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Date: 30 September 2015

Dear Stakeholder,

Notice of decision for the determination of a proposed relevant adjustment associated with specified streetworks costs under the RIIO-GD1

We recently consulted on our minded-to position[1] with regard to National Grid Gas plc's (NGGD) proposed adjustment in relation to specified streetworks costs for the RIIO-GD1 price control period 2013-2021. The proposed adjustment was submitted under NGGD's Gas Transporter Licence, Special Condition 3F - Arrangements for the recovery of uncertain costs.

This letter sets out our decision for the determination of the relevant adjustment to NGGD's allowed expenditure and the timeframe over which this should be recovered.

Following consideration of the responses to our minded-to consultation, we have increased our allowed adjustment by approximately £1.2 million for NGGD's North West network. We are therefore determined to allow efficient additional costs of £20.8 million against NGGD's application of £33.3 million.

In NGGD's response to our minded to position it provided further additional information on volumes of permits which were not previously provided in its original submission. This information largely impacted its North West network and had an immaterial impact on its London network. Given the immaterial impact on London, we maintain our minded-to position for this network. We also maintain our minded-to position for the East of England network and determine to not allow any costs for this GDN as the efficient costs proposed fall below the one per cent materiality threshold trigger[2]. We also considered East of England's combined applications for specified streetworks costs and enhanced physical security costs. East of England did not exceed the required the materiality threshold amount under the combined applications[3].

[1] Consultation on our minded-to position for specified streetworks costs under the RIIO-GD1 price control review

[2] Our view of efficient costs of £3.1 million fall below the one per cent threshold of £6 million, hence our determination to not allow any additional costs for East of England

[3] Applications under licence condition 3F.7(a) for relevant adjustments to its allowed expenditure for a single cost category are subject to a one per cent materiality threshold. However, where a GDN makes applications under licence condition 3F.7(b) for more than one uncertain cost category, the combined materiality threshold of three per cent comes into effect. This means the amount of change to allowed expenditure aggregated across the multiple categories should exceed the three per cent threshold. In order for individual elements to be considered as part of the three per cent materiality they must also each exceed 0.5 per cent of the materiality threshold amount

Table 1: Cost impact – Allowed adjustments

GDN *2014/15 prices*	Materiality threshold 1% trigger	GDN's submitted costs	*Ofgem's minded-to position*	Ofgem's view of efficient costs	Ofgem's relevant adjustment
East of England	£6.0 m	£10.0 m	*zero*	£3.1 m	zero
London	£4.2 m	£14.3 m	*£12.7 m*	£12.7 m	£12.7 m
North West	£4.3 m	£9.0 m	*£6.9 m*	£8.1 m	£8.1 m
Total	**£14.5 m**	**£33.3 m**	***£19.6 m***	**£23.9 m**	**£20.8 m**

Based on our decision the average annual impact on customer bills over the remaining five years of the RIIO-GD1 period for each GDN is set out on Table 2. Further details on revenue and customer bill impact are set out in Appendix 1.

Table 2: Customer bill average annual impact 2016-2021 – GDNs' submitted and Ofgem's allowed adjustments

Customer bill impact - annual average 2016-2021 *2014/15 prices*	Impact based on GDN's submitted costs	Impact based on Ofgem's proposed relevant adjustment
East of England	£ 0.27	zero
London	£ 0.60	£ 0.54
North West	£ 0.34	£ 0.31

Background

The RIIO-GD1 price control for 2013-2021 allows the gas distribution network companies (GDNs) to apply to the Authority[4], by means of an uncertainty mechanism, to adjust their allowed expenditure to accommodate specified streetworks costs.

Streetworks costs are costs incurred or likely to be incurred by GDNs in complying with their obligations under the Traffic Management Act (TMA) 2004[5] when working in the highway.

At the time of setting allowed expenditure for RIIO-GD1, there was uncertainty around streetwork costs where Highway Authorities (HAs) had not introduced permit schemes prior to the start of RIIO. We therefore put in place a reopener uncertainty mechanism to allow companies to apply to recover additional efficient specified streetworks costs, where the amount exceeds or is likely to exceed one per cent of the relevant GDNs materiality threshold (or a three per cent threshold for combined applications under more than one cost category with a minimum 0.5 per cent for each category).

The GDNs may apply for relevant adjustments to their allowed expenditure during two defined reopener windows, May 2015 and May 2018.

Three of NGGD's GDNs, East of England, London and North West, gave notice to the Authority in May 2015 and proposed relevant adjustments to their allowed expenditure as set out in Table 1.

[4] Authority means the Gas and Electricity Markets Authority that is established under section 1 of the Utilities Act 2000. In this consultation, references to the Authority are used interchangeably with references to Ofgem and to the regulator.
[5] TMA covers England and Wales. Scotland is covered under the Transport (Scotland) Act 2005

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Responses

We received two responses to our consultation, one from NGGD and one from the Centrica Group. The responses have been published along with our decision.

NGGD accepted our minded-to position for East of England and believe it would be appropriate to submit a claim for this GDN at the second reopener window in May 2018.

NGGD disagreed with our adjustment mechanism for permit variations and with our three per cent adjustment for efficiency and the impact of innovation.

In respect of permit variations, NGGD suggested our adjustment mechanism was incorrect as we assumed all variations were chargeable. NGGD provided new information and additional data, analysing the variations between chargeable and non-chargeable and providing associated costs for chargeable variations and permits granted.

In respect of efficiency and innovation, NGGD commented that they took the decision not to include real price effects (RPEs) of 1.2% in forecast costs as they considered this could be offset by efficiencies. NGGD also commented that innovation has already been factored into actual and forecast costs and therefore it is unacceptable to factor an additional three per cent when many of the innovation techniques have already been deployed.

The Centrica Group does not believe that any additional revenue should be allowed at this stage, because: evidence required by Ofgem has not been provided; the evidence submitted does not provide assurance that costs are efficient; there is a lack of historic data to generate forecasts; resubmissions may be made during the 2018 reopener application window. In addition, the Centrica Group believe a consultation period of only one month is insufficient for stakeholders other than GDNs to properly assess the proposals and believe all future GDNs' allowance requests should be published much earlier in order to give non-GDN stakeholders early sight in light of the short assessment window.

Our decision

We have considered the responses following our consultation.

NGGD

Permits

In respect of NGGD we reviewed the additional information provided for permits, which included an analysis of permit variations split between chargeable and non-chargeable volumes and costs split between permits granted and chargeable variations. This new information was not made available as part of NGGD's original submission, and it was therefore assumed that all permits were chargeable for our initial assessment and minded-to decision.

We accept the revised permit variation volumes for both London and North West. Based on the new information the revised unit cost per permit for chargeable variations fell within the expected range of £35-£45. However, in London the unit cost for permits granted exceeded £80, which was the unit cost we used when we set streetwork costs for existing highway authorities as part of RIIO-GD1. These changes had no overall material impact on London, and therefore we maintain our minded-to position for this GDN. The overall impact was more significant for North West, resulting in increased efficient costs of £1.2 million.

Efficiency and innovation adjustment

We maintain our minded-to position to apply a three per cent adjustment across all cost categories for all GDNs.

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NGGD’s submission is based on an extrapolation of its 2013-2014 actual costs. There is no evidence that these actual costs included any benefits of planned innovation. In addition, there was also no adjustment for innovation made to the forecast costs in the extrapolation model.

NGGD has previously referred to the future benefits of innovation in other publications such as its recent Discretionary Reward Scheme submission and in its current year annual report, where the use of innovation is clearly forecast throughout the RIIO-GD1 period including the latter years.

We do not agree with NGGD’s comment on RPEs. As part of their price control annual reporting for 2013-14 and 2014-15 they have not highlighted RPEs as a significant driver for any change in actual or forecast costs.

Centrica Group

Whilst we accept that there were some weaknesses in NGGD’s claim, we also recognise that additional costs are being incurred for streetworks. However, we also consider that GDNs should strive to become more efficient and use innovation whilst working in the highway, hence our three per cent adjustment applied across all cost categories.

In respect of the consultation period we will consider for future uncertainty mechanism how the companies can improve their engagement with stakeholders, for example, including the possibility, as Centrica suggests, of publishing any re-opener requests when we receive them.

Yours faithfully,

Paul Branston
Associate Partner, Gas Networks

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Appendix 1 – Financial mechanisms for price control variable value re-openers

The mechanism for implementation of adjustments to the variable value re-openers within the price control period will follow the procedures as outlined in the financial handbook[6] Chapter 7 for Gas Distribution and can be outlined as follows:

Revision to the allowances will be implemented through the Price Controls Financial Model as part of the Annual Iteration Process. The changes to the allowances will impact on the value of MOD through changes in Totex[7].

Treatment on the revision of allowed Totex will be subject to the Totex Incentive Mechanism (TIM), whereby, subject to the various capitalisation rates across Gas Distribution, Totex will be split into fast pot expenditure and slow pot expenditure.

Fast pot expenditure is treated as revenue and will inform the changes to base revenue. Slow pot expenditure is added to the Regulatory Asset Value (RAV) and is recovered over the life of the RAV through regulatory depreciation and return.

The revenue impact and the customer bill impact across the price control period based on the GDN submissions and our proposed adjustments are set out in tables A1.1 and A1.2 below.

Table A1.1 – revenue impact

Revenue impact - GDN proposed adjustments *2014/15 prices*	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
East of England	£2.8 m	£0.8 m	£0.7 m	£0.7 m	£0.7 m
London	£4.5 m	£1.1 m	£1.0 m	£1.0 m	£1.0 m
North West	£2.5 m	£0.7 m	£0.7 m	£0.7 m	£0.6 m
Revenue impact - Ofgem proposed adjustments *2014/15 prices*	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
East of England	zero	zero	zero	zero	zero
London	£4.1 m	£0.9 m	£0.9 m	£0.9 m	£0.8 m
North West	£2.0 m	£0.5 m	£0.5 m	£0.5 m	£0.5 m

Table A1.2 – customer bill impact

Annual bill impact - GDN proposed adjustments £'s *2014/15 prices*	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**Annual average 2016-2021**
East of England	0.66	0.18	0.18	0.17	0.17	0.27
London	1.57	0.38	0.37	0.36	0.35	0.60
North West	0.81	0.23	0.22	0.21	0.21	0.34
Annual bill impact - Ofgem proposed adjustments £'s *2014/15 prices*	**2016-17**	**2017-18**	**2018-19**	**2019-20**	**2020-21**	**Annual average 2016-2021**
East of England	zero	zero	zero	zero	zero	zero
London	1.45	0.33	0.31	0.30	0.29	0.54
North West	0.79	0.21	0.20	0.19	0.18	0.31

[6] RIIO-GD1 financial handbook
[7] Totex means total expenditure

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