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29<sup>th</sup> August 2018

### **RIIO-T1 and GD1 Reopener Consultation – Enhanced Physical Site Security Costs**

Dear Kiran,

I am writing in response to the above consultation, in particular to object to Ofgem's proposal to disallow circa £0.5m of cost incurred by Wales & West Utilities Limited (WWU) in respect of our delivery of the Physical Security Upgrade Programme (PSUP) directed by Government.

As you are aware WWU elected to make what is almost entirely an ex post submission for funding in the May 2018 reopener window, expecting to fully recover its efficiently incurred costs delivering the PSUP, foregoing any opportunity for outperformance that may have been available had we made an ex ante submission at an earlier opportunity. This approach has entirely de-risked the costs of PSUP delivery from a consumer perspective, but based on your proposed adjustment to revenue allowances will leave our programme underfunded based on an arbitrary cut of £0.3m to Licensee Project Management costs and £0.2m to Contractor Project Management costs.

I set out below in more detail our response to the specific questions posed in the consultation document:

#### **Question 1: Do you agree with our assessment approach?**

- *Our approach to Project Management costs*

WWU accept that at circa 18% our overall project management costs do exceed the arbitrary 15% ceiling level suggested by Frazer Nash Consulting for civils projects.

WWU was already aware that this area, in particular, would be scrutinised closely, based on Ofgem's decision in respect of submissions by other operators in May 2015 for their physical security upgrade programmes. As such, every effort has been made by WWU managers, from project inception, throughout delivery and to completion of every part of our programme, to target project management effort only where value could be delivered against overall quality and cost of the project.

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Whilst the application of a fixed upper limit on project management costs is helpfully simplistic for the purposes of evaluating submissions, this approach completely ignores the measured value added by effective project management by the Licensee. In the case of our PSUP we have already explained that £4.3m saving has been delivered both by removing duplicated effort and avoiding delays to the programme and any resulting compensation events, as well as by engaging SMEs for some elements of work where cost efficient to do so. This, in addition to the £9.5m saving delivered through our procurement strategy, has only been possible due to the effective level of project management effort invested by WWU.

We would also point out that the WWU contractor management strategy appears to have put WWU at the frontier in this cost element and therefore we would expect full funding of Licensee Project Management Costs, rather than the proposed cut of £0.3m.

Looked at another way, in outturn prices WWU project management at £2.1m saved £4.3m, or over £2 per £1 invested in project management effort by WWU. Any reduction in this project management effort could easily have resulted in delays to the project resulting in compensation events, or the principal contractor exploiting inadequate management, jeopardising some or all of the savings realised through our approach.

The table below illustrates an alternate scenario where project management effort was reduced by £0.3m, leading to the £4.3m saving in construction costs not being delivered. Much of this is related to the challenge back to CPNI on the detailed scope of works, which amongst other successes included the retention of existing fencing, delivering construction savings.

	Base cost £m (excluding PM)	PM element	PM cost £m	Full cost £m
Outturn prices	20.26	13%	3.02	23.28
2009/10 prices	16.10	13%	2.40	18.50

As can be seen whilst overall project management cost is now £3.02m, overall cost in outturn prices has risen to £23.28m and the proportion of project management cost is now below Ofgem's arbitrary 15% 'acceptability' ceiling at 13%. Clearly however this would not be efficient, or a good outcome for the consumer, as WWU would be requesting £18.5m in 2009/10 prices as opposed to £15.4m applied for in this reopener window.

We welcome the decision that, following assessment of the detailed breakdown of actual and forecast costs across the sites being upgraded, Ofgem is satisfied that WWU has justified all cost areas, and therefore doesn't propose to make any adjustment to specific work activities. We consider this further demonstrates the effectiveness of our project management effort and thus the associated Licensee Project Management costs should be allowed in full.

In respect of Contractor Project Management costs WWU does not agree that the PSUP can be directly compared to other civils projects, as is suggested in the consultation document, for the purposes of determining an appropriate percentage to be allowed for project management cost.

It should be noted that in addition to the civils element of each build, there is a significant amount of complex electronic hardware and software incorporated into the security solution

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for each site, requiring very specific project management skill and effort which is at a premium as compared to less complex civils projects. Furthermore the skills and accreditations required from project managers competent to deliver such a programme, along with the security clearances they require, also attract a premium.

Since the project was subject to competitive tender and awarded to the successful bidder at an overall cost some £9.5m lower than the next best bid, it is unreasonable to have disallowed £0.2m of the Contractor Project Management costs included therein, these should be allowed in full.

- *Our approach to Risk costs*

WWU accepts the approach applied by Ofgem in estimating the contractors risk cost element and thus the total project risk cost of approximately 7%. We welcome Ofgem's proposal not to adjust WWU's requested allowance for risk on the basis that it falls below 10% of the total project costs.

*Question 2: Do you agree with the outcome of our assessment?*

- *Our proposed adjustment on specific work costs*

There is no proposed adjustment to WWU specific work costs and as previously stated we welcome the decision that, following assessment of the detailed breakdown of actual and forecast costs across the sites being upgraded, Ofgem is satisfied WWU has justified all cost areas.

- *Our proposed adjustment for NGGT development costs*

No comments.

- *The application of the materiality threshold*

No comments.

Please do not hesitate to contact me should you require any further information in respect of the above response to the consultation.

Yours sincerely,



Steve Edwards  
Director of Regulation and Commercial  
Wales & West Utilities

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