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17<sup>th</sup> May 2023

Contact / Extension

Scott Mathieson  
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Dear Rebecca,

### Opex Escalator Concerns – Statutory Consultation and Decision on NGET’s 2022 MSIP re-opener applications

This response relates to the decision on NGET’s 2022 MSIP re-opener applications<sup>1</sup> and subsequent statutory consultation on a proposal to modify the Special Conditions of the Electricity Transmission Licence held by National Grid Electricity Transmission plc<sup>2</sup>. Specifically, our response focusses on Ofgem’s decision regarding the application of the Opex Escalator (OE) in MSIP projects. Please note our views regarding the change in OE application were also set out in cross TO letter issued in February (attached).

The RIIO-T2 Final Determination clearly states that the purpose of the OE is to “ensure ETOs are funded through an automatic mechanism for varying operational costs associated with capital investments delivered through Uncertainty Mechanisms (UM)”<sup>3</sup>. In other words, the OE is attempting to account for the additional costs which the TOs will incur in its “day-to-day operation of the network”, as a result of the new capital expenditure which has been allowed by Ofgem through the UM. Attempting to capture contractors’ indirect costs within this mechanism, which are costs in no way related to the expenditure of TOs themselves in the “day-to-day operation of the network” and, in fact, are costs relating to a capex project funded through a UM, is not in keeping with the purpose for which this mechanism was introduced. These contractor costs represent capital expenditure on network upgrades and should be covered by the UM itself, not the OE. To do otherwise would be to move away from the fundamental distinction between capex and opex on which the RIIO framework is based.

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<sup>1</sup> Decision on NGET’s 2022 MSIP Re-opener Applications | Ofgem

<sup>2</sup> Statutory Consultation on a proposal to modify the Special Conditions of the Electricity Transmission Licence held by National Grid Electricity Transmission Plc | Ofgem

<sup>3</sup> Decision - RIIO-2 Final Determinations Electricity Transmission System Annex (REVISED), Page 76

As per our response to Ofgem's consultation<sup>4</sup> on NGET's Melksham, Cellarhead and Frodsham MSIP applications, we highlighted that the "RIIO-T2 business plan RIGs<sup>5</sup> define contractors' costs as "the total charges invoiced by external contractors for the primary purpose of performing direct activities" and 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". On this basis, SPT classified the appropriate contractor costs as Direct, consistent with the RIGs guidance, in the RIIO-T2 business plan submission. Therefore the Opex Escalator calculation for SPT will not fund any element of contractor costs. To highlight the scale of this change, the impact of the Opex Escalator policy change amounts to an estimated £170m adverse impact for SPT over the current RIIO-T2 price control period.

We disagree with Ofgem's decision and subsequent proposed licence modifications which changes the application of the OE for the following key reasons:

- i. The calibration of OE was based on the contractor Indirect costs being included within the TOs' Direct cost allowance request. Ofgem's decision states that such costs should be excluded from Direct costs as OE should provide appropriate funding for these activities. However, this is impossible, given that the calibration of OE mechanism was based on the assumptions in compliance with the RIIO-T2 BPDT v1.4 Guidance, where TOs could include Contractor indirect costs within Direct cost allowance requests. The effect of Ofgem's decision is to disallow Contractor indirect costs, which were previously deemed efficient.
- ii. Ofgem did not indicate that the intention was to apply the cost allocation set out in the RIIO-T2 BPDT v1.4 Guidance for calibration of the OE only, and not for future application of the OE. It is unfair and unreasonable for Ofgem to now change its policy position.
- iii. Based on the decision, the application of OE will be applied on lower capex that it would have been based on in the RIGs which were developed for RIIO-T2. This results in lower CAI allowances as well as the disallowance of Contractor Indirect costs, with no further assessment.
- iv. The decision notes that baseline allowances were not disputed at the time of RIIO-T2 Final Determination, however we were not aware of Ofgem's intention to change the application of the OE mechanism two years into the price control. The application of OE within RIIO-T2 Final Determination was appropriate based on Ofgem guidance at the time.
- v. Paragraph 2.23 of Ofgem's decision states that "*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*". TOs have quantified the potential impact of the change in the application of the OE and the impact is material<sup>6</sup>. The quantified impact is clear evidence that, if OE application is changed as per the published MSIP decision, the automatic OE mechanism is not operating as intended within RIIO-T2 Final Determination, as it fails to provide sufficient funding to the TOs.

We disagree with the proposed change set out in Ofgem's statutory consultation and propose that the existing OE is retained in full.

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<sup>4</sup> Response was submitted to Ofgem on 27<sup>th</sup> June 2022

<sup>5</sup> RIIO-T2 Electricity Transmission Price Control – Guidance on Business Plan Data Templates: Version 1.4 published 20 September 2019

<sup>6</sup> As shared in the Cross TO letter issued in May 2023

We would welcome the opportunity to engage with Ofgem at earliest convenience. It is essential that Ofgem apply the Opex Escalator in a way that is consistent with its definition and the RIIO-2 Final Determination.

Yours sincerely,



Stephanie Anderson  
Head of Regulation and Policy