

Reference

Cadent response to January 2024 Re-opener
Applications Draft Determinations

Date

1st October 2024

Cadent Gas Limited

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Catherine Warrilow

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Commonwealth House
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Correspondence sent by email to ReopenerConsultations@ofgem.gov.uk

Dear Catherine,

Consultation on Re-opener Applications 2024 Draft Determinations

I am writing in response to your consultation, published on 3rd September 2024, regarding Ofgem's draft determinations of Cadent's Diversions & Loss of Development Claims Policy, MOB's Safety and New Large Loads Connections Re-Opener submissions from January 2024.

We are supportive and agree with Ofgem's assessment of our needs case and optioneering across our various re-opener submissions. These projects will allow us to deliver safety critical work and meet the needs of our customers. However, we do not support the assessment of our costs, specifically in relation to our overhead costs and in some areas of our unit costs. We have provided further evidence and clarification to justify these costs. We do not agree with the proposal to disallow all costs and volumes provided within our MOB's Safety re-opener submission on the basis that it is out of scope. We have provided further evidence of why we believe the policy intent was for this workload to be within scope of this re-opener.

The annex to this letter provides responses to the specific questions set out within your consultation on each of the re-opener submissions.

We have valued Ofgem's constructive engagement throughout the re-opener process, and hope you find our feedback helpful in making your final determination. If you would like to discuss any of our comments further, please contact me on howard.forster@cadentgas.com.

Yours sincerely,

Howard Forster

Chief Operating Officer, Cadent Gas Ltd

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Annex – Cadent’s response to specific questions

GD.Q1. Do you have any views on the draft directions contained in Appendix 1?

We provide our views on the draft directions on the specific re-openers in the questions which follow.

GD.Q2. Do you agree with our assessment of applications under the Diversions and Loss of Development Claims Policy Re-opener and our Draft Determinations? Please include your views on our assessment of the needs case, optioneering and draft allowances.

Named diversion projects

We are supportive and agree with Ofgem’s assessment of our needs case and optioneering for the named diversion projects we have included within the Diversions and Loss of Development Claims Policy Re-opener. These projects allow us to divert our pipelines to mitigate the risk associated with third-party works encroaching our assets.

However, we disagree with Ofgem's proposed overhead rate reduction from [REDACTED] to 11%. Our overhead for named diversions was [REDACTED] (years 1-2) and [REDACTED] (years 3-5), however a large portion of these ([REDACTED]) were attributable costs that are in effect direct costs. Therefore, the 11% used by WWU for reinforcements is more comparable to our [REDACTED] allocated overhead for diversions. Below we have explained how our overheads work and how these rates should be interpreted.

How our overheads work

For projects using direct and contract labour, the overhead uplift rates shown in Table 1 (see below) apply to direct costs, encompassing hourly rates, contractor rates, material costs, and purchased services. These overhead uplifts include:

- Attributable Overheads – these can be directly related to a specific activity and would be eliminated if the activity ceased. In accounting terms, they would be considered direct costs but are defined as overheads in the Cadent configuration of SAP.
- Allocated Overheads - these are overheads not attributable to a specific activity and which are spread across all activities in relation to direct costs. They include costs of supporting multiple activities, services which support the entire business e.g. finance team.
- The Fully Loaded Overhead is the Attributable overhead plus the Allocated Overhead.

	Attributed	Allocated	Fully Loaded
Years 1 and 2	[REDACTED]	[REDACTED]	[REDACTED]
Years 3 to 5	[REDACTED]	[REDACTED]	[REDACTED]

Table 1: Cadent overhead rates

The costs categorised as "attributable overhead" are, in fact, direct costs. This is a consequence of our delivery model, which aggregates these costs. Appendix 1 provides a detailed explanation and cost breakdown of these items, including:

- Project supervision and operational management (mandated by construction design management laws).
- Project planning and programming.



- Project support functions (customer liaison, safety and assurance compliance).
- Where applicable, data capture, environmental, and reinstatement specialists.

The difference between our overhead and WWU overhead is about cost allocation. Our delivery model efficiently handles multiple workstreams under a single contract, as opposed to individually contracting services. Therefore, our "attributable overhead" should be considered direct costs.

Allocated overhead varies significantly between work types due to differing effort requirements. Diversions, for instance, incur considerably higher overhead than reinforcement projects (like WWU). Diversions involve initial customer engagement; multiple third-party site visits to assess asset diversion needs; design team input to develop a robust target cost; customer feedback; payment processing; variation tracking; and refund management (if necessary). Reinforcement projects do not require these steps. Ofgem's draft determination incorrectly assumes a blanket percentage application across all projects. However, our overhead is applied project-specifically based on the delivery method. For example, internally managed projects like Ulverston (handled by our Capital Delivery function) incorporate supervision costs directly, resulting in a lower overhead percentage ([REDACTED]), reflecting only allocated costs. Conversely, our Named Diversion projects, managed by our Construction Management Organisation (CMO), have a higher overhead rate ([REDACTED]) because supervision, being less specialised, is included as an attributable cost *in addition to* allocated costs.

How our overheads should be interpreted – Ulverston example

Our overhead costs have been misinterpreted as a [REDACTED] addition to direct costs. This is inaccurate. Our overheads represent a distinct allocation/distribution of costs. While traditionally some costs (like those detailed below in Table 2) would be classified as direct costs, our internal finance guidance categorises them as overheads. To clarify this, we provide Ulverston as an example, detailing its costs from the re-opener submission.

Ulverston project	Cost
Early feasibility cost	[REDACTED]
Project Management	[REDACTED]
Materials	[REDACTED]
Construction	[REDACTED]
Land and Consents	[REDACTED]
Risk	[REDACTED]

Table 2: Ulverston cost breakdown

As Ulverston is managed by our internal capital works function, all attributable costs are included within the direct costs. However, under our Construction Management Office (CMO) model who deliver our named diversions, costs such as early feasibility ([REDACTED]), project management ([REDACTED]), and Land and Consents ([REDACTED]) would be classified as overheads. Therefore, our overhead calculation reflects this internal allocation rather than a simple percentage markup of direct costs. To illustrate this, the total of the three cost elements highlighted totals to [REDACTED] which if it were to be treated as a CMO delivered named diversion would equate to [REDACTED] in line with our attributable overhead in Table 1, in addition to the [REDACTED] allocated overhead totalling [REDACTED].

In Table 3 below we have carried out the same overhead allocation exercise on our named diversions to demonstrate what the costs would look like under this overhead distribution with attributable costs now included within direct costs.



Named Diversions	Cost Elements	Re-opener cost	Adjusted costs (attributable costs are now within direct costs)
[REDACTED]	Direct cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
[REDACTED]	Direct cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
[REDACTED]	Direct cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
[REDACTED]	Direct cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
[REDACTED]	Direct cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
[REDACTED]	Direct cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
[REDACTED]	Direct cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
[REDACTED]	Direct cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]

Table 3: Named Diversion Projects – Overhead adjustment

We are supportive of the introduction of an evaluative PCD to deliver the named diversions projects. This will ensure delivery of the project and protect consumers from any non-delivery.

Encroached mains

We are supportive and agree with Ofgem’s assessment of our needs case and optioneering for the encroached mains we have included within the Diversions and Loss of Development Claims Policy Re-opener. This will allow us to minimise the risk of damage and potential safety risks such as fires and explosions, and to ensure that the assets can be safely operated and maintained in future.

We disagree with Ofgem's proposed unit cost of [REDACTED] for encroached mains, based on the median of a limited dataset. To justify our mains unit cost we have decided to respond in the following way:

- 1) Explain our unit cost methodology in the re-opener
- 2) Explain the complexity of work



Our Unit Cost methodology

Ofgem's proposed unit cost of [REDACTED], calculated using the median of only 26 completed jobs (just over 4% of the total volume), is not representative of the full range of encroached mains work. This small sample size is insufficient to accurately reflect the cost of addressing 461 encroachments across 4 networks. While the median is less susceptible to outliers than the mean, even a small, skewed dataset can significantly distort the median, particularly when significant cost variations exist. For example, the average length of the 26 diversions used by Ofgem is 52.11m, considerably shorter than the average length of 83.02m projected for future work. This difference in project scale directly impacts cost, making the median an inaccurate unit cost to be used for future expenditure on longer, more complex projects.

Complexity of Work

To demonstrate the complexity of some of our schemes, Appendix 2 – Encroached Mains Design Example contains a design drawing for a project in our eastern network, illustrating the nature of our built-over mains projects. The design drawing shows our strategy of integrating these projects into larger, more efficient schemes. These projects encompass substantial mains laying, extensive customer interaction, and significant internal works (copper runbacks).

On this basis, we believe the unit cost proposed in our re-opener submission is more representative of the work we need to deliver and ensures we have the right level of funding to deliver these. We are supportive of the introduction of an evaluative PCD to deliver these mains encroachment projects. This will ensure delivery of the project and protect consumers from any non-delivery.

Encroached services

We are supportive and agree with Ofgem's assessment of our needs case and optioneering for the encroached mains we have included within the Diversions and Loss of Development Claims Policy re-opener. Encroached service pipes have the potential to pose a serious risk to life and property due to the increased chance of escapes and unknown leaks. Delivering this work will help enable us to keep our customers and their properties safe.

However, we disagree with Ofgem's proposal to use the unit cost of £577 per service to reflect the allowances awarded as part of the RIIO-GD2 Final Determinations. Through the RIIO-GD2 Final Determinations, Ofgem awarded us the full baseline allowance of our submitted Mains diversions and associated services costs. However, associated services are the remediation of services carried out in conjunction with a mains diversion job. Therefore, the costs of remediating the associated services, such as labour, materials and reinstatement, are built into the overall diversions job, resulting in lower costs due to our on-site presence and completion of excavation and related work.

Furthermore, the services referenced in the RIIO-GD2 Final Determinations are representative of a typical blend of services within a network (a balanced ratio of relays & transfers with an average of strenuous services such as deep excavations or copper reruns) and are not comparable with the complexities that are involved with remediating a standalone encroached service. The services associated with the Final Determination unit cost would not include any costs to support the replacement itself such as traffic management, permits or any planning & programming.

In contrast, in our re-opener, we have defined an encroached service as "a gas service that has been compromised by building work resulting in the creation of an unsafe situation as identified within the Gas Industry Unsafe Situations Procedure (IGEM/G/11)". Encroached services, in the context of our submission, are not associated with an existing

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mains diversion and are a standalone job meaning the unit cost breakdown will inevitably be higher.

Therefore, the costs of a mains diversion-associated service job are not comparable to an encroached service job so to use this as a basis for a unit cost does not adequately allow us the expenditure to complete standalone service encroachments.

Our encroached service unit costs per network are derived from the total cost divided by the total volume of encroached services delivered at the time of submission. These are actual costs that are incurred and coded against the built-over services line in our financial systems, based on allocated job times per service which vary significantly per unique service. An example of this would be a service built over with a porch on a terraced house requiring a small length relay to the existing meter point, versus a complex maisonette with significant deviation from the original route and associated customer interaction. We have included images from an example built-over service job in Appendices 4-7 to highlight some of the complexities.

Network	EoE	NL	NW	WM
Unit Cost	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

Table 4: Encroached services unit cost

An average unit cost consists of multiple elements including team, first-call operative, material, reinstatement and permit costs. We provide an example of this from our WM network below.

Unit	Description	Cost (18/19 prices)
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]

Table 5: Example of Encroached Service Job (West Midlands Network)

The value of these varies between networks, specifically in our London network where we see a higher average cost due to regional factors that affect all elements. The costs to deliver Repex diversions in London involve the use of similar inputs to other Repex-related work, for which the cost has been accepted by Ofgem as being higher in London. For example, when assessing the vast majority of Repex within its GD2 Totex regression, Ofgem makes pre-modelling adjustments for regional factors, accounting for a higher operating cost. In particular, adjustments to reflect the higher wage level of local labour and the need to utilise greater quantities of labour due to reduced productivity. Likewise,



London attracts a higher material and permit cost than our counterpart networks, which, alongside the higher labour costs and quantity, equates to the average unit cost shown in Table 4.

Structural removal/legal remediation

We are supportive and agree with Ofgem's assessment of our needs case and optioneering for the encroached mains we have included within the Diversions and Loss of Development Claims Policy Re-opener. Structural removals as a resolution to encroachments in some instances are a more efficient alternative to a diversion.

Ofgem used our supplementary question response to allocate the value of the PCD where we outlined our structural removal/legal remediations forecasted volumes against a lower cost range of £9.98m and a higher cost range of £12.88m.

We are supportive of Ofgem's proposal to implement a PCD of £9.98m for Structural Removal/ Legal Remediation work as opposed to an additional re-opener window due to this work being considered a core activity. However, it is not clear how this funding will be split across our four networks. We propose an even distribution of the overall funding across our four networks. Given the unpredictable outcomes and uncertain number of resolutions, equitable funding ensures consistency and fairness across all networks.

Loss of development claims

We are supportive and agree with Ofgem's assessment of our needs case and optioneering for the loss of development claims we have included within the Diversions and Loss of Development Claims Policy Re-opener. We endeavour to use the most cost-efficient approach and ensure that all of our loss of development claims are evaluated by specialists and are thoroughly assessed by their compliance with the criteria for compensation.

We submitted a total of £8.3m for completed and planned future loss of development claims. We are supportive of Ofgem's proposal to allow our submission of £1.9m for the projects we have completed. Ofgem has proposed to disallow our planned future project costs of £6.38m in favour of an additional window when these costs are higher confidence. We agree that there is still significant uncertainty in if these future costs will materialise and therefore are supportive of the proposal for an additional window to be introduced if required. However, we would propose that the application of the materiality threshold considers previous re-opener determinations, and the costs associated in addition to the costs we include in the new re-opener submission.

[REDACTED] and [REDACTED] projects

We are supportive and agree with Ofgem's assessment of our needs case and optioneering for the [REDACTED] and [REDACTED] projects we have included within the Diversions and Loss of Development Claims Policy Re-opener. Both of these projects are subject to adverse environmental factors that require a diversion of our pipelines to ensure the protection of these pipelines and maintain the security of supply.

However, we disagree with Ofgem's proposal to reduce our overheads from [REDACTED] for [REDACTED] and [REDACTED] for [REDACTED] to an overarching [REDACTED]. For an explanation of how our overhead rates are allocated, please see our Named Diversions section above.

To reiterate, [REDACTED] is managed by our internal Capital Delivery function, which incorporates supervision costs within direct costs. This results in a lower overhead percentage of [REDACTED] reflecting only allocated overheads.

As [REDACTED] is delivered and managed by our CMO model, it is allocated a [REDACTED] fully loaded overhead rate as detailed in Table 1, which is made up of a [REDACTED] attributable and an [REDACTED] allocated overhead rate.

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In Table 6 below, we have carried out a similar overhead exercise as shown in Table 2 to demonstrate the correct overhead distribution. [REDACTED] values remain the same as it is delivered by our internal capital works function so is allocated the Capital Delivery rate ([REDACTED]). For [REDACTED], we have included the [REDACTED] attributable overhead value within the direct costs and the adjusted overhead has been made up of the [REDACTED] allocated overhead rate only.

Environmental Project name	Cost Elements	Re-opener total amount	Adjusted cost (Attributable costs are now within direct costs)
[REDACTED]	Direct Cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
[REDACTED]	Direct Cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]

Table 6: Environmental Projects – Overhead adjustment

GD.Q3. Do you agree with our Draft Determination of Cadent’s application under the MOB’s Safety Re-opener?

We do not agree with Ofgem’s position to disallow all requested expenditure under the MOB’s Safety Re-opener on the basis that our submission does not meet the scope of the Re-opener. We believe the policy intent for this re-opener was to allow for us to submit an application to recover the additional costs for increased workload related to an Approved MOB Safety Works Programme.

The MOB’s Safety re-opener, as stated in our GT licence, allows us to make an application ‘where there have been changes to the Safety Requirements Relating to Multiple Occupancy Buildings and or the development of an Approved MOB Safety Works Programme, that result in material changes to the costs of carrying out Licensed Activity.’

Our application in January 2024 related to the trigger of changes in our costs to an Approved MOB Safety Works Programme, due to increased volume of medium rise surveys and associated fault resolution and is a programme of work agreed with the HSE.

During the Final Determination of the RIIO-GD2 business planning process, Ofgem made a downward adjustment of £59.2m to our MOB’s maintenance costs due to concerns around resources for increased workloads, however decided to increase the scope of the MOB’s Safety re-opener to include MOB’s safety related maintenance. We have pulled out some excerpts from the RIIO-2 Final Determinations to support this:

- “We have decided to broaden the scope of the re-opener to include any program of safety related maintenance, repairs and surveys in medium rise MOB’s between three and five floors that has been developed in agreement with the HSE. We think that this is appropriate as it will facilitate the funding of programs of work where there was insufficient certainty over workload or unit costs to provide all the baseline funding requested at Final Determinations. (see Cadent Annex Chapter 3 and SGN Annex Chapter 3).”
- “We recognise the need to fund this type of work, however upon further assessment we have serious concerns about the significant increases in proposed baseline costs in RIIO-GD2 and the company’s ability to resource the increased workloads, particularly in London. For Final Determinations, we have decided to put in place a common re-opener for MOB’s safety, which includes MOB’s safety related maintenance” (RIIO-2 FD Cadent annex)



- *“Due to current uncertainty on volume and scope, the re-opener can also provide additional funding for safety related maintenance, repairs and riser surveys in medium rise MOBs.” (RIIO-2 FD GD annex)*

Therefore, Ofgem’s intent was to allow networks to make a re-opener application if and when there is greater certainty in MOB’s safety-related maintenance costs in medium rise buildings. It is incorrect to suggest that this trigger relates to changes in requirements of an Approved MOB Safety Works programme. The changes in requirements relate to the first trigger i.e. to respond to any new safety standards for MOB’s that the Ministry of Housing, Communities & Local Government (MHCLG), HSE or other relevant regulators or devolved governments may require in response to the Hackitt Review’, and not the second trigger relating to the development of an Approved MOB Safety Works Programme, which our re-opener demonstrates by evidencing the development of the required costs and volumes for our HSE approved programme of work with the certainty that was lacking at RIIO-GD2 Final Determinations.

Secondly, Ofgem claimed that all work should be carried out with regards to Pipeline Safety Regulations without additional funding. The MOB’s programme we featured in our Re-opener submission allows us to meet our commitments of providing ongoing network reliability at 90% fault resolution, allowing us to remain compliant with the Health and Safety at Work Act 1974 and the Pipeline Safety Regulations (PSR) (1996). To reach 90% fault resolution, there is a clear need for the additional funding, and without, would directly hinder our commitments made against these legal standards. The way to which we have utilised the uncertainty mechanism matches the given purpose of facilitating additional “safety related activities in MOB’s”.

Required Changes to the MOB’s Safety Re-opener License Condition

Licence Condition 3.21 of our GT licence includes within it further evidence of this difference between what is required to meet each of the two triggers. 3.21.7 indicates that a legislative change must be demonstrated to trigger an adjustment in allowances for Safety Requirements Relating to Multiple Occupancy Buildings. However, 3.21.8 indicates that the same ‘change’ does not need to be demonstrated for an adjustment in allowances relating to an Approved MOB Safety Works Programme:

3.21.7 An application under paragraph 3.21.4(a) must:

- a) relate to changes that have come into effect on or after 1 April 2021;
- b) take account of any allowed expenditure, which can be avoided as a result of the change;
- c) request changes to allowances that exceed the Materiality Threshold; and
- d) be confined to costs incurred or expected to be incurred on or after 1 April 2021.

3.21.8 An application under paragraph 3.21.4(b) must:

- a) take account of any allowed expenditure, which can be avoided as a result of the change;
- b) request changes to allowances that exceed the Materiality Threshold; and
- c) be confined to costs incurred or expected to be incurred on or after 1 April 2021.

However, we have found some inconsistencies in other aspects of the licence which do not align with the policy intent for the re-opener and have drafted some changes to the existing license condition (Special Condition 3.21 Multiple Occupancy Buildings safety Re-opener (MOBSt)). This can be found in Appendix 3.



Confidence in deliverability

As articulated in our response to SQ4, we stand by the commitment made in our MOB re-opener application to deliver 90% of the faults identified in RIIO-GD2. At the time of the re-opener submission, we provided actuals up to September 2023. At this point in time, we had identified [REDACTED] faults of which we had rectified [REDACTED]. Since our re-opener submission we have tracked and collated our delivery in each network and as of September 2024, we have identified a total of [REDACTED] faults, of which we have rectified [REDACTED]. Therefore, we are confident that we are able to deliver the workload, both in terms of surveys and fault resolution, that we have set out in our application.

We would be supportive of the introduction of an evaluative PCD to deliver the workload we have committed to deliver within our MOB Safety re-opener application. This will ensure delivery of the workload and protect our consumers from any non-delivery.

To conclude, the reduction in the amount of funding provided from RIIO-GD2 Draft to Final Determinations, justified with the addition of the re-opener, provided us confidence that funding for this safety crucial work would be available to us when the work package was mature enough to provide the additional cost and deliverability evidence. Our re-opener submission demonstrated a change to our overall programme of work, driven by greater certainty of costs and volumes for an Approved MOB Safety Works Programme in relation to repairs and surveys in Multi Occupancy Buildings between 3-5 floors developed in agreement with the HSE. We are confident this work can be delivered and would be open to the consideration of the introduction of a PCD to ensure delivery. Without the funding requested, it will have an adverse impact on our ability to deliver safety critical work that the HSE expect us to deliver.

GD.Q4. Do you agree with our assessment of applications under the New Large Load Connections Re-opener and our Draft Determinations? Please include your views on our assessment of the needs case, optioneering and draft allowances.

We are supportive and agree with Ofgem's assessment of our needs case and optioneering for the associated projects included within our New Large Load Connections re-opener submission. This will support the necessary work we need to undertake (network reinforcement) to ensure our gas network remains resilient, in response to varying levels of demand, as a result of requests for a New Large Load Connection.

However, we disagree with the proposal to reduce our overhead rates from [REDACTED] to [REDACTED]. Our overhead costs have been misinterpreted as a [REDACTED] addition to direct costs. This is inaccurate. Our overheads represent a distinct allocation/distribution of costs. While traditionally some costs (like those detailed below) would be classified as direct costs, our internal finance guidance categorises them as overheads. This is explained in more detail above, in the Diversions named projects section. To see how this applies to our New Large Load Connections application, please see below.

Cadent Networks		Re-opener Total amount	Adjusted costs (attributable costs are now within direct costs)
North West	Direct Cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]
Eastern	Direct Cost	[REDACTED]	[REDACTED]
	O/H	[REDACTED]	[REDACTED]
	Total	[REDACTED]	[REDACTED]

Table 7: New Large Load Connections – Overhead adjustment

We are supportive of the introduction of an evaluative PCD to deliver these essential reinforcement projects. This will ensure delivery of the projects and protect consumers from any non-delivery.