

Cost Assessment Working Group – Meeting 9

From: Ofgem

Date: 9th May 2019

Time: 10:00 – 14:00

Location: Ofgem, London

1. Repex

- 1.1. There was a brief recap of the discussion on repex regressions in the previous working group. Stakeholders agreed that the replacement of larger diameter band pipes has more volatile costs, but that these costs should still be taken into account for RIIO-GD2 cost assessment.
- 1.2. The group noted that the repex regressions may not be presenting a comprehensive view of efficiencies due to the negotiation of contracts (e.g. pain / gain share arrangements) and opex/capex trade-offs, in addition to actual operational efficiencies.
- 1.3. There was a discussion on the volatility of repex costs, and how this should be overcome. The group were in general agreement that repex costs shouldn't be based on data from just one year due to this year-on-year volatility of costs. The presentation showed possible options for addressing the volatility by smoothing over time (moving average) or aggregating costs and workload over time. Ofgem highlighted that aggregating the data gives just eight data points and leads to a weak regression result. There was general agreement from stakeholders that either smoothing or aggregation should take place to address the volatility of the data. Ofgem noted that the key issue here is the use of a snapshot year of these volatile costs, and that they will consider how to deal with this issue for RIIO-GD2.

- 1.4. One stakeholder added that it is also important to find out why the data is volatile. It was suggested by a stakeholder that volatile data is a reason to put more weight on totex, which is less variable.
- 1.5. In the presentation, SGN suggested that the synthetic costs for repex need updating with more recent cost data for RIIO-GD2, and stakeholders were in agreement on this point.
- 1.6. One stakeholder raised that Tier 2 and 3 repex work is mostly carried out due to condition, and is justified through cost benefit analysis. It was noted that the more selective approach to Tier 2 and 3 work in RIIO-GD1 means that actual unit costs may have displayed greater deviation from synthetic costs than for Tier 1 mains. It was suggested that Tier 2 and 3 mains could be removed from the repex regressions and assessed separately.
- 1.7. One stakeholder suggested that there should be additional sense checks on allowances that are generated from modelling for Tier 2 and 3 repex, and that the Investment Decision Packs would be useful to consider alongside the regression results. Another stakeholder added that anomalous projects should be identified in Business Plans so they can be considered separately to the regression, in the same way London Medium Pressure project was highlighted in the RIIO-GD1 Business Plan.
- 1.8. SGN's presentation included a section on how the use of new innovative technology may impact costs in regressions. They used the example of CISBOT, a new technology that is used to manage the risk of large iron mains through refurbishment, and prevents or delays the need to carry out expensive replacement. They explained that using CISBOT has a cost associated with it, but isn't captured in the workload part of the repex regression which uses the length of laid pipe. They argued that this could impact the regression result, making GDNs that use CISBOT appear less efficient. One

stakeholder questioned this view of the role of CISBOT, and stated that they consider it is used as a repair tool rather than to manage risk.

- 1.9. There was a discussion on CISBOT, and some stakeholders argued that it should reduce the unit cost of the work done because it helps identify where services are, and exactly where the repair needs to take place. There was a general agreement that it would be useful to know more about the savings associated with the use of CISBOT.
- 1.10. The discussion on CISBOT identified a possible reporting inconsistency between the network companies. CISBOT has several uses (eg camera surveying and internal repairs), which adds complication to where costs should be reported. It was agreed that CISBOT cost allocation should be discussed in the new repex/NARM working group, and that engineers should be brought into the conversation.
- 1.11. SGN suggested that there may be other innovative technology that can impact cost assessment, however the group didn't identify any other examples in the meeting.
- 1.12. Ofgem asked if there are any innovative technologies for abandonment. Stakeholders stated that stub abandonment is an innovative practice, but all networks are carrying them out already, so there is no need to split these costs out.
- 1.13. The group discussed the possibility of abandonment as a driver for repex instead of the length of new pipe laid. Ofgem highlighted that there could be issues with capturing upsizing and downsizing if abandonment was used as a driver for repex. The discussion also highlighted some possible inconsistencies in reporting of abandonment workload.
- 1.14. The group discussed if and how quality should be considered in repex cost assessment. There was general agreement that quality (eg customer service or interruptions) is difficult to bring into the regression analysis. Some stakeholders

thought that quality should be considered alongside the regression analysis as a sense check.

- 1.15. The group discussed whether the cost of parking bay suspensions might represent a material regional factor for repex. There was some uncertainty as to whether the cost was already included within the street works table of the RRP.

2. Business support

- 2.1. Cadent explained how the costs that are coded to business support are split to opex, capex and repex. This led to a discussion that identified reporting differences between companies.
- 2.2. The discussion highlighted that there are different accounting policies between some of the companies for the way staff are coded and allocated to different cost areas. One stakeholder stated that it is unlikely to get perfectly comparable data here, especially when companies have different patterns of outsourcing. There was a suggestion from a stakeholder that striking the upper quartile at the end (once the top-down and bottom-up regressions have been weighted) reduces the impact of the different outsourcing patterns.
- 2.3. A stakeholder raised the point that in RIIO-1, costs were assessed at the gross level, but allowances were applied to the net costs. However, there was concern that gross costs would be difficult to produce where contractors are used.

3. Routine and non-routine maintenance

- 3.1. WWU provided an update on the work they are doing with the other GDNs into the inconsistencies in reporting maintenance costs. They stated that they are still in discussion with one of the network companies, so don't have the full findings to present yet. The findings so far identified faults as one area with inconsistent reporting. It was suggested that the definition of faults should be clarified to ensure they are reported in routine maintenance by each network company.

- 3.2. In the presentation, WWU suggested that the remaining non-routine maintenance costs could be grouped into the capex regression. Stakeholders agreed that it would be useful to discuss this topic again once the information is consolidated from each network company.

4. Ongoing efficiency

- 4.1. The presentation provided a high level update on the ongoing efficiency report recently commissioned by Frontier Economics through the ENA, which is expected to be finalised shortly. The group discussed the concept of applying ongoing efficiency adjustments to future allowances, given that efficiency assumptions will already be embedded in forecast costs.
- 4.2. The presentation highlighted two graphs showing the drop in productivity since 2007. There was a discussion the potential causes of this drop in productivity, and the group consensus was that the cause is uncertain.
- 4.3. The group discussed the Ofwat approach to ongoing efficiency (frontier shift), and how their proposed approach in PR19 differs from Ofgem's approach in RIIO-1. One stakeholder did not think that Ofwat was a good comparator to Ofgem, due to the difference in regulatory history between the water and energy industries.
- 4.4. A stakeholder noted that consideration should be given to the effect that the end of the Repex programme may have on productivity gains between now and 2032. For example, efficiencies from innovation would only apply for a limited period of time, which may subdue productivity improvements in the future. In addition, the stakeholder raised the issue of asset stranding, and how this could impact productivity.
- 4.5. Ofgem stated that they are considering ways in which we could use historic/actual cost data to measure outturn ongoing efficiency in RIIO-GD1. There was a group discussion

about the need to untangle output costs into the components of RPEs, catch-up efficiency and ongoing efficiency.

5. Regional factors

- 5.1. Ofgem confirmed its intention to present options for the assessment of regional factors in the summer consultation, which in this respect will mainly discuss the methodology used for assessment and the evidence required for accepting general or company specific cost claims. Moreover, it was highlighted that the summer consultation also intends to address more general issues.
- 5.2. Further engagement on the topic of regional factors was also discussed, but it was not decided whether this would take place through CAWGs or bilaterals starting from September.
- 5.3. Ofgem briefly illustrated the approach to regional labour costs adjustments in RIIO-GD1 and Ofwat's PR19, and provided some initial evidence that in some cases these adjustments might have been overstated, while in others it appeared understated. The stakeholders asked for details on the computation of the adjustments. Ofgem clarified that in this preliminary analysis predicted labour costs were replaced with actuals from the RRP, while keeping all the other RIIO-GD1 assumptions (eg cost indices and labour shares) constant.
- 5.4. Ofgem provided a summary of the approaches to sparsity adjustments in RIIO-GD1 and Ofwat's PR19, and mentioned that preliminary analyses suggest the presence of a U-shaped relationship between emergency and repairs costs and population density measures. There was a discussion on the appropriate level of granularity of density measures. One stakeholder pointed out that a density variable could only be useful in absence of actual evidence supporting regional factors. Ofgem noted their intention to explore the inclusion of some density measures in the econometric models while explicitly accounting for the selection criteria presented at the previous working group.

- 5.5. The group discussed emergency unit costs, and one stakeholder noted that the low unit costs in this area might be explained by metering work contracts still in place. There were several suggested alternative approaches for the computation of unit costs, including using population or PREs instead of customer numbers, and considering emergency costs only adjusted for regional pay. A similar approach was discussed for repairs costs.
- 5.6. When discussing Ofwat's approach to materiality thresholds for cost claims, Ofgem highlighted the principles that could be applied to the gas distribution context. One stakeholder noted that Ofwat's approach is different (ie adjustments are made post modelling) and less logical, and that some of the principles need to be clarified. Another stakeholder highlighted the importance of analysing data to understand the actual materiality of some regional factors and to clarify the level of analysis (eg ownership group vs. GDN) before discussing materiality issues.
- 5.7. The group discussed the idea that GDNs may not have an incentive to propose downward regional factors adjustments. One stakeholder noted that the ownership structure might provide incentives for multi-GDN companies to identify downward factors, and that the Business Plan Incentive may also encourage downwards regional factors to be identified by GDNs. The group promoted the idea of a collaborative approach to identifying regional factors for RIIO-GD2, and proposed a session to reveal and discuss potential upward and downward regional factors.