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Interested parties and
stakeholders

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Date: 30 September 2015

Dear Stakeholder,

Notice of our decision for the review of costs associated with the TPCR4[1] enhanced physical security upgrade programme and the RIIO-T1[2] and RIIO-GD1[3] enhanced physical site security uncertainty mechanisms

We recently consulted on our minded-to position[4] with regard to:

1. our review of TPCR4 enhanced physical site security costs
2. additional allowances for enhanced physical site security costs requested under RIIO-T1 uncertainty mechanisms (reopeners). The proposed adjustments were submitted under National Grid Electricity Transmission's (NGET) Electricity Transmission Licence, Special Condition 6H - Arrangements for the recovery of uncertain costs and National Grid Gas Transmission's (NGGT) Gas Transporter Licence, Special Condition 5E - Arrangements for the recovery of uncertain costs, and
3. additional allowances for enhanced physical site security costs requested under RIIO-GD1 uncertainty mechanisms (reopeners). The proposed adjustments were submitted under NGGD's and SGN's Gas Transporter Licences, Special Condition 3F - Arrangements for the recovery of uncertain costs.

This letter sets out our final decision for the adjustments to National Grid's (NG), Scottish Hydro Electricity Transmission's (SHE Transmission) and Scottish Power Transmission's (SPT) Regulatory Asset Value (RAV) following our review of TPCR4 security costs and additional allowances requested by NG and Scotia Gas Networks (SGN) under the RIIO-T1 and RIIO-GD1 uncertainty mechanisms.

Background

In 2005, as part of a wider Government review, a small number of transmission sites were identified as being critical national infrastructure (CNI)[5] and were approved to undergo an upgrade of the physical security measures at the site (upgrade).

[1] TPCR4 is the price control period for transmission companies from 2007 to 2012. For the purposes of this letter, any reference to TPCR4 also includes the TPCR4 rollover year (2012-13).
[2] RIIO-T1 is the price control period for transmission companies from 2013 to 2021.
[3] RIIO-GD1 is the price control period for gas distribution companies from 2013 to 2021.
[4] https://www.ofgem.gov.uk/publications-and-updates/consultation-our-minded-position-tpcr4-cost-reviews-and-riio-t1gd1-uncertainty-mechanisms-enhanced-security-upgrades
[5] Infrastructure assets that are vital to the continued delivery and integrity of the essential services upon which the UK relies, the loss or compromise of which would lead to severe economic or social consequences or to loss of life.

Following further reviews in 2009, 2011 and 2013 by the Department of Energy and Climate Change (DECC) (now the lead government department for this project) and the Centre for the Protection of National Infrastructure (CPNI)[6], the number of sites approved for an upgrade increased substantially. The list of sites has now also been widened to include gas and electricity distribution sites.

At the time of setting the allowances for TPCR4 and GDPCR1[7] in 2006 and 2007 respectively, only a few transmission sites had been approved to undergo an upgrade and the full scope of work required was not known. Due to this, no allowance was made for the upgrade work required at these sites and no uncertainty mechanism was included.

In Final Proposals for the TPCR4 rollover (2012-13), we stated that upgrade costs up to 31 March 2012 would be added to RAV at the start of the rollover year on a provisional basis and that efficient costs incurred during the rollover year would be included in the RAV as part of RIIO-T1. We stated that these numbers would remain provisional until we carried out an efficiency review of these costs.

At the time of setting the RIIO-T1 and RIIO-GD1 price controls, NGET claimed for £174.0 million ex ante funding and NGGT claimed for £16.4 million ex ante funding. SPT claimed for £12.7 million. SHE Transmission did not claim for any allowance. We made no specific allowance for GDNs. Due to the ongoing uncertainty surrounding the requirements for this work, no ex ante allowance was given.

Instead, an uncertainty mechanism was included within RIIO-T1 and RIIO-GD1 whereby companies could apply for costs incurred in upgrading the security at CNI sites during two reopener windows in 2015 and 2018.

In May 2015, we received reopener applications from NGET and NGGT for RIIO-T1. We also received applications from NGG (East of England, London and North West) and SGN (Scotland and Southern) for RIIO-GD1. We published our minded-to position in a consultation letter at the end of July[8].

Responses

We received six responses to our consultation. These were from NG (covering TPCR4, RIIO-T1 and RIIO-GD1), SGN (covering RIIO-GD1) and SHE Transmission (covering TPCR4). We also received responses from Centrica, E.ON and RWE. These responses have been published alongside this decision letter.

NG and SGN disagreed with a number of areas of our assessment. Further detail on their responses is contained in Appendices 1-3.

SHE Transmission agreed with our minded-to decision to make no adjustment to their RAV.

E.ON and RWE raised concerns that NG and SGN did not provide up-to-date information to suppliers regarding their proposed security costs. They stated that this may lead to higher costs for consumers if suppliers include the risk of increased gas distribution charges within their tariffs. Both respondents also proposed that these additional costs should not be reflected within bills in 2016-17. Instead they propose that any adjustment to company revenues should take place in 2017-18 which is consistent with the two year lag which applies to incentive revenues in RIIO.

Centrica were supportive of the approach we took to assess TPCR4 costs. However, they questioned our decision to allow funding for the reopener for sites where companies had

[6] The Government agency which provides security advice to national infrastructure owners.
[7] GDPCR1 is the price control for gas distribution companies for the period from 2008 to 2013.
[8] https://www.ofgem.gov.uk/publications-and-updates/consultation-our-minded-position-tpcr4-cost-reviews-and-riio-t1gd1-uncertainty-mechanisms-enhanced-security-upgrades

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not provided value for money (VfM) audits. They recommended that companies should reapply during the 2018 reopener window in order to allow them time to carry out VfM audits for each site. Centrica also stated that the insufficient time was given for stakeholders to assess the companies' reopener submissions.

All respondents (with the exception of RWE and SHE Transmission who did not comment) agreed with our proposal to introduce an output commitment in relation to enhanced physical security.

Our decision

We consider that the companies have, in general, provided sufficient evidence for us to be able to make a decision on adjusting their allowances. The companies did not have clarity on which sites would require security upgrades until early 2015 which did not allow enough time for VfM audits to be carried out on all sites. As part of their submissions, we requested that each company provides a breakdown of costs which is identical to the costs provided within the VfM audits. This enabled Ofgem to benchmark costs against other companies and against historical data, thereby allowing us to assess whether the costs were efficient.

TPCR4 costs

We are reducing the disallowance for NGET and NGGT from our minded-to position. The reductions are due to allowing increased project management costs of 20% of the total project costs, an increase from the 15% on which we consulted, and allowing TPCR4 rollover opex costs. This change is in recognition of the challenging circumstances that NG had to deal with at the time. This included a significant increase in the number of sites requiring upgrade during TPCR4 which lead to the need for greater project management resource. Further detail of their response and our decision can be found within Appendix 1.

We maintain our minded-to position for SHE Transmission and SPT and will not make any change to the amount allowed into their RAV. Table 1 shows our final decision.

Table 1: TPCR4 physical security upgrade adjustments

Company	Allowed into RAV	Ofgem proposed adjustment (Consultation)	Ofgem adjustment (Decision)
NGET	£139.4m	-£27.5m	-£22.4m
NGGT	£235.7m	-£45.0m	-£33.4m
SHE Transmission	£3.5m	-	-
SPT	£7.8m	-	-
Total	**£386.4m**	**-£72.5m**	**-£55.8m**

RIIO-T1 costs

We are allowing NGET £342.5m and NGGT £190.4m which is consistent with our minded-to position. We have assessed the information provided within their response and do not consider that the arguments provided by NG justify any change to our minded-to position. Further detail of their response and our decision can be found within Appendix 2.

Table 2: RIIO-T1 security upgrade allowances

Company	Company submissions	Ofgem proposed allowance (Consultation)	Ofgem allowed adjustment (Decision)
NGET	£408.6m	£342.5m	£342.5m
NGGT	£223.2m	£190.4m	£190.4m
Total	**£631.8m**	**£532.9m**	**£532.9m**

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RIIO-GD1 costs

We are maintaining our minded-to position on cost allowances for both NGG and SGN. We have assessed the evidence provided by both companies and considered further the information provided within their responses. We do not consider that the arguments provided by NG justify any change to our minded-to position. Further detail of their response and our decision can be found within Appendix 2.

However, following consideration of SGN's response we will allow them to apply for funding for Site J at the 2018 reopener window even if costs for this site are below the materiality threshold[9]. If SGN make a claim for any further sites in 2018 that claim would have to exceed the materiality threshold (eg excluding any claim for Site J). Further detail of their response and our decision can be found within Appendix 3.

Table 3: RIIO-GD1 security upgrade allowances

Company	**Company submissions**	**Ofgem proposed allowance (Consultation)**	**Ofgem allowed adjustment (Decision)**
NGG East of England	£38.8m	£32.3m	£32.3m
NGG London	£20.3m	£17.0m	£17.0m
NGG North West	£15.5m	£13.3m	£13.3m
SGN Scotland	£18.1m	£13.5m	£13.5m
SGN Southern	£34.0m	£25.7m	£25.7m
Total	**£126.8m**	**£101.8m**	**£101.8m**

Bill impact

Costs will be recovered over the remainder of RIIO-T1 and RIIO-GD1 (2016-2021). Table 4 shows the combined impact of the additional RIIO-T1 and RIIO-GD1 allowances on an average customer's annual bill in each of the affected regions.

Table 4: Bill impact

GDN area[10]	**2016/17**	**2017/18**	**2018/19**	**2019/20**	**2020/21**
NGG East of England	£0.94	£3.42	£2.73	£0.82	£0.42
NGG London	£1.07	£2.89	£1.73	£0.86	£0.40
NGG North West	£2.62	£0.80	£1.08	£0.53	£0.45
SGN Scotland	£5.77	£0.18	£0.28	£0.37	£0.40
SGN Southern	£2.93	£1.06	£1.23	£0.33	£0.37
All other areas	£0.45	£0.18	£0.25	£0.31	£0.32

Output commitment to ensure all CNI sites comply with DECC requirements by 2021

We confirm our minded-to position to put in place a requirement for all network companies[11] to ensure all their sites are critical national infrastructure (CNI) compliant, as required by DECC, by the end of RIIO-T1 or RIIO-GD1.

[9] The adjustment, when multiplied by the relevant Distribution Network's Totex Incentive Strength Rate, must exceed 1% of the Distribution Network's materiality threshold amount. Alternatively, the total adjustment across four specified categories multiplied by the relevant Distribution Network's Totex Incentive Strength Rate must exceed 3% of the Distribution Network's materiality threshold amount (provided the security adjustment multiplied by the Totex Incentive Strength Rate exceeds 0.5% of the materiality threshold amount (see licence condition 3F (paragraph 1A.7(a))

[10] Only customers within areas where GDN's have requested additional allowances will be affected by the additional RIIO-GD1 allowances. All GB customers will be affected by the additional RIIO-T1 allowances.

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2018 reopener window

For the 2018 reopener window, we will only provide funding for sites which have had VfM audits carried out. We consider that the companies now have certainty over which sites require security upgrades, and there is sufficient time to arrange VfM audits for these sites before 2018. We will not provide further allowances for sites which have been included within the TPCR4 review or the 2015 reopener submission[12].

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

Yours faithfully,

Paul Branston
Associate Partner, Gas Networks

Appendices

Appendix 1 – NG (TPCR4) – Detailed response and our decision
Appendix 2 – NG (RIIO) – Detailed response and our decision
Appendix 3 – SGN – Detailed response and our decision

[11] Any network company (licensee) that submits an application for a reopener in relation to Enhanced Physical Site Security Costs under either the Gas Transporter Licence Special Condition 5E– Arrangements for the recovery of uncertain costs, National Grid Electricity Transmission PLC Electricity Transmission Licence Special Condition 6H – Arrangements for the recovery of uncertain costs or Gas Transporter Licence Special condition 3F – Arrangements for the recovery of uncertain costs.

[12] With the exception of SGN's Site J

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Appendix 1 – National Grid (TPCR4) – Detailed response and our decision

In our minded-to consultation, we proposed to disallow £27.5 million from NGET's RAV (from £139.4 million) and £45.0 million from NGGT's RAV (from £235.7 million). We proposed reductions for the following areas:

- project management costs
- initial contractor costs
- site specific queries
- opex.

NG disagreed with our minded-to position for each of the four areas where we intended to make reductions. A summary of NG's points in each of these areas is provided below.

Project management – NG response

In our consultation letter we proposed to disallow £51.4 million project management costs. We considered NG's project management costs to be higher than those incurred by SHE Transmission and SPT and proposed reducing these to the average level of 15%.

NG disagrees with our proposed disallowance and state the following.

- NG faced a challenging context during TPCR4 (eg unclear scope, rapid increase in sites, Olympics deadline).
- Ofgem acknowledges the challenging context and recognises this could lead to high costs.
- Project management costs should fall in the future but not during TPCR4.
- VfM2 reports did not flag project management as inefficient.
- Other reviews and audits support the view that NG's costs are reasonable.

Project management – Our decision

During TPCR4, all companies faced the issues of uncertain scopes of works and the added complexity of working on live sites. However, we acknowledge that NG had to deal with a significant increase in the number of sites requiring upgrade during TPCR4 which led to the need for greater project management resource.

We do not consider that project management costs should be greater than 20% when other companies are able to deliver comparable projects for between 3% and 10% (albeit with fewer sites). The EC Harris report which NG provided to demonstrate the reasonableness of their costs does not provide sufficient detail regarding the comparator projects. We consider that the other upgrade projects we have compared against are the most suitable benchmark to use.

NG quotes the Harnser report's recommended cost per week as being value for money for project management costs. However, this value has been calculated based on SPT's forecast project management costs. If SPT's outturn project management costs are used, the weekly costs are reduced. We also consider that SHE Transmission's costs should have been included within the calculations rather than SGN's forecast costs in order to provide an average based on actual costs. This would lead to even lower weekly project management costs.

Although the VfM reports do not identify project management costs as inefficient, we decided to review these costs separately due to the significant cost difference between NG and other companies. The Requirements document[13], states that the VfM reports are to

[13] Issued by DECC and Ofgem to network operators which outlines the process for upgrading security at designated sites.

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provide advice to Ofgem on value for money and that Ofgem may choose to carry out its own review of costs as part of the TPCR4 review.

Based on the arguments outlined above and within NG's response, we consider that the uncertainty during TPCR4 coupled with the large increase in sites does justify higher project management costs for NG for the TPCR4 period. However, we also consider that the figures NG are claiming are considerably higher than other comparable projects. Therefore we propose to reduce our disallowance for project management costs to £37.6 million from our minded-to position (£51.4 million). This is based on increasing project management costs to 20% which we consider adequately addresses the additional uncertainties NG faced.

Initial contractor costs

In our minded-to position we proposed to disallow £10.5 million for inefficient costs incurred by the initial contractor which NG employed at the start of the project.

In their response, NG provides reasons behind their decision to appoint the initial contractor and state that from 2006, the contractor had delivered the sites and had received good VfM and technical audit reports. NG argues that the decision to extend the contract in 2007 was taken with the best intentions and with the range of information available at the time.

However, from the KEMA's investigation into the contract, they discovered indications that NG were not satisfied with the initial contractor's performance prior to the contract extension (including a note identifying a report sent from NG to the company outlining poor quality of works and a briefing note to the Transmission Investment Committee noting problems with delivery and quality). KEMA were not provided with all of the documents they requested and so were unable to probe these issues further.

NG also argues that they successfully negotiated the unsubstantiated costs from £30 million to £4.4 million (£4.8 million including inflation) and that this figure would have been much higher if the claim had gone through legal proceedings.

We have considered NG's response to our consultation. KEMA's report indicates that, despite the positive VfM and technical reports, NG were aware of issues with the contractor prior to 2007. We consider that NG should have considered alternatives to extending the contract at a time when the number of sites was known to be expanding. We consider that NG's decision led to inefficient costs and additional unsubstantiated costs being incurred on subsequent projects. Due to these reasons, we maintain our position as set out in our consultation letter.

Site specific queries

In our minded-to position we proposed to disallow £8.2 million for site specific queries.

NG disagreed with our proposal to disallow costs for three sites; Sites B, C and D.

For Site B we disallowed costs of £5.4 million as we stated that these costs are included within the Milford Haven review. NG state in their response that these costs have not been included within the Milford Haven review.

We can confirm that costs for Site B have been included within the Milford Haven review. These costs are included within the £14.5 million additional overspend to the £241.4 million identified at TPCR4 Final Proposals[14]. Therefore, we maintain our minded-to position to disallow these costs from the TPCR4 security upgrade review.

[14] Consultation on the ex-post efficiency review of NGGT Milford Haven pipeline project. https://www.ofgem.gov.uk/publications-and-updates/consultation-ex-post-efficiency-review-nggt-s-milford-haven-pipeline-project (see page 5, footnote 16)

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For Site C, we proposed disallowing £1.3 million which was incurred as a result of emergency work to an asset. NG's response states that the asset was monitored and that it was a coincidence that the asset deteriorated to the extent that a risk management zone was required. NG also states that the impact of the risk management zone was mitigated as much as possible.

We will maintain our minded-to position our decision regarding Site C. The deterioration of the asset was a known risk which materialised and NG has not provided sufficient reasoning as to why the project could not be postponed until the asset was replaced.

For Site D, we proposed disallowing £0.4 million incurred due to delays caused by waiting for fence posts to be delivered.

In their response, NG have provided further detail to demonstrate that they had ordered sufficient fence posts, but due to quality issues, these could not be used. NG had difficulty in sourcing fence posts from an alternative source due to the increase in demand and a lack of approved suppliers.

Due to these issues being outside of NG's control, we will allow the additional £0.4 million costs incurred due to a lack of fence posts at this site.

Opex

NG provided evidence to show that the 2012-13 opex costs (£2.5 million) for NGGT have not already been funded via the TPCR4 rollover price control. We will allow these costs in our final decision.

TPCR4 capex incentive mechanism

NG argues that our proposed disallowances are not demonstrably inefficient and state that any disallowed costs should be run through the TPCR4 capex incentive mechanism.

Our decision

Following our review of NG's consultation response, our decision is to reduce NGET's disallowance to £22.4 million, and NGGT's disallowance to £33.4 million. This is due increasing the allowed project management costs from 15% in our consultation letter to 20%, allowing NG's TPCR4 rollover opex costs (£2.5 million) and allowing £0.4 million for Site D.

We will not apply the capex incentive mechanism to disallowed costs. NGET's and NGGT's licence and Financial Handbooks show that TPCR4 Logged-up and Security cost revenue adjustments should not be run through the capex incentive mechanism.

Appendix 2 – National Grid (RIIO) – Detailed response and our decision

In our RIIO-T1 minded-to consultation, we proposed to allow additional funding of £342.5 million for NGET (compared to £408.6 million applied for) and £190.4 million for NGGT (compared to £223.2 million).

In our RIIO-GD1 minded-to consultation, we proposed to allow additional funding of £32.3 million for NGG East of England (compared to £38.8 million applied for), £17.0 million for NGG London (compared to £20.3 million) and £13.3 million for NGG North West (compared to £15.5 million).

We proposed reductions for general items and preliminaries[15] and project management costs which we consider to be high in comparison to other companies. The reductions have been applied using the same methodology for both RIIO-T1 and RIIO-GD1.

NG disagreed with our minded-to position for general items and preliminaries and project management costs.

General items & preliminaries - NG response

NG argues that Harnser's method of calculating the disallowance for these costs is based on a small sample of historical sites and that the calculation does not take into account the efficiencies already included within their submission.

General items & preliminaries – Our decision

We will maintain our minded-to position in relation to general items and preliminaries.

We do not consider that NG have provided sufficient detail to explain why they should receive the high level of costs as included within their submission, or the alternative cost calculations as detailed within their response.

However, we recognise that NG will face some higher costs due to the extra layer of security they require during the upgrade (as agreed with CPNI) and the additional site set-up costs they may incur for some sites located in cities.

Due to the small sample size of comparable sites, Harnser's has included NG's sites within the average cost calculation (leading to a higher average cost than if NG sites were excluded). We have used this calculation for our final decision as this provides NG with a higher allowance to allow for their increased costs.

Project management – NG response

We allowed NG 15% project management costs for RIIO-T1 and RIIO-GD1 compared to 25% requested within their reopener application.

NG argues that their project management costs are higher than other operators as they include additional activities (mainly, the development of operational solutions and the project uncertainty caused during DECC's review of the programme. NG also states that their project management costs are reasonable when compared to other references (including Harnser's report).

Project management – Our decision

We will maintain our minded-to position in relation to RIIO project management costs.

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[15] Costs which are not part of the actual security solution, but have been incurred as part of the project (eg site accommodation and temporary site security).

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We acknowledge that NG may incur slightly higher project management costs than other companies due to these reasons. However, 25% is far higher than the project management costs claimed by other network companies. With the experience of delivering sites during TPCR4 and with the certainty of the future programme, we consider that NG's RIIO project management costs should be closer to the levels of other network companies.

We based the allowance for NG's project management costs on the average cost incurred by all companies. As with general items and preliminaries (above), we included NG's higher costs within the calculation which gives results in a higher average cost than if we excluded NG's data. We consider that this provides NG with a slightly higher level of project management costs to allow for the additional costs they have incurred.

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Appendix 3 – SGN – Detailed response and our decision

In our minded-to consultation, we proposed to allow additional funding of £13.5 million for SGN Scotland (compared to £18.1 million applied for) and £25.7 million for SGN Southern (compared to £34.0 million). We have not received any further evidence to justify changing our view, therefore we maintain our minded-to position.

SGN disagreed with our minded-to position in three main areas:

- disallowance of costs for Site J
- technical variations
- operating costs.

Site J

We proposed to disallow £8.3 million of costs for Site J (shared between SGN Scotland and SGN Southern) as we did not consider that SGN had provided evidence to show that their proposed solution for this site is the most efficient option.

Within their response, SGN do provide further detail behind their proposed solution and compare this against an alternative solution. However, we consider that further solutions must also be explored to ensure that SGN choose the most efficient option. Due to this, we maintain our position to disallow costs for Site J.

SGN have raised the issue that a future reopener application in 2018 for Site J would not be above the materiality threshold required to apply for additional funding. We acknowledge this and will allow them to apply for funding for Site J at the 2018 reopener window even if costs for this site are below the materiality threshold. If SGN make a claim for any further sites in 2018 that claim would have to exceed the materiality threshold (eg excluding any claim for Site J).

Technical variations

We proposed to disallow £3.3 million of technical variation (project risk) costs as we consider that the 5% we allowed for technical variations provides sufficient protection alongside the totex incentive mechanism.

SGN disagree with our proposal stating that they had not carried out the required survey work (due to time constraints) and had included what they consider an appropriate level of risk.

We do not consider that this argument warrants the level of technical variation within SGN's submission and we will maintain our position as set out in our consultation.

Operating costs

We proposed to disallow £1.4 million of operating costs and central overheads as these costs were considered high against NG's costs.

SGN disagree with our proposal. They state that the post-delivery costs are not comparable with other companies and that different providers may offer different levels of service.

We have reviewed the operating costs for both NG and SGN and do not see the justification for allowing higher post-delivery support costs. We consider that we have allowed an efficient level of costs for SGN.

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