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RIIO-GD1 Reopener Consultation – Specified Street Works Costs

Consultation

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Overview:

The RIIO-GD1 price control includes two reopener windows for companies or Ofgem to propose adjustments to expenditure allowances for certain categories of costs that were too uncertain to provide ex ante allowances at the time of our Final Proposals.

This document sets out our initial views on Cadent's application for an adjustment to its East of England network allowed expenditure for street works during the RIIO-GD1 price control.

We welcome the views of interested parties on the issues set out in this document. Responses should be addressed to gasnetworks@ofgem.gov.uk and received no later than 29 August 2018. Unless clearly marked as confidential, responses will be published on our website. We will consider the responses before we make our final determination, which we will publish by the end of September 2018.

Context

RIIO-T1 and GD1 were the first price controls to reflect the new RIIO (Revenue = Incentives + Innovation + Outputs) model. The RIIO-GD1 price control sets the outputs that the gas distribution network companies need to deliver for consumers and the associated revenues they are allowed to collect for the eight year period from 1 April 2013 until 31 March 2021.

For cost categories where there was significant uncertainty about expenditure requirements at the time of setting allowances, the price controls include a "reopener" mechanism. The mechanism allows network companies to propose adjustments to baseline expenditure allowances for these costs when there is more certainty. The reopener mechanism specifies two windows during which adjustments to allowances may be proposed – one in May 2015 and the other in May 2018.

We have received reopener submissions for the following cost categories:

- One-off Asset Health Costs (Feeder 9)
- Industrial Emissions Costs
- Enhanced Security Costs
- Enhanced Physical Site Security Costs
- Quarry and Loss Development Claims Costs
- Specified Street Works Costs

The reopener process fits into priorities 3 and 4 of the 2018-2019 Ofgem Corporate Strategy.

We are required to make a determination by 30 September 2018 on any application received through the reopener process.

Associated documents

Informal consultation on RIIO-1 price control reopeners (May 2018)

RIIO-GD1 Specified Street Works Costs Reopener submission from Cadent (May 2018)

RIIO-GD1 Final Proposals Overview

RIIO-GD1 Initial Proposals Overview

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Executive Summary

The current price control for gas distribution network companies includes a reopener provision for licensees to apply for an adjustment to their expenditure allowances in relation to Specified Street Works Costs. These are certain costs that have been incurred, or are expected to be incurred, by a licensee in complying with its obligations under the Traffic Management Act 2004 (in England and Wales) and the Transport (Scotland) Act 2005 in Scotland, or under any wider street works legislation which applies to the licensee.

The licence provides two reopener windows for applications to be submitted, May 2015 and May 2018.

In May 2015, Cadent (previously National Grid Gas Distribution) submitted an application for additional allowances for Specified Street Works Costs relating to its East of England network area. Following our assessment, we did not direct an adjustment to Cadent's allowances because our view of efficient costs fell below the materiality threshold set out in the licence.

We have now received another application from Cadent as part of the May 2018 reopener for additional allowances for Specified Street Works Costs. The application requests an additional allowance of £21.3m[1]. We propose to allow £17.3m of this request.

Cadent's application covers three categories of Specified Street Works Costs:

- **Permit fees –** These are costs associated with obtaining permits for undertaking street works in highway authority areas covered by a permit scheme.
- **Administration costs –** These are costs relating to administration and management work required to support street works undertaken in areas covered by a permit scheme.
- **Productivity cost impacts –** These are costs incurred as a result of the impact of permit conditions imposed on street works undertaken in areas covered by a permit scheme.

Our initial views are that:

- We are satisfied that Cadent's actual reported expenditure to date in the three categories of Specified Street Works Costs appears reasonable.
- We consider that Cadent's approach for forecasting permit fees appears reasonable, however it used a different methodology for forecasting administration and productivity cost impacts. We consider that the same methodology should also be applied to administration and productivity cost impacts. Applying the same methodology to all forecast costs reduces the forecasted costs in those categories by £3.9m.

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[1] All costs in this document are reported in the 2009/2010 price base, unless otherwise stated.

Following our review, we are proposing to increase Cadent's allowance by £17.3m. This amount exceeds the materiality threshold of £5.0m, and therefore meets the materiality test set out in the licence.

The requested and proposed allowed adjustments to allowances are shown in Table 1.

	Requested Funding for RIIO-GD1	Proposed Allowed Funding for RIIO-GD1	Difference	Percentage difference
Permit Fees	£5.0m	£4.9m	£0.2m	3.1%
Administration Costs	£7.3m	£5.3m	£2.0m	26.9%
Productivity Cost Impacts	£9.0m	£7.2m	£1.8m	20.2%
Total	**£21.3m**	**£17.3m**	**£3.9m**	**18.5%**

Table 1: *The requested and proposed allowed funding for Cadent's Specified Street Works Costs during the RIIO-GD1 period (2009/2010 price base).*

Next Steps

This consultation will close on 29 August 2018. Please send in your response by emailing us at gasnetworks@ofgem.gov.uk.

In proceeding with a 21-day consultation, we welcome engagement from interested stakeholders during the consultation period. The shorter period is driven by the licence requirement to determine any relevant adjustments to Cadent's allowed expenditure by the end of September and the time we need to take into account comments made in response to the consultation, engage with interested stakeholders and revise our analysis, if necessary.

Our decision will be implemented through the 2018 Annual Iteration Process, which means that any adjustments to Cadent's allowed revenues will take effect from 2019/20.

1. Introduction

1.1. The RIIO-GD1 price control will be in place for eight years, from April 2013 to March 2021. The RIIO-GD1 price control allows gas distribution network companies (GDNs) to apply for adjustments to their expenditure allowances for certain Specified Street Works Costs.

1.2. Specified Street Works Costs are defined in Special Condition 1A of Cadent's licence as:

Specified Street Works Costs means costs specified below that have been incurred, or are expected to be incurred, by the Licensee in complying with obligations or requirements arising under any orders or regulations made pursuant to Part 3 of the Traffic Management Act 2004 (or, in Scotland, the Transport (Scotland) Act 2005) that impose a permit scheme, or under any wider street works legislation applicable to the Licensee:

(a) one-off set-up costs;

(b) permit fee costs;

(c) administrative costs arising from the introduction of permit schemes;

(d) costs arising from the introduction of permit conditions;

(e) costs arising from changes to working practices required by the introduction or alteration of any code of practice applicable to the Licensee;

(f) costs arising from lane rental charges levied on the Licensee by highway authorities;

(g) costs arising from changes to inspection fees payable by the Licensee;

(h) costs arising from changes to the requirements imposed on the Licensee in respect of highway reinstatement; and

(i) costs arising from the introduction of new congestion charging schemes or changes to existing ones.

as further clarified in the RIGs;

1.3. As part of setting allowances for RIIO-GD1, we allowed efficient street works costs where Highway Authorities (HAs) had already implemented a permit scheme prior to the start of RIIO-GD1. However, there was uncertainty around street works costs where HAs had not introduced permit schemes prior to the start of RIIO, but were expected to do so during the price control period. We therefore put in place an uncertainty mechanism in Special Condition 3F (Arrangements for the recovery of uncertain costs) of the gas transporter licence held by the GDNs. This was to allow them to apply to adjust their expenditure allowances to cover additional efficient Specified

Street Works Costs, where the amount exceeds or is likely to exceed a materiality threshold.

1.4. There are two application windows for reopeners, providing that the materiality thresholds are met, May 2015 and May 2018.

1.5. In May 2015, Cadent (then known as National Grid Gas Distribution) submitted an application under Special Condition 3F for additional allowances for Specified Street Works Costs in respect of three of its network areas: East of England (EofE), London and North West. Following our assessment of the application, we concluded that the efficient costs for the EofE network had failed to meet the materiality threshold of £5.0m. As a result, we did not make an adjustment to allowances for the EofE area.

1.6. During the May 2018 reopener window, Cadent submitted an application under Special Condition 3F for an adjustment to its allowed expenditure of £21.3m to cover Specified Street Works Costs for its EofE network, which it has incurred, or expects to incur, during the RIIO-GD1 price control. The submission is available on our website.[2] We propose to allow £17.3m of the requested funding.

1.7. Cadent's application covers costs associated with permit fees, administration and productivity cost impacts.

- Permit fees are costs incurred in securing permits for carrying out work on public highways in areas that operate a permit scheme. The cost of a permit will vary depending on the HA and the nature of the street.

- Administration costs are costs relating to back office and support staff involved in managing permit schemes.

- Productivity cost impacts are costs incurred by companies carrying out street works in areas covered by permit schemes. Street works permits can carry conditions that restrict the timing and duration of works, and so can also cause additional costs (e.g. temporary traffic lights).

1.8. The adjustments proposed by Cadent for each of these cost categories are set out in Table 2.

Table 2: Cadent's requested allowances.

Cost category	EofE submitted costs
Permit Fees	£5.0m
Administration Costs	£7.3m

[2] Informal consultation on RIIO-1 price control reopeners (May 2018).

Productivity Cost Impacts	£9.0m
Total	£21.3m

1.9. The remainder of this document:

- Sets out our assessment methodology, and
- Presents our initial views on Cadent's submission.

2. Our assessment of the submission

Chapter Summary

In this chapter, we set out our assessment of Cadent's request for additional allowances for Specified Street Works Costs in the EofE network area.

Question box

We are interested in stakeholders' views on our assessment of Cadent's submission and the allowances we have proposed. When reading the following, please consider the following questions:

Question 1: Do you have any views on our assessment methodology?

Question 2: Do you have any views on the outcome of our assessment?

2.1. We have assessed the reopener application and data provided by Cadent. As part of our assessment, we have considered the following:

- Whether the actual reported expenditure (April 2013 – June 2017) is efficient.
- Whether Cadent's forecasts of expenditure in the remaining years of the price control are reasonable.
- Whether Cadent has put in place processes to ensure that additional costs incurred as a result of permit schemes are managed efficiently.

Our assessment of the submission

Permit Fees

2.2. Cadent has requested additional allowances of £5.0m to cover costs associated with permit fees. This covers actual costs incurred in the first four years of the RIIO-GD1 price control, £1.8m (2013/14 – 2016/17), as well as forecast costs for the remaining four years, £3.2m (2017/18 – 2020/21).

Actual expenditure

2.3. Cadent provided data on actual expenditure on permit fees in the first four years. The number of HAs that have a permit scheme in place has been increasing. Cadent predicts that 88% of all HAs in the EofE region will have a permit scheme in place by 2018/19.

2.4. The unit cost per permit has been around £58/unit (nominal prices) since the start of RIIO-GD1 with one exception in 2014/15, where unit costs fell to £54.70/unit (nominal prices).

2.5. There were minor errors in Cadent's calculation of the historical number of permits in each year for four HAs, which resulted in the inclusion of costs that are not eligible for this reopener. This was relatively insignificant and has been corrected as part of our analysis.

2.6. Cadent's submission includes permit costs associated with four HAs (Transport for London, Barnet, Enfield and Haringey) for which we have already provided funding as part of our RIIO-GD1 price control. Therefore, we propose to remove permit costs associated with them from both the actual and forecast costs.

2.7. Cadent's analysis was otherwise an accurate reflection of permit fees incurred.

Forecast expenditure

2.8. Cadent provided a forecast of the number of permits required in the remaining four years of the price control. These forecasts have been provided for each HA that operates, or is expected to operate, a permit scheme during that period. Our initial view is that this is a reasonable approach to forecasting permit volumes and costs.

2.9. We note that in the administration and productivity cost impact proposals, Cadent used an alternative method to forecast permit volumes. The calculation involved in these forecasts is reliant on an assumption that the workload for each HA is equal, which is clearly not the case and is likely to result in an inaccurate forecast. As Cadent provided an acceptable method in its permit costs proposal to forecast volumes, we therefore propose that this is replicated in the administration and productivity cost impact forecasts.

2.10. Cadent's method of forecasting the number of permits varies between different HAs, depending on the length of time that a permit scheme has been operating in that area. In all cases, these forecasts are based on the number of street works notices that are expected to be issued, which in turn is based on the forecast work load in that area.

2.11. Cadent then forecast overall permit fee costs by multiplying forecast volumes by the average cost per permit in each HA in the first four years. If the HA had not operated a scheme for all four years, the most recently available year's data was used (i.e. 2016/17), rather than an average. This is because the data had high costs in the early years whilst the scheme was bedding in and we do not want this to unduly distort any averages over a short time horizon. Where no cost data was available, Cadent estimated the average cost using assumptions about the proportion of notices that would be categorised as major, standard or minor works.

2.12. Having assessed Cadent's methodologies for forecasting the number of permits, the overall costs and the assumptions used, we are satisfied that these are broadly reasonable. However, we have made minor amendments to Cadent's forecasts as set out below.

2.13. The errors identified in Cadent's submission for permit costs associated with four HAs (Transport for London, Barnet, Enfield and Haringey) were removed from the forecast costs, as well as the actuals.

2.14. Four other HAs' permit schemes were due to go live in 2017/18 and a claim was included based on a forecast of these costs. Subsequent information from Cadent, however, showed that of these four HAs, one did not implement the scheme until February 2018 and the other three implemented their schemes after April 2018. We have adjusted Cadent's forecasts to reflect the actual start scheme of these HAs.

2.15. We consider Cadent's approach to engaging with stakeholders and HAs to manage and improve its processes to minimise cost associated with street works to be reasonable.

2.16. Cadent is currently in the process of developing and testing systems and processes to reduce the cost impacts of permit schemes. One example it provided in its submission was the development of a lane rental app to help work designers avoid routes which attract charges. Cadent has advised that innovative techniques such as these are still at an early stage (still in the research and development or initial testing phases) and as such, will provide little or no cost saving through RIIO-GD1.

2.17. For the reasons set out in paragraphs 2.13 and 2.14, our initial view is to reduce Cadent's application in respect of permit fees costs by £0.2m to £4.8m.

Administration Costs

2.18. Cadent has requested an allowance of £7.3m to cover administration costs relating to permit schemes. This covers actual costs incurred in the first four years of the RIIO-GD1 price control, £2.6m (2013/14 – 2016/17), as well as forecast costs for the remaining four years, £4.62m (2017/18 – 2020/21).

2.19. The increase in the number of HAs adopting permit schemes has required increased administrative knowledge and understanding of requirements of those schemes. One way in which Cadent has achieved this is by using internal training courses and lessons learned sessions to draw on experiences of colleagues.

2.20. We examined the costs and forecasting methods for the eight subcategories of administration costs: back office administration, management costs, training costs, IT costs, traffic management schemes, traffic management plans, pre-site surveys and site meetings.

Actual expenditure

2.21. Following our assessment, we consider that the costs incurred to date appear broadly reasonable and we propose to allow these costs.

Forecast expenditure

2.22. We have concerns about the methodologies used by Cadent to forecast administration costs over the remaining four years of the price control.

2.23. Firstly, Cadent's method of forecasting administration costs relies on forecasts of permit volumes that do not match their method used to forecast permit fees.

2.24. Secondly, the method assumes that the administration workload for each HA is the same, which is not the case. For example, Hertfordshire issued 12,590 permits between 2013/14 and 2016/17, while Surrey issued 37 in the same period.

2.25. We do not consider it appropriate to use two separate methods to forecast permit numbers. For consistency, we think that the method used to forecast permit fee costs, which appears to us to be reasonable, should also be used to forecast administration costs.

2.26. For the forecast costs from 2017/18 to 2020/21, we have therefore used an alternative method that we consider to be more robust. Our calculation is based on the following:

- We propose to use the same forecasts of permit volumes that Cadent used to forecast permit fees.

- We estimate a unit administration cost (per permit) based on 2016/17 data by dividing actual administration costs by the actual number of permits from 2016/17. This unit cost figure is then multiplied by the forecast number of permits for each of the four years.

- Due to a significant spike in costs during 2015/16, which distorts the values in a way that is not representative going forward, we decided to use the 2016/17 unit costs within the calculation rather than an average across the four years. Cadent notes that this could be a result of a reduction in the number of conditions due to changes in legislation which reduced costs in 2016/17.

- We then propose to apply an efficiency improvement of 3% per year to account for efficiencies within Cadent's administration as its processes improve and settle (e.g. training impacts and staff becoming more experienced). Cadent had not included an efficiency improvement in its calculation, however, we consider this is reasonable as we can see efficiencies made in the submitted year-on-year data, reflecting ongoing improvements in Cadent's systems and processes. We therefore consider it reasonable to expect efficiencies to continue.

2.27. We have used data from 2016/17 to estimate unit costs because Cadent told us that there has been a significant decrease in the number of permit conditions relative to the previous year due to changes in legislation. Using previous years' cost data would therefore not provide a reasonable forecast of unit costs.

2.28. For the above reasons, our initial view is to allow a total of £5.3m compared to Cadent's requested £7.3m for administration costs over RIIO-GD1, which is a reduction of £2.0m.

Productivity cost impacts

2.29. Cadent has requested £9.0m of funding to cover productivity cost impacts. This covers actual costs incurred in the first four years of the RIIO-GD1 price control, £4.01m (2013/14 – 2016/17), as well as forecast costs for the remaining four years, £4.97m (2017/18 – 2020/21).

2.30. Productivity cost impacts cover the additional costs imposed by permit condition restrictions or different working practices being required by HAs to minimise the disruption to road users. These include:

- Timing and duration: These conditions restrict the time the GDN can work on the road/highway and the overall duration of the works.
- Road space: This restriction limits the space the GDN has to carry out works efficiently.
- Traffic management provisions: Specific requirements and plans can be imposed by the HA to ensure traffic movement, which can add additional costs, e.g. planning and operational costs.
- Parking bay suspensions, temporary traffic restriction costs and modifications to existing traffic signal equipment.

2.31. Cadent has provided actual and forecast data for all subcategories of its submission in respect of productivity cost impacts. We have reviewed each of these, and compared and confirmed these figures with the total costs set out by Cadent.

Actual expenditure

2.32. Following our assessment, we consider that the costs incurred to date appear broadly reasonable and we propose to allow them.

Forecast expenditure

2.33. As in the case of administration costs, we have concerns about the methodology used by Cadent to forecast productivity cost impacts over the remaining four years of the price control.

2.34. To forecast productivity cost impacts, Cadent used a similar method to its approach to forecasting administration costs. This involved using the percentage coverage of network calculation, which assumes that workload and productivity impacts, as a result of the permit scheme, are equal in all HAs, which is not the case (see paragraph 2.24).

2.35. We propose to use the same forecasts of permit volumes that we have used for permit fees and administration costs. We have forecasted the productivity cost impacts using permit volumes and length of mains decommissioned under the replacement expenditure (Repex) programme as the main drivers.

2.36. For the reasons set out above, our initial view is to allow a total of £7.2m compared to Cadent's requested £9.0m for productivity cost impacts over RIIO-GD1, which is a reduction of £1.8m.

3. Our initial view

Chapter Summary

In this chapter, we set out our initial views on Cadent's request for additional allowances for Specified Street Works Costs in the EofE network area. We also outline the next steps of the consultation.

3.1. Cadent requested £21.3m of funding to cover Specified Street Works Costs in its EofE network during the RIIO-GD1 period. Having fully assessed its claim, we propose to allow £17.3m, which is a reduction of approximately 19%. Table 3 shows the requested allowance and proposed allowance broken down year-by-year of in the price control.

Table 3: Requested and proposed expenditure allowance profile for Specified Street Works Costs.

(09/10 Prices) £m	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21	Total
Requested Allowance	0.58	1.79	3.45	2.65	2.89	3.11	3.27	3.52	**21.26**
Proposed Allowance	0.58	1.77	3.39	2.57	2.16	2.33	2.31	2.21	**17.34**

Next steps

3.2. This consultation will close on 29 August 2018. Please send in your response by emailing us at gasnetworks@ofgem.gov.uk.

3.3. In proceeding with a 21-day consultation, we welcome engagement from interested stakeholders during the consultation period. The shorter period is driven by the licence requirement to determine any relevant adjustments to Cadent's allowed expenditure by the end of September and the time we need to take into account comments made in response to the consultation, engage with interested stakeholders and revise our analysis, if necessary.

3.4. Our decision will be implemented through the 2018 Annual Iteration Process, which will mean that any adjustments to Cadent's allowed revenues will take effect from 2019/20.

Appendix 1 - Feedback on this consultation

How to respond

1.1 We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

1.2 We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

1.3 We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations, and put it in our library.

Your response, data, and confidentiality

1.4 You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.5 If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.6 If the information you give in your response contains personal data under the General Data Protection Regulations 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations.

1.7 If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.