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Dear Sai Wing Lo,

Response from National Grid Electricity Transmission plc (NGET) to the Statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission Licence held by NGET

NGET welcomes the opportunity to respond to the above consultation in relation to proposed modifications to Special Condition 3.14 Medium Sized Investment Projects Re-opener and Price Control Deliverable (MSIPREt) of the NGET licence.

NGET agrees with Ofgem's proposed changes to the defined term "NGET Redacted Information Document" in Special Condition 1 but has concerns with the other proposals as set out further in this response.

Sulphur hexafluoride (SF6) Asset Intervention

Thank you for confirming your decision on the SF6 MSIP and approving the needs case for the proposed interventions and associated funding, except for the gas circuit breaker (GCB) repairs which (while you have approved the needs case) you have advised should be funded through NARM.

We are disappointed about this outcome for GCB repairs because we see this as creating unnecessary uncertainty and additional bureaucracy. However, based on ongoing conversations between our organisations, we await confirmation that funding through NARM would be practicable. A prerequisite for this is for Ofgem to change the NARM methodology for NGET to introduce a 'zero floor' to remove negative long term risk benefit (LTRB) from the calculations. We therefore require written confirmation from Ofgem regarding how this would work, and how much funding would be triggered (all other things being equal) at T2 close-out. We require swift resolution on this matter so that we can then progress these important interventions.

Extreme Weather Resilience, Cellarhead Customer Connection, Frodsham Customer Connection, Lister Drive Customer Connection and Melksham Operational Tripping Scheme Phase 2 Project

NGET does not agree with the proposed allowances for the above projects that are proposed to be included in Appendix 1 of Special Condition 3.14. These proposed modifications are based on an error of fact. NGET disagrees with the proposed allowances because of the removal of contractor preliminaries from our funding requests for these projects and the categorisation of these costs as Closely Associated Indirect (CAI) costs. This is an error and is fundamentally at odds with the CAI and Opex Escalator (OE) framework designed for RIIO-T2. Ofgem's position is inconsistent with the position consulted upon during RIIO-T2 and set out in the Final Determinations, (i.e., to ensure that

the allowances for Indirect costs are consistent with those set for baseline allowances). Our concerns with and objections to Ofgem's approach are set out at Appendix A to this letter which contains a paragraph-by-paragraph analysis of Ofgem's position as published in Ofgem's "Decision on NGET's 2022 MSIP re-opener applications" dated 19 April 2023. Ofgem is required to consider these representations made in response to the statutory consultation and must state how it has taken account of these representations when publishing its decision on the proposed modifications. We therefore request that Ofgem reconsiders its proposed approach in light of these representations ahead of directing the proposed modifications to the NGET licence.

NGET submitted costs for these MSIP re-openers in accordance with 'The Re-opener Guidance and Application Requirements Document and Standard Condition B15 (RIGs) of NGET's Transmission Licence'. For clarity, at the time of the MSIP re-opener submissions, the RIGs definition of "Direct Activities" in force at that time stated that "where contractors 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".

The above is consistent with the approach taken by other licensed Electricity Transmission Operators (ETOs) and forms the basis of discussions held between Ofgem and ETOs regarding ETOs' concerns in relation to Ofgem's inconsistent application of the CAI and OE framework designed for RIIO-T2. All three ETOs submitted a joint letter to Ofgem on 2 March 2023 and a further letter dated 17 May 2023 setting out these significant and material concerns.

The proposed application of the OE in a manner which is not consistent with how the OE was originally derived means that activities undertaken by external contractors that Ofgem now classifies as 'Indirect' are not funded. This can be observed from this re-opener decision, where there is a 21% reduction in allowances vs NGET's total costs for the four applicable projects (only 2% of which is due to specific exclusion of risk costs). The remainder of the funding gap is due to a 63% reduction in allowances for what Ofgem terms 'Indirects' compared to total Indirects (NGET Indirects plus contractors costs that Ofgem now class as Indirect). This is despite Ofgem not identifying any of these 'Indirects' as inefficient or unnecessary and therefore illustrates the impact of the inconsistency.

This inconsistency will adversely impact all ETOs financially, such that they will not be funded for efficiently incurred costs. This inconsistency in the application of OE plus uncertainty of GCB funding, along with the recent decision on the Civils re-opener, represents a significant change in our overall regulatory risk profile.

This response is made entirely without prejudice to NGET's rights including those under the Electricity Act 1989.

Confidentiality

I confirm that this response can be published on Ofgem's website.

Yours sincerely,

Patrick Hynes

New Infrastructure Regulation Manager

APPENDIX A - NGET Analysis of Ofgem’s “Decision on NGET’s 2022 MSIP re-opener applications” dated 19 April 2023.

Responses and decision regarding the application of Opex Escalator (OE) in MSIP projects

(Taken from pages 14-20 of [Decision on NGET’s 2022 MSIP re-opener applications \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/decision-on-nget-2022-msip-re-opener-applications))

N.B. Throughout this Appendix A, reference is made to contractors’ Indirect costs (as opposed to NGET Indirect costs). These are costs incurred by contractors in delivering projects (i.e., site activities and activities that directly support those site activities such as project management and site safety). Where NGET uses contractors or consultants to supplement NGET engineering roles, e.g., to undertake Front End Engineering Design as part of optioneering and development, these costs are treated as though they were NGET Indirect costs, i.e., mapped to CAI.

While this is not the split that Ofgem is seeking to implement for Electricity Transmission now, this is to the best of our knowledge consistent with how Electricity Distribution report costs. Please can Ofgem explain why this divergence is being required for Transmission?

Ofgem position	National Grid position
<p>Background</p> <p>2.1. ETO’s costs are broadly categorised as two types:</p> <ul style="list-style-type: none"> • Direct Costs – associated with installing new long-life assets or running/maintaining/upgrading existing assets. The RIIO-ET2 Business Plan Data Template (BPDT) Guidance v1.4 defines Direct Costs as “expenditure incurred undertaking Direct Activities.” Direct Activities are defined as “those activities which involve physical contact with high voltage network assets.”¹ • Indirect costs – relate to the Indirect Activities undertaken in support of direct costs. Indirect costs are not themselves defined in the RIIO-ET2 BPDT Guidance v1.4, but Indirect Activities are described as “activities... which in most cases support work being physically carried out on high voltage network assets that could not, on their own, be classed as a direct network activity.”² Indirect 	<p>We agree that ETO costs can be broadly categorised as two types.</p> <p>However, the description of Direct costs has excluded the important clause: “<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 costs in their invoice, all costs will be treated as direct</i>”. (This clause is referred to as ‘the omitted Clause’ throughout this response.)</p> <p>This split between Direct and Indirect costs did not exist prior to 2019, i.e., reporting on this basis had not been established prior to the T2 Business Plan Data Tables (BPDT) development process. When these changes were introduced by Ofgem in late March 2019, NGET was so concerned that the underlying data did not exist that we escalated this issue to senior representatives of Ofgem on 28 March 2019. As an immediate consequence, Ofgem added the above Clause to the next draft version of BPDT Guidance (issued 29 March 2019).</p>

¹ RIIO-ET2 BPDT Guidance v1.4, p47 and p110-111; accessible via: <https://www.ofgem.gov.uk/publications/riio-2-final-data-templates-and-associated-instructions-and-guidance>

² RIIO-ET2 BPDT Guidance v1.4, p48

<p>Activities include Closely Associated Indirects (CAI),³ which are defined as “costs that support the operational activities. CAI activities include network policy (including research and development), network design and engineering, engineering management and clerical, wayleaves administration, control centre, system mapping and health and safety functions.”⁴ Each of these CAI activities are defined within the RIGs, which provide the types of activities which sit within each sub-category.</p>	<p>Because we did not have costs invoiced on this basis for historical projects, and obviously we would not have invoices for forecast projects, all contractor costs were mapped to Direct and only NGET costs were mapped to Indirects. It is on this basis that NGET submitted costs for T2 BPDT, and these costs were subsequently used in deriving the OE coefficient. Contractors’ costs were mapped to Direct capex, and these were subsequently included in Ofgem’s assessment of efficient Direct capex costs for projects.</p>
<p>2.2. The requirement for delineation of direct and indirect costs is essential in Ofgem’s approach to monitoring performance and cost assessment and is applicable irrespective of which party undertakes the activity. It is the direct or indirect nature of the activity as described in 2.1 and its conformity with the cost category definitions provided within Ofgem’s Regulatory Instructions and Guidance (the RIGs) that determines the reporting requirements.</p>	<p>The requirement outlined in 2.2 is a summary of Ofgem’s current position, however it is not ‘essential’. During the RIIO-T1 period (and previous price controls), project costs were viewed as a whole rather than split into component parts – this being key to ensuring best value is delivered for consumers.</p> <p>While it is possible to assess costs in a different way, a prerequisite is to agree commonly understood and consistent definitions, introduce reporting in a timely fashion so that data sets can be established, and then undertake analysis. No definition of Direct activities (i.e., those activities which involve physical contact with high voltage network assets) existed in the prevailing RIIO-T1 RIGs, there was no requirement to split costs this way for RIIO-T1 RRP and consequently this data was not collected. We are still at a point where we do not have adequate definitions in RIGs that all parties agree with and can work to, and therefore we still do not have such data.</p> <p>Regardless, our T2 BPDT submission conformed to the RIGS with the addition of the then existing omitted Clause that was omitted in your paragraph 2.1. This omitted Clause allowed us to complete the T2 BPDT and RRP22 submissions consistently by mapping contractors’ costs (including those that Ofgem now classify as Indirect) to Direct capex.</p>

³ RIIO-ET2 BPDT Guidance v1.4, p48 Decision – Decision on NGET’s 2022 MSIP re-opener applications

⁴ RIIO-ET2 BPDT Guidance v1.4, p110

The OE mechanism

2.3. As part of RIIO-ET2, we introduced the OE. The chronology for the development and implementation of the OE is detailed below:

- The policy for the OE was consulted on within the RIIO-ET2 Draft Determinations (published on 9 July 2020).⁵
- After considering consultation responses, the policy for the OE was decided within the FDs (originally published on 8 December 2020, with a revised version correcting some errors published on 3 February 2021).⁶
- The OE was introduced into each ETO's licence via SpC 3.36, following the statutory licence modification consultation published on 17 December 2020⁷ and decided on 3 February 2021.⁸ These licence modifications then came into effect at the start of the RIIO-ET2 period, on 1 April 2021.⁹
- The RIGs, containing detailed reporting rules, for use in year 1 of the RIIO-ET2 price control were then consulted on in April 2022,¹⁰ with a decision made on 1 June 2022.¹¹ These came into effect ahead of the submission of Regulatory Reporting Pack (RRP) on 31 July 2022.

We agree that the concept of OE was introduced at Draft Determinations, and a decision made as part of Final Determinations (FDs). The OE is described in FDs as follows:

Purpose: *To ensure ETOs are funded through an automatic mechanism for varying operational costs associated with capital investments delivered through UMs.*

Benefits: *Provides the ETOs 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”.*

Since baseline allowances and the OE coefficient were set using the data submitted using the definitions outlined in 2.1 including the omitted Clause “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 costs in their invoice, all costs will be treated as direct.”, the analysis therefore excluded contractors’ Indirect costs from the OE coefficient. This means that the OE coefficient, when applied to total Direct costs (including what Ofgem now refer to as contractors’ Indirect costs) will provide funding for the licensee’s Indirect costs only. Applying this coefficient as part of a re-opener to Direct costs excluding contractors’ Indirect costs will not provide allowances consistent with those set for baseline allowances, i.e., will not achieve the stated benefits.

⁵ Our proposal for the OE mechanism was set out within paragraph 4.62-4.66 of the ET Sector Annex of the RIIO-ET2 Draft Determinations; https://www.ofgem.gov.uk/sites/default/files/docs/2020/07/draft_determinations_-_et_sector_0.pdf

⁶ Our decision on the OE mechanism was set out within paragraphs 4.43 – 4.48 of the ET Sector Annex of the FDs; https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_et_an_nex_revised.pdf

⁷ Statutory consultation for RIIO-ET2 licences, 17 December 2020: <https://www.ofgem.gov.uk/publications/statutory-consultation-riio-2-transmission-gasdistribution-and-electricity-system-operator-licences>

⁸ Decision on modifications to RIIO-ET2 licences, 3 February 2021: <https://www.ofgem.gov.uk/publications/decision-proposed-modifications-riio-2-transmission-gas-distribution-and-electricity-system-operator-licences>

⁹ NGET’s licence can be accessed via the Electronic Public Register (EPR): <https://epr.ofgem.gov.uk//Content/Documents/National%20Grid%20Electricity%20Transmission%20plc%20-%20Special%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

¹⁰ Notice of proposed modification to the RIGs and RRP, 14 April 2022: <https://www.ofgem.gov.uk/publications/notice-proposed-modifications-regulatoryinstructions-and-guidance-and-regulatory-reporting-packs-riio-2>

¹¹ Decision on modification to the RIGs and RRP, 1 June 2022: <https://www.ofgem.gov.uk/publications/decision-modifications-regulatory-instructionsand-guidance-rigs-regulatory-reporting-packs-rrps-and-pcfm-guidance-riio-2>

<p>2.4. The purpose of the OE is to fund the additional indirect costs incurred by a network when it takes on additional investments on top of the baseline allowance via the re-openers and uncertainty mechanisms (UMs). It is a mechanistic calculation which provides efficient CAI allowances across a licensee's full RIIO-ET2 capital programme.¹²</p>	<p>We agree with this statement: "The purpose of the OE is to fund the additional indirect costs incurred by a network when it takes on additional investments on top of the baseline allowance via the re-openers and uncertainty mechanisms (UMs)." Specifically, the OE covers the licensee's additional indirect costs. It does not cover the contractors' costs that Ofgem now describe as 'Indirect'.</p>
<p>2.5. The OE allowance for each of the projects awarded funding via re-openers consists of a percentage uplift on the total efficient direct cost allowance assessed. The percentage uplift for each ETO is different because of the differing relationship for each ETO's cost (CAI) to cost driver (capex) employed in the regression analysis used in setting baseline allowances. Details of the OE approach, the applicable UM and the calculation methodology is set out in full within FDs.¹³ We have also described our approach in paragraph 2.6 and 2.7 below. In summary, through the regression analysis employed in determining the economic and efficient indirect costs required to support the capital programme allowed for by Ofgem in each of the ETO's RIIO-ET2 baseline settlement, an algebraic formulae was derived and replicated for the OE. This ensured that indirect funding levels were consistent whether applied to baseline capital programmes or any subsequent awards derived from applicable re-openers.</p>	<p>This paragraph again refers to each ETO's cost as 'CAI', which was our understanding at the time when the OE was established. It is therefore not surprising that none of the ETOs understood that the OE was intended to cover a proportion of contractors' costs (i.e., those contractors' costs that Ofgem now categorise as Indirect). This lack of clarity from Ofgem has caused sufficient miscommunication that all three ETOs accepted the T2 framework without understanding what Ofgem now seemingly intends to do when applying the OE to re-openers.</p> <p>We note that the algebraic formula derived and replicated for OE is predicated on:</p> <ol style="list-style-type: none">1. the inputs into the coefficient which for all ETOs included licensees' Indirect costs and excluded contractors' Indirects costs which were classified as Direct capex costs for the reasons stated above, and2. the corresponding classification of the spend submitted via the MSIP re-opener (again in line with the definition outlined in our response to 2.1). <p>Any change in classification of the capex costs between Direct and Indirect costs will invalidate the coefficient calculated and result in subsequent funding awards that are not consistent with baseline allowances. This is what has happened with the MSIP re-openers that are the subject of this decision document; the split between Direct and Indirect costs is inconsistent with the basis of T2 FDs and hence application of the OE results in contractors' Indirect costs being unfunded (plus the secondary impact of the OE coefficient being applied to artificially low Direct costs).</p>

¹² The OE also provides for an uplift for Network Operating Costs (NOC); however, no issues with the NOC uplift have been identified in these MSIP projects and are therefore the uplift for NOC is not discussed further. For further detail on NOCs, see paragraph 3.39 of the FDs – ET Annex:

https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_et_annex_revised.pdf

¹³ RIIO-ET2 FDs – ET Annex, chapter 4, decisions on OE contained in paragraphs 4.42 – 4.48:

https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_et_annex_revised.pdf

<p>2.6. This OE calculation for CAI allowances uses a formula¹⁴ which is predicated on the assessed, efficient CAI baseline allowances established at FDs. This reflects the relationship established at FDs between direct activity and CAI using econometric analysis. The OE formula is applied to any direct activity allowances agreed under UMs including the MSIP re-openers.</p>	<p>The assessed, efficient CAI baseline allowances established at FDs only included licensees’ Indirect costs. All ETOs consistently mapped all contractor costs to the Direct categories, in line with the specific omitted Clause introduced to allow this to happen. NGET’s Indirect costs as described in our T2 submission averaged 16% of the total project cost based on analysis of completed T1 projects; this is what was mapped to CAI. Had contractors’ Indirect costs (as defined by Ofgem) been mapped to CAI as well, this percentage would have been ~ 30%. This can be seen from the four projects that Ofgem has analysed as part of this MSIP re-opener.</p> <p>Any change in classification of activity between Direct and Indirect from those applied when the coefficient was derived will invalidate the relationship established by the econometric modelling undertaken for FDs.</p>
<p>2.7. Full information on our cost assessment approach for RIIO-ET2 can be found within FDs.¹⁵ In setting indirect allowances for RIIO-ET2, we used the historical data provided by ETOs (based on the BPDT guidance)¹⁶ to establish the relationship between directs and indirect costs through econometric analysis. The econometric analysis consisted of a mathematical model with multiple variables (known as multivariate regression model), which included total capex as an explanatory variable, was designed to be intuitively appropriate, and verified using statistical testing. Once set, this relationship could then be applied to future forecasts, as was the case in setting RIIO-ET2 baseline indirect allowances. This relationship and the mathematical formulae were subsequently used in the OE mechanism to set efficient indirect costs for applicable UMs by replicating the relationship established between direct and indirect costs used in setting RIIO-ET2 efficient indirect</p>	<p>We fully support the points in this paragraph.</p> <p>Historical data was provided by ETOs in compliance with BPDT guidance because all ETOs categorised contractors’ Indirect costs as Direct because they were not explicitly separated in invoices or specifically captured historically, in line with the omitted Clause that allowed this approach.</p> <p>This was made clear in the document “NGET_A14.05_How we contract and deliver efficiently” provided as part of our RIIO-T2 submission which clearly states within the “Efficiency and productivity ambition” section that we reviewed completed projects in RIIO-T1 to understand that our average indirect costs (<u>client-side</u> Project Management, overheads and other <u>client</u> costs) averaged ~16% of the totals costs, with <u>client-side</u> project management costs being closer to 10%.</p>

¹⁴ <https://epr.ofgem.gov.uk/Content/Documents/National%20Grid%20Electricity%20Transmission%20plc%20-%20Special%20Conditions%20Consolidated%20-%20Current%20Version.pdf> (3.36.5 contains the value of CAIAt)

¹⁵ RIIO-ET2 FDs – ET Annex, chapter 3: https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_et_annex_revised.pdf

¹⁶ RIIO-ET2 BPDT guidance v1.4 published here: <https://www.ofgem.gov.uk/publications/riio-2-final-data-templates-and-associatedinstructions-and-guidance>
 The BPDT was consulted on 29 March 2019 and was published on 20 September 2019. <https://www.ofgem.gov.uk/publications/riio-2-final-data-templates-and-associatedinstructions-and-guidance>

<p>allowances. This relationship is set out in the licence algebra within the OE licence condition, SpC 3.36 of the ETO licence. The reporting rules have remained consistent between setting allowances in RIIO-ET2 FDs and within the subsequent MSIP application process, i.e. there has been a need for ETOs to delineate between direct and indirect costs as defined within the RIGs.</p>	<p>We also agree the reporting rules have remained consistent between FDs and the submission of the MSIP re-openers; it is Ofgem’s interpretation that has altered the classification of costs between Direct and Indirect and resulted in a disallowance of contractors’ Indirect costs, a reduction in the value of allowances generated via the OE, and the projects being materially underfunded. This is an error.</p> <p>We would also point out that the RRP23 RIGs published on 12 May 2023 (v2.3) has removed the omitted Clause “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 costs in their invoice, all costs will be treated as direct” with Ofgem stating that the TOs now have this data available to them as justification for the change. This is not the case, as we stated in our response to the RRP RIGs consultation. We will be contacting Ofgem separately about how to report for RRP23 because we do not have this data and still need to agree a robust definition against which to start to collect this data.</p>
<p>2.8. A product of the OE is consistency between all applicable UM indirect allowances and baseline indirect allowances, by using an automated formulaic mechanism to determine the uplifts. This also enables a fair and proportionate assessment of individual re-opener projects as Ofgem does not need to individually assess indirect costs on projects and ensures consistent and appropriate funding of indirect costs across a licensee’s RIIO-ET2 portfolio.¹⁷</p>	<p>We agree that these were the aims of the OE, and we are fully supportive of those aims. However, unfortunately these aims have not been achieved because:</p> <ul style="list-style-type: none"> • Consistency has not been maintained between UM Indirect allowances and baseline Indirect allowances since the treatment of contractors’ Indirect costs is different between how baseline allowances were derived and subsequently how UM allowances are being derived, resulting in inappropriate allowances being calculated. For the four applicable MSIP projects, there has been a 63% reduction between what NGET requested and Ofgem allowed for Indirect costs. • More time has elapsed for Ofgem’s review of contractor Indirect costs for four MSIP projects totalling less than £0.02bn than was spent reviewing the RIIO-T2 business plan submission for Indirects (totalling in excess of £1bn).
<p>Our minded-to view applying the OE</p>	<p>We disagree with this statement for the reasons outlined above; any change to classification from those applied when deriving the OE coefficient will invalidate the application of the coefficient. Therefore, to apply the OE, it is necessary to assess all</p>

¹⁷ Note that although the OE was originally intended to apply to Large Onshore Transmission Investment (LOTI) projects, a decision was made that LOTI projects were typically unsuited to a mechanistic CAI/NOC uplift and therefore the LOTI was removed from scope of the OE.

<p>2.9. In NGET’s January 2022 MSIP re-opener submissions, NGET included costs for activities that fall within the definition of CAI activities, namely:</p> <ul style="list-style-type: none"> • NGET’s Extreme Weather Resilience funding requests included an amount for Site Management and Supervision • Cellarhead, Frodsham and Lister Drive Customer Connection and Melksham OTS Phase 2 Projects included an amount for Site Management and Detailed Design subcategories, which was included in Contractor costs and/or contractors’ preliminary activities. We understand from the supporting information that these preliminary activities comprise site set up, site civils, as well as site management and supervision. 	<p>costs (including the contractors’ costs that Ofgem now categorise as Indirect) consistently with how they were submitted in our T2 BPDT, which was as Direct costs (in line with the omitted Clause).</p>
<p>2.10. Our minded-to view was to reduce these categories in NGET’s funding request for the four relevant projects because under the RIIO-ET2 arrangements, these CAI activities fall under the scope of the costs covered by the OE as the appropriate funding mechanism for these costs. Additionally, removing CAI costs from the funding awarded via the MSIP re-opener prevents the double recovery of funds from both the OE and via the MSIP re-opener funding.</p>	<p>We disagree with this statement. As we have shown above, the OE coefficient as derived for RIIO-T2 does not cover these categories of costs, and therefore appropriate funding would include these as Direct costs.</p> <p>We also disagree with the assertion that there would be ‘double recovery’. Since the coefficient never reflected these types of costs in its derivation, by removing these costs the end result is to underfund by a value equal to these disallowed costs plus the value of OE that would have been attributed to them.</p>
<p>2.11. Although OE applies to all projects under the MSIP re-opener mechanism, there are no disputed CAI costs submitted within the Sulphur Hexafluoride (SF6) Asset Intervention project. Hence, the responses on the application of OE do not apply to this project.</p>	<p>Not disputed.</p>
<p>Consultation responses 2.12. Three respondents (NGET, SSENT and SPT) responded to the MSIP consultations regarding the application of the OE in MSIP projects.</p>	<p>Not disputed.</p>
<p>2.13. These three respondents disagreed with our proposed application of the OE. They expressed concerns that Ofgem could apply definitions of direct and indirect costs that are inconsistent with the definitions used by the ETOs when the OE rates were set as part of the RIIO-ET2 settlement. The respondents claim that within</p>	<p>Not disputed.</p>

<p>the RIIO-ET2 FDs, Site Management and Supervision and Detailed Design were included in the baseline capex allowance and not the baseline CAI allowance. They claimed to have followed a specific allowance provided for in our RIGs guidelines: “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”.¹⁸</p>	
<p>2.14. SSEN also submitted a worked example showing the impact of Ofgem’s application of the OE on their application for funding. It would include a reduction in project cost allowance after taking out the contractor indirect cost and, as a result, a reduction in the uplift from OE mechanism.</p>	<p>Not disputed.</p>
<p>2.15. NGET argues that all contractor costs in the Extreme Weather Resilience project are onsite work relating directly to the assets on the transmission system, dedicated for the period of delivery to assets and cannot be classed as indirect or support roles.</p>	<p>Not disputed for the purposes of deriving an OE uplift consistent with the methodology applied at FDs.</p>
<p>2.16. The respondents proposed two alternative solutions: 1) Ofgem should top up the allowances provided through the OE to the assessed efficient level for each individual project, or 2) Ofgem could recalibrate the coefficient on which the OE relies.</p>	<p>Our proposals were to:</p> <ol style="list-style-type: none"> 1. Apply definitions consistently between how the OE coefficient was derived and how it is now being applied, or 2. Recalibrate the coefficient. <p>Our preference was for option 1, which would also be quicker and easier for all and would avoid the need to reopen the price control.</p>
<p>2.17. During the course of our normal engagement with the ETOs, after the consultations closed and individual responses were received, the three ETOs submitted a joint letter to us on 2 March 2023 on the OE. The letter reiterates the comments made in their individual responses to the consultations. Primarily, that “the interpretation of ‘indirects’ is applied in a manner that is consistent with how the OE was calculated and set, ie for contractor ‘indirects’ to be treated as direct costs”. Points were also repeated about the</p>	<p>This quote has been taken out of context. The joint letter and our responses said that the delineation between Direct and Indirect costs needs to be applied in a <u>consistent</u> manner. For clarity, the joint TO letter stated:</p> <p><i>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.</i></p>

¹⁸ RIIO-ET2 RIGS version 1, Page 103: https://www.ofgem.gov.uk/sites/default/files/2022-03/ET%20RIGs_Version1.0.pdf

<p>Extreme Weather Resilience Project and the margin of error in the regression analysis. They also re-submitted the worked example as mentioned in paragraph 2.14.</p>	
<p>Our decision and rationale for it 2.18. Following due consideration of all of the consultation responses and the ETO letter dated 2 March 2023, we have decided that our initial proposal, to reduce an amount for Site Management and Supervision and Detailed Design categories in NGET’s funding request for the four relevant projects, remains appropriate. We remain of the view that, under the RIIO-ET2 arrangements as established in RIIO-ET2 FDs and as described in detail in paragraphs 2.1 to 2.8 above, these cost areas are CAI activities which fall under the scope of the costs covered by the OE.</p>	<p>We disagree with this decision. Our reasons for identifying this as being an inconsistent application of the OE have been outlined above and below.</p>
<p>2.19. As outlined in paragraphs 2.3 to 2.8 above, which set out how we introduced the OE. We acted in a procedurally proper way by consulting extensively on the OE before FDs, covering the delineation between direct and indirect costs, and the application of the OE mechanism. Our decisions on the OE mechanism were further to our principal objective to protect the interests of existing and future electricity consumers.¹⁹ As stated in FDs, we sought to ensure network companies received an efficient cost of service and efficient financing.²⁰ Given the longstanding reporting rules in relation to the disaggregation of indirect and direct costs, it is not reasonable to infer any intended application of the OE other than the one we are now applying.</p>	<p>The consultation on delineation between Direct and Indirect costs was covered in the T2 RIGs consultation. These are not “longstanding reporting rules in relation to the disaggregation of indirect and direct costs”. This split between Direct and Indirect costs did not exist prior to 2019 RIIO-T1. As previously stated, when these changes were introduced by Ofgem in March 2019, NGET was so concerned that the underlying data did not exist that we escalated our concerns to senior representatives of Ofgem on 28 March 2019. As an immediate consequence, Ofgem added the omitted Clause to the next version of BPDT guidance dated 29 March 2019. We are yet to agree robust and consistent definitions for Direct vs Indirect costs with Ofgem such that we can start to report this split now that the omitted Clause has been removed from the RRP23 RIGs v2.3 (as of 12 May 2023).</p> <p>We are not aware of any consultation to change from the approach taken in FDs until the consultation on the minded to position for these MSIP re-openers was issued, at which point all ETOs formally raised our concerns over the change in application.</p>

¹⁹ As set out in s.3A Electricity Act 1989

²⁰ RIIO-ET2 FDs – Core Document, para 2.19-22.23; https://www.ofgem.gov.uk/sites/default/files/docs/2020/12/final_determinations_-_core_document.pdf

	<p>Please also see the ET Sector Specific Final Determinations document which states that the purpose of the OE is to <i>“Provide(s) the ETOs 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”</i>. We believe that it is entirely reasonable to infer that the application would be consistent with that used to derive FDs and the OE coefficient.</p> <p>If Ofgem is seeking “to ensure network companies received an efficient cost of service and efficient financing”, it is evident from the MSIP re-openers that an error has been made. We estimated the total cost for these projects as £19.94m; Ofgem has allowed funding of £15.68m (a 21% reduction). Given that Ofgem has not identified these activities as inefficient or not required, why are they not being funded either as Direct or Indirect costs?</p>
<p>2.20. We are applying the OE as previously decided in RIIO-ET2 FDs. Within FDs, we shared the relevant baseline capex and CAI allowances that are relevant for the OE.²¹ These values were not disputed by the companies at the time.</p>	<p>The values for baseline capex and CAI allowances were not disputed, however at no point did Ofgem state that its understanding was that the allowed CAI values included contractors’ CAI as Indirect rather than Direct costs. Had this assumption been stated, the licensees would have corrected this misinterpretation of the data.</p>
<p>2.21. Econometric analysis and a resultant multivariate regression model were used to establish our view of efficient costs. This modelling used the data sets available at the time of the Business Plan submissions and we considered our principal objective and statutory duties. Once the relationship between direct and indirect costs had been established through the modelling, the resultant mathematical formula for adjusting indirect cost allowances was defined in the licence through the statutory licence modification process. It was our view of efficient costs delineated between the two broader categories of direct and indirect costs at a portfolio level.</p>	<p>As has been previously stated, we do not disagree with this statement. That was our understanding of the process, subject to all contractors’ costs being classed as Direct. Our issue is with the subsequent change in categorisation of costs between Direct and Indirect costs by Ofgem when considering re-openers which has undermined the OE coefficient. Ofgem is now applying a relationship derived from a set of data with one classification to a different set of data with a different categorisation leading to a mathematically incorrect outcome. This is an error.</p> <p>This error is evident from the significant reduction in allowances compared to our MSIP submission. Given that Ofgem have not identified these ‘Indirect’ costs as inefficient or unnecessary, why is there a 63% reduction?</p>
<p>2.22. Given the differing approaches taken by licensees in their reporting regimes and contracting strategies, some projects may</p>	<p>In the joint TO letter of 2 March 2023, we have provided a calculation based on information already provided to Ofgem showing that the impact of this inconsistency</p>

²¹ RIIO-ET2 FDs – ET Annex, Table 6; https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_et_an_nex_revised.pdf

<p>have indirect expenditure greater than the uplift provided by the OE, while other projects may have an uplift provided by the OE greater than the indirect expenditure incurred. In totality across a number of projects in the price control, the OE uplift provides an efficient allowance for indirect costs.</p>	<p>is approximately £80m of under-funding over the T2 period for NGET. Therefore, we do not agree that the OE uplift provides an efficient allowance for indirect costs across a number of projects; we can see no circumstances where we will be allowed significantly more for Indirects than we are forecasting to spend on a project. Please can Ofgem evidence their statements?</p>
<p>2.23. The OE therefore should not be revisited without strong evidence and justification to suggest that it is not operating as intended, which is not the case here. The direct and indirect allowances we awarded NGET and OE mechanism were decided upon following consultation and have been set out in the licence, as explained in paragraph 2.3 above. Hence, we do not consider that the proposed solution 2) in paragraph 2.16 for us to recalibrate the OE coefficient is appropriate.</p>	<p>We disagree with this statement. We have provided clear evidence that there are inconsistencies between the derivation of the OE coefficient and how re-openers are now being assessed.</p> <p>We agree that recalibration, whilst a possible solution, is not the most attractive, not least that there still does not exist an agreed, workable, and commonly understood definition for delineating between Direct and Indirect costs that takes into account the many and various forms of contracting strategies that exist across the variety of projects undertaken by ETOs, as well as taking into account differing approaches between ETOs.</p> <p>Our proposal is to maintain consistency between the derivation of the OE coefficient at FDs and the way in which it is applied to re-opener submissions, i.e., to treat all contractors' costs as Direct costs.</p>
<p>2.24. The line in the RIGs on which NGET, SSENT and SPT are relying (as mentioned in paragraph 2.13) does not refer to estimating future costs and allowances. It has been taken out of context and should be considered as part of the full definition of Direct Activities in Appendix 1 of the RIGs, which includes: <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. However, where the indirect activity is explicitly costed and detailed in their invoice this should be recorded against the relevant indirect activity”.</i>²² [emphasis added]</p>	<p>At no point has this been discussed. The BPDT table to which the definition applies contains actual spend in the RIIO-T1 period up to 2018/19. The remaining columns contain forecast cost data.</p> <p>If the omitted Clause was to only apply to historic data, then this should have been made clear in the BPDT instructions and the RIGs.</p> <p>However, it is also worth noting that the OE coefficient was derived using <i>“the historical data provided by ETOs (based on the BPDT guidance)”</i> as stated in Para2.7 of this decision document. Given this confirms that the OE coefficient was derived using historic data submitted in line the definition including emphasis, the</p>

²² RIIO-ET2 RIGS version 1, Page 103: https://www.ofgem.gov.uk/sites/default/files/2022-03/ET%20RIGs_Version1.0.pdf

	<p>point being made in 2.24 is not clear. We believe this merely highlights and confirms the inconsistency we are questioning.</p>
<p>2.25. We acknowledge the historical cost base on which our allowance assessment methodology, due to the reporting rules, may have had an unquantified indirect value included. This arose from the invoicing arrangements of third parties and the ETOs' inability to delineate between these activities on projects where their contractors didn't split them out. For example, where an ETO is recharged by a third party for the primary purpose of undertaking a direct activity (such as when installing an electrical asset) that contracted cost may have included some supporting indirect activity. That indirect cost could be included in the direct activity cost ONLY where the ETO is unable to distinguish the individual cost components. It is important to note, that this was a specific derogation to assist the ETOs in circumstances where they were unable to properly delineate between direct and indirect costs. However, this does not alter the requirement to make this distinction going forwards or to allow known indirect costs to be included in the direct activity cost. There should be sufficient time for licensees to ensure that the derogation in the definition is the exception rather than the rule for their reporting of project costs from RIIO-ET2.</p>	<p>As we stated in our response to para 2.24, this only further highlights and confirms the inconsistency that is central to this issue.</p> <p>By setting the OE coefficient using historic data that includes contractors' Indirect costs as Direct capex and then treating them differently in forward looking submissions, there is the consequence of reducing the Direct allowances awarded, and the resulting allowances awarded through OE to leave the projects underfunded.</p> <p>In terms of sufficient time to ensure the 'derogation' is the exception rather than the norm, firstly the 'derogation' has been removed from the latest RRP23 RIGs in spite of ETOs' representations in the consultation response. Secondly, as has been stated in our response to 2.23, there still does not exist an agreed, workable and commonly understood clear definition of separation between direct and indirect costs that takes into account the many various forms of contracting strategies that exist across the variety of projects undertaken by TOs as well as taking into account differing approaches between ETOs. As such, we are unable to clearly communicate the reporting requirement to our contractors. Finally, as has been discussed previously at cost visits, many contracts are already awarded and so a change in reporting requirements will attract cost, assuming it is even possible to restate for long-running projects. Once definitions are agreed, there will be a lag between agreement and data flowing into reporting tables. This leads to a confused picture of mixed reporting for a period, making the data difficult to use in the econometric analysis undertaken in RIIO-T2.</p>
<p>2.26. Furthermore, the extent of any potential impact of not delineating between direct and indirect costs on either the direct unit cost or indirect allowances has not been evidenced or substantiated by any respondent. The ETOs mentioned in their joint letter (in paragraph 2.17) that the potential impact does not fall within the "margin of error" of regression analysis and the OE factor could be more than double. Given the reporting derogation is specifically due to an ETO's inability to distinguish costs in their</p>	<p>As stated in our response to 2.22, within the joint TO letter we have provided a calculation based on information already provided to Ofgem showing that the impact of this inconsistency is approximately £80m for NGET over the T2 period. The Scottish TOs have also provided estimates of the impact.</p> <p>Ofgem state that "Given the reporting derogation is specifically due to an ETO's inability to distinguish costs in their historical reporting, the validity and/or accuracy of its impact is unverifiable". However, Ofgem's own analysis of the four applicable</p>

<p>historical reporting, the validity and/or accuracy of its impact is unverifiable.</p>	<p>projects illustrates that the impact is 19% of total forecast costs and 63% of 'Indirects'. This is similar to our assessment, and if applied across future T2 re-openers would result in an impact in excess of the £80m calculated for NGET.</p>
<p>2.27. In the 2022 MSIP applications, NGET has submitted a forecast cost for these MSIP projects (i.e. contractors have not charged for the project and have yet to be contracted), and NGET can, and is obliged under the reporting rules,²³ to identify and provide cost estimations for indirect costs whether these will be undertaken by internal staff or subsequently contracted to a 3rd party. Given that the indirect activity is explicitly costed and detailed in NGET's submission this should be recorded against the relevant indirect activity (not direct activity). The cost submission is not done after the event for reporting purposes and therefore should not be allowed to rely on the derogation for recharging the licensee.</p>	<p>We do not disagree with this point in principle; however, our reasonable expectation is that there would be consistency between the derivation of the OE coefficient and the calculation of allowances derived under the OE mechanism. As we have demonstrated, this is not the approach taken by Ofgem on the MSIP re-openers.</p> <p>The fact that we are able to split out such costs from forecast costs for these MSIP projects does not change the fact that the OE coefficient was calculated based on a dataset where all such costs were consistently mapped to Direct capex, and therefore the OE uplift will not cover such costs.</p>
<p>2.28. As part of the RIIO-ET2 price control, and consistent with that applied in the RIIO ET2 business plan submissions, we set out a clear distinction between direct and indirect costs in the RIIO-ET2 BPDT and our RIGs. The ETOs were required to follow these guidelines, providing the basis for which the OE rates were set within RIIO-ET2 FDs. The definitions in the RIGs remained unchanged, and we do not consider our application of the OE to be inconsistent. There has been no change in the categorisation of costs and/or the definition of direct/indirect costs established for the RIIO-ET2 Business Plan submission and the subsequent T2 reporting, including at the time of the MSIP applications.</p>	<p>This paragraph again fails to acknowledge the omitted Clause. This allowed contractors Indirect costs to be reported as Direct costs in T2 BPDT and the MSIP submission, and this is what all ETOs did. Therefore, there was not (and still is not) the clear distinction between direct and indirect costs that Ofgem claim.</p> <p>We have shown the inconsistency between the derivation of the OE coefficient and its application in these re-openers. Indeed, Ofgem have admitted this inconsistency in paragraphs 2.24 and 2.25 by acknowledging that the OE coefficient was based on historic data which treated contractors' Indirects as Direct costs. These costs have then been removed for these re-openers by Ofgem through the cost assessment process and are evidently unfunded.</p>
<p>2.29. We also do not consider it to be consistent with the original intent of the OE to award additional funding for CAI on individual re-opener projects. The OE is intended to provide the sole funding for CAI costs and it is not appropriate to include additional funding with the direct funding awarded to re-opener projects. This would</p>	<p>We disagree with this conclusion. As we have previously stated, our proposal is for OE to be applied consistently with how the coefficient was derived.</p> <p>This paragraph refers to "potentially awarding higher allowances for re-openers than that which was awarded for baseline projects". From the four applicable projects in</p>

²³ RIIO-ET2 Re-opener Guidance and Application Requirements version 2, paragraph 3.20: <https://www.ofgem.gov.uk/publications/riio2-re-opener-guidance-and-applicationrequirements-version-2>

<p>amount to inefficient funding of CAI activities, and would be inconsistent with the funding methodology employed at FDs, potentially awarding higher allowances for re-openers than that which was awarded for baseline projects. Hence, we do not consider that the proposed solution 1) in paragraph 2.16 for us to top up the allowances provided through the OE to the assessed efficient level for each individual project is appropriate.</p>	<p>this re-opener, it is apparent that the way the OE is now being applied results in a 63% reduction in funding for total 'Indirects' (as classified by Ofgem); this is very different to baseline allowances.</p> <p>Finally, how can it be inappropriate to "top up the allowances provided through the OE to the <u>assessed efficient level</u> for each individual project"? Surely the purpose of Ofgem's assessment process is to provide an efficient level of funding for projects? If Ofgem will not apply the OE as derived, then this is the alternative.</p>
<p>2.30. We have been clear throughout the development and implementation of the OE that that the relevant CAI costs would not be recoverable as direct costs, as the OE mechanism clearly categorises them as indirect. The ETOs did not raise concerns as part of their response to our consultations on the OE to the effect that the statement in the RIGs on which they seek to rely would allow them to change the categorisation of the costs from indirect to direct. We are not looking to revisit decisions on the use of the OE made in the RIIO-ET2 FDs. To change the categorisation now we would be to deviate from RIIO-ET2 FDs and the RIGs and not apply the mechanism in the way that was intended. Additionally, it would not now be in consumers' interests to reopen previously decided policies.</p>	<p>This clarity is not apparent to us, through the consultation documents or the Draft or Final Determination documents that have been issued. That is why we are now currently in dispute about the application of the OE.</p> <p>We have outlined in our response to para 2.7, 2.19 and 2.20 where clarity in the consultation process has been provided and also where lack of clarity and misunderstanding still exists both with ETOs and with Ofgem. Fundamentally, as has been stated in our response to 2.19 and 2.20, it was only at the point of Ofgem publishing their 'minded to' consultation for these re-openers that we were made aware of the intention to treat contractor Indirect costs differently from FDs. At this point, we raised our concerns to Ofgem.</p> <p>Our concern is that Ofgem are retrospectively changing the categorisations, deviating from RIIO-ET2 FDs, and indeed have recently changed the definition in RIGs (even though we have been clear that we do not yet have the data to comply with this change).</p> <p>As previously stated, we are not seeking to reopen previously decided policies. All we are asking is for Ofgem to apply the OE consistently with the basis upon which it was set.</p>
<p>2.31. In response to the Extreme Weather Resilience consultation, NGET argued that including Site Management and Supervision in the baseline capex allowance in the funding request was in line with the definitions of direct and indirect costs in the RIIO-ET2 BPD Guidance. In the joint ETOs letter dated 2 March 2023, the three</p>	<p>Contractors' Site Management and Supervision costs were mapped to Direct capex in our T2 submission, in accordance with the omitted Clause.</p> <p>Therefore, Ofgem's position is contrary to the basis upon which the OE was agreed, and these costs will not be covered by the current OE rate. This can clearly be seen</p>

ETOs reiterated their disagreement with our proposal to remove these costs from the project on the basis that these are CAI activities which fall under the scope of the costs covered by the OE. In their view, our position is contrary to the basis on which the OE was agreed, as these costs would not be covered by the current OE rate. According to NGET, Site Supervision would sit in direct costs as it is based on-site with assets. However, our RIGs clearly stated that CAI costs include those costs associated with “on-site supervision and technical guidance”.²⁴ Additionally, the RIGs set out that CAI costs include Engineering Management and Clerical Support, which includes costs associated with “Compliance checks on staff and contractors work carried out, Site safety inspections, Operational safety checks”.²⁵ By their very nature, we consider that it is clear that compliance checks are carried out on-site to verify work done. Throughout the process, we used the RIIO-ET2 Uncertainty Mechanism Cost Template²⁶ consistently and did not move away from the original definitions of direct and indirect costs. We disagree that our proposal to remove Site Management and Supervision from NGET’s funding request is an error and disagree that it is fundamentally at odds with the CAI and OE framework designed for RIIO-ET2.

2.32. Tables 2 to 5 set out at paragraphs 4.15, 5.12, 6.10, and 7.10 quantify the cost adjustments we have made for each project as a result of our reclassification of some of NGET’s costs as indirect. Over the four applicable projects this amounts to a £2.87m reduction to NGET’s funding request. The adjusted costs will then

from the outcome of the funding decision which has driven a 21% reduction vs submission, only 2% (£0.46m) of which was a specific removal of costs by Ofgem. This is a 63% reduction in funding for total ‘Indirects’ across four applicable projects, so it is unclear how Ofgem can maintain that the current OE rate is correct and consistent with what was agreed at FDs.

The T2 RIGs do state that all these categories should be treated as CAI however by stating these definitions Ofgem is ignoring the omitted Clause which allows licensees to report such costs as Direct if they were not invoiced separately. We did not and do not have the data to create these splits and therefore all these costs were consistently mapped to Direct capex in our T2 BPDT and RRP22.

Whilst we can see the cost delineation that Ofgem are trying to create (albeit we need robust and consistent definitions to be able to do this), it does not yet exist in licensees’ data and cannot be retrospectively recreated for historical data (i.e., the data that was used to set the OE coefficient).

Therefore, we reiterate our view that Ofgem’s proposal to remove Site Management and Supervision from NGET’s funding request is an error and that it is fundamentally at odds with the CAI and OE framework designed for RIIO-ET2. We cannot understand how Ofgem can ignore the fact that the data does not exist. Please can Ofgem explain on what basis it believes the OE was derived, and how that covers what Ofgem now seemingly intends to classify (by ignoring and more recently removing the omitted Clause) as contractors’ Indirect costs?

Ofgem seems to be suggesting that £3.36m is immaterial. However, NGET’s forecast for the four applicable projects totalled £19.94m (£16.75m Direct and £3.19m NGET Indirects). The OE (if applied consistently with how it was derived) is meant to fund NGET’s Indirect costs, i.e., Ofgem will have applied a 29% efficiency challenge to NGET’s Indirect costs (£2.27m funding for £3.19m NGET Indirects). Importantly, the

²⁴ RIIO-ET2 regulatory instructions and guidance (RIGs) v1.1), p.92; https://www.ofgem.gov.uk/sites/default/files/2022-03/ET%20RIGs_Version1.0.pdf

²⁵ RIIO-ET2 regulatory instructions and guidance (RIGs) v1.1), p.102; https://www.ofgem.gov.uk/sites/default/files/2022-03/ET%20RIGs_Version1.0.pdf

²⁶ <https://www.ofgem.gov.uk/sites/default/files/2022-02/Reopener%20Guidance%20And%20Application%20Requirements%20Document%20Version%202.pdf> (paragraph 3.20)

be at the efficient direct cost that is then uplifted by the OE. Based on the level of direct funding we are awarding, we estimate (using the calculations set out in SpC 3.14, based on the information we have now) that the OE uplift for NGET's four MSIP projects would be approximately £2.27m. This uplift is £0.49m less than the OE uplift based on NGET's funding request, before we reclassified the costs as indirect. We estimate that the impact of properly accounting for the indirect costs through the OE rather than under the MSIP re-opener to be of the value of approximately £3.36m (ie £2.87m + £0.49m). We have given due regard and consideration to the impact of our decision and we consider the approach of calculation by ETO's as mentioned in 2.14 aligns to our calculations. It is important to note that the ETO impact assessment is predicated on the ETO inclusion of CAI in the direct cost allowances, and that the MSIP re-opener decision is therefore a material change to the application of direct and indirect. As noted above, we disagree with this interpretation and are of the opinion that this MSIP re-opener decision does not represent a change (material or otherwise) in the proper application of the term indirect or the OE mechanism.

contractors' costs that Ofgem has classified as Indirect (£2.87m) are not funded at all. The OE uplift is £3.8m (63%) less than the £6.06m identified for Indirects including the contractors' costs classified as such by Ofgem.

The table summarises this position, which shows a net reduction in funding vs forecast costs of 21% for the four applicable projects. Given that only £0.46m (2%) of submitted costs were explicitly removed by Ofgem, please can Ofgem explain why the remaining 19% of total cost (63% of Indirect costs as classified by Ofgem) are unfunded?

	NGET Direct	NGET Indirects	Removed by Ofgem	Reclassified as Indirects by Ofgem	Final 'Direct' funding	OE funding (Ofgem view)
Extreme weather	4.06	0.77	-0.46	-0.56	3.03	0.51
Cellarhead	0.52	0.07		-0.08	0.44	0.08
Frodsham and Lister Drive	1.49	0.46		-0.35	1.14	0.19
Melksham	10.69	1.89		-1.88	8.81	1.49
SUBTOTAL	16.75	3.19	-0.46	-2.87	13.41	2.27
TOTAL Directs & Indirects	19.94				15.68	
TOTAL 'Indirects'		6.06				2.27

We do not understand how Ofgem can disagree that ETOs included contractors' Indirect costs as Direct costs in our T2 submission because that was explained to be the case. At no point have ETOs stated that we are able to consistently break out historical contractors' Indirect costs and map them to CAI.

Ofgem's own assessment of these four projects shows that the impact is a 19% funding gap. NGET estimate that, when this is extrapolated over future re-openers, the total impact on T2 funding for NGET is ~£80m. The other ETOs have estimated similar impacts. The MSIP re-opener decision is therefore a material change to the application of Direct and Indirect as compared to the T2 FDs. This is an error.

2.33. Finally, NGET has submitted cost forecasts for these MSIP projects to us and we recognise that NGET will have commercial flexibility when taking forward projects. NGET can choose who performs each activity within a project, if possible (ie whether or not

We agree that licensees should retain commercial flexibility in order to be able to get the best outcome for consumers, and this includes being able to choose who performs each activity.

they employ a contractor to do indirect activities). Accordingly, NGET should have the flexibility to adapt its strategy for delivering indirect activities within these MSIP projects or future projects to mitigate any impact from the use of the OE. Applying the OE as ETOs have asked would be incentivising one delivery and contracting model over others.

However, applying the OE as Ofgem has for T2 re-openers means that licensees are unfunded for contractors' Indirect costs. Applying the OE as ETOs have asked is entirely consistent with how the OE coefficient was derived.

The way to overcome the issue of unintentionally incentivising one delivery and contracting model over others is to assess the total cost of project delivery (Direct and Indirect), as was done for previous price controls.