

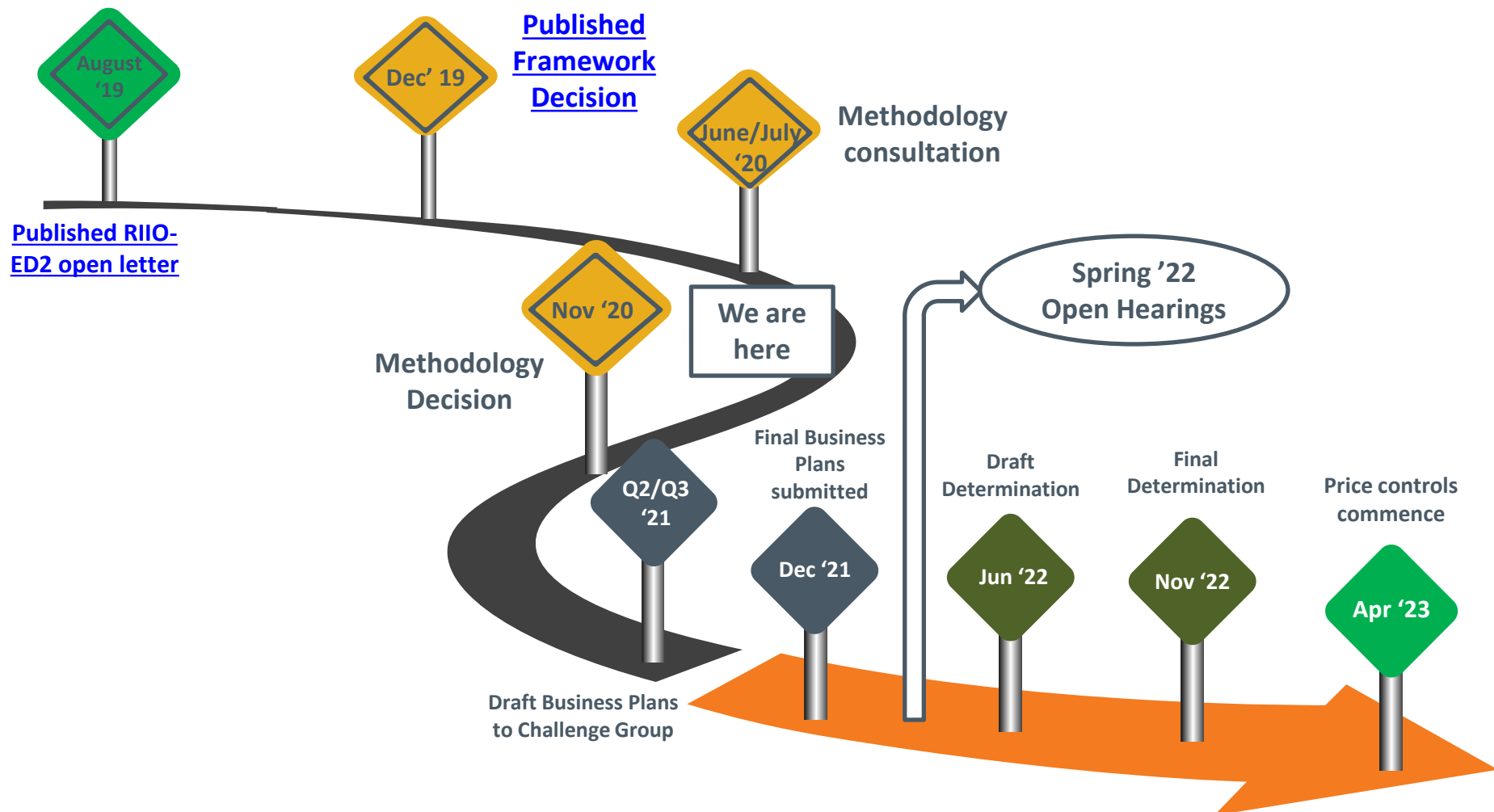
RIO-ED2

Cost Assessment Working Group – Meeting 11



Electricity Distribution Team
3rd September 2020

- Welcome and Introductions: 10:00-10:10
- SSMC clarifications and options discussions: 10:10-10:30
- WPD presentation on RPEs and Ongoing Efficiency: 10:30-11:00
- Round table on Draft Determinations: 11:00-11:20
- Review of Working Group plan: 11:20-11:45
- Actions, Next Steps, and AOB: 11:45-12:00



SSMC clarifications and options discussion

- We set out the **wide spectrum of options and approaches** to econometric benchmarking that exists for RIIO-ED2: totex, hybrid (including middle) and disaggregated modelling.
- We also set out questions around the more **technical aspects of our econometric analysis** including estimation techniques and model specification.
- We included proposals for the selection of **cost drivers**, assessment of suitable **cost pools** for middle/ disaggregated modelling, as well as an assessment criteria for selecting suitable **regression models**.
- In ED2, we proposed **using the full suite of historical data** that we have available, where appropriate to do so. This suite of data includes up to 13 years of historical data from the DPCR5 and RIIO-ED1 price controls, and a minimum of 5 years of forecast data for RIIO-ED2.

- **COQ1**: Do you agree with our proposal to include totex benchmarking in our toolbox for cost assessment in RIIO-ED2?
- **COQ2**: What cost drivers do you consider appropriate for our proposed totex benchmarking? Why?
- **COQ3**: What are your views on the use of both historical and forecast data in our modelling?
- **COQ4**: At what level should we set the efficiency benchmark?
- **COQ5**: Do you agree with the proposed criteria for developing cost pools for a middle-up approach?
- **COQ6**: What cost drivers would be appropriate in a middle-up approach?
- **COQ7**: What are your views on the CEPA developed totex and opex plus approach? What opex activities are there trade-offs that support the rationale for testing 'totex and opex plus' modelling?
- **COQ8**: Do you believe it is appropriate to use bottom-up, activity-level, disaggregated modelling in RIIO-ED2?
- **COQ9**: If we use a combination of aggregated and disaggregated modelling approaches, how should we determine the weight we apply to each, in combining our analysis?
- **COQ10**: If we did not use disaggregated modelling approaches, what approach should we consider for disaggregating totex allowances for the setting of PCDs?
- **COQ11**: What model estimation options should be considered for our cost assessment and why?
- **COQ12**: Do you agree with our proposal to continue using Cobb-Douglas functional form? Why?
- **COQ13**: Do you have any views on our proposed model selection criteria?

- We consider that the onus is on **DNOs to justify their case** for any proposed regional or company specific adjustments.
- We set out our **proposed criteria** to assess regional/ company specific factors, broadly:
 - **Clear definition** of the proposed factor in the business plan
 - The factor, or subsequent costs, is **out of control** of an efficient company
 - Companies are **significantly impacted**, with material differences across companies
- We propose to set a **high evidential bar** for accepting any cost adjustment claims, stating that we do not expect to consider claims that are not materially significant enough to warrant an adjustment.
- We outlined **different approaches for taking account of any proposed adjustments**: pre-modelling adjustments, within-model adjustments and post-modelling adjustments.

- **COQ14**: Do you agree with the proposed criteria for assessing regional and company specific cost factors that we have outlined?
- **COQ15**: What are your views on our approaches to account for regional and company specific cost factors in our modelling?

Real Price Effects (RPEs)

- We set out our proposed approach to **index DNOs' uncertain costs** where possible, as opposed to setting ex-ante RPE allowances based on forecasts.
- We expect **DNOs to provide evidence justifying the need for RPEs**, as well as proposing and justifying **input price indices** as part of their Business Plans.
- We proposed to place **strong emphasis on the materiality of RPE claims**, and to impose a high evidential bar to ensure their appropriateness.
- We also suggested using the same input and expenditure categories as ED1 to create DNOs' **notional cost structure**.

Ongoing Efficiency

- We expect network companies to **provide forecasts of their ongoing efficiency assumptions** as part of their Business Plans, and to clearly demonstrate how these forecasts compare to what they have delivered previously.
- The SSMC **presented different methodological approaches** to inform our OE decision. We suggested growth accounting as our primary approach, similar to ED1.

Real Price Effects (RPEs)

- **COQ16**: Do you agree with our proposed approach to index RPEs, rather than setting an ex-ante allowance based on forecasts?
- **COQ17**: Do you agree with our proposal to have a high materiality threshold for RPEs? What are your views on the materiality level for RPE submissions, and the criteria we use to select input price indices?
- **COQ18**: Do you agree with the suggested common input and expenditure categories for structuring RPEs in ED2?

Ongoing Efficiency

- **COQ19**: Do you agree with our proposed approach, and its scope, to set an ongoing efficiency assumption for RIIO-ED2?
- **COQ20**: Do you agree with our proposal to use a growth accounting approach as our primary source of evidence to set an ongoing efficiency assumption? What parameters would best support this approach?

- We set our proposal to **use the RIIO-ED1 disaggregated modelling approach as a starting point** in developing our approach for RIIO-ED2.
- On **Load Related Expenditure**, we discussed proposals for the following issues:
 - Forecasting for Net Zero
 - Establishing network impacts
 - Treatment of flexibility
 - Load Indices.
- On **Non-Load Related Expenditure**, we set out proposals for the following:
 - Network Asset Risk Metric (NARM) reporting
 - Treatment of incremental costs.
- We are **not proposing any material developments** to the cost reporting or assessment of **Non-Operational Capital expenditure** in RIIO-ED2. Similarly, we are currently proposing to use the **same approach applied under RIIO-ED1** to assessing **Network Operating Costs**.
- We have also stated that we will be **working with the DNOs and ENA** over the next few months to develop the reporting of **DSO related costs**.

- **COQ21**: Do you agree with our proposed approach on forecasting options for RIIO-ED2
- **COQ22**: What are your views on our proposal for establishing network impacts and assessing LRE requirements for RIIO-ED2?
- **COQ23**: Do you agree with our proposal to compare flexibility solutions and network based solutions evenly in our cost assessment?
- **COQ24**: How should we treat the fixed costs of procuring flexibility when considering flexibility solutions as an alternative to reinforcement?
- **COQ25**: What are your views on the use of LIs as outputs in RIIO-ED2?
- **COQ26**: What are your views on the treatment of incremental costs in RIIOED2?
- **COQ27**: Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing Non-op capex costs in RIIO-ED2?
- **COQ28**: Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing NLRE in RIIO-ED2?
- **COQ29**: Do you agree with our proposal to maintain the RIIO-ED1 approach to assessing NOCs in RIIO-ED2?
- **COQ30**: Do you agree with our proposal to maintain the RIIO-ED1 approach for assessing CAIs in RIIO-ED2?
- **COQ31**: What are your views on the different approaches presented for the treatment of BSCs in RIIO-ED2?

In the SSMC, we proposed the following uncertainty mechanisms for ED2:

Name	Type of mechanism	Comparison to RIIO-1	Reference
Cross-sector mechanisms			
Ofgem licence fee	Pass-through	No change proposed	Chapter 11
Business rates	Pass-through	No change proposed	Chapter 11
Inflation indexation of RAV and allowed return	Indexation	Revised for RIIO-ED2	Finance Annex
Cost of debt indexation	Indexation	Options for change proposed	Finance Annex
Cost of equity indexation	Indexation	New for RIIO-ED2	Finance Annex
Real Price Effects	Indexation	Revised for RIIO-ED2	Chapter 6
Tax review	Re-opener	New for RIIO-ED2	Finance Annex
Pensions adjustment	Pass-through	Revised for RIIO-ED2	Chapter 11
Enhanced Physical Site security	Baseline allowance and/or re-opener	No change proposed	Annex 1, Chapter 8
Cyber resilience	Baseline allowance and/or re-opener	New for RIIO-ED2	Annex 1, Chapter 8
Net Zero	Re-opener	New for RIIO-ED2	Overview, Chapter 4

Name	Type of mechanism	Comparison to RIIO-1	Reference
Coordinated Adjustment Mechanism (CAM)	Re-opener	New for RIIO-ED2	Overview, Chapter 7
Specific to RIIO-ED2			
Strategic investment/Load related expenditure	Dependent on Model for strategic investment: could include volume drivers and/or reopener	New/reformed for RIIO-ED2	Overview, Chapter 4
Street works costs	Re-opener	No change	Chapter 11
Rail Electrification	Re-opener	Reform for RIIO-ED2	Chapter 11
Black start	Re-opener	New for RIIO-ED2	Annex 1, Chapter 8 and Chapter 11
Miscellaneous pass-through	Pass-through	No change	Chapter 11
Smart Meter interventions	Volume driver	No change	Chapter 11
Environmental legislation	Re-opener	New for RIIO-ED2	Annex 1, Chapter 9

- **COQ37**: Do you agree with our proposed uncertainty mechanisms and their design?
- **COQ38**: Are there any other uncertainty mechanisms that we should consider? If so, how should these be designed?
- **COQ39**: Do you agree with our proposed removal of the above uncertainty mechanisms for RIIO-ED2?
- **COQ40**: Do you agree with our proposed common approach for re-openers being applied to RIIO-ED2?

WPD presentation on RPEs and Ongoing Efficiency

RPEs and OE BPDT

CAWG 11

Thurs 3rd Sept 2020

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Reporting Requirements

RPEs and OE

- SSMC proposal is for DNO ED2 forecasts in the main part of the BPDT to be exclusive of any RPEs and ongoing efficiency assumption
For OE assumptions this is different to ED1
Ofgem expect DNOs forecasts to remain inclusive of a catch-up efficiency assumption
- This would support having a £m table for both RPE information and OE information in the ED2 BPDTs
£m tables are excluded from the SSMC version of the BPDT

RPEs – Expenditure Categories

- ED1 RPE expenditure categories align to the ED1 PCFM
- For ED2, Ofgem are proposing the same expenditure categories

Load related capex
Non-load related capex - asset replacement
Non-load related capex - other
Faults
Tree cutting
Controllable opex

- Can Ofgem confirm that these align to the ED2 BPFM?

RPEs – Input Categories

Input Categories	ED1	GD2	ED2 Proposal	RRP Cost Types	ED1	Input Categories	PR19
General Labour (opex / capex)	✓	✓	✓	Labour	✓	Labour	✓
Specialist Labour (opex / capex)	✓	✓	✓	Pensions	✓	Energy	✓
Materials (opex / capex)	✓	✓	✓	Contractors	✓	Chemicals	✓
Equipment/Plant	✓	✓	✓	Materials	✓	Materials, Plant and Equipment	✓
Transport	✓	✓	✓	Wayleaves (inc Easements/Servitudes)	✓	Other	✓
Other	✓	✓	✓	Street Works	✓		
				Other	✓		
				Related Party Margins	✓		

- Labour – general / specialist vs. direct / contractor?

Direct / contractor was consulted on in the RIIO-2 Tools for Cost Assessment (June 2019) however Ofgem retained a general / specialist split for GD2 DD. Can Ofgem confirm the reason for this position?

- DNOs do not annually report Labour split by general / specialist, Equipment / Plant or Transport
- Boundary considerations of Materials, Plant / Equipment?
- Is there a case for an Energy RPE? E.g. separate / additional to a Transport RPE?

RPEs – Weightings (Cost Structure)

- The RPE table for ED1 / proposed ED2 table is are organised by PCFM categories
- The RPE table for GD2 is organised by expenditure categories (opex, capex, repex).
- **Can Ofgem confirm the difference in treatment by sector?**
- **Can Ofgem confirm how in GD2 the weightings have been used to inform the notional cost structure and the level of aggregation at which this has been derived?**

RPEs – True-up Process

- Can Ofgem share any insight as to how this will work, e.g. for GD2, for ED2?
- What information will be required – e.g. via BPDTs, annually?

- **Ofgem need to consider what level of information they require on OE in the BDPT for ED2 planning and whether the ED1 table is fit for purpose. Some considerations:**
- Proposed change for ED2 forecasts to be exclusive of OE assumptions may mean Ofgem may wish to consider collating more OE information in the separate BPDT
- Regulatory precedence appears to support OE assumptions set at an opex and capex level. Ofgem could consider streamlining the level of OE information collated in the separate BPDT to two lines, opex and capex
- Alternatively Ofgem could retain the ED1 approach of collating OE assumptions by PCFM category

Summary of Key Considerations

RPEs

- **Expenditure Categories** – requirement to confirm with ED2 Finance WG alignment between the ED2 RPE / OE table and the ED2 BPFM. Can Ofgem confirm?
- **Input Categories** - the ED2 BDPT proposed categories are not currently defined terms or are not currently reported categories in the RPP
- **Weightings (Notional Cost Structure)** – What is the most appropriate structure for establishing the weights – e.g. by PCFM cost type (as per ED1), expenditure category (as per GD2). Can Ofgem confirm the difference in treatment by sector?
- **RPE True-up process** - how will this work in GD2? Can Ofgem confirm?

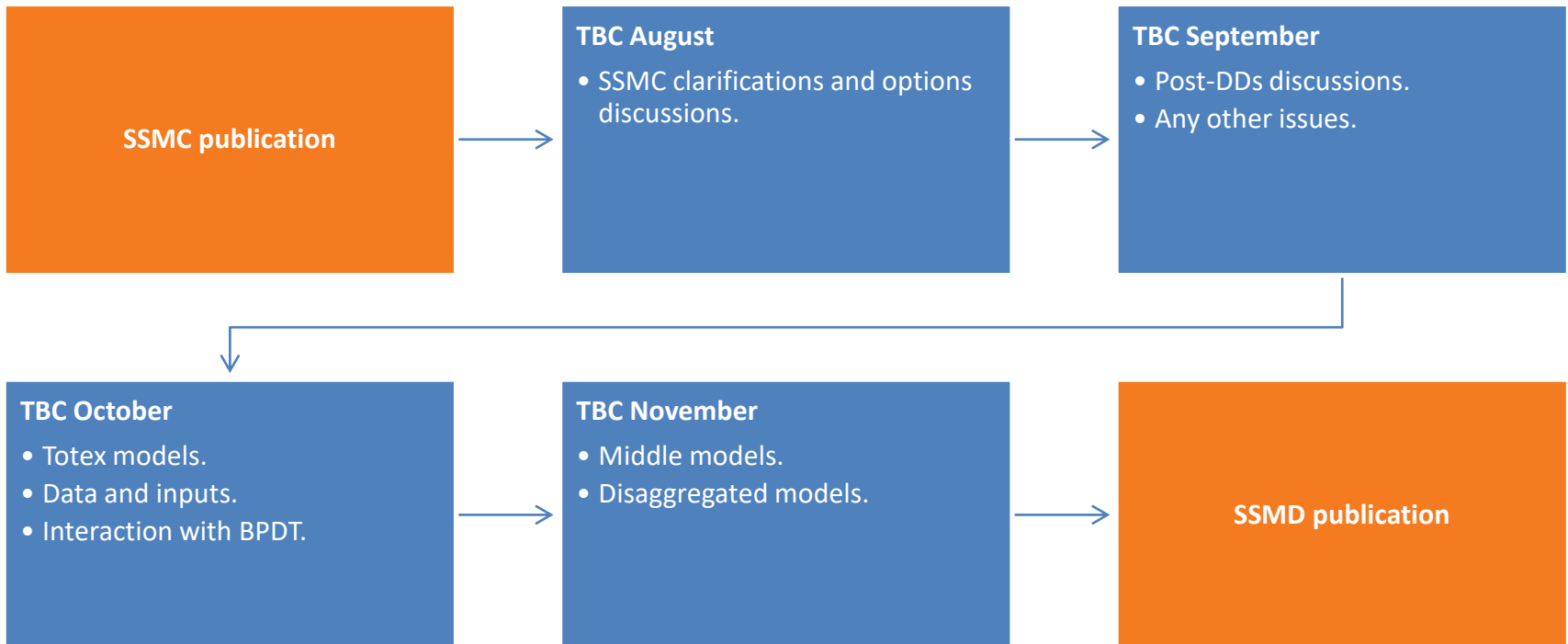
Ongoing Efficiency

- **OE exclusion from DNO forecasts** - Can Ofgem confirmed required information to be collected from DNOs?

Placeholder for round table on Draft Determinations

Working Group Plan

- Our proposal:
 - Monthly CAWG meetings between SSMC and SSMD publications.
 - Focus on policy / high level issues.
 - Deep dives on specific areas and models post-SSMD.



- See workbook attached to meeting invite.

Actions, next steps, AOB

- The next meeting date for the CAWG is Thursday 1st October.
- We will circulate notes and an actions log from this meeting.