Kier Integrated Services' Response to GD23 Draft Determination Consultation on Cost Rates for Capital Expenditure

Summary

Kier, working on behalf of all three of NI's Gas Distribution Networks (GDNs), have built approximately 6,000km of gas distribution network in NI since 1996 and connected over 350,000 Domestic and Industrial and Commercial customers to NI's natural gas networks in that time. We have competitively tendered 11 separate contracts to deliver these works, all of which were awarded on the most economically advantageous tender (MEAT) basis. As with previous price controls, we have reviewed The Utility Regulator's (UReg's) Draft Determination (DD) that was published on 9th March 2022 and – based on our extensive and unique experience of construction delivery of the physical gas network infrastructure for Northern Ireland – must raise significant concerns around the likely unintended curtailment of investment in natural gas networks the DD will cause as its primary outcome.

This is the first time that Kier (formerly McNicholas) have raised concerns over a draft determination as we assessed previous price controls to be challenging, yet achievable. In the two previous consolidated price controls, GD14 & GD17, some unit rates were lower than the cost to construct, whilst other were higher; however, the workload and work mix meant that the aggregated works across all work types was deliverable in line with UReg's determined unit rates. The significant changes to workload and work mix, along with 'cherry-picking' previous lowest (below cost) outturn rates means that the GD23 workload and work mix cannot be delivered in line with UReg's proposed unit rates.

From our bottom-up view, there are elements within the DD that do not reflect what we, and our peer organisations, would recognise as a clear representation of the actual costs to efficiently develop a gas network displayed in UReg's methodology; this in turn represents a potential self-administered blow to the economy of Northern Ireland directly in gas distribution and downstream activities in manufacturing, agriculture and food processing. Additionally, the unit rates in the DD are contrary to the outcomes of the DfE's Energy Strategy and 10X economy.

The outturn of this is an imbalanced DD that does not comply with UReg's principal objectives under Article 40 of the Gas Directive, particularly:
(a) promoting, in close cooperation with the Agency, regulatory authorities of other Member States and the Commission, a competitive, secure and environmentally sustainable internal market in natural gas within the Community, and effective market opening for all customers and suppliers in the Community and ensuring appropriate conditions for the effective and reliable operation of gas networks, taking into account long-term objectives.
Neither does the DD fulfil UReg's functions under Article 14 of the Energy (Northern Ireland) Order, namely:
14(1) The principal objective of the Department and the Authority in carrying out their respective gas functions is to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland, and to do so in a way that is consistent with the fulfilment by the Authority;
14 (2)(b) the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under Part II of the Gas Order or this Order;

14(5)(c) to secure a diverse, viable and environmentally sustainable long-term energy supply, including the need to guard against climate change.
The DD will result in GDNs being underfunded due to uneconomic and unsustainable unit rates for certain key activities, particularly domestic services – existing and new build.

This underfunding in turn will significantly curtail the development of the gas networks and reduce customers connecting to the gas networks. Restricting the economic development of the NI Gas Networks significantly reduces the carbon reduction performance in the short term (moving domestic properties from oil), medium term (biomethane and hydrogen blending) and long term (zero emissions green gas).

We trust that our response to UReg's GD23 DD helps to inform UReg and provide a fuller understanding of the cost principles and actual costs required to develop a gas network – after all, it would be considered unwise to budget a house refurbishment without first consulting with builders. As our response will be made public, we are unable to include confidential commercially sensitive information. We would welcome a meeting with UReg where we can provide further details regarding confidential information and answer any queries that UReg may have regarding our consultation response.

Detailed responses

Benchmark cost rates for capital expenditure:

UReg have "based much of the draft determination on the unit rates derived from analysis of a historical basket of works, with some smaller elements of the programme based on current contract rates or outturn costs" [1] . Whilst sound as a desktop modelling exercise, this has severe limits on a practically implementable basis as detailed below:

- Basket of Works Approach - The basket of works, which UReg have relied heavily on when setting unit rates for the GD23 price control period have changed so significantly since GD17 and from the GDNs' historical workload & work mix that the basket of works approach is unable to provide an accurate assessment for capex unit rates required between 2023 and 2028. An example of the workload and work mix change is firmus energy's (FE's) reduction in main laying volume from 200Km (as stated in their 2019 Invitation to Negotiate) to the GD23 DD of <12Km of New Build mains only. All of the contract rates i.e. the outturn costs to FE are based on 200Km mains, where the high volume mains work off-set the below cost connections rates. A more accurate and equitable approach for GDNs and consumers is bottom-up assessment alongside benchmarking across other Utilities works across NI and GB.

- Mains Cross Subsidy - UReg assumes that the outturn costs for each activity for all GDNs reflect the contractor's actual cost. This is not the case. In the main DD report, Section 6.17 and annex f S3.63, UReg discounts the argument that the cost of services have been cross subsidised by mains construction works, stating that there is no external evidence for this. This is incorrect. We would welcome a meeting with UReg to provide evidence of this. Cross subsidies have been applied through equally spreading prelims and overheads across all work types even though services take up between 80% to 85% of staff input, and by targeted

pricing in the knowledge of high-volume mains works. By applying incorrect assumptions regarding outturn costs for customer connections UReg has undervalued the cost of unit rates required for some elements capital of expenditure, particularly domestic customer connection / services. The change of work mix from mains to services results in customer connections being uneconomic and unsustainable in the GD23 period i.e. a significantly higher proportion of loss making works. All three NI GDNs have advised UReg of this and their business plans show that UReg allowances for services need to be significantly increased to allow the GDNs to connect new customers.

- Comparison of high-level unit rates – The large differences between GDNs outturn unit costs shows that rates are 'tailored' to the specifics of each contract including tender marking, workload, work mix and other items specific to each GDN. This also shows that some items cross subsidise others, and that some actual costs are higher than outturn cost i.e. historical ***actual*** costs for domestic connections are not adequately reflected in the GD23 DD unit rates.

- Capitalised opex – In annex f, S3.49 UReg's stated view is that, on balance, capitalised opex should be proportional to workload irrespective of its value or type. This is incorrect. Approximately 80% - 85% of staff time is spent on customer connections versus 20% - 25% time on mains, therefore capitalised opex is linked to workload and especially to work type. As an organisation at the coalface of planning and delivering the various work types, our experience that "capitalised opex should be proportional to workload irrespective of its value or type" is manifestly an incorrect assumption so far and we would be pleased to factually illustrate this to UReg in greater detail in a meeting.

- Contractor Overheads – In annex f, S3.63 UReg states "It is not clear to us why a contractor would not allocate its overheads in line with its costs. GDN's mention cross subsidisation from mains to services by the contractor, but this can't be demonstrated". It is established tendering and estimating practice to work out the total Prime Cost and apply the overhead equally to all rates. There are often hundreds or even thousands of rates in a typical tender, and it is not possible to individually allocate overhead to each rate item. Overheads primarily consist of fixed costs which need to be expressed and recovered as a percentage of overall annual expenditure on a Contract. If we were to attempt to allocate overhead cost to this degree of detail if would require us to employ more commercial administration staff and thus additional cost for little demonstrable benefit to either clients or customers. Again, we would welcome a meeting with UReg to demonstrate this. Further to overheads, Preliminary Costs (prelims) are predominately made up of staff and facilities costs (offices, yards & stores). The geographic spread and the materials logistics associated with services means that none of the existing offices, yards or stores can be closed or significantly downsized. This combined with the staff numbers required to deliver services (at c. 80% - 85% of total staff time) shows that the prelims part of the contractor's prime costs cannot be reduced proportionally to the reduced mains works and associated turnover.

- Cost increases - In annex f, S3.68 UReg suggests that GDNs have selected cost increases from a list provided by the contractor. This is not correct. Kier used our experience and expertise, and that of our supply chains in engineering materials, civils materials, plant, equipment and resourcing to assess short-, medium- and long-term movements in our core cost areas. Each GDN is different from another, therefore their core cost areas differ slightly. A tailored assessment for cost movements was provided to each GDN. UReg's DD assumes that the cost increases "are either short term and/or reflected in general inflation" [2] , which in incorrect. Analysis shows that the current exceptional cost increases, which are significantly larger in Utilities works than in general inflation and significantly outstrips inflation, are set to run into the GD23 price control period. We can share the detailed analysis with UReg on a confidential basis. The expenditure unit rates set in the DD are applied from 1st January 2023, therefore the current exceptional cost increases have been ignored by UReg. This issue will be made worse if inflation comes down significantly in the medium term and turns negative, as the already-below-costs unit rates will have a further negative inflationary deduction applied. If UReg truly believes that future inflation will reverse the current exceptional inflation i.e., short term and/or reflected in general inflation, then it should allow for it now and let future annual inflationary adjustments reverse the current increases.

- Red Diesel – In annex f, S3.46 UReg has discounted the impact of the tax change to red diesel. This is based on the estimated 0.4% increase being below the resolution of the calculations used to set the basket of works unit rates. The actual increase directly linked to the tax change to red diesel has now been experienced and lies between 1.1% and 1.4% across the 3 GDNs. This change alone accounts for over 1/3 of the total net profit on Utility works, so is significant enough to be included.

- Benchmarking – Alongside a bottom-up assessment, we recommend UReg should benchmark customer connections against similar gas connections in GB, with an allowance for the increased depth of cover as there are limited similar works in NI. In NI BT/ VM / Fibrus / NIE have less depth of cover and are significantly different, whereas water mains customer connections are predominantly in footway or verges as they were one of the first utilities constructed, and as such had much more access to construct their networks in those locations. Gas has come behind water electric and telecoms so more gas services are fed from networks constructed in the (more costly) carriageway. A more comparable benchmark rate in NI would be a carriageway sewer repair. The work to excavate to the sewer and carry out a minor repair, backfill and reinstate is quite similar to the connection to an existing gas main as part of a new (existing property) customer connection. In addition to the mains connection (similar to a sewer repair), a new connection requires excavation, pipe installation, testing, commissioning, backfilling and reinstating the service from the main, including civils and engineering materials.

- Move from RPI to CPIH – Whilst we appreciate that a move from RPI is based on concerns expressed by the UK Statistics Authority (UKSA), the suggested replacement is not reflective of inflationary pressures on gas networks. It should be noted that UKSA isn't happy with CPIH either. It removed its status as a National Statistic in 2014. The ONS indices that are

more reflective of gas networks construction and maintenance works are BCIS (construction activities) and PPI (engineering materials). Both of these indices are higher than RPI and CPIH. The suggested change may result in a nominal reduction in tariffs; however, it will likely result in under- or overpricing the inflationary risk – neither of which supports an optimised economically sustainable solution for consumers and GDNs. UReg should strike a balance between gas consumers and promoting the development and maintenance of an efficient, economic and co-ordinated gas Industry in NI. As with other elements of UReg's GD23 DD, the balance has not been correctly assessed or struck. The imbalance means that UReg has not met its objectives or obligations, which will restrict the future development of the gas networks, resulting in detriment to climate change outcomes.

[1] GD23 Draft Determination, Annex F, 3.37 (page 22)

[2] GD23 Draft Determination, Annex F, 3.68 (page 28)