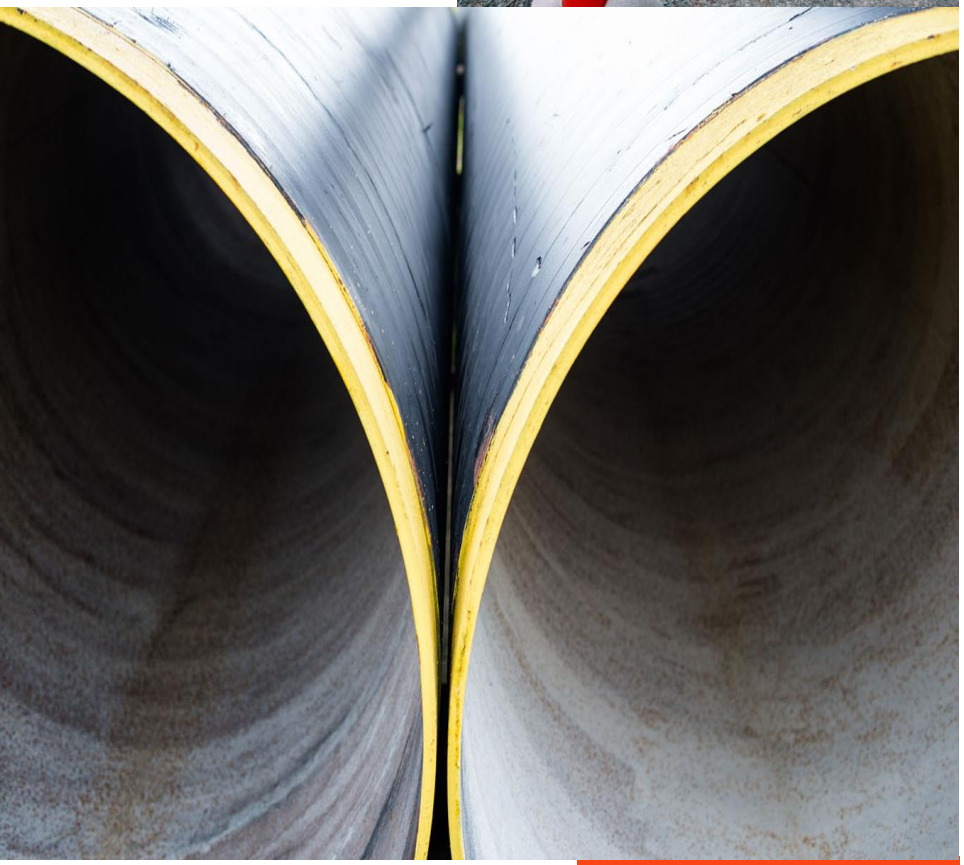

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# RIIO-GD2 CAWG – RPE indexation

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Your Gas Network

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# In RIIO2 what costs are so variable that totex becomes significantly unpredictable?

Initial view - threshold of a 0.5% or higher totex ***variability*** potential equates to around 0.2% RoRE

For most GDNs this equates to around £1m, with £2m for East and Southern

*Does this level of variability appear a reasonable materiality threshold?*

Application to:

- Direct Labour & Contractor Labour - around two thirds of controllable totex (based on Ofgem GD1 analysis)
- Certain Materials - around 10% of controllable totex, but commodity prices can be highly variable, especially relevant for

⇒ PE pipe, Blacktop reinstatement materials, Copper, Steel and Brass

*Are these the right cost categories? Should others be included?*

# What are the characteristics of a good index?

Initial view that an index needs to fulfill a number of criteria, to be

- Representative of efficient GDN costs - *fundamental*
- Not dominated by GDNs - *or pass through*
- Produced by a reputable body
- Continuous in its method of calculation - *no jumps*
- Finalised on a timely basis – *for PCFM*

*Are these the right criteria? Should others be included?*

# What indices might be used? – Direct labour (1)

Identified 3 potential sources of data for some or all of Direct Labour as shown below.

| Index | Source | Data type | When | Timing of revisions | Changes in calculation | Ofgem GD1 use |
|---|---|---|---|---|---|---|
| ONS: Average Weekly Earnings (AWE) | Monthly survey of 9,000 businesses and 121,000 individuals | Mean data at sector level | Monthly - two months in arrears | One month later | Single data set | RPE projections |
| ONS: Annual Survey of Hourly Earnings (ASHE) | Sample of 1% of HMRC records for adults in post > a year, at reference date in April | Mean and median data at detailed job type level (SOC codes) | Annually – autumn after reference date: recently October | Following year's publication | Usually twin data sets | Regional Pay adjustments |
| BCIS Price Adjustment Formula Index (PAFI) | Monthly survey | Mean data for various construction costs | Monthly | ? | ? | RPE projections |

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# What indices might be used? – Direct labour (2)

Using these sources, we have identified 5 potential options for Direct Labour

- Private sector: ONS AWE
- Private sector: ONS ASHE
- Sectoral: ONS AWE Transport & Storage, Construction, BCIS PAFI
- Sectoral: ONS AWE Professional / Scientific / Technical, Construction, Administration
- Notional GDN workforce: detailed ONS ASHE SOC data – see Appendix

An assessment of these options using the criteria is shown below.

| Direct labour indices | Proxy for efficient GDN costs | Not dominated by GDNs | Produced by a reputable body | Continuous method of calculation | Finalised on a timely basis |
|---|---|---|---|---|---|
| | | | | | |
| Private sector earnings – AWE | | | | | |
| Private sector earnings- ASHE | | | | | |
| Sectoral-AWE T&S, Construction, PAFI | | | | | |
| Sectoral-AWE Construction, Prof Scientific & Tech, Admin | | | | | |
| Notional GDN Workforce – ASHE data | | | | | |

Not the best match for GDN costs

Accurate but data may be revised

The last 2 options appear potentially suitable

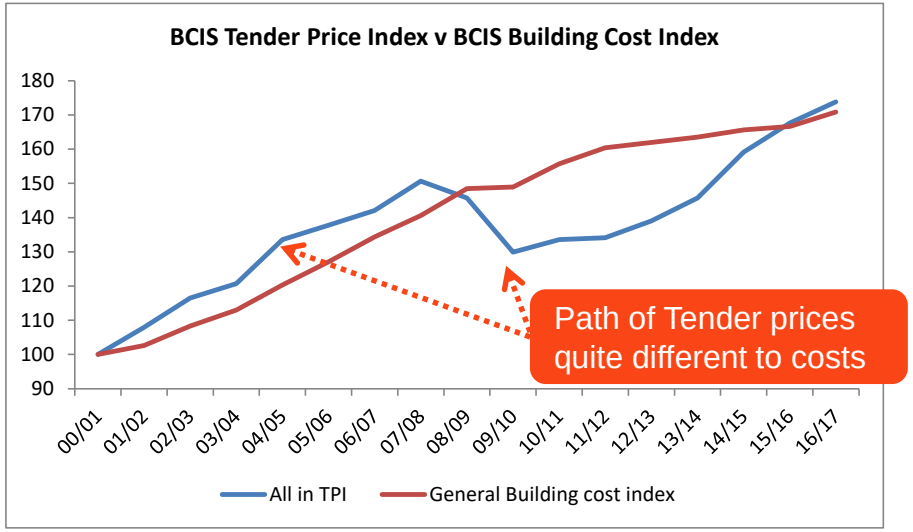
*Can we use Notional GDN workforce pay data that might be revised later?*

# What indices might be used? – Contract labour

For contract labour managed by GDNs, similar to Direct labour – propose to use indices as Direct Labour.

*Does this seem reasonable?*

For contract labour managed by third parties, GDN costs driven by Tender Prices which can move quite independently to contractors' costs




Still looking for a suitable index. Needs to take into account

- Main-laying rather than general construction BUT does this mean that it would be dominated by GDNs?
- That sub-contractors can walk away / go bust if tied to an unsuitable index

Example unsuitable index, Ofwat's COPI for capital indexation – heavily influenced by house building: at PR09 Ofwat unhappy that index artificially high, water companies then suffered when COPI fell sharply to become artificially low

*Views on suitable indices for Contractor labour managed by third parties?*

# What indices might be used? – Materials

Options for PE pipe, blacktop reinstatement materials, copper, steel and brass

| Significant materials cost indices | Proxy for efficient GDN costs | Not dominated by GDNs | Produced by a reputable body | Continuous method of calculation | Finalised on a timely basis |
|---|---|---|---|---|---|
| **PE Pipe & Fittings** | | | | | |
| ICIS London Oil Reports PE100 index | | | | | |
| BCIS PAFI PE Pipes & Fittings index | | | | | |
| **Reinstatement materials - oil based** | | | | | |
| BCIS PAFI coated Macadam & Bituminous products | | | | | |
| **Steel** | | | | | |
| BCIS PAFI Steel | | | | | |
| **Copper** | | | | | |
| BCIS Copper pipe & fittings | | | | | |
| LME Metal index | | | | | |
| **Brass** | | | | | |
| LME Metal indices | | | | | |

PE100 is gas pipe grade, but PAFI covers all the cost

Brasses have differing %s of copper and zinc

*Views on suitable indices for materials?*

# Application to allowances or actual costs?

| | Indexation applied to allowances | Indexation applied to actual costs |
|---|---|---|
| Compensates only for RPEs actually incurred | | |
| Mimics ex-ante approach | | |
| Does not incentivise certain organisational structures and reporting over others | | |
| Avoids reliance on accurate and consistent GDN reporting | | |
| Does not add to complexity of regulatory regime | | |

*Balance of arguments suggests applying indexation to allowances. Views?*

# Should the approach be tailored by GDN?

Could apply index to common notional or individual GDN structures - precedents for both, but reporting consistency issue with individual GDN structures

Propose notional structure tailored by GDN to reflect price control allowances containing different proportions of reporting cost categories - Emergency, Repair, repex etc

Common cost split applied to allowance for each activity

| | | Common assumed split | GDN A allowance | GDN A Assumed split | GDN B allowance | GDN B Assumed split |
|---|---|---|---|---|---|---|
| | **Emergency** | | | | | |
| **Opex** | Direct labour subject to RPEs | 75% | | 75 | | 53 |
| | Contract Labour subject to RPEs | 20% | | 20 | | 14 |
| | Materials subject to RPEs | 0% | | 0 | | 0 |
| | Other | 5% | | 5 | | 4 |
| | | **100%** | **100** | **100** | **70** | **70** |
| | **Repair** | | | | | |
| **Opex** | Direct labour subject to RPEs | 40% | | 40 | | 52 |
| | Contract Labour subject to RPEs | 40% | | 40 | | 52 |
| | Materials subject to RPEs | 5% | | 5 | | 7 |
| | Other | 15% | | 15 | | 20 |
| | | **100%** | **100** | **100** | **130** | **130** |
| | **Subtotal** | | | | | |
| | Direct labour subject to RPEs | | *58%* | 115 | *52%* | 105 |
| | Contract Labour subject to RPEs | | *30%* | 60 | *33%* | 66 |
| | Materials subject to RPEs | | *3%* | 5 | *3%* | 7 |
| | Other | | *10%* | 20 | *12%* | 23 |
| | | | ***100%*** | **200** | ***100%*** | **200** |

Same overall allowance but different split of costs for indexation

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# Interactions with other mechanisms

We have identified interactions with four other price control mechanisms

| Price Control Mechanism | Link with Indexation | Implications |
|---|---|---|
| Totex Incentive Mechanism | Indexation changes allowances – so impacts over or under performance | Price Control Financial Model run by 30 November – so need indexation by then |
| Uncertainty mechanisms | In effect delayed price control allowances, so subject to indexation | Will need a notional split of costs for each uncertainty mechanism to apply indexation |
| Revenue drivers | Amend price control allowances, so subject to indexation | Will need a notional split of costs for each revenue driver to apply indexation |
| Failsafe Mechanism | Time lag in applying indexation could impact RoRE and so Failsafe Mechanism | Failsafe Mechanism needs to take account of timing differences |

None of the above seem insuperable problems, but will need to be considered when designing the price control architecture for GD2

*Have we missed any other interactions?*

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# How can volatility in customer bills be overcome?

RPE indexation mechanisms will add to the volatility in customer bills

We propose that volatility in bills be addressed when considering all RIIO2 adjustment mechanisms together, rather than piecemeal - with an aim to minimise volatility

# Appendix: GD1 ONS ASHE SOC codes and occupation weights

| Description | Code | Industry Average |
|---|---|---|
| Corporate Managers And Senior Officials | 111 | 0.41 |
| Production Managers | 112 | 4.94 |
| Functional Managers | 113 | 4.19 |
| Quality And Customer Care Managers | 114 | 0.10 |
| Financial Institution And Office Managers | 115 | 0.07 |
| Managers In Distribution, Storage And Retailing | 116 | 0.28 |
| Engineering Professionals | 212 | 21.18 |
| Information And Communication Technology Professionals | 213 | 0.59 |
| Legal Professionals | 241 | 0.22 |
| Business And Statistical Professionals | 242 | 0.94 |
| Architects, Town Planners, Surveyors | 243 | 0.04 |
| Science And Engineering Technicians | 311 | 14.47 |
| Draughtspersons And Building Inspectors | 312 | 0.30 |
| IT Service Delivery Occupations | 313 | 0.52 |
| Media Associate Professionals | 343 | 0.07 |
| Transport Associate Professionals | 351 | 0.03 |
| Legal Associate Professionals | 352 | 0.09 |
| Business And Finance Associate Professionals | 353 | 1.44 |
| Sales And Related Associate Professionals | 354 | 0.12 |
| Public Service And Other Associate Professionals | 356 | 1.57 |
| Administrative Occupations: Finance | 412 | 0.41 |
| Administrative Occupations: Records | 413 | 2.14 |
| Administrative Occupations: General | 415 | 5.00 |
| Secretarial And Related Occupations | 421 | 0.05 |
| Metal Machining, Fitting And Instrument Making Trades | 522 | 0.84 |
| Electrical Trades | 524 | 0.10 |
| Construction Trades | 531 | 31.54 |
| Customer Service Occupations | 721 | 0.10 |
| Construction Operatives | 814 | 3.61 |
| Transport Operatives And Drivers | 821 | 0.08 |
| Elementary Construction Occupations | 912 | 4.52 |
| | | **99.97** |