Decision

Making a positive difference for energy consumers

SGN Non-Operational IT Capex Re-opener Final Determination

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This document sets out our decision on SGN Non-Operational Information Technology (IT) Capex Re-opener submission.

As part of the RIIO-2 price control, network companies can apply for additional allowances via the Non-Operational Information Technology Capex Re-opener uncertainty mechanism.

In the 23 January 2023 to 30 January 2023 Re-opener window, we received a submission from SGN for additional allowances. We consulted on our Draft Determination and associated draft direction between 22 May 2023 and 24 June 2023. Having considered all responses to our consultation, this document sets out our decision on what allowances, if any, to award. This document also includes the formal direction used to implement our decision into SGN's licence.

Contents

Introduction

Section summary

This section explains SGN's submission, our assessment and consultation process, and how we came to a decision.

Introduction to RIIO-2

1.1 Network companies are natural monopolies. Effective regulation of privatised for-profit monopolies is essential to ensure they cannot unfairly exercise their monopoly power to the detriment of their customers. This is particularly important in the case of essential utilities, such as energy, where consumers have no choice on whether or not to pay what they are charged. It is therefore crucial that an effective regulator protects energy consumers by controlling how much network companies can charge their customers. Ofgem does this through periodic price controls that are designed to ensure network companies are properly incentivised to deliver the best possible outcomes for current and future energy consumers. This includes ensuring that consumers only pay for investments that are needed and do not overpay for those investments.

1.2 The current price control model is known as RIIO (Revenue = Incentives + Innovation + Outputs). RIIO-2 is the second price control under the RIIO model for electricity transmission, gas transmission and gas distribution, and runs from 1 April 2021 until 31 March 2026. It includes a range of Uncertainty Mechanisms (UMs) that allow us to assess applications for further funding during RIIO-2 as the need, cost or timing of proposed projects becomes clearer. This ensures that consumers fund projects only when there is clear evidence of benefit to consumers, and we have clarity on likely costs and cost efficiency. These mechanisms also ensure that the RIIO-2 price control has flexibility to adapt as the pathways to Net Zero become clearer.

1.3 Where possible, we have set automatic UMs, such as the Generation and Demand Connection Volume Drivers, which provide Electricity Transmission Owners with immediate funding when they are required to undertake new customer connection works. In other areas, where the degree of uncertainty is too great to allow for an automatic mechanism, we set 're-openers' which will allow us to assess proposals robustly once information with sufficient accuracy is made available.

1.4 The Non-Operational IT Capex Re-opener provides network companies with specific windows within the RIIO-2 period where they can request additional funding for new and replacement IT assets, including hardware, infrastructure, and software development projects, some of which may be critical for achieving Net Zero.

What did we consult on?

1.5 We[1] consulted on adjusting SGN's Non-operational Information Technology (IT) Capex[2] outputs and allowances under the RIIO-2 Non-operational IT Capex Re-opener.

1.6 In accordance with Special Condition 3.7 (Non-operational IT Capex Re-opener), SGN applied to Ofgem to add additional allowances for Non-operational IT projects into its RIIO-2 price control framework. Following its submission in January 2023, SGN also provided additional information to us through a combination of bilateral meetings and Supplementary Question (SQ) responses.

1.7 We considered SGN's proposals and its justification for the funding requested in accordance with our principal objective and statutory duties. In line with the Re-opener Guidance and Application Requirement Document[3], our assessment covered the following three areas:

- the needs case
- the options assessment and the justification for the proposed project
- the efficient costs for the proposed project

We combined this information to create our Draft Determination on what additional allowances, if any, should be provided to SGN to undertake the project.

1.8 We issued a consultation on our Draft Determination[4] for stakeholder feedback, alongside a draft of the direction that would be used to implement the Draft Determination. Only one stakeholder, SGN, responded to the consultation. A summary of this consultation response is included in Chapter 2. Having considered the response, our Decision is set out in Chapter 3.

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[1] The terms "we", "us", "our", "Ofgem" and "the Authority" are used interchangeably in this document and refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority.

[2] Expenditure on new and replacement IT assets, including Hardware & Infrastructure and Application Software Development

[3] Re-opener Guidance and Application Requirements Document: Version 3 | Ofgem

[4] RIIO-2 Non-operational IT Capex Re-opener Draft Determination: SGN | Ofgem

1.9 Throughout this document all monetary figures are in 2018/19 prices, to align with the original RIIO-2 price base.

Context and related publications

1.10 The scope of this document is limited to SGN's Non-operational IT Capex Re-opener. This document is intended to be read alongside:

- SGN Non-Operational IT Capex Re-opener Draft Determination (May 2023)[5]
- SGN's Licence Special Conditions 3.7
- RIIO-2 Re-opener Guidance and Application Requirements Document
- RIIO-2 Draft Determinations – Core Document[6]
- RIIO-2 Final Determinations – Core Document (REVISED)[7]

[5] RIIO-2 Non-operational IT Capex Re-opener Draft Determination: SGN | Ofgem
[6] https://www.ofgem.gov.uk/system/files/docs/2020/07/draft_determinations_-_core_document_redacted.pdf
[7] https://www.ofgem.gov.uk/system/files/docs/2021/02/final_determinations_-_core_document_revised.pdf

2. Summary of Draft Determination and SGN's response

Section summary

This section outlines our Draft Determination and SGN's response to it.

Summary of Draft Determination

2.1 The re-opener submission identified the need for additional allowances for SGN to accelerate its compliance against its licence conditions (Special Condition (SpC) 9.5), particularly the Data Best Practice (DBP) Guidance[8].

2.2 In our Draft Determination, we agreed that SGN needed to improve the maturity of its policies, processes, and governance against the DBP Guidance, in order to comply with its licence obligations (Special Condition 9.5) and stakeholders' growing expectations.

2.3 SGN explored three options to address this needs case.

- Option 1: 'do nothing' (Cost £0m)
- Option 2: 'industry appoints a centralised / partially centralised service' (Cost £9.3m)
- Option 3: 'SGN delivers DBPG and Open Data Services' (Cost £9.15m)

2.4 We assessed that Options 1 and 2 were not viable, as Option 1 would lead SGN being unable to meet its licence conditions, and we are unaware of any existing industry move towards a centralised service which would make Option 2 viable.

2.5 On this basis, we agreed with SGN that there was a clear needs case that should be addressed during the current RIIO-2 price control period, and that Option 3 is the most appropriate option to address it.

2.6 However, we concluded that some elements of SGN's proposal did not need to be undertaken during RIIO-2 and could be delayed until the next price control period. This was because we considered that these elements either did not contribute towards meeting DBP Guidance, or user needs had not been clearly articulated during the submission. We also concluded that some of the costs proposed were relatively high relative to industry comparators. On this basis we proposed the following reductions:

[8] The Data Best Practice Guidance Data_Best_Practice_Guidance_v1.pdf (ofgem.gov.uk) is a principles-based approach that provides guidance on the quality, accuracy and accessibility of data. The Guidance is underpinned by 11 principles, for example Principle 1 is "Identify the roles of stakeholders of Data Assets".

- -£0.341m on preparing for Energy Data Taskforce (EDiT) recommendations
- -£0.341m on preparing for RRP changes
- -£1.481m on Enterprise Architecture work and third-party Application Programming Interface costs
- -£3.139m on resourcing costs
- -£1.274m for risks

2.7 **Table 1** details SGN's requested funding, our proposed adjustments for rejecting the Interoperability workstream, and our proposed allowances against each workstream.

Table 1: SGN's requested funding and our Draft Determination

	SGN Proposal	Proposed adjustments	Draft allowances
Allowances	£9.155m	-£6.576m	£2.579m

Summary of stakeholder's responses

2.8 We only received one response to our consultation, from SGN.

2.9 SGN agreed with our Draft Determination on its needs case, which set out that SGN should receive efficient funding to meet its Data Best Practice obligations. However, it raised some concerns that "the amounts provided for within the draft determination may increase the overall 'lifetime' costs by not permitting appropriate focus on effective long-term delivery."

2.10 SGN agreed with our Draft Determination on its optioneering, which concluded that Option 3 was the right option to tackle the needs case.

2.11 SGN mostly disagreed with our Draft Determination on its costs. It split its response into six segments, which we have summarised in the following six paragraphs.

2.12 **Preparing for EDiT recommendations:** SGN acknowledged our position to reject funding for this element, stating that given the stage of development it was happy to postpone this work until a future re-opener window or the next price control period once the outcomes are more clearly defined.

2.13 **Preparing for RRP changes:** SGN acknowledged our position on this but stated that it was expecting significant changes to the RRP process. SGN concluded that "if Ofgem's preference is to postpone this work until requirements are more clearly established, then we [SGN] can work within these confines".

2.14 **Enterprise Architecture (EA):** SGN disagreed with our position to reject funding for this element. SGN set out that investing in EA correctly at the outset will enable it to take a structured approach to data standards, meet data/cyber security requirements, automate production and publication of datasets in the future, and enable discovery work to underpin a data sharing platform that could be accessed by third parties via automated mechanisms such as APIs. To emphasise this point, SGN stated that there is a risk that if it does not invest upfront in EA then this could increase its total costs in the long run due to an increased need for operational resource. SGN explains that delivering EA during the next price control period could decrease business efficiency, increase cyber security risks, build data debt due to a lack of clear standards and guidance, and create labour-intensive publishing processes that diverts resources from implementing the Data Best Practice Guidance. Investing now would remedy these issues.

2.15 **Application Programming Interface (APIs):** SGN disagreed with our position to reject funding for this element. SGN argued that investing in establishing third party APIs should be undertaken during RIIO-2, as, in its view, this would help integrate its systems with its data consumers' (such as other utilities and government/regulators) systems. It points to the Greater London Authority as one such user of data and gives the example of the National Energy Outage Platform as a requirement for SGN to provide near real-time data on gas network outages via an API. SGN adds that investing in APIs now would help to manage the publication of its datasets and "create seamless and frictionless data pipelines throughout the broader ecosystem of systems that enable value to be created at a sector and national level". SGN highlights that not investing now would lead to issues in each of these areas.

2.16 **Resourcing:** SGN partly disagreed with our position to reject funding for this element. SGN recognised our challenge on efficiency and explained that it's model of 100% contractor staff for delivering this project was to "mitigate the inherent risk of this project needing specific data skills from a very challenging job market". SGN provided additional evidence that if it used the resourcing model calculated as a benchmark for our Draft Determination, that this would lead to a reduction in resourcing costs of 33%, rather than 66% as we estimated in our Draft Determination.

2.17 **Risk allowances:** SGN disagreed with our proposal to reduce the risk allowance from 15.5% to 7.5%. It explained that 15.5% aligns with its internal guidelines and is designed to mitigate against potential changes in the scope, requirements, design and implementation as government and industry continue to define data standards. Finally, SGN explained that the Green Book[9], issued by HM Treasury to provide guidance on how to appraise policies and projects, recommends that the risk allowance for Equipment/Development project capital costs should fall between 10% and 200%.

[9] The Green Book (2022) - GOV.UK (www.gov.uk)

3. Final Determination

Section summary

This section sets out our decision.

Final Determination

3.1 Following our Draft Determination, we have considered SGN's consultation response.

3.2 We recognise SGN's acknowledgement of our positions on the 'Preparing for EDiT recommendations' and 'Preparing for RRP changes' workstreams and confirm that we are rejecting funding for these workstreams, as set out in our Draft Determination.

3.3 The following paragraphs discuss the remaining four elements where SGN have at least partially disagreed with our determination, as set out in Paragraphs 2.14 to 2.17.

3.4 **Enterprise Architecture and APIs:** SGN consider that delaying Enterprise Architecture and API work may be cheaper in the short term but increase the total costs. This is primarily due to needing to rework datasets and data processing operations in the future, as well as needing to use more resources to manually process data. Additionally, SGN have provided two examples of needing APIs to provide data to the GLA to "make its data ingest more efficient" and to the National Energy Outage Platform which has a "requirement for near real-time data on gas network outage". However, neither of the two potential user needs are explored in detail or demonstrate a significant requirement for funding now. So, whilst we can see the merit in undertaking this work, we continue to conclude that there is minimal evidence of user requirements at this stage. We consider that, on balance, the risks of SGN potentially having a higher resourcing spend in the short term are lower than the risks of unnecessarily spending consumer funding now on activities that may need to be scrapped or significantly altered in the future. We stand by our Draft Determination position that SGN should continue to build the basic building blocks needed to meet the DBP Guidance and continue to build its evidence for funding this type of work in the next price control period.

3.5 **Resourcing:** In our Draft Determination we created a benchmark for resource costs that used a model of contractor resourcing for year 1 of the project and internal resourcing for years 2 and 3, which we considered to be a more efficient resourcing benchmark. In its consultation response, SGN has provided additional information that shows this resourcing benchmark costed against each member of staff. We have assessed that this analysis put forward by SGN is more accurate than the assumptions used in our original benchmark, as it uses figures for each individual member of staff. We are content that this is accurate and represents an efficient level of spend, as opposed to our original benchmark. Therefore, we have changed our position from our Draft Determination, moving from a 67% reduction in resource allowances to a 33% reduction in resource allowances, as requested by SGN. <u>This will increase the allowances awarded by £1.223m</u> compared to our Draft Determination position.

3.6 **Risk allowances:** Across RIIO-ET2 determinations we used a capped average risk across projects at 7.5% of our assessed efficient costs, following a review of outturn risk on a number of RIIO-1 projects. We appreciate that for certain projects this average may be too high or too low. However, unless there are specific reasons why this number is significantly different compared to similar projects then we propose to maintain this level of risk. We do not agree that the Green Book value for optimism bias is a good benchmark for risk allowances under RIIO-2, given we have other risk mitigation measures such as the Totex Incentive Mechanism, which means network companies are only exposed to a portion of any overspend risk. On this basis, we disagree with SGN's consultation response and will maintain the risk pot at 7.5%. However, this 7.5% will apply to the new total which includes the increased resourcing allowances. This will <u>increase the allowances awarded by £0.092m</u> compared to our Draft Determination position.

3.7 Finally, in its consultation response, SGN suggested that a new risk should be added: a risk that SGN cannot recruit internal staff for year two and year three of the project. SGN valued this risk at £1.436m and if allowed would roughly cancel out the proposed disallowances. However, we consider that the overall risk allowance of 7.5% is an efficient level, as set out in Paragraph 3.6, and any new risks that SGN has identified should be covered within this. So, we are rejecting SGN's proposal for an additional risk allowance.

3.8 **Table 2** details the final allowances awarded.

Table 2: SGN's requested funding and our Final Determination.

SGN's original request	**Our Draft Determination**	**Our adjustments following consultation**	**Our Final Determination**
£9.155m	£2.579m	+£1.315m	£3.894m

3.9 **Table 3** splits our Final Determination down by financial year, with the overall reduction of 57.47% split pro-rata for each year. SGN hold two licences and this project covers licences, so the table splits the Final Determination by licence with a 37%/63% split as requested by SGN.

Table 3: Final Determination split by financial year.

Financial year	**2023/24**	**2024/25**	**2025/26**	**Total**
Scotland Gas Networks plc	0.233	0.582	0.626	1.441
Southern Gas Networks plc	0.396	0.991	1.066	2.453
Total award (£m)	0.629	1.573	1.692	3.894

3.10 As set out in the Draft Determination, we do not consider it necessary to impose specific Price Control Deliverables for these allowances as SGN have licencing requirements[10] to meet the DBP Guidance.

3.11 The formal direction that will implement these allowances into SGN's licence is in Appendix 1. Since the draft direction, we have made some minor amendments to formalise the language used, but the licence changes themselves remain the same as shown in the draft direction.

[10] Gas transporters, such as SGN, are required to give their best endeavours to follow the DBP Guidance Principles by virtue of Part of Special Condition 9.5 (Digitalisation) of its Gas Transport Licence.

Appendices

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Appendix 1 – Direction

Direction under Special Condition 3.7.6 of the gas transporter licence held by SGN (the Licensee) to add allowances for Non-Operational IT Capex

A1.1 The SGN Group[11] is the holder of two licences granted or treated as granted under S.7 of the Gas Act 1986.

A1.2 Special Condition 3.7 of SGN's licences provides a re-opener mechanism by which the Licensee may seek additional funding during the RIIO-2 price control period for activities capable of improving the efficiency or performance of its Non-operational IT Capex. The Licensee applied to the Authority under Special Condition 3.7.6 in January 2023.

A1.3 The Gas and Electricity Markets Authority ('the Authority') gave notice on 22 May 2023 in accordance with Special Condition 3.7.12 of our issuance of a direction under Special Condition 3.7.6 to amend Appendix 1 (Total Non-operational IT Capex Re-opener allowance) of Special Condition 3.7. The notice, published on the Authorities website, included the text of the proposed direction to issue, the reasons for the proposed direction and provided for representations to be made on or before 24 June 2023.

A1.4 The Authority received one non-confidential representation and has placed it on ofgem.gov.uk. Having considered this representation, the Authority has decided to proceed with making this direction. This document constitutes notice of the Authority's reasons for the direction.

A1.5 This direction will implement the Authority's decision on the Licensee's application to the Authority to add additional Non-Operational IT Capex allowances into its RIIO-2 price control framework. Further details on the reasons for and effect of this direction can be found in the main body of this document.

A1.6 Pursuant to Special Condition 3.7.6, the Authority hereby directs the changes to Appendix 1 Special Condition 3.7 as set out in this direction.

A1.7 SGN has two licences, one for Scotland Gas Networks plc and one for Southern Gas Networks plc, and this project will impact both licences. So, the amount awarded has been split between the two licences using a 37%/63% percentage split respectively, as requested by SGN.

[11] Scotland Gas Networks plc and Southern Gas Networks plc

A1.8 For Scotland Gas Networks plc's licence, this direction will replace the existing table within Special Condition 3.7 Appendix 1 in the licence (replicated in Table A1) with Table A2 below.

A1.9 For Southern Gas Networks plc's licence, this direction will replace the existing table within Special Condition 3.7 Appendix 1 in the licence (replicated in Table A3) with Table A4 below.

A1.10 The new award has been added to the existing amounts in each licence. The formatting of the tables has been improved to reduce ambiguity and align with tables used elsewhere in the licences.

Table A1 (Existing table in Scotland Gas Networks plc licence)

~~Total Non-operational IT Capex Re-opener allowance (£m)~~

	~~2022~~	~~2023~~	~~2024~~	~~2025~~	~~2026~~	~~Total~~
~~Re-opener Allowance~~	~~0.631~~	~~2.040~~	~~1.857~~	~~1.105~~	~~0.345~~	~~5.978~~

Table A2 (New replacement table in Scotland Gas Networks plc licence)

Total Non-operational IT Capex Re-opener allowance (£m)

	2021/22	2022/23	2023/24	2024/25	2025/26	All years
Re-opener Allowance	0.631	2.04	2.09	1.687	0.971	7.419

Table A3 (Existing table in Southern Gas Networks plc licence)

~~Total Non-operational IT Capex Re-opener allowance (£m)~~

	~~2022~~	~~2023~~	~~2024~~	~~2025~~	~~2026~~	~~Total~~
~~Re-opener Allowance~~	~~0.861~~	~~2.783~~	~~2.534~~	~~1.508~~	~~0.470~~	~~8.156~~

Table A4 (New replacement table in Southern Gas Networks plc licence)

Total Non-operational IT Capex Re-opener allowance (£m)

	2021/22	2022/23	2023/24	2024/25	2025/26	All years
Re-opener Allowance	0.861	2.783	2.93	2.499	1.536	10.609

A1.11 This direction will take effect immediately.

Yours sincerely,

Jourdan Edwards

Interim Deputy Director Onshore Price Control Operations

For and on behalf of the Authority