

RIIO-ED2 Cost Assessment Working Group (CAWG) – 22nd October 2020

From: Ofgem

Date: 22nd October

Location:

Time: 10am to 2pm

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. Role of Engineering Justification Papers (EJPs)

1.1. Ofgem presented slides on the role of Engineering Justification Papers (EJPs) for cost assessment. For ED2, we need to reflect on what the EJP challenges are, learning from other sectors' experience. A commonality in approaches to EJPs are needed across DNOs, including for materiality thresholds. The latter is key to have the correct selection of projects and programmes with EJPs. Ofgem set out the key principles behind EJPs, previously outlined in the SSMC. Ofgem welcomed feedback from DNOs on EJPs, especially as they consider this aspect more closely when developing their business plan going forward.

1.2. ENWL stressed the need for further clarity on the role of EJPs in the cost assessment process, warning of the risk that it introduces a parallel process producing a lot of material with no links with the rest of the assessment. ENWL asked whether there had been examples where EJPs had led to allowance increases in other sectors. Ofgem replied that there had been several examples of this occurring in transmission, where EJPs have justified higher expenditures that would have been granted through a

benchmarking exercise alone. Ofgem added that EJPs were important for transparency, and increased confidence in the allowances granted to DNOs for ED2.

1.3. NPG pointed out that the electricity distribution sector differed from transmission in its greater availability of data for benchmarking. As a result, ED could rely on benchmarking more than EJPs in ED2. Ofgem stressed that setting the appropriate materiality threshold for EJPs was necessary to carefully select the projects and programmes requiring an EJP. ENWL added that the conclusions of an EJP assessment would test the appropriateness of unit cost or a volume, and this information could then feed through the benchmarking exercise.

1.4. NPG identified two key questions with regards to EJPs:

1. What are the materiality thresholds for submitting EJPs?
2. What goes into an EJP?

1.5. NPG also asked for the number of EJPs that had been received in RIIO2 for other sectors. Ofgem provided the following orders of magnitude:

- Two transmission licensees submitted EJPs on a project-basis, had submitted around 30 EJPs each. Another transmission licensee submitted EJPs for every asset type.
- GDNs took an inconsistent approach. For instance one GDN submitted above 100 EJPs, while another only submitted 8.

1.6. ENWL anticipated a lesser role of EJPs in the Ed sector, due to the wider cost-assessment toolkit available. If a 'mechanistic' materiality threshold was to be designed for ED2, ENWL stated that it would need to be chosen as to not lead to a high volume of submissions for each licensee.

1.7. NPG pointed out that cost areas excluded from benchmarking would see a greater role of EJPs, since modelling would not be able to provide confidence in these costs. NPG recommended that cost exclusion categories should be used as a starting point for EJPs. Ofgem replied that mapping out cost categories that are or are not covered by benchmarking would indeed help future discussions on EJPs. **Action: Ofgem to propose a schematic of where cost categories could fall with respect to benchmarking.**

1.8. Ofgem presented a slide initially developed by UKPN with a proposal for the content to include in the EJPs. The EJP content structure proposal covers:

- Context: relevant background information
- Need: what are the investment drivers?
- Options: what options have been considered to address the issue?
- Assessment: cost/benefit of each option with link to CBA & investment drivers
- Preferred option: reasoning & scope of option selected
- Delivery: assurance around the deliverability of the preferred option

1.9. Ofgem stated that having common approach to EJPs across DNOs is key. Ofgem asked whether DNOs had had any thoughts on the potential structures of their EJPs. ENWL expressed their agreement with the proposed EJP content structure. ENWL added that CBAs were sometimes constrained, and did not cover all the facets that were relevant to the justification of a cost, and so EJPs would give space to provide more information.

1.10. Ofgem highlighted that multiple forms of EJPs had been submitted in transmission for RIIO-2. For instance, some EJPs had been submitted covering multiple CBAs, some EJPs did not include a comparison of options, or some other EJPs argued for a different preferred option than the one resulting from a CBA. Ofgem stated that it would prefer avoiding multiple EJPs for the same CBA.

1.11. Ofgem asked whether the materiality threshold or EJP submissions had been considered by DNOs. Ofgem highlighted that while it was key to get all the information needed through EJPs, it should not become an unnecessary burden on DNOs either. NPG pointed out that a £1m materiality threshold would lead to many EJPs in areas where they would not be needed. Further, until the ED2 business plans are ready, not all cost areas might be identified for EJPs. NPG suggested building the materiality threshold based on how many projects in each tranche of cost-size might require an EJP. Ofgem stressed the importance of landing on a common approach across DNOs.

1.12. Ofgem called for feedback from DNOs on the use of EJPs in cost areas excluded from benchmarking. ENWL reiterated the need to develop a schematic of which costs

would fall where with respect to benchmarking, in order to identify areas where EJPs would be needed most.

- 1.13. SSE asked whether DNOs had a common approach for the CBA, flagging that no ED2 CBA template had been circulated. Ofgem replied that a CBA session was needed in a future CAWG meeting - the CBA work will be kicked off soon.

2. RIGs returns and findings

- 2.1. Ofgem presented the latest RIIO-ED1 RIG's data and commented that load and non-load are the key drivers of understand. Ofgem commented that costs visits will be challenging given the timelines for the SSMD and high volume of Working Groups planned.
- 2.2. Ofgem suggested that bi-laterals should commence next year discussing RIIO-ED1 performance. WPD questioned whether slide 16 was all 8 years of RIIO-ED1, Ofgem said they will check the numbers and flag any issues.

3. WPD presentation on RAV Equivalent for DSO

- 3.1. WPD presented a proposal for a 'RAV equivalent' incentive mechanism to better take into account flexibility costs in the price control. With flexibility expected to take a greater role in ED2, WPD attempted to ensure a fair treatment of the costs of traditional reinforcement against flexibility in the price control.
- 3.2. WPD warned that assigning reinforcement allowances based on flexibility costs only would risk that DNOs are stuck if the need for a traditional reinforcement unexpectedly arises instead. For WPD, the main risks faced by DNOs on flexibility are:
- The lack of flexibility providers in an area where there is a flexibility requirement
 - Contracted flexibility providers not providing a flexibility response when needed
 - The market costs of flexibility exceeding the DNO's forecasts

3.3. NPG queried whether the proposed mechanism differed from the existing ED1 mechanism. The existing TIM incentivises DNOs to invest in the most cost effective solutions, and incentives to use flexibility where cost-efficient also comes through cost benchmarking. As a result, there are already strong incentives to procure flexibility.

3.4. WPD stated its desire to be ambitious about flexibility procurement, and that the additional risk because of flexibility procurement was a concern. Several DNOs and Ofgem signalled that they would need more time to review and understand WPD's RAV equivalent proposal. **Action: WPD to circulate a worked example of their RAV equivalent proposal to illustrate how it would work.**

4. Incremental costs

4.1. Ofgem presented the three options proposed in the SSMC to account for incremental costs and provided a summary of key responses. NPG commented that they support option three as it can be implemented with totex benchmarking.

4.2. NPG continued and suggested if unit costs are split in different parts (i.e. splitting base costs and incremental costs), this can distort unit costs in the cost assessment and therefore need to think about how incremental costs would be used in the cost assessment.

5. Business Plan Incentive

5.1. NPG presented slides on the Business Plan Incentive and commented that there should be less emphasis on low and high confidence costs as it creates distortions. WPD agreed that there should have clear prospects of material rewards for companies that submit plans based on challenging cost levels.

5.2. ENWL stated that they were concerned with the BPI mechanics and the way it has been set out as a 'penalty' only mechanism and not driving the right behaviours. SSE requested whether its possible to have a walkthrough of the BPI process as to how the assessment is carried out and how this leads to a reward/penalty. Ofgem noted and will provide an overview of the BPI process and assessment.

6. DNO sub group presentation on cost exclusions

- 6.1. SPEN went through slides on the proposed ED2 criteria for cost exclusions. They asked what the criteria and categories should be for exclusions.
- 6.2. NPG stated that DNOs will have different thoughts on the criteria for cost exclusions. They made the point that if a cost is worth excluding, but is substitutable with a cost in the cost base, that would create some distortions eg tree cutting. SPEN stated that non-controllable costs should be excluded, and NPG stated that pass-through costs should also be on the list of criteria for excluded costs.
- 6.3. There was a discussion on the cost categories to exclude in ED2. SSE agree that the four items on slide 49 should be excluded. SPEN stated that they wouldn't support losses being excluded, but would support the exclusion of environmental costs. NPG flagged that the appropriate approach to cost exclusions depends on how the benchmark is set up for cost assessment. ENWL made the point that, given that ED2 framework contains CVPs and PCDs, there is discretion for DNOs as to what they propose. Where companies might be proposing a bespoke PCD, this fits into the 'not shared by all DNOs' category of cost exclusions. NPG stated that a bespoke PCD depends on what the DNO puts in its plan, not on the actual costs it should incur.
- 6.4. Ofgem stated that in December we will not be confirming what benchmarking approach we will be taking. However, next year we would be keen to explore and identify the exclusions for the different benchmarking methods. ENWL asked whether five of the companies (not UKPN) working on cost drivers in a review of Frontier Economic's work was worthwhile. Ofgem clarified that it was very useful, as was the work on cost exclusions. SPEN asked whether Ofgem was happy to be involved in scoping the cost driver work. Ofgem stated that they could set up a prioritisation piece to help with this process.
- 6.5. Linking back to the EJP, ENWL asked if areas would need EJPs if the case was made that they should be excluded. Ofgem stated that for costs that are part of the C&V pack, atypical costs and volumes could spur the need for an EJP. It would be useful to have a materiality test and a criteria for using an EJP, similar to the criteria developed

for cost exclusions. NPG agreed that that sounded workable. They stated that there is a need to clarify how the BPDT commentary is separate from the EJPs. **Action: Ofgem to set up a separate session on EJPs with engineering colleagues, to try to firm up a criteria and a materiality threshold for EJPs.**

6.6. SPEN asked what the next steps on cost exclusions were. Ofgem stated that we are keen to explore other approaches to ED2 cost assessment. ED is different from transmission, in that it has a mix of load-related costs and might require different ways of looking at costs eg ex-ante approach to non-load areas. The review of Frontier's work would be useful, given that we do need to look at cost drivers next year.

7. Actions, Next Steps, and AOB

7.1. The next CAWG will be on 19 November. Ofgem will add a BPI discussion to the agenda for this.

7.2. Ofgem will aim for the end of November for the EJP session, which will also cover CBA. Ofgem will investigate whether there is a CBA set up for next week.

7.3. SPEN asked if Ofgem could send out an email regarding the data-share of the DNO early forecasts. **Action: Ofgem will do this**

7.4. Ofgem confirmed that 27 November is the day by which we would need to add anything new to the SSMD.