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Dear Graeme,

Thank you for the opportunity to respond to Ofgem's minded-to position for the Extreme Weather Resilience Medium Sized Investment Project (MSIP) reopener. Our response is limited to Ofgem's cost assessment methodology and application of the Opex Escalator mechanism (Consultation Question 4). We previously raised similar points as part of our response to Ofgem's consultation on modifications to Special Condition 3.36.<sup>1</sup>

It is important to note the original purpose of the Opex Escalator (OE). It is intended to provide licensees with automatic allowance adjustments for operational costs (closely associated indirects and network operating costs) associated with the capital expenditure required through our RIIO-T2 uncertainty mechanism projects. This was intended to provide both regulatory certainty and proportionate regulation.

We note the OE for each Transmission Owner (TO) is different and based on the efficient capital and operational costs set for each individual TO's baseline allowance for RIIO-T2. These costs are in turn based on each TO's interpretation of the Regulatory Instruction and Guidance (RIGs) and Business Plan Data Table (BDPT) Guidance<sup>2</sup> as to the allocation costs as direct or indirect. Within both the RIIO-T1 and T2 RIGs under the Direct Activities definition<sup>3</sup> Ofgem note that "where contractors have recharged the licensee **for the primary purpose of performing direct activities which include costs for indirect activities but these are not explicitly costed in their invoice, all costs will be treated as direct**". Our RIIO-T1 delivery strategy means that indirect contractor costs will have been allocated against the direct activities and not included within our indirect cost allocation. These historic opex costs will have in turn informed our RIIO-T2 Opex ask and the OE percentage uplift.

We cannot provide comment on the make-up of NGET's OE but note that paragraph 5.13 of the MSIP reopener consultation states Ofgem's proposal to reduce the funding allocated for contractors' preliminary activities by 49% with the view expressed that the OE mechanism will increase allowances to cover site management and supervision costs.

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<sup>1</sup> <https://www.ofgem.gov.uk/publications/notice-statutory-consultation-modify-special-condition-336-opex-escalator-electricity-transmission>

<sup>2</sup> As at the time of submitting the RIIO-2 Business Plan.

<sup>3</sup> Page 145 of RIIO-T2 RIGS

We raised concern in our response to Ofgem's consultation on modifications to Special Condition 3.36 that Ofgem could apply definitions of direct and indirect costs that are inconsistent with the definitions used by the TOs when the OE rates were set as part of the RIIO-T2 settlement. This inconsistency in definitions could lead to under-recovery of indirect project costs. For example, historic contracting strategies will determine how indirect costs have been captured and thus informed the RIIO-T2 OE value.

By way of illustration, failure to do so could result in Ofgem classifying cost categories as indirect based on differing interpretations of definitions such that the adjustment would not be reflected by the OE, as the escalator uplift is based on that cost being classed as direct capex. This would result in a double reduction to allowances as the TO would lose the direct capex allowance, and the associated indirect opex allowance would also be reduced as it is calculated on the basis of the residual direct capex. This would leave the TO with insufficient allowances to cover the cost of economically and efficiently delivering the project. The only alternative would be to recalibrate the OE for each of the TOs which is not proportionate or practical. Ofgem need to be consistent with the approach set out for RIIO-T2 when defining cost categories to ensure the OE delivers on its policy intent for RIIO-T2.

Ofgem must ensure that the assessment of direct costs is consistent with how each of the TOs has defined and captured direct and indirect elements when setting the OE. It is inappropriate to impose a different view of definitions, even if the three TOs have applied different interpretations, as the OE has been set based on each TO's interpretation. Another potential option would be if Ofgem were to provide these disallowed "indirect costs" as additional indirect allowances above the OE as part of the MSIP. The only alternative would be to recalibrate the OE for each of the TOs which is not proportionate or practical. Ofgem need to be consistent with the approach set out for RIIO-T2 when defining cost categories.

Yours sincerely

Craig Molyneux  
**SSEN Transmission**