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Dear Jourdan,

RIIO-T2 Opex Escalator Uncertainty Mechanism

This is a joint letter submitted to Ofgem on behalf of the three electricity transmission operators ('the TOs'), collectively SSEN Transmission (SSENT), National Grid Electricity Transmission (NGET) and SP Transmission (SPT).

The Opex Escalator (OE) is designed to provide licensees with automatic allowance adjustments for costs (Closely Associated Indirects (CAI) and Network Operating Costs) relative to capital expenditure approved through specified RIIO-T2 uncertainty mechanisms. This was intended to provide both regulatory certainty and proportionate regulation.

The purpose and benefits of the OE were stated in RIIO-ET2 Final Determinations¹. The following is taken from the TOs RIIO-T2 company specific annexes:

- Purpose: To ensure [NGET/SHET/SPT] is funded through an automatic mechanism for varying operational costs associated with capital investments delivered through UMs.
- Benefit: Provides [NGET/SHET/SPT] with opex allowances when capex allowances are funded through the relevant UM **and ensures that those opex allowances are consistent with those set for baseline allowances** *[emphasis added]*.

The above emphasis indicates the basis of our understanding of the OE. Each TO's RIIO-T1 delivery strategy means that all contractor costs (including those that Ofgem is now proposing to class as 'indirect') were allocated against direct activities for the purpose of RIIO-T1 annual reporting and our RIIO-T2 Business Plan Data Template (BPDT) submissions. No contractor costs were included within our CAI cost allocation (consistent with Ofgem's own guidance, as outlined in the Appendix). These historic costs in turn informed the setting of each of our OE automatic percentage uplift relative to direct costs. Any change in the treatment of such costs during the RIIO-T2 price control period would therefore necessitate a recalculation of the coefficient to ensure that both consumers and network operators are treated fairly.

There has recently been a clear shift in interpretation by Ofgem, of the definition of Direct and CAI activities, making Ofgem's cost assessment process inconsistent with the basis upon which baseline allowances were set and the basis upon which the OE was derived for the RIIO-T2 period. If implemented, this change will lead to an under-recovery of total project costs.

¹ Decision RIIO-2 Final Determinations - NGET Annex (REVISED), page 78. SHET Annex (Revised), page 58. SPT Annex (REVISED), page 63.

Ofgem's interpretation was recently confirmed as part of the consultation on NGET's Extreme Weather Resilience funding request². NGET's request included an amount for contractor costs associated with preliminary works such as site management and supervision. Ofgem's view is that these costs should be disallowed on the basis these *'are closely associated indirect (CAI) activities which fall under the scope of the costs covered by the opex escalator'*. In our view this statement is contrary to the basis on which the OE was agreed, as these costs would not be covered by the current OE rate.

For Ofgem to legitimately apply the OE rate in the way it is proposing, there must be consistency between the data used in the calculation of the escalator and its application. This is not the case for Ofgem's proposed revision to the OE. Consequently, Ofgem will be making a mathematical error pursuing its proposed change. This is not in the 'margin of error' of regression analysis; if the OE were calculated consistently with how Ofgem is looking to apply the definition today, the factor could be more than double.

We set out in the Appendix our joint view and understanding of the RIIO-T2 OE and provide an illustrative example of the impact to the TOs. The impact is demonstrated in terms of totex recovery for capital investments delivered through re-openers should Ofgem continue to treat contractor 'indirects' in a manner that is inconsistent with Final Determinations. It is not an acceptable scenario whereby projects are underfunded due to the application of the OE on a different basis from its original calculation. It is not necessary to reopen the RIIO-T2 price control to address this issue but rather the interpretation of 'indirects' is applied in a manner that is consistent with how the OE was calculated and set, i.e. for contractor 'indirects' to be treated as direct costs.

We, respectfully, request Ofgem maintain the current position, applying the OE in accordance with the agreed understanding at Final Determination. Alternatively, Ofgem should work with TO's to review the impact of changes to relevant definitions which act on the OE rate to agree revised arrangements for application at a future date.

We also note Ofgem issued the 2023 RIGs for formal consultation with response date of 30th March³. Given the potential materiality associated with amending definitions (noting Ofgem's interpretation of historic definitions) and the impact of retrospectively amending definitions under OE, we intend to withhold comment on the definition of CAI and Direct Activities until such point as there is sufficient clarity as to the treatment of RIIO-T2 cost categories.

Yours sincerely

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Patrick Hynes - New Infrastructure Submissions Manager – National Grid Electricity Transmission

Stephanie Anderson – Head of Regulation & Policy – SP Transmission

² Consultation on an Extreme Weather Resilience Medium Sized Investment Project from National Grid Electricity Transmission published 18 May 2022.

³ [Notice proposing modifications to the Regulatory Reporting Pack \(RRP\) and Regulatory Instructions and Guidance \(RIGs\) for RIIO-ET2 | Ofgem](#)

Appendix

Application of the RIGs for Business Plan Data Table population

The table below provides an overview of the evolution of the definition of Direct Activates within the various reporting instruments during RIIO-T1 and RIIO-T2. Of note, the RIIO-T2 Business Plan Data Templates (BPDTs) Guidance⁴ and RIIO-T2 Regulatory Instructions and Guidance⁵ (RIGs) under the Direct Activities definition notes 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”*. [emphasis added]

RIIO-T1 RIGs v8.1 20/21	No reference to treatment of contractor indirects
RIIO-T2 BPDTs v1.4	Under Direct Activities definition notes: <i>“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”</i> .
RIIO-T2 RIGs v1.3 (2021/22)	Under Direct Activities definition notes: <i>“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”</i> .
RIIO-T2 RIGs v1.6 (2022/23)	Under Direct Activities definition notes: <i>“direct cost of an asset will reflect the purchase, transportation and installation of the asset. We consider that the manufacturing configuration design costs i.e. “the cost of the asset leaving the factory gate” to be a legitimate purchase cost and therefore included in the direct cost of the asset. See table below for a number of worked examples to illustrate this point.”</i> The examples provided relating to manufacturing configuration design and functional design are helpful but provide clarity for only one activity type which cannot be easily extrapolated across all CAI categories.

TO costs submitted as part of the RIIO-T2 BPDTs were derived from historical contract or outturn costs from the RIIO-T1 period. The TOs have no business need to separate these costs into regulatory reporting categories, and because the RIGs in force during RIIO-T1 did not require it, contractors were not required to provide invoices in this way. Due to the time elapsed (some of those projects were contracted ~seven years before Ofgem introduced this new requirement), we had not collected or reported cost data in this way during the RIIO-T1 period and the structure of

⁴ RIIO-T2 Electricity Transmission Price Control – Guidance on Business Plan Data Templates: Version 1.4 published 20 September 2019

⁵ Decision on Regulatory Instructions and Guidance (RIGs), Transmission Glossary and Regulatory Reporting Pack (RRP) to apply during RIIO-ET2 published 14 March 2022

contractor invoices made it impossible for us to go back and reasonably split out contractor 'indirect' costs.

Further, it is important to note that the submitted costs for any activity were not taken directly from any particular contract, rather they were aggregates of contract or incurred costs chosen to best represent the forecast efficient costs for the RIIO-T2 period. This process (e.g., selecting the median or calculating a mean following removal of outliers and applying an efficiency stretch) results in costs which do not have a direct linkage to a particular contract so could not be followed back to individual invoices. Therefore, the BPDTs, by definition, treated all contractor costs as direct (consistent with Ofgem's guidance).

These historic costs in turn informed the setting of each of our OE automatic percentage uplifts relative to direct costs. Any change in definition or interpretation of the definition of CAI and Direct Activities from those used to calculate the coefficient during the RIIO-T2 price control period would necessitate a recalculation of the coefficient to ensure that both consumers and network operators are treated fairly.

Setting the RIIO-T2 Opex Allowances and Escalator

When setting indirect allowances for RIIO-T2, Ofgem's multivariate regression analysis "*used only historical data to avoid undue dependency on network company view*".⁶

The reporting of contractor 'indirects' as Direct costs, in line with the RIGS, means that the subsequent CAI baseline allowance and the uplift for the OE only cover internal (TOs) indirect costs, and do not include contractor 'indirects'.

Ofgem has indicated its expectation that contractor 'indirect' costs were split out from the direct costs within the BPDT using forecasts for RIIO-T2. However, its own methodology for calculating indirect allowances and the OE was focused on using historic data and not 'forecast' data as the basis of the modelling. Therefore, to avoid undue dependency on the company view of indirect costs, all contractor costs would have had to be deemed direct costs, based on historical reporting.

Application of the Opex Escalator in RIIO-T2

In full compliance with the RIGs, the OE rate was calculated including all contractor costs as Direct costs. The RIIO-T2 OE (as currently constructed) therefore only provides Ofgem's view of efficient allowances for a TOs indirect costs (relative to direct allowances).

Any proposal to re-categorise what were previously assessed as Direct costs to 'indirect' when estimating future costs will have an impact on allowances in a manner inconsistent with the approach taken towards setting the OE prior to RIIO-T2 commencing.

More specifically, removing the contractor 'indirects' from the direct costs results in a double cut in allowances for the TOs:

- There is a cut to our capex allowances due to the removal of contractor 'indirects' which are then not funded by the OE; and

⁶ RIIO-2 Draft Determinations: ET Annex – Paragraph 3.50, p60

- The OE will be calculating an uplift on capex which is less than otherwise would have been the case, therefore both the TOs' CAI allowances and the 0.5% opex uplift will be lower than is mathematically correct and fair.

Ofgem's Error

As we noted above, calculating the OE rate using one set of data and then applying inconsistently to future cost data will lead to errors. The TOs affirm that the price control determined a relationship between TO indirect costs and the explanatory variables (the cost drivers). The explanatory variables included direct costs which, historically, included contractor 'indirect' costs. Ofgem's position is to now calculate future 'indirect' allowance requirements by using the same escalator rate but applying a capex cost driver which now excludes contractor 'indirects' (i.e. a lower level of cost driver). The effect is incorrectly low indirect allowances.

It is a simple task to establish the basis for the OE derived during the RIIO-T2 price control process and affirm the following:

- Most importantly, each of the TOs has confirmed that the direct capex submitted in the BPDTs (historic and forecast) includes contractor 'indirect' costs. Therefore, the opex multiplier (or OE) derived from the econometric analysis of that data must also be applied to forecast capex expenditure on the same basis, i.e. including contractor 'indirects'.
- Moreover, the basis of the TO BPDTs is self-evident from and can be checked by examination of the data used to derive the OE.
 - TOs have reported capex expenditure each year throughout RIIO-T1 (2014 onwards). The early years pre-date any proposal to split contractor 'indirect' costs out from the sums invoiced to TOs.
 - **Conclusion:** The capex data within early RIIO-T1 is therefore capex including contractor indirects.
 - Examining the indirects reported by each TO (within BPDTs or RRP) shows steady and consistent indirect costs from RIIO-T1 into RIIO-T2. If TOs had changed from including contractor 'indirects' within their capex activities to including within CAIs, this would result in a step change in cost levels in that year. There is no such change.
 - **Conclusion:** TOs have continued to include contractor indirects within their reported capex activities (as permitted by the RIIO-T2 guidelines and as communicated to Ofgem during the process).

Materiality of the Issue

The outcome of underfunding of allowance against cost will be consistent and systemic across every project. The TO's will face under recovery of cost vs allowance. As the value of the project increases the materiality of the funding gap increases. The TOs estimate that this could equate to tens of £m over the RIIO-T2 period.

Illustrative Worked Example (using SSEN Transmission's OE) - Transformer Substation Upgrade

We have provided a simplistic example below of how the re-allocation of 'indirect' contractor costs (previously treated as Direct costs for the purpose of setting baseline allowances and calculating the OE) as to indirect costs impacts the allowances generated by the OE if implemented differently

from how it has been derived. In this worked example, the resulting outcome is a £5.6m shortfall in allowance against the efficient project totex cost.

Table 1: How the OE was derived

Direct Costs			Indirect Costs		
Asset Cost	Contractor Indirects	Total Direct Cost	SSEN-T CAI	Total Indirect	Total Project Costs
£30.0m	£5.0m	35.0m	£3.8m	£3.8m	£38.8m

Table 2: How Ofgem is proposing to apply the OE to UM submissions

Direct Costs		Indirect Costs			
Asset Cost	Contractor Indirects	SSEN-T CAI	Total required Indirect Costs	Indirect Allowance	Total Project Allowance
£30.0m	£5.0m	£3.8m	£8.8m	£3.2m	£33.2m

Outcome - Project Cost vs Project Allowance

Total Project Cost £m	Total Project Allowance £m	Difference £m
£38.8m	£33.2	-£5.6m