|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Cadent Final Determination** | | | | |
| **FDQ Query** | | |
|  | | **SQ Reference number** | CADENT\_FDQ\_ 28 |
|  | | **Priority** | High – Technical Error |
|  | | **Document Name** | FD modelling suite |
|  | | **Topic/Activity:** | Technical Assessment - LTS Diversions |
|  | | **Question:** | This FDQ raises a highly significant error with regard to the treatment of expenditure on Cadent’s LTS Diversions, in particular the failure to remove these from the regression model in line with the approach to Technical Assessment of these types of cost, resulting in GDN costs not being treated equally, and the modelled efficiency regression being materially affected  **Issue**  LTS Diversions are raised by external organisations/developers who require GDNs to divert our LTS pipes given their investment development. These are individual bespoke jobs, from diversions due to road construction (M25 and M42), railway development (HS2 and other) and also Lower Thames river crossings. The third parties pay for these diversions hence net costs to the consumers are broadly zero.  Paragraphs 3.170 and 3.39 of the GD Annex set out how Ofgem has decided how to apply Technical Assessment outside of the regression, in particular for capex projects with a cost threshold of £5m.  Paragraph 3.170 states that “*The discrete nature of some investments limits our ability to model costs and benchmark through direct comparisons. This may be because an investment is uncommon across networks, lacks historical comparators or has other highly unique characteristics*”  Paragraph 3.39 states that “*We have decided to increase the materiality threshold for technically assessed capex projects from £1m to £5m, because including costs in our regression model wherever possible allows for a more integrated totex assessment, better accounts for opex / capex trade-offs, and strikes a more even proportion of technically assessed costs across networks*.”  According to the policy set out in FD, Cadent’s LTS Diversions, which almost entirely consist of bespoke projects with a gross cost (the FD’s basis of assessment being gross costs) in excess of £5m, should have been subject to Technical Assessment – and so removed from the regression – but were not.  **Why this is a problem**  This is a problem for two reasons.  First, because the level of LTS diversion costs is very different between GDNs – the chart below shows that Cadent forecast around £250m of LTS diversions costs (shown here are the projected customer contribution in RIIO-2 which is broadly same amount), against zero for the other GDNs plans.    Second, because the regression has no workload driver for LTS work. Consequently, any additional LTS activity, not taken out of the regression for Technical Assessment, feeds through into apparent inefficiency, as shown in the example below.  *Example*  Assume two GDNs are the same size and have the same cost efficiency, i.e. the same Totex. The only difference is that GDN1 has an LTS Diversion.  Both experience a cost reduction as not operating at the deemed efficient level, but GD1 has a greater disallowance because LTS Diversion cost category has no workload driver associated with it in the CSV.  Instead the regression uses MEAV values as the driver for LTS, which are the same for the two GDNs, so the CSVs are same but GDN1 has higher gross costs.  This higher gross cost is deemed cost inefficiency – it is not.  The use of gross costs for LTS Diversions will therefore create a bias against GDN1.    **Modelling**  Applying this correction to treat LTS Diversions as Technically Assessed costs to the model suite, based on our latest approximate modelling, we obtained the following results.    The correction to the modelling has a major impact. The regression now has a higher R2, and passes the RESET test. In respect of efficiency and allowances, the rankings for the Cadent GDNs are significantly improved, and those for other GDNs worsened, leading to a significant reduction in the other network company allowances.  For clarity, in this modelling we applied 4 changes:   1. We removed the LTS contributions for GD1 and GD2 from the Normalised costs for all GDNs. 2. We adjusted the Net to Gross ratio applied to the regression result to remove the gross cost of LTS Diversions and associated Contributions – so increasing the Net to Gross ratio for Cadent’s GDNs. It would be a clear error not to make this adjustment because not to do so would effectively double count several hundred million pounds of LTS contributions. 3. We removed the cap on EoE’s allowance, which restricts its allowance to the level of modelled costs in the Plan. We consider that, due to cost allocation issues, such a cap can only reasonably be applied at a company, rather than GDN, level, and given that our company Plan costs are above modelled costs a cap should not apply. 4. We made a TA allowance for LTS diversions of zero – because the TA allowances are made after the application of the Net to Gross ratio, and, because the work is chargeable, the net cost should be zero.   Because EoE represents the second ranked GDN against which others are benchmarked, the correction acts to remove an error under which customers in other GDNs are paying higher bills driven by the gross cost of EoE’s LTS diversions.  The correction also results in far greater consistency in the treatment of projects of a similar nature between GDNs, with GDNs and their customers being treated more equally.  Please could Ofgem confirm this error, and how it proposes to correct it. |
|  | |  | |  | |
|  | | **Confidential** | No |
|  | | **FDQ raised by** | Adrian Swift / Jeremy Thomson |
|  | | **Date Sent** | 11/01/2021 |
|  | | **Response Due Date** | 14/01/2021 |
|  | | **Attachments:** | |
|  | |  | |
|  | | **Response to Cadent:**   * Whilst we recognise that LTS diversion costs may vary between networks at specific points in time, as set out in Chapter 3 of the FD Core Document we have applied two measures in our assessment to account for this. Firstly, we have based our assessment on a long time-period of 13 years (GD1 + GD2) to avoid short-term projects creating material distortions. Secondly, we have smoothed LTS diversion costs using a 7-year average to account for projects occurring on different networks at different points in time. These two measures are applicable to other LTS activities, which are subject to similar variances. * We accept that some LTS diversions are driven and fully funded by third parties, but this is not exclusively the case and, in some instances, GDNs/customers are required to self-fund diversion works either in part or in full. Assessing costs on a gross basis accommodates such differences between networks in terms of the proportion of costs they are able to recover from third parties. Since there are various drivers of LTS diversion projects, there can be opex/capex trade-offs. As we set out in our Final Determinations, including costs in our regression model wherever possible allows for a more integrated totex assessment and better accounts for opex/capex trade-offs. * We have included these costs in the regression, consistent with our approach to other companies’ costs that were submitted on a similar basis. Our technical assessment process for RIIO-GD2 was applied to large, discrete projects that passed our engineering needs case assessment, as determined through our engineering review of project EJPs. We note that Cadent did not submit project-level EJPs for their LTS diversion works. * Our decision at FDs to include LTS diversions in the regression on a gross basis is consistent with our proposed position that we consulted on at Draft Determinations, and reflects open discussions that we held with companies prior to Draft Determinations to identify pre-regression adjustments and normalisations. Similarly, our decision to use MEAV to represent LTS costs in the regression, as was our approach at RIIO-GD1, is the position that was proposed at Draft Determinations. * For the reasons set out above, and in line with the decisions set out in FDs, we do not think there is an error in our approach to assessing LTS diversions. | |