

RIIO-ED2 Cost Assessment Working Group (CAWG) – 3rd September 2020

From: Ofgem

Date: 3rd September

Time: 10am to 12pm

Location:

Teleconference

Present

Ofgem

UK Power Networks (UKPN)

Western Power Distribution (WPD)

Northern Powergrid (NPG)

Scottish Power Energy Networks (SPEN)

Electricity North West (ENWL)

Scottish and Southern Energy Networks (SSEN)

1. SSMC clarifications and options discussion

1.1. Ofgem presented slides summarising the SSMC position on the cost assessment approach, regional factors, real price effects (RPEs) and ongoing efficiency, disaggregated cost assessment, and uncertainty mechanisms.

1.2. UKPN and ENWL noted some challenges associated with the proposed use of the full suite of historical data, specifically the potential for inconsistency when using DPCR5 data alongside RIIO-ED1 data, the lack of relevance that DPCR5 data might have for some activity level expenditure. ENWL also commented that, while Ofgem noted in the SSMC that there may be up to 13 years of historical data available from DPCR5 and RIIO-ED1, the reality is that given the timings of the RIIO-ED2, it is more likely that 11 years of historical data will be available.

1.3. UKPN commented that sufficient time would be required to develop an approach / methodology on middle modelling given that this area doesn't have as strong a base

to build from, in comparison to totex and disaggregated modelling which were developed for RIIO-ED1.

- 1.4. On regional factors, NPG questioned the interlinkage with the Business Plan Incentive (BPI) and suggested that some sort of incentivisation through the BPI could introduce some risk on DNOs submitting poorly justified, upside only, regional adjustment claims. UKPN responded, suggesting that if a DNO submitted a poorly justified regional adjustment claim, that was not accepted by Ofgem, the risk to the DNO would be that they would look inefficient in the econometric benchmarking process.
- 1.5. On disaggregated modelling, ENWL sought clarification on Ofgems SSMC position on Business Support Costs (BSCs). WPD highlighted the GD approach to cost assessment at Draft Determinations, which was carried out at a totex level, and questioned what role disaggregated modelling for BSCs played. Ofgem noted that there probably wasn't any read across to GD2 approach. In our SSMC, we stated that if we were to proceed with a disaggregated approach to cost assessment in ED2, then the starting point for this analysis would be the ED1 approach.

2. WPD presentation on RPEs and Ongoing Efficiency

- 2.1. WPD presented slides on the reporting of Ongoing Efficiency (OE) and Real Price Effects (RPEs) assumptions in the Business Plan Data Templates (BPDTs). This presentation followed a bilateral meeting between WPD and Ofgem in August 2020.
- 2.2. WPD suggested adding a table summarising the impact, in £m, of RPE adjustments. WPD argued that this would increase the transparency of RPE assumptions.
- 2.3. On expenditure categories, WPD asked Ofgem to confirm whether the ED2 RPE expenditure categories used to build the notional cost structure aligned with the ED2 BPFM. In ED1, these categories aligned with the PCFM. As RPE adjustments would feed into financial models, WPD flagged that categories should match.
- 2.4. Ofgem pointed out that it was still engaging internally on this, and will put this issue on the agenda of the Regulatory Finance team. Ofgem also stated the importance to line sight across ED2 working groups.

2.5. On input categories, WPD asked clarifications on the treatment of labour costs in GD2.

Ofgem replied that:

- The direct/ contract split of labour cost was consulted on in GD2. This approach received mixed responses, as it could bias companies' choice to contract labour.
- More data was available for the generalist/ specialist split for GD2.

2.6. WPD asked for further insights from GD2, which could inform ED2 on RPEs and OE.

Ofgem shared some feedback from GD2:

- Separating out ongoing efficiency and catch-up efficiency in BPDTs is very useful, as it increases transparency.
- GDNs used different methodologies to derive their OE assumptions. As a result, it was resource intensive to understand the methodological differences between these assumptions. It would be helpful if DNOs followed a consistent approach in ED2.
- DNOs should be transparent on the parameters used to derive their OE assumption, as there are no prescribed approach for this from Ofgem.

2.7. WPD stated that there is a potential merit in having an Energy RPE in ED2. Energy prices are hard to forecast and quite volatile, so this would provide greater protection to consumers and DNOs. ENWL replied that, unlike the water sector where a similar RPE was used, the energy needs of DNOs were particularly high.

2.8. WPD asked if Ofgem could clarify the difference in treatment of the notional cost structure for RPEs between GD2 and proposed ED2 BPDTs.

2.9. Ofgem pointed out that RPEs were disaggregated by cost types to keep the possibility to remove RPEs on certain cost categories. The question was whether RPE indexation was relevant for costs subject to an uncertainty mechanism. WPD noted that this question was relevant for ED2 as well.

2.10. UKPN highlighted that ED2 did not always have to align with GD2.

Understanding what led to the GD2 decision is useful to inform ED2, but the ED2 cost assessment process has to be fit for ED2. Ofgem agreed with this statement.

2.11. WPD asked Ofgem to clarify the annual true up process for RPEs in GD and T.

Ofgem replied that:

- The true up will be done annually through the financial handbook.
- The formulas are not yet available for the true up, but are currently being developed.
- The formulas will form part of a consultation in October 2020.
- The notional cost structures are not expected to be updated annually, but this is still up for consultation.

2.12. UKPN noted that it would be useful to build in a mechanism to update notional cost structures annually for ED2. In the current set up, notional cost structures are rigid thorough the price control. If DNOs cost structures change drastically during ED2, Ofgem would potentially need to assess this change and intervene.

2.13. Ofgem replied that having a notional cost structure true up could be considered for ED2. NPG warned that the RPE process was very complex already, so updating notional cost structures would only increase the complexity of the price control.

2.14. WPD flagged the need to consider the aggregation/ disaggregation of OE assumptions in the BPDT. UKPN echoed this point and argued that a single aggregated OE assumption would avoid biases across cost categories.

3. Round table on Draft Determinations

3.1. A number of DNOs discussed the RIIO-2 Draft Determinations. NPg questioned what was the rationale to the limited use of disaggregated models in RIIO-GD2. Ofgem

replied that the performance of bottom-up models were not satisfactory in some cases.

4. Review of Working Group plan

4.1. Ofgem shared a working group plan and presented different areas to discuss prior to SSMD.

4.2. Action: DNOs to formally comment and add items to the workbook (that will be circulated by SPEN) by 18th September.

4.3. ENWL stated that Ofgem needs to think about the issues which needs further discussion prior to SSMD at the right level of detail. NPg suggested that ED1 models should be used as a starting point. NPg questioned what will the SSMD outlining whether Ofgem will use the RIIO-ED1 models as a starting point. Ofgem agreed with the comment.

4.4. Ofgem asked whether there is merit to have a session focusing on disaggregated modelling. UKPN acknowledged and suggested that there needs to be an understanding to what needs to be improved in the RIIO-ED1 disaggregated models to be robust in RIIO-ED2.

5. Actions, Next Steps, AOB

5.1. Ofgem confirmed that the next CAWG is on the 1st October.