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Ofgem
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Dear Rebecca,

RIIO-T2 Opex Escalator Uncertainty Mechanism

We are writing to you jointly following Ofgem's decision on NGET's 2022 MSIP¹ re-opener applications, specifically Ofgem's minded-to view on applying the Opex Escalator (OE) for the remainder of the RIIO-ET2 price control ('the MSIP decision').

Our respective teams have been engaging on the treatment of certain costs (capex/opex which are equivalent to the Direct/Indirect costs discussed in Ofgem's decision document) and how these are subsequently applied via the OE. This uncertainty mechanism provides TOs with automatic indirect allowances² when funding for additional projects is agreed through specified uncertainty mechanisms. Ofgem designed the mechanism to ensure that those allowances are consistent with those set for baseline allowances³. 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 UMs".

In Ofgem's MSIP decision, it has further failed to acknowledge that the way it is proposing to apply the OE amounts to a mathematical impossibility, which constitutes an error. The relationship established between capex and opex spending will no longer be consistent with that set for baseline allowances, and subsequently will not align with the RIIO-T2 Final Determination. The correct automatic uplift in opex allowances relative to capex is therefore no longer provided and will lead to a material and systematic underfunding of all projects subject to reopener applications. This leads to an estimated £300m shortfall in funding across all TOs.

Ofgem has made a decision which constitutes a change in its OE policy position, through a consultation and decision relating to NGET's 2022 MSIP projects. From a process perspective, it is inappropriate for Ofgem not to consult more widely on a policy change that equally impacts all TOs. The MSIP decision includes an assumption that TOs are to 'infer' how Ofgem *intended* to apply the OE during RIIO-ET2. Clearly this is not a viable position. We have been clear on the basis on which forecast costs for RIIO-ET2 were prepared and we did so consistent with Ofgem's requirements set out in RIGS for RIIO-ET2 BPDT. At no point during development of RIIO-ET2 did Ofgem consult on the application of the OE that it is now proposing. Despite this, Ofgem continue to disagree that the new definition of costs represents a change and has failed to consider the materiality of the problem⁴.

¹ Ofgem's 'Decision on NGET's 2022 MSIP Re-opener Applications' dated 19 April 2023.

² Mainly an uplift in support of additional Closely Associated Indirect (CAI) costs

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

⁴ SSEN Transmission's response to Ofgem's 'Proposal to modify the Regulatory Reporting Pack (RRP), Regulatory Instructions and Guidance (RIGs) and the Price Control Financial Model (PCFM) Guidance for RIIO-ET2' dated 31 March 2023.

The MSIP decision also notes that baseline allowances for RIIO-ET2 were not disputed at the time they were set. This is correct, however, all data was produced and provided in accordance with Ofgem's guidance and so there was no reason for the TOs to dispute this. As we outline above, had Ofgem indicated its intention from the outset of RIIO-ET2, the result would have been very different. This would not have been accepted by the TOs.

In its MSIP decision, Ofgem has removed the funding NGET requested and require for contractor preliminary activities that comprise site set up, site civils along with site management and supervision. Such activities are an integral and crucial part of any major construction project. Ofgem's application of the OE to derive project opex allowances will not compensate for this reduction. The reason is simple; the escalator is based on historic reported data where such costs are part of the capex cost driver (the explanatory variable) and not the opex (the dependent variable).

All TOs included these costs as 'direct' capex at the RIIO-2 Business Plan submission stage (consistent with Ofgem's guidance⁵) as they had done throughout RIIO-ET1 in their annual RRP returns. At the RIIO-ET2 Business Plan submission the requirement was not in place to capture these costs separately. Ofgem, through the Project Assessment Model (PAM) process, undertook cost assessment to establish efficient allowances for each project, which would (inherently) have included such costs. In parallel, Ofgem and its consultants established an efficient relationship between opex (closely associated indirects) and capex costs, using the same historic data which included contractor indirect costs as capital expenditure. This efficient outcome is the baseline for the OE metric consulted on and set out in the Final Determinations.

Ofgem's change has meant that such contractor costs are now 'orphaned' as they are excluded from the MSIP cost assessment process. Moreover, by fixing the escalator multiplier and applying it to a lower capex base, the original TO opex allowances are also reduced. These costs will, therefore, not be provided for via the OE mechanism. Ofgem's removal of these costs from NGET's core project funding means TOs are unfunded for such activities. These activities, such as site management and supervision, are not discretionary and are required to maintain site safety and security and have at no point been questioned in the engagement with Ofgem. The impact of Ofgem's decision will mean neither activity will be funded for projects subject to the OE.

The table below includes the quantified impact of Ofgem's decision on our current MSIP portfolio. These costs were previously deemed as efficient, now they are to be removed entirely.

Transmission Operator (TO)	MSIP portfolio Total estimate (£m 18/19)	Impact of new interpretation of Opex Escalator (error) (£m 18/19)
NGET	450	80
SSEN-T	260	50
SPT	1,267	170
Total	1,977	300

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

We do not agree with Ofgem's mathematically incorrect approach of setting the Opex Escalator rate on one basis of "Direct Cost" definition and applying it on another basis part way through a price control agreement. Therefore, we strongly encourage Ofgem to reconsider its approach ahead of any formal decision on licence drafting that will be based wholly on an error of fact.

We would welcome the opportunity to discuss further at your earliest convenience.

Yours sincerely,

Michael Ferguson – SSEN Transmission

Chris Bennett – National Grid Electricity Transmission

Scott Mathieson – SP Transmission