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all gas and electricity customers*

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Date: 4 August 2011

Dear Colleague

**Proposed process for the determination of re-opener applications in respect of a Traffic Management Act income adjusting event under the first gas distribution price control review**

**Introduction**

The first gas distribution price control for the period 2008-2013 allows the gas distribution network operators to apply to us to adjust their revenues to accommodate costs associated with the Traffic Management Act 2004 and the Transport (Scotland) Act 2005. They can do this if the costs associated with the implementation of this new legislation are in excess of one per cent of their base revenues. The purpose of this open letter is to consult with all relevant parties regarding our approach for assessing such applications.

We outline below our proposed process and key policy issues including how we propose to assess the efficiency of any additional costs incurred, what additional data we will require from the gas distribution network operators (GDNs) and the proposed process for potential recovery of costs.

This consultation will inform the principles which we will apply as part of assessing the efficiency of costs relating to the Traffic Management Act 2004 ("TMA") and the Transport (Scotland) Act 2005 ("T(S)A")<sup>1</sup> for any future applications and when assessing the RIIO-GD1<sup>2</sup> business plans.

Three of the eight GDNs, Scotland, Southern and London, have given notice to Ofgem confirming that they have started to incur significant costs following the implementation of the TMA. The total gross<sup>3</sup> claim for the full price control period (2008-2013) by the three GDNs amounts to an additional £92.5 million.

**Background on the income adjusting event mechanism**

When we were setting the last price control (for the 2008-2013 period) it was not clear what impact the implementation of the TMA would have on the costs of the GDNs and we were not in a position to make provision for an efficient level of cost for work carried out as

<sup>1</sup> Traffic Management Act 2004 and the Transport (Scotland) Act 2005 referred to throughout this document as "TMA"

<sup>2</sup> The price control review for gas distribution for the period 2013-2021 which will reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model.

<sup>3</sup> Costs prior to any GDPCR1 adjustments for IQI or replacement incentive mechanism.

a result of the TMA. (The exception was expenditure allowance related to the systems which GDNs were putting in place in anticipation of its introduction, where we provided GDNs as a whole with a capital expenditure allowance of £11.3 million for 2008-09 to cover these costs.) For this reason we introduced a specific price control reopener mechanism so that any further TMA costs could be considered in isolation from the GDNs' financial performance within the price control period. The term in the price control formula which reflects the ability for a further adjustment to be made to allowed revenues is  $ITMA_t$ .

Special Condition E7<sup>4</sup> ("the condition") sets out a mechanism under which GDNs can apply for their allowed revenues to be adjusted, together with a notice of costs or expenses incurred or likely to be incurred. Following consultation the Authority determines whether the threshold has been reached to trigger the reopener and whether any or all of the costs or expenses were or are likely to be efficiently incurred and any adjustment can be made to their allowed revenue.

## Process

Appendix 1 sets out the process we plan to follow to assess the additional costs incurred and how we propose to compare these between the GDNs that have given notice. In this we set out what we will be considering and our interpretation of the licence condition in respect of their applications to adjust their revenues for additional funding associated with the TMA. We also discuss how we plan to assess the efficiency of the companies' costs with an emphasis on their claim for the affect of the implementation following the change in legislation has had on productivity.

Prior to making our final decision we plan to publish our minded to position for consultation in October 2011. Appendix 1 sets out what we plan to include as part of this.

## Proposed timetable

Our proposed timetable is as follows:

<b>Task</b>	<b>Date complete</b>
GDNs submit their notices for the $ITMA_t$	30 June 2011
Issue this open letter consulting on our approach for managing the $ITMA_t$	4 August 2011
Request additional information from GDNs	5 August 2011
Responses from GDNs following request for additional information	2 September 2011
Consultation on approach closes	2 September 2011
Publish our minded to position for the adjustment proposals following the notices submitted by the GDNs	14 October 2011
Consultation for our minded to position closes	11 November 2011
Publish final decision for the $ITMA_t$	December 2011

## Decision

Following the closure of the consultation on our minded to position we will consider the responses and make our final decision by the end of December 2011.

## Responses and consent to share information

<sup>4</sup> [Gas Transporter Licence: Standard Condition E7: Determination of any adjustment factor to be applied to MRT \(IAEt\).](#)

We would like to hear the views of interested parties in relation to the approach set out in this open letter. We would especially welcome responses to the specific questions which have been set out below:

**Question 1: Do you agree with the overall approach we plan to take and our timetable?**

**Question 2: Do you agree with our methodology for assessing the efficiency of GDNs in dealing with the impact of TMA?**

Responses should be received by **2 September 2011** and sent to:

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Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). Respondents may request that their response, or part of response, is kept confidential. Ofgem shall respect this request, subject to any obligation to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and/or in writing.

Yours sincerely,



Rachel Fletcher  
Partner, Distribution

## **Appendix 1: Process for assessing ITMA<sub>t</sub>**

This appendix sets out our summary of the licence condition and our view on the proposed process we should follow to assess the efficient costs incurred and how we plan to compare the costs of the GDNs that have given notice.

On receipt of an application from a GDN for a price control reopener related to the TMA, the licence allows us to consider any reasonable costs associated with any order or regulation associated with the implementation of TMA. Any costs must be supported by six months of actual cost data.

A notice of an ITMA<sub>t</sub> shall be given as soon as is reasonably practicable after the occurrence of the ITMA<sub>t</sub>, and, in any event, not later than three months after the end of the relevant formula year in which it occurs.

The Authority must make its determination of the value of approved allowance of an ITMA<sub>t</sub> within six months of the date on which the notice of an ITMA<sub>t</sub> was provided to the Authority. If the Authority has not made a determination within this time, the amount of the allowed income adjustment will be that proposed in the notice.

### **Authority consideration**

As part of our assessment we will consider:

- Whether the notice was received not later than three months after the end of the relevant formula year, in this case 30 June 2011?
- Whether the costs have arisen as a result of reasonable costs incurred from the following items associated with any order or regulation pursuant to Part 3, or any provision of New Roads and Streetworks Act 1991 (NRSWA) amended by Part 4 of TMA or equivalent provision under T(S)A:
  - Permit costs;
  - Fixed penalties;
  - Ongoing administration; or
  - Other costs that the Authority directs should be treated as TMA costs.
- Whether the notice served by the licensee is in accordance with paragraph 8 of the condition and:
  - states the obligations, events or requirements under the TMA to which the notice relates;
  - sets out reference to each such obligation or requirement the basis on which the licensee has calculated the relevant adjustment;
  - is accompanied by at least six months of actual cost data; and
  - states the date from which the licensee wishes the Authority to agree that the relevant adjustment shall have effect (“the adjustment date”).

## Interpretation

It is our interpretation that any notice of additional costs incurred should only include reasonable efficient costs associated with any order or regulation made following the introduction of TMA and any ITMA<sub>t</sub> should not include any additional costs associated with NRSWA. Any efficient costs claimed should be supported by at least six months of actual cost data relating to the order or regulation.

## Assessment of efficiency

Our principal objective is to protect the interests of existing and future consumers, so it is important that we carry out appropriate analysis to ensure that any costs, that are allowed to be funded through the ITMA<sub>t</sub>, are efficient and are appropriately related to the change in legislation. In order to do this we seek the views of relevant parties about the best approach to assessing efficiency recognising that lowest cost is not the only determining factor.

### **Question 2: Do you agree with our methodology for assessing the efficiency of GDNs in dealing with the impact of TMA?**

As part of our assessment of efficiency our current thinking is that a combination of approaches such as reviewing the relevant expenditure and the GDNs processes and procedures to deal with the impacts of TMA is likely to be appropriate.

We expect any costs included in the notices to only include the incremental costs of implementing TMA and not any ongoing costs or increased costs associated with NRSWA. We aim to assess efficient levels of costs associated with meeting the obligations under TMA in two ways; firstly by carrying out cost comparisons across GDNs and using relevant distribution network operators (DNOs) information and secondly by reviewing the GDNs' strategies and approaches for managing the impacts of TMA and the effects on productivity.

In considering the impact of TMA on the GDNs costs we will be considering the workloads and costs incurred historically back to 2007/08 prior to, and after, implementation of the TMA by a number of local authorities. We will be undertaking relevant inter-GDN comparisons including unit cost comparisons where possible. We also aim to look at how an increase in the number of Local Authorities (LAs) implementing the TMA will further impact on GDNs' costs. For that reason we intend to review separately the actual and projected costs associated with LAs with TMA already implemented and for those LAs that are expected to implement it in the future.

Regarding the companies' strategies and approaches for managing the impacts from TMA we will take into account the initiatives, processes and procedures the companies have put in place in order to meet the needs of TMA. GDNs need to demonstrate that they seek to improve their performance against the introduction of permits' and fixed penalty notices' (FPNs) associated with TMA implementation. The companies have introduced new work management systems, additional back office and in-field administration and staff training in order to minimise the impact of TMA implementation on running their businesses and consequently on their productivity.

We believe that productivity is an important element under this ITMA<sub>t</sub> as we recognise that TMA can potentially impact on GDNs' activities and particularly on their gas mains replacement programmes. We will seek to understand how the restrictions that the implementation of TMA has brought such as restricted working hours and working areas and how this has affected the way the companies are carrying out their work. We will also expect GDNs to demonstrate the affect on costs/productivity between LAs that have and have not implemented TMA. For such productivity impacts to be allowed the companies will need to have provided robust evidence both to show the there is an impact, to appropriately quantify it and show what steps they have taken or will take to mitigate the

impact. As part of this we will seek further information from the GDNs to enable us to examine the differences in costs between selected LAs that have both implemented and not implemented TMA, one of which will be Transport for London (TfL) which has impacted both Southern and London GDNs

Special Condition E7 prescribes the relevant TMA costs as follows:

- Permit costs;
- Fixed penalties;
- Ongoing administration; or
- Other costs that the Authority directs should be treated as TMA costs.

The condition sets out high level costs relevant to TMA. However, we need to gather more detailed information relating to the additional costs associated with the implementation of the TMA to obtain transparency and enable us to assess whether there is a case for adjustment to the price control and set the associated efficient level of costs.

The GDNs have already provided data on their additional costs associated with TMA, however given the variances in how they have reported these and the need for consistency to enable the comparison we would like to gather the information on a uniform basis regarding details of the methods of resolution and the basis of calculation of unit costs where possible.

We have developed a template which can be found in Appendix 2 which we propose the companies complete. This will enable comparability between the GDNs and will be used to inform our minded to position. The template includes the following data requirements:

- Permit costs (including volume of permits, number of authorities with permit scheme, gross and net costs of permits);
- FPN costs (including volume and costs of FPNs);
- Administration costs (including management, training, IT costs, back office and field-based administration costs associated with TMA; and
- Other costs – under this category we are primarily focused on productivity. How productivity is affected as a result of the implementation of TMA by LAs and how the companies manage to reduce the impact on productivity as a result. Restrictions on working hours and restrictions on road lengths reduce the flexibility of the GDNs to do their work resulting in impacts on productivity. In addition to the cost data we would seek information on how the reduction in productivity associated with gas mains replacement activities has occurred.

We recognise that LAs operate different policies with regards to TMA implementation resulting in varying TMA costs and therefore different workloads for GDNs to meet the TMA requirements. Therefore, in addition to the above information we aim to ask the companies to provide information about the number of LAs that have implemented TMA, those that are planning to implement over the remaining years of the current price control and some information on the background environment of these LAs (eg urban, rural) which will assist in our analysis and particularly in any unit cost comparisons.

Furthermore we need the companies to attribute the total costs into operational expenditure (opex), capital expenditure (capex) and replacement expenditure (repex).

We will also consider whether the GDNs should be allowed to recover any costs for additional costs that are expected up to the end of GDPCR1; these include lane rental. We

will require documented evidence of the impact of TMA on their costs and their performance to determine if any allowance adjustment is appropriate for the current ITMA<sub>t</sub>. As part of Appendix 2 we require the companies to separately identify these costs relevant to charges for lane rental and section 74. Any additional costs should be supported by at least six months of actual cost data.

Our intention is that Appendix 2 will be completed by all GDNs applying for a reopener so that we can carry out an assessment of efficiency by comparative analysis using data from them.

### Minded to position

Following the consultation on our approach for managing the ITMA<sub>t</sub> and carrying out our assessment of the notices we aim to consult on our minded to position regarding the ITMA<sub>t</sub> applications by the GDNs associated with the implementation of TMA and whether we believe there is a case, as part of GDPCR1, to set additional revenue allowances relating to expenditure associated with TMA implementation and how we are planning to set the associated efficient level of costs.

Our minded to position will take into account response to this consultation and set out the rationale of our assessment of the companies actual and forecasted expenditure associated with TMA and their strategies and approaches in dealing with TMA impacts, and the subsequent effect on productivity. Our minded to position will include:

- Consideration to the responses received as part of this consultation.
- Our assessment of the efficient overall level of costs associated with the TMA implementation based on our cost analysis and the review of the GDNs strategies and management structures to deal with the requirements of the TMA.
- Setting out our view on the appropriate amount of additional allowance for the impact of TMA as part of GDPCR1.
- Establish the principles which will be used for any future notice for an ITMA<sub>t</sub> and assessment as part of RIIO-GD1.
- We will also present our views on the appropriate timeframe over which the additional revenue should be recovered and how it will be recovered taking into consideration the potential impact on customers.

## **Appendix 2: TMA cost and workload template**

See separate excel document - [here](#).