

## Cost assessment working group – Meeting 5

From: Ofgem

Date: 15<sup>th</sup>  
November 2018  
Time: 10:00 – 15:00

Location: Ofgem,  
London

### 1. Introduction and recap of actions

- 1.1. Ofgem informed the group that Tessa Hall is the new head of the gas distribution cost analysis team, and will therefore chair these working group meetings from now on.
- 1.2. There was a discussion on the input data required to re-run the RIIO-GD1 regressions with actual data. Ofgem recently sent a draft dataset to GDNs for validation. One stakeholder pointed out that the forecasts don't reflect the most up-to-date position, and may need to be updated. The group then discussed additional forecast workload data requirements to re-run the RIIO-GD1 regressions over the entire RIIO-GD1 price control period.

### 2. Non-regression analysis (WWU)

- 2.1. The presentation stated that in RIIO-GD1, there were a number of cost areas that were not suitable for regression analysis. One stakeholder highlighted that the asset integrity capex category is split out into several categories (LTS, district governors etc.) in some of tables in the RIIO-GD1 consultation documents. It was noted that not all non-regression categories were used in both the top-down and bottom-up analysis in RIIO-GD1.
- 2.2. The group discussed whether the list of non-regression activities in RIIO-GD1 should include business support. One stakeholder stated that they were benchmarked against an external view of efficient costs (Hackett benchmarking), and included in the top-

down analysis. This category was benchmarked, but separately to the other disaggregated activities that Ofgem regressed.

- 2.3. One stakeholder stated that for LTS and storage, Ofgem asked GDNs at RIIO-GD1 to provide information on alternative options considered. Ofgem stated that this is for transparency and to help Ofgem understand the justification for business plans (linked to the cost benefit analysis process).
- 2.4. The presentation prompted a discussion on whether there will be any new costs for non-regression analysis in RIIO-GD2. The presentation listed two possible ideas: whole systems solutions/future of energy and company/project specific costs. One stakeholder highlighted that the roll out of smart meters could be extended to 2026, which adds uncertainty on the workload for GDNs associated with this for RIIO-GD2. It was pointed out that instead of using a reopener mechanism for smart meters, because volumes were more uncertain than unit costs, Ofgem could consider using a volume driver for RIIO-GD2.
- 2.5. There was also a discussion on RIIO-GD1 non-regression categories that might be suitable for regression analysis in RIIO-GD2. One stakeholder identified fuel poor connections as a possible cost that could be regressed for RIIO-GD2, through the inclusion of a new synthetic unit cost in the connections regression. This is something that has also been suggested by stakeholders in relation to cost drivers at previous working groups.
- 2.6. The possibility of gas holder demolition becoming a regression item in RIIO-GD2 was also raised by a stakeholder. They stated that there is more available information on this area than there was when the allowances were set for RIIO-GD1, and that the regression could incorporate the type and size of holder. One stakeholder questioned if the costs associated with remaining gas holder demolition was sufficiently material to justify regression analysis.

- 2.7. One stakeholder suggested that specified street works costs will remain uncertain for RIIO-GD2 due to possibility of lane rental charging to be introduced more widely. They asked Ofgem for their view on how to address specified street works costs in RIIO-GD2. Ofgem confirmed that the December consultation will include Ofgem's initial thoughts on uncertainty mechanisms.
- 2.8. There was a discussion on multiple occupancy buildings (MOBs), where one stakeholder stated that they would be difficult to regress because each individual case is very different.
- 2.9. One stakeholder brought up the use of independent reports in RIIO-GD1, stating that they were used as supporting evidence for several non-regression cost categories. The stakeholder wanted to know if independent reports would be considered/required by Ofgem for RIIO-GD2 so that they could begin to plan for this. Ofgem suggested that this is for GDNs to decide if an independent view supports their business plan. Ofgem will need to be able to understand justifications behind business plans.
- 2.10. One stakeholder raised that there is a consistency issue with the business support category because the network companies have differing accounting policies and internal structures, impacting for example IT services (other examples, in addition to Business Support, were also given). It was explained that differing accounting policies were the reason business support costs were benchmarked at a gross level in RIIO-GD1, while the totex approach largely addressed differing business structures. It was suggested that an alternative approach could be to allocate business support costs across all output categories but this would require a number of assumptions. One stakeholder suggested that for RIIO-GD2, consideration should be made of the fact different companies are at different stages of implementing IT systems, which impact the balance between opex and capex, such as cloud computing.

### **3. Cost drivers (Ofgem)**

- 3.1. Ofgem recapped the principles of a good cost driver, as presented at the third CAWG meeting. One stakeholder suggested that the principle that a good cost driver should be measurable/quantifiable could be amended to state that cost drivers should be accurately and consistently measurable. Ofgem agreed that accuracy and consistency are important, and that the principle should be amended as per this suggestion.
- 3.2. This session involved group discussion on the cost drivers used in each of the bottom-up and top-down regressions in RIIO-GD1. Ofgem recapped any previous comments on the RIIO-GD1 cost drivers that have been made by stakeholders in previous engagement. The group was asked to add any additional viewpoints, and to suggest alternative cost drivers for RIIO-GD2.
- 3.3. There was a discussion on MEAV as a cost driver for work management costs. Ofgem stated their concern that network companies have some control over MEAV (undermining one of the principles for a good cost driver). In general, the group acknowledged that whilst this may be true in theory, in practice, they argued, it is unlikely network companies would influence MEAV for the purpose of influencing the regression results – they would have to spend a lot to change MEAV. One stakeholder stated that MEAV might not be the right driver for all four cost categories included within work management, and suggested that an additional driver could be added. Another stakeholder considered that MEAV should be updated from GD1 to include MOBs and embedded entry points.
- 3.4. One stakeholder suggested an alternative cost driver for the emergency category; the use of publically reported escapes (PREs). It was suggested that the maximum PREs over a period of several years could be used to overcome the volatility in the number of PREs.
- 3.5. One stakeholder suggested that Ofgem could look at emergency and repair costs combined, as there are clear linkages between the two categories. It was also

suggested that operations management could be included here, instead of in work management. It was raised that there should be a consistency check before looking into combining these cost categories. Another stakeholder suggested that Ofgem could just reconsider the weightings of the existing drivers.

- 3.6. There was some discussion over the cost driver for maintenance: maintenance MEAV. In addition to the comments received at previous working groups, there was a suggestion that the lumpy nature of maintenance costs should be taken into account (eg by smoothing or averaging over a few years). Similarly, the lumpy nature of mains reinforcement costs was noted.
- 3.7. When the group discussed the repex regression, one stakeholder suggested that insertion rates (as opposed to open cut) could be a cost driver because it drives a large proportion of the repex costs, and is largely beyond company control. The group highlighted that there are regional differences in insertion rates. Other suggestions for drivers of the repex costs were abandonment to lay ratios, the proportion of mains in the footpath, carriageway, and verge, and the number of connections.
- 3.8. The group then discussed the cost drivers for the totex regression. In RIIO-GD1, a CSV was used comprising a number of cost drivers, including MEAV. One stakeholder stated that this is an appropriate approach, but that the CSV weights would need to be reviewed for RIIO-GD2. One stakeholder raised support over the inclusion of MEAV in the totex regression CSV, stating that workload drivers should be used where possible, but where not, it is doubtful whether there is a better scale driver than MEAV. .

#### **4. BPDs and cost consistency (Ofgem)**

- 4.1. Ofgem went through the RIIO-GD1 regulatory reporting pack (RRP) tables, one at a time, and asked stakeholders for their views on any reporting consistency issues and whether the reporting template is appropriate for using as a baseline from which to

develop RIIO-GD2 business plan data templates (BPDTs). Stakeholders identified a number of areas that they think may not be necessary to forecast in RIIO-GD2 BPDTs. For example, the information on full time equivalent (FTE) labour in the opex cost matrix table, and the year on year opex movements, which can be covered in the business plan narratives rather than the BPDTs. For many other areas, it was suggested that the information will be necessary in the BPDTs for RIIO-GD2, with some amendments.

- 4.2. There was a discussion on the revenue business plan tables and the RIIO-GD2 price control financial model (PCFM). The Ofgem regulatory finance team took an action to pick up this point and continue to engage with the GDNs on the progress of the RIIO-GD2 PCFM in the new year.
- 4.3. WWU presented their findings on the reporting inconsistencies of other direct activities (ODA) between companies. ODA includes a number of different costs, and some of these were found to be reported inconsistently, including GD2 costs and asset decommissioning. The stakeholders agreed to decide on a consistent approach to reporting costs and to suggest this to Ofgem as part of annual updates to Regulatory Instructions and Guidance (RIGs).
- 4.4. Ofgem suggested GDNs could be asked to complete draft BPDTs by July, ready for challenge by the CCG. GDNs responded that they were not clear whether this was feasible, given the amount of work required and the fact that the RRP was also due at the same time, or desirable at that level of detail, given that there would be two further iterations later in the year.

## **5. Summary**

- 5.1. Ofgem presented their indicative next steps timeline, to be confirmed in the December sector-specific methodology consultation.

- 5.2. Ofgem also informed the group that they intend to continue running these working group sessions in the new year, possibly beginning again in late January, depending on stakeholders' availabilities. Ofgem mentioned that they are considering if it would be useful to carry out a joint policy and cost assessment working group (potentially for repex and more widely across RIIO-GD2) in the new year.