM asset categories.

The following comments assume that categories A1, A2 and A3 relate to NARM asset categories:

- Category A1 (NARM Funding Adjustment and Penalty Mechanism)
  - We agree that this category should be specifically associated with defined asset replacement and refurbishment activities. This allows the funding and associated outputs to be clearly linked.
  - The inclusion of other work where risk mitigation is not the primary driver potentially confuses the link between funding and outputs. The situations where such inclusion is allowed should be clearly specified. Alternatively, to avoid the potential confusion the associated outputs should not be included.
- Category A2 (Funding Under a Separate Mechanism)
  - We agree that work which is not asset replacement or refurbishment, i.e. work on NARM assets that is separately funded (such as load related investment), should not count towards the delivery of NARM targets.
  - We agree that where the load driver does not materialise and the work is carried out under a risk driver that the output should count towards the NARM target. This is because the driver becomes asset replacement or refurbishment.
- Category A3 (Ring Fenced Project/Activity)
  - This appears to cover interventions that are captured under separate assessment approaches such as PCDs and within-period determinations.
  - In this case there will be specific arrangements for the assets and therefore it is correct to exclude them from the NARMs outputs

### ***Proposed Sector-Specific Funding Arrangements***

We agree with the principle that “unless there is a more appropriate funding mechanism, then all interventions on NARM Assets should be within the A1 funding category and subject to the NARM Funding Adjustment and Penalty Mechanism”.

The following comments relate to sector specific proposals:

- Electricity Transmission
  - As stated above we agree that where a load related driver does not materialise, then asset replacement or refurbishment work on the NARM assets should be included in the assessment against NARM target.
  - We question the need to provide specific justification for the replacement and refurbishment of these assets. These assets would be considered alongside the other assets and prioritised for replacement accordingly. The requirement to provide asset specific justification introduces regulatory burden, especially where the reporting of output delivery will be captured in annual regulatory returns.
- Gas Transmission
  - The proposal to include interventions on secondary assets appears logical, but the ‘indirect interventions’ that contribute to NARM targets should be clearly defined to enable both NGGT and Ofgem to have clarity on what interventions do/don’t count towards delivery of NARM targets
- Gas Distribution
  - We agree that activities covered by PCDs should be excluded from assessment under NARM targets (see following comment on Repex).
  - Whilst in general, PCD assessment should standalone, it is recognised that the Tier 1 Repex programme is associated with safety issues and



therefore an over-delivery may be required. It appears sensible that any over-delivery of the Tier 1 Repex PCD is allowed to be assessed under the NARM outputs.

### **Cost Associated with Baseline Network Risk Outputs**

The proposal in paragraph 3.18 to include full project costs appears to be a fundamental change to cost capture. We are particularly concerned about the inclusion of indirect costs.

Indirect costs can cover, project design, planning and delivery co-ordination. These costs are for staff that are not time-sheeted and therefore the specific costs are not readily identifiable. The need to capture indirect costs associated with projects would mean a fundamental change to how companies account for indirect resource time and would require changes to cost capture and management systems. It would be more appropriate to only include the direct costs of delivery.

We agree that relevant intervention on secondary assets should be included, if those activities contribute to NARM outputs. If work on secondary assets is not deemed to contribute to NARM outputs, it should be excluded.

### **→ NARMQ2. Do you agree the funding adjustment principles and our proposals for applying funding adjustments?**

We have significant concerns about the amount of ex-post assessment that the proposals require.

### **Excessive Complexity**

The current proposals add significant complexity to an existing data intensive and complicated process.

The requirement for using long-term risk has led to ETOs providing data in a format that Ofgem suggests is incorrect. Appendix 4 of the NARM annex describes issues with ETO submissions and highlights inconsistencies across Gas Distribution to the extent that the long term risk approach is abandoned for RIIO-2.

The new requirements for the submission of efficiency justification add a further burden for identification, tracking and valuation of such benefits; along with the need to document them and have them assessed by Ofgem.

We accept that it is necessary to hold companies to account for delivery of the agreed work programmes. However, if the overall regulatory objective is to drive companies to deliver the volumes agreed then this can be implemented using a simple volume driver that adjusts allowances based upon delivered volumes. This would significantly simplify the process and remove the need for masses of data being processed and reported; complex models being developed, managed and maintained; and resources dedicated to reporting the data, writing reports and tracking justification.

### **Windfall gains**

We agree that companies should aim to deliver the justified and agreed work programmes for the price control.

We agree that there should be mechanisms in place to prevent gaming such as wholesale substitution of work programmes with lower cost alternatives. However, there

should be sufficient scope for companies to respond to new information, reprioritise work and gain reasonable benefits for delivering outputs at a lower cost.

WPD therefore has concerns about the impact of the Delivery Adjustment Factor (see response to NARM Q3), the ex-post assessment of efficiency (see response to NARM Q3) and treatment of non-intervention risk changes (such as deterioration and consequences of failure changes).

We also have concerns about the stability of the NARM assessment mechanism, if the NARM methodology changes during the price control.

### ***NARM methodology changes***

We agree that companies should be neutral to changes to the NARM methodology, so that both targets and actual delivery is assessed using a consistent methodology. Such changes may lead to amended condition scoring, degradation assumptions and consequence of failure derivations and therefore the mix of work following the methodology change may be different to the preceding mix of work.

We question the need to make changes to the NARM methodology during the price control. The NARM methodology is a tool to hold companies accountable. Making changes to the NARM methodology introduces differences to how risk is measured and therefore requires the targets and delivery-to-date to be rebased. As the price control progresses this becomes an increasing challenge as more historic delivery has to be rebased. Numerous changes to the NARM methodology will lead to numerous rebasing exercises overlaid onto each other, which add regulatory burden, but more importantly can lead to confusion and difficulty to explain and assess asset data.

We propose that the NARM methodology should be fixed for the duration of a price control. This establishes a single set of rules that are fixed, allowing targets and associated delivery to be clearly tracked.

This does not prevent the development and evolution of NARM methodologies, which can take place in parallel for use in the following price control.

### ***Deterioration Changes***

We agree assets may deteriorate slower or faster than assumed in forecasts. The known condition of assets at the time of replacement should determine the risk benefit delivered, not the value of the forecast.

Deterioration information is refreshed when asset data is collected during inspection or maintenance. New data about assets is continuously being collected and allows reprioritisation of work programmes to address assets in more need of intervention. Changes to deterioration data therefore are valid changes to the risk of assets.

For some assets, some data may only be refreshed infrequently (e.g. every x years when an asset is maintained). Such information may change the view of deterioration of the asset and be critical to determining intervention reprioritisation. This revised data represents the true deterioration and associated risk of the assets and should be used to define the risk benefit delivery.

The revision of deterioration should apply in both circumstances where the condition of the assets ends up being better than forecast or worse than forecast.

### ***Consequence of Failure Changes***

The proposals for dealing with changes to consequence of failure are unclear. Paragraph 4.11 refers to holding companies neutral for changes to consequence of failure, but it is unclear what this means in practice.

Consequence of failure changes arise where circumstances associated with an asset change. This may be as a result of more customers being associated with an asset either through new developments connecting to the network or following a network reconfiguration.

Such changes lead to valid differences in consequence of failure and hence risk associated with the asset, which in turn may lead to reprioritisation of asset interventions.

When these assets are replaced the risk being removed should be based upon the contemporary risk associated with that asset. This means that the risk benefit delivered should be based on the consequence of failure applicable at the time of the intervention, rather than the original value used when setting the business plan.

### **Data Cleansing**

In the Electricity Distribution sector, data cleansing has a very specific meaning in ED1. It is associated with correction to asset register volumes, rather than any refresh of data about the risk of assets.

We therefore would not expect any impact on risk changes delivered by interventions through data cleansing (should this interpretation of data cleansing continue).

It appears that the interpretation of data cleansing may differ across sectors and therefore further clarification should be provided on what constitutes as data cleansing. In paragraph 4.13, Ofgem makes the statement "Any data cleansing above the reasonable levels we would expect from a company that is effectively managing its assets could raise wider concerns and may be subject to a case-by-case investigation and appropriate actions". This raises the following questions:

- What are reasonable levels of data cleansing?
- Where has Ofgem specified what it perceives as "effectively managing its assets"?
- What would trigger a case-by-case investigation?
- What actions could be taken following an investigation?

### **→ NARMQ3. Do you agree with our proposed approaches to calculating funding adjustments and to application of penalties?**

The proposals introduce complex, detailed and burdensome ex-post close out requirements.

We agree with the aspirations to hold companies accountable for delivery of plans, but we are concerned about the vast amounts of data, evidence and justification that the ex-post close out will require. This will be a burden for both the companies and Ofgem.

### **Efficiency Justification**

Ofgem correctly identifies (in paragraph 4.23) that genuine efficiency improvements should not be penalised.

However, placing a regulatory burden on the companies to provide evidence for each area of cost efficiency improvement may deter companies from developing

improvements, especially if there is a risk that such improvements may be not accepted by Ofgem.

No guidance is given on what evidence would need to be provided to demonstrate cost efficiencies. It would be helpful and more transparent if Ofgem could specify the requirements of cost efficiency evidence in a similar way to guidance provided on the justification of over/under delivery of outputs. This could cover areas such as: more efficient working practices, alternative contractual arrangements, adoption of lower cost materials, using innovative approaches to delivering the work or reassessment of network investment needs.

As already highlighted, we are concerned about the amount of evidence and justification that will need to be provided by licensees and assessed by Ofgem at the close out of RIIO-2. We therefore propose an alternative simplified approach:

- We propose that the requirement for provision of justification for efficiency improvement is removed.
- We propose that the Delivery Adjustment Factor value is changed to allow companies to keep more of the cost savings (based upon an implicit assumption that some of the costs savings are genuine efficiency savings).
- This would remove the need for companies to provide evidence for efficiency savings and for Ofgem to assess them.
- It would reduce the complexity of the close out assessment calculations.
- Consequently we suggest that the DAF should be set at 75%, thus assuming that 25% of cost reductions are based upon genuine efficiency improvements.

#### ***Perverse impact of a high Delivery Adjustment Factor (DAF)***

Ofgem suggests that substitution of asset categories and intervention types could be exploited by companies to gain an advantageous output position. The introduction of the Delivery Adjustment Factor (DAF) is aimed at reducing such behaviour. However, a very high DAF (as currently proposed) could have a perverse impact by discouraging companies to reassess network requirements during the price control. It may lead to companies focussing solely on the delivery of the agreed plan, irrespective of updated condition data or changing needs on the network. This would be driven by the fear that any substitution with lower cost alternatives will lead to clawback of the majority of the savings.

A more reasonable DAF of 75% would allow companies to keep a greater proportion of savings and encourage licensees to make changes to plans where such changes are required.

#### ***Application of penalties***

The application of a penalty for unjustified under-delivery is reasonable.

#### **→ NARMQ4. Do you agree with our proposals in regards to requirements for justification cases?**

The four principles in paragraph 4.44 are reasonable requirements for justification.

However, they are joined together by an 'and' suggesting that all the principles need to be in place for justification. We believe that these should be joined by an 'or' because any one of the principles could be sufficient justification.

We reiterate the point made in response to NARMQ3, where we suggest that principles for the provision of cost efficiency evidence should also be specified (assuming that such a requirement continues).

### **Other Comments / Non-Question Specific Responses**

It is important to highlight the BPI, in particular stages 3 and 4? As a matter of process there is no consultation question. In terms of the regulatory framework, stages 3 and 4 provide no incentive for network companies to do things differently; therefore WPD would question its labelling as an incentive mechanism – the level of reward or penalty a network company is subject to is a reflection of the respective network characteristics, which ultimately reflects the number of data observations (i.e. networks in a sector) over which networks have no control. Furthermore the labelling of costs into high and low confidence reflects Ofgem's confidence in their own cost assessment models. One could suggest this is self-fulfilling. Whilst to some extent confidence in the models is linked to the quality of inputs, it is also linked to the model design which network companies have limited opportunity to influence.

Can Ofgem confirm what assurance and auditing activities have taken place with respect to Ofgem's draft determination cost assessment methods and results?

In the GD2 Draft Determination Ofgem set out some updates to MEAV<sup>110</sup>. WPD disagrees with Ofgem's use of the RIIO-GD1 replacement values rebased to 18/19 prices (the GD2 price base chosen) as the method of updating the unit cost replacement values. The current replacement value of an asset now may be different to the replacement value of MEAV as set at the start of RIIO-1 by more than simply an inflation factor. For many reasons the replacement value of some assets may have changed more so than others, e.g. due to changes in the relative prices of inputs to make them and changes in the input supplier market conditions. It is important that Ofgem updates these to reflect the current prevailing values, especially given that MEAV drivers are a fundamental component of the GD2 draft determination cost assessment approach. WPD further adds that the GD2 Draft Determination approach to updating MEAV should not be precedent setting for the ED2 control and that sector-specific consultation is required.

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<sup>110</sup> Ofgem (2020) RIIO-GD2: Step-by-Step Guide to Cost Assessment, p.9-10, para. 1.35-1.39