

Decision

Decision on Statutory Consultation: licence modifications to give effect to decision on NGET's 2022 MSIP applications

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This document sets out our¹ decision following a statutory consultation on our proposals to modify the Special Conditions ('SpCs') of the Electricity Transmission Licence ('the Licence') held by National Grid Electricity Transmission plc ('NGET'). The modifications comprise amendment of the defined term "NGET Redacted Information Document" in SpC 1.1.16, as well as amendment of Appendix 1 of SpC 3.14 (Medium Sized Investment Projects ('MSIP') Re-opener and Price Control Deliverable ('MSIPREt')) of the Licence to add allowances for five approved MSIP project funding applications and give effect to the decision dated 19 April 2023.

We published a statutory consultation on 19 April 2023, setting out proposals to amend the Licence, alongside our decision on NGET's 2022 applications relating to five projects under the MSIP Re-opener mechanism ('NGET 2022 MSIP Decision'). The licence modification consultation closed on 18 May 2023. We published non-confidential responses to the consultation on 2 June 2023². This decision document and the corresponding Notice of Modification of the SpC of the Licence, published alongside it, confirms our decision to make the notified modifications to SpCs 1.1.16 and 3.14 of the Licence.

Defined terms used in this decision document and their definitions, are listed in Appendix 1.

¹ The terms 'we', 'us', 'our' refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority.

² <https://www.ofgem.gov.uk/publications/statutory-consultation-proposal-modify-special-conditions-electricity-transmission-licence-held-national-grid-electricity-transmission-plc>

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1. Introduction

Context and related publications

1.1. Network companies are natural monopolies. Effective regulation of privatised for-profit monopolies is essential to ensure they cannot unfairly exercise their monopoly power to the detriment of their customers. This is particularly important in the case of essential utilities, such as energy, where consumers have no choice about whether or not to pay what they are charged. It is therefore crucial that an effective regulator protects energy consumers by controlling how much network companies can charge their customers. Ofgem³ does this through periodic price controls that are designed to ensure network companies are properly incentivised to deliver the best possible outcomes for current and future energy consumers. This includes ensuring that consumers only pay for investments that are needed and do not overpay for those investments.

1.2. NGET is the holder of an electricity transmission licence (‘the Licence’) granted or treated as granted under section 6(1)(b) of the Electricity Act 1989 (‘the Act’).

1.3. Special Condition (‘SpC’) 3.14 Medium Sized Investment Projects Re-opener and Price Control Deliverable (‘MSIPRE_t’) (‘MSIP Re-opener’) of the Licence is a mechanism that provides Electricity Transmission Owners (‘ETOs’), such as NGET, with an opportunity to request additional funding on projects with a value of less than £100m. Applications may only be made on projects where Baseline Allowances have not already been provided, and subject to other qualifying criteria as set out in SpC 3.14.

1.4. On 19 April 2023, we published our decision on NGET’s 2022 MSIP Re-opener applications (‘NGET 2022 MSIP Decision’).⁴ As part of this decision, we confirmed the application of the Opex Escalator (‘OE’) (as set out in SpC 3.36 of the ETO’s Licence) to

³ The terms ‘the Authority’, ‘Ofgem’, ‘we’, ‘us’ and ‘our’ are used interchangeably in this document. The Authority is the Gas and Electricity Markets Authority. Ofgem is the office of the Authority.

⁴ For reference only - the document is located here: [Decision on NGET’s 2022 MSIP Re-opener Applications | Ofgem](#)

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be in line with the application we set out in RIIO-ET2 Final Determinations (‘FDs’)⁵ and in our consultations⁶ on the NGET’s 2022 MSIP Re-opener applications.

1.5. Alongside our NGET 2022 MSIP Decision we published a statutory consultation on 19 April 2023, proposing to modify the defined term “NGET Redacted Information Document” in SpC 1.1.16 and Appendix 1 of SpC 3.14 MSIP Re-opener of the Licence.⁷

1.6. We are making these licence changes because:

- a) removing the reference to the date of the NGET Redacted Information Document in SpC 1.1.16 enables the version in force to be the latest iteration of the document received by NGET from the Authority; and
- b) adding the Price Control Deliverables (‘PCDs’) into Appendix 1 of SpC 3.14 gives effect to the decision of the Authority dated 19 April 2023 to approve funding for NGET’s five MSIP projects.

1.7. The effects of the modifications are:

- a) to enable necessary updates to be made to the NGET Redacted Information Document in cases where confidential information is redacted from the Licence by way of a direction issued by the Authority. This is further to information included by virtue of a modification of the definition provided for by section 11(A) of the Act; and
- b) to set Price Control Deliverables (PCDs) related to NGET’s five MSIP projects and the allowances for their delivery. If NGET does not deliver the PCDs during RIIO-ET2, then the price control framework provides for the allowances to be clawed back.

⁵ [RIIO-2 Final Determinations for Transmission and Gas Distribution network companies and the Electricity System Operator | Ofgem](https://www.ofgem.gov.uk/sites/default/files/docs/2021/02/final_determinations_et_annex_revise_d.pdf). In particular please see the 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_revise_d.pdf

⁶ For reference only - we consulted on three occasions covering the 5 Applications: (i) [Consultation on an Extreme Weather Resilience Medium Sized Investment Project from National Grid Electricity Transmission | Ofgem](#); (ii) [Consultation on a Sulphur Hexafluoride \(SF6\) Asset Intervention Medium Sized Investment Project from National Grid Electricity Transmission | Ofgem](#); and (iii) [RIIO-2 Medium Sized Investment Project \(MSIP\) Re-opener Consultation | Ofgem](#)

⁷ For reference only - the document is located here: [Statutory Consultation on a proposal to modify the Special Conditions of the Electricity Transmission Licence held by National Grid Electricity Transmission Plc | Ofgem](#)

Our decision-making process

Responses to the statutory consultation

1.8. We received four responses to the April 2023 licence modification statutory consultation, one each from the three ETOs (NGET, SP Transmission plc (SPT), and Scottish Hydro Electric Transmission plc (SHET⁸)) and a joint response from all three ETOs. We have carefully considered all responses and taken them into account.

1.9. The responses mostly focused on our decision to remove Contractor Indirects from Direct Activity Costs based on our view that the Contractor Indirects fall within the CAI Activity categorisation, and therefore are funded through the OE. The respondents disagreed with this application of the OE, suggesting that it did not provide sufficient allowances for Contractor Indirects, and proposed an alternative application. As the responses were the same in substance, we discuss them together when setting out our views regarding OE application in Chapter 2 – Opex Escalator: Responses and decision regarding the application of the OE.

1.10. We cover ETOs’ responses relating to other areas in Chapter 3.

Our decision-making

1.11. The decision-making stages are detailed below:

Date	Stage description
19/04/2023	Stage 1: Licence Modification Statutory Consultation opens
17/05/2023	Stage 2: Licence Modification Statutory Consultation closes (awaiting decision), Deadline for responses
02/06/2023	Stage 3: Responses reviewed and published
06/10/2023	Stage 4: Licence Modification decision and Notice of Modification of the Licence Special Conditions

1.12. In reaching this decision on changes to the Licence, to give effect to our 2022 NGET MSIP Decision, we have had regard to, and promoted, our principal objective to protect the interests of existing and future consumers, as well as to wider statutory

⁸ Scottish Hydro Electric Transmission plc (SHET) is an electricity transmission licensee that trades under the name Scottish & Southern Electricity Networks Transmission (SSENT).

consumer interests, functions, duties, considerations and needs, as variously set out under section 3A of the Act.

1.13. The RIIO-ET2 price control, of which the OE mechanism is an integral part, was designed to ensure that ETOs are properly incentivised to deliver the best possible outcomes for current and future energy consumers. This includes ensuring that consumers only pay for investments that are needed and do not overpay for those investments. To implement the OE in a way that was not intended when it was designed would run contrary to our principal objective under the Act, which is to protect the interests of current and future consumers.

1.14. The full rationale and reasons for our decisions relating to the application of the OE are set out in Chapter 2, and in relation to other areas are set out in Chapter 3.

2. Responses and our decision relating to the application of Opex Escalator

Background to the Opex Escalator (OE)

2.1. This background section explains the purpose of the OE, how we calibrated it (i.e. how we calculated the OE values), and how it is applied. It also explains the assumptions and considerations associated with calibration and application. This section should be read in conjunction with our NGET 2022 MSIP Decision (in particular, paragraphs 2.1 to 2.8).

2.2. Full details of the OE approach, the applicable uncertainty mechanism (‘UM’) and the calculation methodology are set out in RIIO-2 FDs.⁹

The purpose of the OE

2.3. The OE was introduced as part of RIIO-ET2. As explained in the RIIO-ET2 FDs,¹⁰ its purpose is to provide an automatic means for adjusting ETOs’ Closely Associated Indirect (‘CAI’) Activity Allowances when their Direct Activity Allowances¹¹ are adjusted through specified Re-opener mechanisms¹² and other UMs as set out in the ETOs’ SpCs. This avoids the need for an efficiency assessment of CAI Activity Costs¹³ on individual projects.

⁹ 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.

¹⁰ [RIIO-2 Final Determinations for Transmission and Gas Distribution network companies and the Electricity System Operator | Ofgem](#) (p.76 of RIIO-ET2 FDs – ET Annex).

¹¹ All capitalised terms used below unless otherwise defined have the meanings given to them in the ETO licences. See Appendix 1: Glossary for relevant definitions.

¹² See Appendix 2 for the list of relevant Re-opener mechanisms.

¹³ There are two main opex components: • Network operating costs, which are costs incurred in the day-to-day running of the network, for example, rectifying faults, repairs and maintenance activities • Indirect opex, which encompasses business support costs (BSC), i.e. costs relating to functions such as corporate governance, and closely associated indirect (CAI) costs, i.e. back office functions closely involved in the construction and operation of network assets such as project management and network design.

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2.4. It is an automatic Volume Driver¹⁴ mechanism that provides efficient CAI Activity Allowances across a licensee’s full RIIO-ET2 capital programme.¹⁵ For Re-opener mechanisms, such as MSIP, the OE is applied to individual project allowances. To determine the appropriate individual project allowances, Ofgem directly assesses the Direct Activity costs submitted by the ETO (under the relevant SpC) and, using appropriate cost assessment techniques, sets efficient Direct Activity Allowances. The OE is then applied to the Direct Activity Allowances to calculate the associated CAI Activity Allowances, as per **Equation 1** below. This avoids the need for Ofgem to directly assess and determine efficient CAI Activity Allowances on a project-by-project basis, and ensures that CAI Activity Allowances set through the Re-opener mechanism are consistent with CAI Activity Baseline Allowances.

Equation 1

$$[Project\ Indirect\ Activity\ Allowance] = [Project\ Direct\ Activity\ Allowance] \times [OE\ (\%)]$$

The total allowance for a given project is the sum of the Project Direct Activity Allowance and the Project CAI Activity Allowance.

2.5. Each ETO has a different OE value, which was set at RIIO-ET2 FDs. The OE is fixed for the duration of RIIO-2 (April 2021 to 2026) and applies across an ETO’s entire portfolio of RIIO-2 operational investments. The OE values for the three ETOs are:

- NGET: 16.89%
- SHET: 10.81%
- SPT: 13.42%

Calibrating the OE

2.6. The OE values given in paragraph 2.5 above were set (calibrated) at RIIO-ET2 FDs.

2.7. We utilised regression analysis to calibrate the OE for each of the ETOs. Regression analysis is an econometric technique that is used to estimate the relationship between the value of a dependent variable (in our case CAI Activity Costs) and one or

¹⁴ A Volume Driver is an Uncertainty Mechanism allowing revenue to vary as a function of a volume measure. An example is a connections Volume Driver that provides an ETO with allowances on the basis of the number of new connections and at a fixed unit cost per connection.

¹⁵ 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_revise_d.pdf

more explanatory variables (Direct Activity Costs). The result of the regression analysis, the OE, is a percentage that provides an indication of how much we would expect CAI Activity Costs to vary if Direct Activity Costs increase or decrease. For example, NGET’s OE is 16.89%. This means that if NGET carries out work with £100 of Direct Activity Costs, we expect it to also incur £16.89 in CAI Activity Costs (i.e. $£100 \times 16.89\%$).

2.8. In calibrating the OE, multivariate regression analysis was utilised. This is the same as the above, the difference being that more than one explanatory variable is included. We included one additional variable in our regression, Modern Equivalent Asset Value (‘MEAV’), which is a measure of the volume of network assets that an ETO has on its network (and thus is a proxy measure for the size of the network). MEAV was included as we found CAI Activity Costs to have a stronger relationship with MEAV and Direct Activity Costs in combination, than CAI Activity Costs does with Direct Activity Costs alone. Its inclusion accounts for the likelihood that the relationship between efficient Direct Activity Costs and efficient CAI Activity Costs might vary with size of the network.

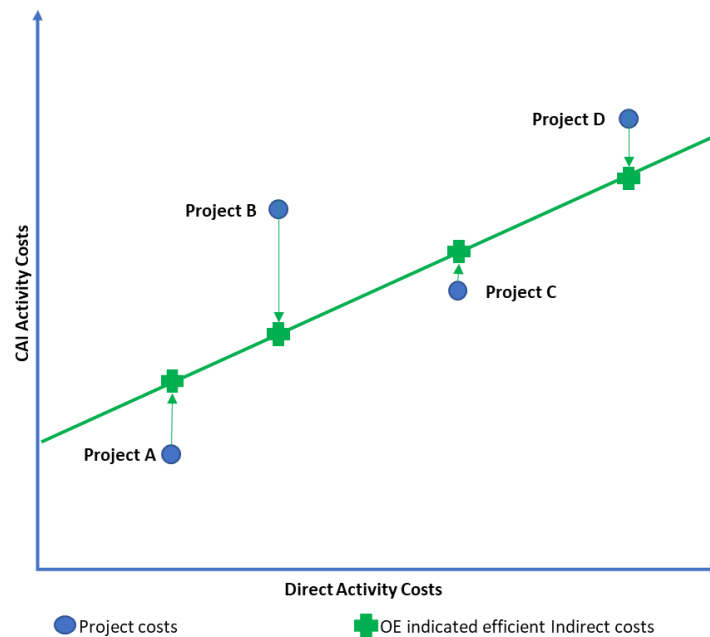
2.9. Additionally, as with all regression analysis we end up with an error term.¹⁶ The error term exists because the relationship between dependent and explanatory variables will not hold precisely for all datapoints (projects). This is illustrated in **Figure 1** below where the OE is denoted by the green line, which gives the relationship between Direct Activity Costs and CAI Activity Costs. The relationship holds on average, but the majority of projects will not sit exactly on OE line, some will be above it and others will be below it. The error term is a result of this imperfection in the relationship. The further away on average the projects are from the OE line the larger the error term will be.

2.10. We can therefore only be sure that the relationship suggested by the OE applies on average across the calibration dataset, ie the historical project portfolio. This does not necessarily mean that it will hold precisely across a future portfolio of projects, and will almost certainly not hold if we consider individual projects.

¹⁶ An error term represents the margin of error around the outputs from a statistical model. It refers to the sum of the deviations around the regression line, which provides an explanation for the difference between the theoretical value of the model and the actual observed results.

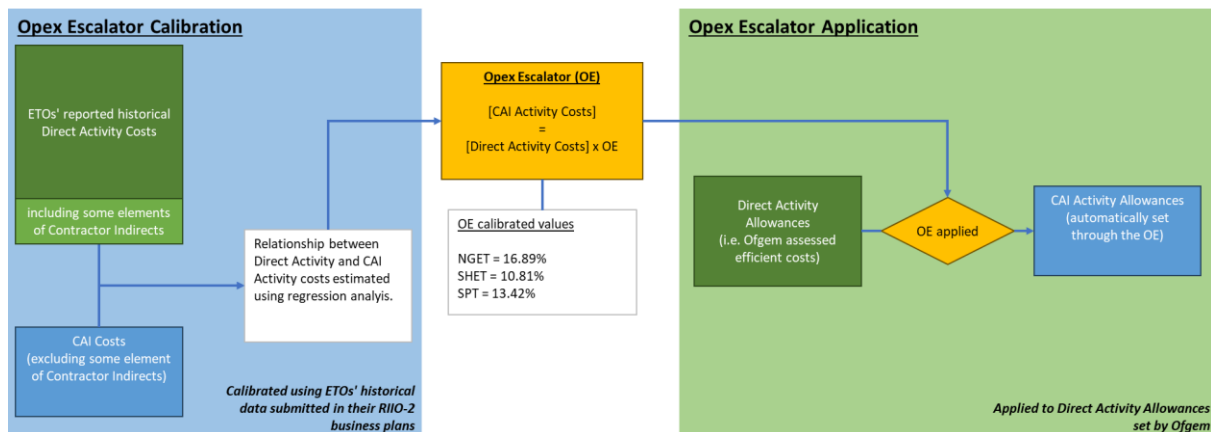
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Figure 1: OE relationship between Direct Activity Costs and CAI Activity Costs



2.11. **Figure 2** below provides an illustration of how the OE was calibrated and the relationship to how it is applied. The next section provides further explanation.

Figure 2: Calibration and application of the Opex Escalator



Applying the OE to determine CAI Activity Allowances

2.12. In order to allow us to use the OE as intended, i.e. to automatically determine the efficient CAI Activity Allowances associated with directly assessed efficient Direct Activity Allowances, we are required to make a number of assumptions, including those listed below. This is because, to use the OE as intended, we need the results of the regression analysis to give us single point estimates of efficient CAI Activity Costs, whereas without making the assumptions below the regression analysis only tells us that the efficient CAI

Activity Costs are likely to fall within a wide confidence range¹⁷. Similar assumptions as those listed below are required for all Volume Driver mechanisms, and for the OE mechanism to be operable will need to be made irrespective of the how Contractor Indirects are treated for calibration purposes:

1. MEAV and Direct Activity Costs are uncorrelated, meaning that any additional Direct Activity Costs will not change MEAV. This is an imperfect assumption as clearly, particularly in the case of load related projects, where a licensee is adding new assets to its network, the investment will increase MEAV.
2. The error term is zero. While this is a reasonable assumption to make across a large portfolio of projects (as positive value errors will cancel out negative value errors) it can be very significant when considering individual projects.
3. The data on which the OE was calibrated was representative of the relationship between efficient Direct Activity Costs and efficient CAI Costs.
4. The assessed Direct Activity Allowances to which the OE is applied are efficient.
5. All data has been robustly quality assured and is free from any material errors, inaccuracies, and inconsistencies.
6. Datasets used for calibration and application are 100% identical in how they are constituted.

2.13. Even though the above assumptions are all imperfect, in order to apply the OE to individual projects we need to assume that each of them is perfect. This allows us to use the OE to calculate a single efficient CAI Activity Allowance for any efficient Direct Activity Allowance that we set through our direct costs assessment. The fact that the above assumptions are imperfect means that the true efficient CAI Activity Allowance value actually sits within an uncertainty range of our OE estimated value. The uncertainty range is represented by 'X' in **Equation 2**, below.

¹⁷ For example without making the assumptions, using the results of the regression analysis on a given project might tell us that we have 95% confidence that the efficient CAI Activity Cost are between £10m and £50m. This is not useful for setting allowances. Making the assumptions enables us to narrow this range down to a single point estimate of e.g. £30m and to set the associated CAI Activity Allowances accordingly.

Equation 2

$$[\textit{True Efficient CAI Activity Costs}] = [\textit{OE Derived CAI Activity Allowance}] \pm X$$

2.14. If we only apply the OE to individual projects or to a small subset of an ETO’s RIIO-2 project portfolio then in aggregate we would expect the uncertainty range ($\pm X$) around the OE Derived CAI Activity Allowances to be large, and therefore for the OE Derived CAI Activity Allowance to be significantly above or below the True Efficient CAI Costs. However, as we apply the OE to more and more projects, we would expect the uncertainty range ($\pm X$) to decrease, as positive values will cancel out negative ones, and the CAI Activity Allowances will in aggregate be closer to the true efficient value.

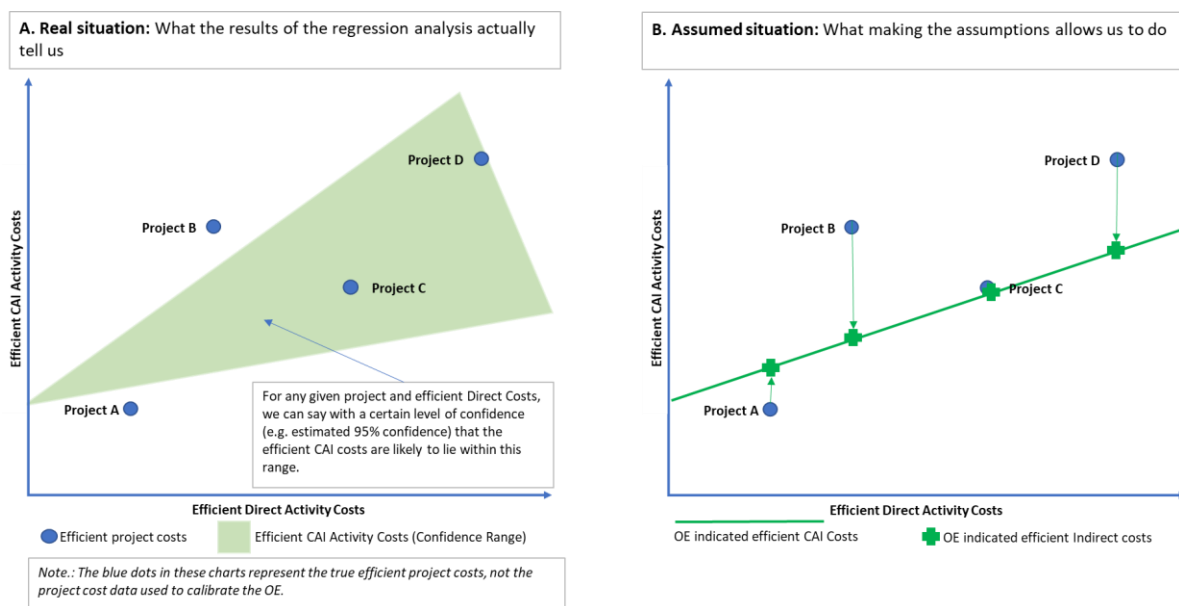
2.15. This is the fundamental concept that allows us to use the OE in RIIO-ET2. However, even though increasing the number of projects that we apply the OE to should in aggregate bring us closer to the true efficient value, because we cannot accurately estimate the combined impact of all of the assumptions we applied, we cannot reliably say how close to the true efficient cost we have come. We are collecting data through the RIIO-ET2 annual reporting process¹⁸ that will help us better understand the relationship between efficient CAI Activity Costs and efficient Direct Activity Costs. This data will help inform our allowance setting and adjustment mechanisms in the next price control.

2.16. The combined effect of making the above assumptions is illustrated in **Figure 3** below. Without making these assumptions, the regression analysis only indicates that the True Efficient Costs on a given project are likely to lie within a wide confidence range (Figure 3: Chart A). Making the assumptions allows us to narrow the efficient costs estimates down to a single line (Figure 3: Chart B). However, although the making of these assumptions gives regression outputs that can be used in a Volume Driver mechanism, such as the OE, it does not change the fact that the situation as illustrated in Chart A is the reality.

¹⁸ For reference only - the document is located here: [Direction to Modify the Regulatory Reporting Pack \(version 2.3\) and Regulatory Instructions and Guidance \(version 1.7\) May 2023 | Ofgem](#)

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Figure 3: Illustration of the combined effect of making the assumptions that are necessary to implement Volume Driver mechanisms such as the OE



2.17. As is the case with other Volume Driver mechanisms, the necessity to make the above assumptions means that the OE mechanism is inevitably imprecise. If having maximum precision was the paramount consideration, we would not introduce any Volume Driver mechanisms, and would instead, individually assess every situation where allowance adjustments are needed. The impreciseness of the Volume Driver mechanism is accepted due to the considered net benefit of the trade-off of impreciseness against the benefits that the mechanism provides. In the case of the OE mechanism, the specific benefits include that it avoids the need to individually assess CAI Activity Costs on individual re-opener applications (and the associated time and resource implications), and that it provides certainty to ETOs on the levels of CAI Activity funding they will receive for any additional Direct Activity Allowances.

2.18. Additionally, the downside of having an imprecise mechanism are mitigated to a large extent by the risk mitigation and sharing mechanisms contained in the RIIO price control framework as whole. These include the Totex Incentive Mechanism (TIM), and the Return Adjustment Mechanisms (RAM), as well as the inclusion of specific allowances for risk in baseline and re-openers. While not specifically designed to mitigate the effect of needing to make the assumptions necessary for operational Volume Drivers, they are designed to reflect and mitigate the uncertainty inherent in ex ante allowances and expenditure across the RIIO price controls.

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The OE development and implementation chronology

2.19. Development and implementation chronology of the OE is detailed below:

- OE was consulted on as part of RIIO-ET2 Draft Determinations (published on 9 July 2020).¹⁹
- 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).²⁰
- The OE was introduced into each ETO’s licence via SpC 3.36, following the statutory licence modification consultation published on 17 December 2020²¹ with a consultation decision made on 3 February 2021.²² These licence modifications then came into effect at the start of the RIIO-ET2 period, on 1 April 2021.²³
- The Regulatory Instructions and Guidance (RIGs), containing detailed reporting rules, for use in year 1 of the RIIO-ET2 price control were then consulted on in April 2022,²⁴ with a decision made on 1 June 2022.²⁵ These

¹⁹ 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

²⁰ 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_annex_revised.pdf

²¹ For reference only - the document is located here: Statutory consultation for RIIO-ET2 licences, 17 December 2020: <https://www.ofgem.gov.uk/publications/statutory-consultation-riio-2-transmission-gas-distribution-and-electricity-system-operator-licences>

²² For reference only - the document is located here: 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>

²³ For reference only - 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>

²⁴ Notice of proposed modification to the RIGs and RRP, 14 April 2022:
<https://www.ofgem.gov.uk/publications/notice-proposed-modifications-regulatory-instructions-and-guidance-and-regulatory-reporting-packs-riio-2>

²⁵ Decision on modification to the RIGs and RRP, 1 June 2022:
<https://www.ofgem.gov.uk/publications/decision-modifications-regulatory-instructions-and-guidance-rigs-regulatory-reporting-packs-rrps-and-pcfm-guidance-riio-2>

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came into effect ahead of the submission of Regulatory Reporting Pack (RRP)) on 31 July 2022.

Consultation responses

2.20. The three ETOs commented on our application of the OE as part of their consultation responses on our assessment of 4 of NGET’s 2022 MSIP applications.²⁶ In coming to our 2022 NGET MSIP Decision (detailed in Chapter 2 of that decision document), we carefully considered all of these comments, and confirmed the application of the OE to be in line with the application we set out in RIIO-ET2 FDs and in the consultation.

2.21. The ETOs’ responses to the licence modification statutory consultation are broadly consistent with their previous comments in response to the MSIP consultations and were considered and taken into account ahead of our 2022 NGET MSIP Decision.

2.22. All three ETOs disagreed with our application of the OE, and expressed the view that we have been incorrect in removing Contractor Indirects from NGET’s Direct Activity Costs. The ETOs’ view is that we should add allowances for Contractor Indirects back into Direct Activity Allowances and apply the OE to this higher Direct Activity Allowance figure. The effect of this would be to increase both Direct Activity allowances and (because the OE is applied to this higher figure) also increase CAI Activity Allowances. The ETOs propose that this should apply to all Re-opener applications and, compared to our application, would lead to higher allowances on every approved Re-opener project. We have summarised the main points of the ETOs’ arguments below and will give our response to each of them in the next subsection.

2.23. The ETOs’ key arguments in support of their view are that:

1. when the OE was calibrated, the Direct Activity Costs included some elements of Contractor Indirect Costs;
2. applying the OE to a dataset that is not identically constituted as the dataset used for calibration, will result in incorrect CAI Activity Allowances on Re-openers;

²⁶ For reference only - the document is located here: (i) [Consultation on an Extreme Weather Resilience Medium Sized Investment Project from National Grid Electricity Transmission | Ofgem](#)
(ii) [RIIO-2 Medium Sized Investment Project \(MSIP\) Re-opener Consultation | Ofgem](#)

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3. although we state in RIIO-2 FDs that a benefit of the OE is that it ensures consistency between Baseline Allowances and those set through UMs (including Re-openers), our application of the OE on the MSIP projects is not consistent with how it was applied to baseline;
4. because the data used to calibrate the OE was inflated by the inclusion of elements of Contractor Indirects, it was reasonable for them to assume that the intention was to apply it to Direct Activity Allowances that were similarly inflated. Therefore, in the ETOs’ view, in applying the OE we should treat all Contractor Indirects as Direct Activity Costs;
5. our application of the OE will leave ETOs under-funded to deliver the projects covered by the Re-opener mechanisms. ETOs estimate their total funding shortfall at £300m across their current and future MSIP applications (NGET: £80m, SHET £50m, SPT £170m)²⁷; and
6. our application of the OE constitutes a change in policy from FDs and we have not followed due process in making the change in the treatment of Contractor Indirects.

2.24. On the 17th of August 2023, the ETOs submitted a report that they had commissioned from the economic consultancy NERA, titled: “Early Findings from a Review of Ofgem’s Application of the Opex Escalator at RIIO-ET2”. We have also given full consideration to this report in coming to our decision. NERA provides two main economic views, which can be summarised as:

1. The decision to treat embedded Contractor Indirects as Direct Activity Costs when calibrating the OE biases the allowances set through the OE downwards; and
2. We are inconsistent in our application of the OE between baseline and Re-opener allowances.

2.25. NERA’s views are consistent with the views expressed by the ETOs in their consultation responses. We agree that, if considered in isolation, the first view is

²⁷ For reference only - the document is located here: ETOs’ joint letter to Ofgem, 18 May 2023: https://www.ofgem.gov.uk/sites/default/files/2023-06/SSENT-SPEN-NGET_Opex%20Escalator_Letter_Ofgem_May23_0.pdf

correct, while the second is incorrect. Our response to both of these views are covered in our responses to the ETO points below.

Our consideration of the ETOs’ responses

2.26. The following paragraphs set out our views on and contain our responses to the six ETO points summarised above.

When the OE was calibrated the Direct Activity Costs included some elements of Contractor Indirect Costs (ETO Point 1 above)

2.27. ETOs are correct in this view.²⁸ Although we would have preferred to have a precise delineation between the Direct Activity Costs and the CAI Activity Costs when we calibrated the OE than that in the figures that the ETOs reported in their RIIO-2 business plans, we accepted that for practical reasons (explained below), this would not be possible. In certain specific circumstances, the ETOs were therefore permitted to treat the relevant Contractor Indirect costs as Direct Activity Costs solely for business plan reporting purposes. That permission only applied in the following circumstances:

- to the reporting relating to historical projects in business plans;
- only where the ETO had employed third party contractors to deliver substantial elements of the work; and
- where the invoices the ETOs had received from the contractor did not provide enough information for the ETO to separate the CAI Activity Costs from total invoiced amounts.

2.28. The permission to treat Contractor Indirects as Direct Activity Costs did not, however, apply to forecast costs. The RIIO-ET2 Regulatory Instructions and Guidance (RIGs) were carefully worded, as follows, to ensure there is no ambiguity on the requirements: “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”²⁹.

2.29. The use of the words “contractors have recharged the licensee” (bolded for emphasis above) makes it clear that the intent was for this exception in the

²⁹ RIIO-ET2 RIGs version 1.0, page 123: https://www.ofgem.gov.uk/sites/default/files/2022-03/ET%20RIGs_Version1.0.pdf

categorisation of Contractor Indirect costs as Direct Activity Costs to apply to the reporting of past (historical) project costs only and not to the categorisation of forecast costs

2.30. Furthermore, although the permission applied to historical project costs, it only did so in cases where the ETO did not have the data for Contractor Indirects to be correctly reported as CAI Activity Costs: *“However, where the indirect activity is explicitly costed and detailed in their invoice this should be recorded against the relevant indirect activity”*.²⁹

2.31. While the permission meant that ETOs were not required to separate Contractor Indirects from historical Direct Activity Costs in specific limited circumstances, it did not alter the activity definitions relevant to data reporting. The activity definitions were consistent for both historical and forecast Direct Activity and CAI Activity costs. The permission simply meant that ETOs would not be found non-compliant with the reporting requirements as a result of their inability to separate Contractor Indirects from Direct Activity Costs for the purpose of reporting historical costs.

Applying the OE to a dataset that is not identically constituted as the dataset used for calibration will result in incorrect CAI Activity Allowances on Re-openers (ETO Point 2 above)

2.32. Although ideally the two datasets should be identically constituted, in reality this is highly unlikely to ever be the case. Differing treatments of Contractor Indirects is just one of a number of ways in which the two data sets will in practice not be identically constituted. Another example of inconsistency is the proportions of sub-activity costs (see Direct Activity definition in Appendix 1: Glossary) making up total Direct Activity Costs. Differences in these proportions between datasets used for calibration and for application are very likely, and as with other practical inconsistencies, will contribute to the impreciseness of the OE derived CAI Activity Allowances (see Appendix 3 for an illustrative example).

2.33. In giving ETOs permission to treat some historical Contractor Indirects as Direct Activity Costs (for the purposes of reporting historical costs rather than for forecast costs), we were aware that it would potentially have a distortionary effect on the regression analysis, and (if we only consider the effect in isolation) that the OE values resulting from it would be biased downwards. This meant that the OE would likely be lower than it would otherwise have been had reliable historical data with precise delineation between Direct Activity Costs and CAI Activity Costs been available to us.

2.34. Although treating some Contractor Indirects as Direct Activity Costs might bias the OE downwards and therefore increase the probability that applying the OE will result in an overall under-funding, this is by no means certain, and it certainly doesn’t eliminate the possibility that the final outcome (at the end of RIIO-2) will be that the ETOs are over-funded. We cannot consider this factor in isolation as there are a number of other factors that mean the allowances set through the OE will almost inevitably be imprecise. To look at one factor in isolation and determine that it may cause a bias in one direction or another assumes that all other uncertainty factors (see paragraph 2.12 above) are symmetrical and therefore do not introduce any bias into the modelling (potentially in opposite directions). This is almost certainly not the case.

2.35. The alternative approach would have been to apply adjustments to the historical data prior to calibration of the OE. This would have required us to apply broad unverifiable assumptions to separate CAI costs and to then adjust the historical Direct Activity Cost and CAI Activity Cost data accordingly. However, given the large uncertainty range caused by other factors (see paragraphs 2.12 to 2.15 above), the arbitrary nature of this alternative approach, and the risk that applying the adjustments would shift the benefit of the doubt from consumers to the ETOs (who, unlike consumers, have the ability to influence final project costs), we made the conscious decision to not choose the alternative calibration approach.

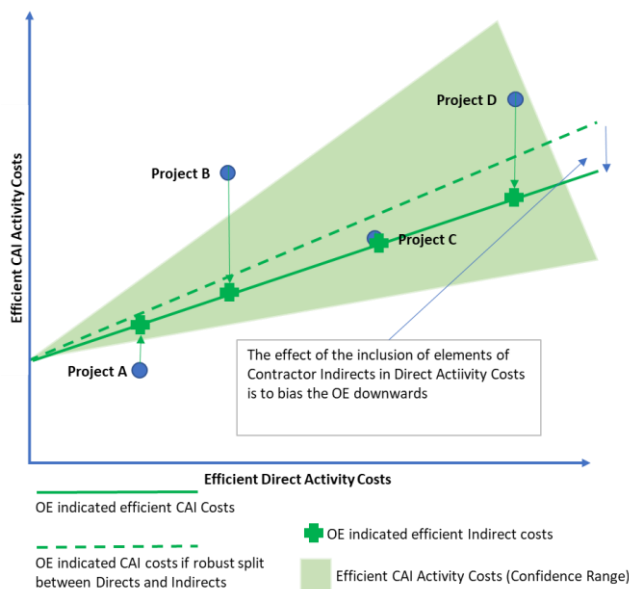
2.36. We therefore disagree with the view that applying the OE to a dataset that is not identically constituted as the dataset used for calibration will result in incorrect CAI Activity Allowances. While applying the above alternative calibration approach would give different answers, because of uncertainty around any calibrated OE values (as illustrated in **Figure 4** below), it is impossible to state with any confidence that it would improve the accuracy of the allowances across RIIO-ET2 and bring them closer to the true efficient values.

2.37. Additionally, the decision to treat historical Contractor Indirects as Direct Activity Costs was made in the knowledge that this would also likely lead to the baseline Direct Activity Allowances, being inflated by indeterminate amounts. This is because the same historical data was used for benchmarking certain Direct Activity Costs. This means that any downward bias on CAI Activity Allowances will be offset, to a greater or lesser extent, by the inflated baseline Direct Activity Allowances. Baseline direct Activity Allowances are £6,228.6m. Therefore, even if these allowances have been inflated by only 5%, the over-funding on baseline Direct Allowances will exceed the £300m claimed under-funding through the Opex Escalator. This does not factor in the inflationary

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impact on Direct Activity Allowances set through Volume Drivers, or the potential impacts on any allowances clawed back for non-delivery of PCDs.

Figure 4: Potential downward bias in the OE due to treatment of Contractor Indirects as Direct Activity Costs



Our application of the OE on the MSIP projects is not consistent with how it was applied to baseline (ETO Point 3 above)

2.38. This view is incorrect.

2.39. Although in reporting the historical data on which the OE was calibrated, ETOs were permitted to treat some elements of Contractor Indirects as Direct Activity Costs, this has no impact on consistency of application of the OE.

2.40. For both baseline and UMs (including MSIP projects and other Re-openers) the OE is applied to Ofgem assessed efficient Direct Activity Allowances (not to ETOs historical or forecast Direct Activity Costs). Neither baseline Direct Activity Allowances (that we set at FD), nor UM and other Re-opener allowances (that we set following our assessment of ETOs’ Re-opener submissions) include any elements of Contractor Indirects.

2.41. In setting baseline Direct Costs Allowances we adhered to the RIIO-ET2 RIGs activity definitions that applied for forecast costs (see paragraphs 2.27 to 2.28 above). Regardless of how the Direct Activity Allowances have been estimated, and even if they have been inflated due to the inclusion of Contractor Indirects in the ETOs’ submitted costs, they are still Direct Activity Allowances and not Direct Activity (plus Contractor

Indirects) Allowances. We do not state in FDs that we have deviated from the activity definitions in setting the allowances.

2.42. In assessing Re-opener submissions, where an ETO has included elements of Contractor Indirects in Direct Activity Costs, in order to achieve consistency with Baseline Allowances we need to remove the Contractor Indirects from the Direct Activity Costs before applying the OE. This is what we have done in the case of NGET’s MSIP applications. We expect that any future re-opener submissions requesting additional Direct Activity Allowances should be compliant with the relevant activity definitions.

It was reasonable for the ETOs to assume that the intention was to apply the OE to Direct Activity Allowances that have been inflated by the inclusion of elements of Contractor Indirects (ETO Point 4 above)

2.43. The ETOs have proposed that, in order to ensure they are sufficiently funded through the Re-opener mechanisms, we should treat all Contractor Indirects as Direct Activity Costs when we apply the OE.

2.44. This is not a rational application of the OE. It would lead to perverse incentives on ETOs, and the intended purpose of the OE means that it is not reasonable to expect that the OE would be applied in this way.

Purpose of the OE

2.45. The OE has been designed to be an automatic mechanism and specifically to avoid the need for Ofgem to assess CAI Activity Costs on Re-opener applications.

2.46. Our current application achieves this objective, as we only have to efficiency assess the ETOs’ Direct Activity Cost forecasts on a given project, and to set efficient **Direct Activity Allowances** accordingly. Associated **CAI Activity Allowances** are then set automatically through the OE mechanism.

2.47. The ETOs proposed alternative application does not achieve the mechanism objectives as it would require us to:

1. Assess the ETOs’ submitted Direct Activity Cost forecasts on a given project and determine the efficient level of Direct Activity Costs;
2. Assess the ETOs’ submitted total CAI Activity Cost forecasts on the project and determine the efficient level of CAI Activity Costs;

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3. Determine the efficient split of CAI Activity Costs between contractor and ETO;
4. Calculate the efficient Contractor Indirect Costs by allocating the contractor proportion (from Step 3) of efficient CAI Activity Costs (from Step 2); and
5. Add the efficient Contractor Indirect Costs (from Step 4) to the efficient Direct Activity Costs (from Step 1) to give efficient **Direct Activity Allowances**. Associated **CAI Activity Allowances** are then set automatically through the OE mechanism.

2.48. It is not logical to assume that we would put in place a mechanism to avoid the need to assess the efficiency of CAI Activity Costs only to implement it in a way that requires us to assess the efficiency of CAI Activity Costs.

Incentives on ETOs

2.49. The ETOs’ proposed application of the OE would give rise to some unsatisfactory outcomes and introduce some perverse incentives:

- It would incentivise an outsourced delivery model over in house delivery (see Appendix 4 for illustrative example), and
- ETOs would be incentivised to pass on as much CAI Activity Costs as possible to contractors on their re-opener applications, as this would maximise their allowance by increasing both their Direct Activity Allowance and the subsequently artificially increase CAI Activity Allowances set through the OE mechanism.
- ETOs would be disincentivised from improving controls over their costs and the cost charged to them by third party contractors, and disincentivised from removing the barriers that currently appear to inhibit robust and transparent reporting of Direct Activity and CAI Activity Costs.

2.50. The allowances that we set reflect our view of the efficient costs. Our view of efficient costs is always independent of the party incurring them and independent of contracting and delivery models. The proportion of CAI Activity Costs passed on to contractors is within the control of the ETO, and increasing the proportion of costs passed on to contractors will reduce the level of costs an efficient ETO will incur. We do

not put in place mechanisms that would incentivise ETOs to favour one particular contracting and delivery model over others.

2.51. Because ETOs have in the past not separated Contractor Indirects for regulatory reporting purposes, our ability to challenge the efficiency of any split between contractor and ETO-incurred CAI Activity Costs might be limited. It is partly for this reason that the annual reporting requirements have changed since RIIO-ET1 to require ETOs to report Direct Activity Costs without any elements of Contractor Indirects included. The data that we gather will help us assess these costs more robustly in future price controls.

2.52. The ETOs’ proposed alternative approach to implementing the OE mechanism is irrational. While we understand why ETOs would prefer their proposed application, as it will lead to increased allowances, and gives them greater scope to influence the levels of increase through their outsourcing strategy and cost allocations, it is not credible that they would have ever assumed that the intention was to apply the OE in the way they are now proposing.

Our application of the OE will leave ETOs under-funded to deliver the projects covered by the Re-opener mechanisms (ETO Point 5 above)

2.53. Due to the levels of uncertainty around the calibrated OE values it is impossible to say whether this is true or not. We do not consider that the ETOs have provided any adequate evidence of this.

2.54. While the ETOs’ proposed alternative application of the OE will lead to higher allowances (because the OE will be applied to a higher Direct Activity Cost), the difference between their alternative application and ours does not equate to an underfunding because, as already stated, it is necessary to bear in mind the range of assumptions that have been made for the OE to operate effectively.

2.55. Although each of the ETOs have provided estimates (NGET: £80m, SHET £50m, SPT £170m) of the underfunding that they claim our application would lead on their expected MSIP funded projects over RIIO-ET2, their method for estimating the potential value of under-funding is flawed.

2.56. ETOs have made assumptions on the proportion of indirect costs to allow them to estimate the value of Contractor Indirects on their MSIP projects. Using this estimate and their current forecast total project costs they have estimated the total allowances they would expect to receive for both our current application of the OE and their

alternative application. Their analysis assumes that the difference between the two equates to an underfunding (**Equation 3** below).

Equation 3: ETOs’ incorrect approach to estimating value of claimed under-funding

$$\begin{aligned} & [ETOs' Claimed Underfunding *] \\ & = [Total Allowance following ETOs' proposed alternative OE application] \\ & - [Total Allowance following Ofgem OE application] \\ & \quad * this will always be positive, potentially incorrectly indicating an underfunding. \end{aligned}$$

2.57. However, the ETOs’ approach is incorrect. In order to determine whether our application of the OE will lead to an underfunding it is not appropriate to compare the estimated results of one application of the OE against another. It is necessary to compare the allowances that would be set through our application of the OE against the true efficient total costs (**Equation 4** below). We consider the allowances that we set through detailed cost assessment to be the true efficient costs. Therefore, to reliably determine whether our application would lead to an underfunding (or potentially to an overfunding) would require us to conduct a robust cost assessment of both Direct and CAI Activity Costs on all past, current, and future Re-opener applications. It is not possible to do this with any reasonable level of confidence.

Equation 4: correct approach to estimating value of any under-funding

$$\begin{aligned} & [Underfunding *] \\ & = [True Efficient Total Costs] \\ & - [Total Allowance following Ofgem OE application] \\ & \quad * this can be either positive (under-funding) or negative (over-funding) \end{aligned}$$

Our application of the OE constitutes a change in policy from FDs and we have not followed due process in making the change (ETO Point 6 above)

2.58. Following the approach to forecast costs that had been clearly set out and on the basis that a range of assumptions were being made to enable the OE to work effectively without further need to assess or delineate costs, we are applying the OE in the way it was intended at FD and in the way that was set out during consultations (see paragraphs 2.43 to 2.52 above). Our policy is therefore unchanged from FDs.

Our decision and rationale for it

2.59. Following careful consideration of all of the consultation responses (as well as all subsequent information submitted by the ETOs) 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 above, these cost areas (Site Management and Supervision and Detailed Design) are CAI Activities which fall under the scope of the costs covered by the OE.

2.60. Our application of the OE on Re-opener mechanisms has been consistent, as demonstrated by the following facts:

- we are applying it as was intended when it was introduced at FD, and in the only way it could reasonably have been assumed we would apply it (see paragraphs 2.43 to 2.52),
- our application is consistent with how it was applied to Baseline Allowances (see paragraphs 2.38 to 2.42),
- any alternative application would introduce perverse incentives on ETOs (see paragraphs 2.49 to 2.50),
- any alternative application would fail to achieve the intended purpose of the OE, i.e. to be an automatic Volume Driver mechanism that removes the need to assess CAI Activity Allowances on Re-opener mechanisms, (see paragraphs 2.45 to 2.48)
- uncertainty around the allowances set through the application of the OE mean that although an alternative application might give different allowances, there is little evidence that the allowances would be closer to the true efficient values (see paragraphs 2.12 to 2.15),
- we consulted extensively on the introduction of the OE mechanism before FDs and specifically on our application of the OE mechanism to NGET’s projects ahead of this decision (see paragraphs 2.58).

3. Responses relating to other areas

3.1. Apart from the response to the application of OE, NGET and SHET also provided responses relating to other areas. SPT did not make any additional comments, observations or raise any other issues.

From NGET

3.2. NGET provided the following responses relating to other areas of the statutory consultation:

- NGET agreed with our proposal to amend the defined term “NGET Redacted Information Document” in SpC 1.1.16;
- Sulphur hexafluoride (SF6) Asset Intervention project: NGET noted our decision that, within this project, the gas circuit breaker (GCB) repairs should be funded through the Network Asset Risk Metric (NARM) mechanism as set out in SpC 3.1. NGET requested confirmation from Ofgem regarding how this would work, and how much funding would be triggered (all other things being equal) at T2 close-out;
- NGET states that when it has contractors directly employed in supporting its own staff on CAI Activities that it reports the associated costs against the relevant CAI Activities. NGET states that this is inconsistent with how cost are reported in the electricity distribution sector, and asked that we explain the reason for the inconsistency.

Our views

3.3. No respondent disagreed with our draft amendment to the defined term “NGET Redacted Information Document” in SpC 1.1.16. We therefore confirm this amendment.

3.4. We are engaging directly with NGET to provide answers to the questions it has raised and to provide additional clarity on relevant funding arrangements under NARM.

3.5. In regard to NGET’s query on inconsistency in reporting requirements between transmission and distribution sectors, we can confirm that all relevant definitions are in general alignment across the two sectors. In particular, ‘direct activities’ in the RIIO-ED2

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RIGs³⁰ does not treat Contractor Indirects as Direct Activity Costs as described in paragraph 2.28.

From SHET

3.6. In addition to the comments on OE, SHET also provided the following responses to the statutory consultation.

- Implementation of MSIP PCDs: SHET agreed *‘our approach to implementing PCDs for NGET’s 2022 MSIP projects sets outputs at an appropriate level of detail for the scale of the projects, and the outputs established in this licence condition are in line with those set for similar projects as part of the baseline RIIO-T2 settlement. However, it questioned whether it is appropriate for Ofgem to set retrospective delivery dates (31 March 2023) for these projects that they fall before the date that these PCDs were added to NGET’s licence. ... Given this consultation closes on 17 May 2023 and the proposed modifications can only take place 56 days after Ofgem implements its decision, a licence obligation for NGET to submit Basic PCD Reports will likely take effect very close to the submission deadline for the 2022/2023 RRP. In our view a more pragmatic approach would be for Ofgem to ensure that any delivery dates it sets for PCDs to allow the licensee sufficient time to submit a Basic PCD Report on time – in this instance delivery dates of 01 August 2023 would allow for submission of Basic PCD Reports alongside the 2024 RRP’.*

Our views

3.7. Due to the lengthy discussions with all ETOs, and consideration regarding the application of OE, the 2022 NGET MSIP Decision was deferred to a date after the actual delivery date of the projects. Before setting the retrospective delivery dates, we have confirmation from NGET that these projects were delivered on time. The allowances therefore apply retrospectively. We expect NGET to comply with PCD reporting requirements in respect of these projects from 2023/24 regulatory year onwards.

³⁰ [Notice to issue regulatory instructions and guidance under the electricity distribution network operators price control RIIO-ED2 | Ofgem](#) (p.76, RIIO-ED2 Regulatory Instructions and Guidance – Glossary)

4. Next Steps

4.1. We have taken full account of all consultation representations as detailed in Chapters 2 and 3.

4.2. We have decided to make and implement the previously consulted modifications to NGET’s Licence. Accordingly, we are publishing a Notice of Modification in conjunction with this decision. The Licence modifications will take effect 56 days after the publication of this decision and Notice of Modification.

4.3. Additionally, although no error has been made in the calibration and implementation of the OE, we acknowledge that, as is the case with all Volume Driver mechanisms, there is potential for outturn funding provision to differ from efficient levels. If, at close of RIIO-ET2, there is strong empirical evidence of systemic under-funding of CAI Activities versus efficient levels on the re-opener mechanisms covered by the OE, then we will apply ex post adjustment(s) to the ETO’s allowances to re-align them to the efficient levels. We have set out draft principles for the operation of this close-out mechanism in Appendix 5. We intend to work with the ETOs to enable us to finalise the design of the mechanism.

Appendix 1: Glossary

Term	Reference	Definition
Baseline Allowance	This document	For the purpose of this document, Baseline Allowance means the allowance for the Direct Expenditure for ETO in RIIO-ET2 FDs.
Closely Associated Indirect (CAI)/ CAI Activity	RIIO-ET2 RIGs	collectively includes the activities listed below: <ul style="list-style-type: none"> • Operational IT and telecoms • Project Management • Network Design and Engineering • System Mapping • Engineering Management and Clerical Support • Network Policy • Health, Safety and Environment • Operational Training • Stores and Logistics • Vehicles and Transport • Market Facilitation • Network Planning <p>More details associated with each of the indirect activities listed above can be found in Table D4.3 Closely Associated Indirects (CAI) of the RIIO-T2 Electricity Transmission Price Control – Regulatory Instructions and Guidance on Data Templates.³¹</p>
Contractor Indirects	This document	means the fees charged, either directly or as part of a wider scope of works, for the delivery or provision of any Closely Associated Indirect Activity by a contractor on behalf of an ETO.
Direct Activities	RIIO-ET2 RIGs	means those activities which involve physical contact with system assets. INCLUDES: <ul style="list-style-type: none"> • Labour cost of staff whose work involves physical contact with system assets. This can include the element of labour costs associated with trench excavation staff, craftsmen, technicians, technical engineers, administration and support staff, network planners and designers where a portion of their time involves physical contact with system assets, however only that portion spent on direct activities may be included. It will include idle, sick, non-operational training and other downtime of staff, which cost should follow their normal time allocations. • Operational engineers working on commissioning of assets, physically changing protection settings, issuing safety

³¹ [Direction to Modify the Regulatory Reporting Pack \(version 2.3\) and Regulatory Instructions and Guidance \(version 1.7\) May 2023 | Ofgem](#)

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Term	Reference	Definition
		<p>documentation or liaising with the control centre are considered direct activities.</p> <ul style="list-style-type: none"> • The cost of contractors being the total charges invoiced by external contractors for the primary purpose of performing direct activities. • The cost of materials drawn from stores or purchased and delivered directly to site for use in performing direct activities. In addition, this includes the cost of the materials (stores issues) for refurbishing system assets. • Servitude and easement payments to enable the direct activity to be performed. This does not include the cost of management or administration of these. • Related Party Margins charged by a Related Party for work performed on direct activities. In addition, includes, for the purposes of flooding, site surveys and non-site based costs.
Direct Activity Allowances	This document	means the allowances for the ETO to undertake Direct Activities.
Direct Costs	RIIO-ET2 RIGs	means the expenditure incurred undertaking Direct Activities.
Direct Expenditure	RIIO-ET2 RIGs	means the expenditure incurred undertaking Direct Activities.
Indirect Activities	RIIO-ET2 RIGs	<p>Activities listed below, which in most cases support work being physically carried out on network assets, that could not, on their own, be classed as a direct network activity. Indirect Activities generally do not involve physical contact with system assets, whereas direct activities do.</p> <p>INCLUDES:</p> <ul style="list-style-type: none"> • Closely Associated Indirects • Business Support Costs • Non-Operational Capex. <p>Note that operational engineers working on planning and project mobilisation, preparing and planning associated with protection settings, administration of outages, contract specification and liaising with contractors and customers are considered Indirect Activities.</p> <p>EXCLUDES:</p>

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Term	Reference	Definition
		<ul style="list-style-type: none"> • site surveys and non site based costs associated with flooding (in Direct Activities) • resourcing and project preparation and Second Tier bid preparation associated with Low Carbon Networks (in Direct Activities).
CAI Activity Allowances	This document	means the allowances for the ETO to undertake activities listed under Closely Associated Indirects.
CAI Costs	RIIO-ET2 RIGs	For the purpose of this document, CAI Costs means the cost incurred undertaking activities listed under CAI. Note: In RIIO-ET2 RIGs, Indirect Costs means the cost incurred undertaking Indirect Activities (including CAI, Business Support Costs and Non-operational Capex).
CAI Activity Costs	This document	see CAI Costs.
Medium Sized Investment Project (MSIP)	Electricity Transmission Special Licence Conditions	means a project of the kind listed at paragraph 3.14.6 of SpC 3.14 (Medium Sized Investment Projects Re-opener and Price Control Deliverable).
NGET 2022 MSIP Decision	This document	our 19 April 2023 decision on NGET’s 2022 applications relating to five projects under the MSIP Re-opener mechanism (https://www.ofgem.gov.uk/publications/decision-ngets-2022-msip-re-opener-applications).
Opex Escalator (OE)	This document	The uncertainty mechanism under Special Condition 3.36 of the electricity transmission licence, as well as the volume driver parameter value used to adjust CAI Activity Allowances for varying Direct Activity Allowances under this mechanism.
Price Control Deliverable (PCD)	RIIO-ET2 FDs	In RIIO-ET2, we will use PCDs to capture those outputs that are directly funded through the price control and where the funding provided is not transferrable to a different output or project. The purpose of a PCD will be to ensure the conditions attached to the funding are clear up-front.
Regulatory Instructions and Guidance (RIGs)	RIIO-ET2 FDs	A document that is published as part of the price control settlement which sets out further detail on how the price control is to be implemented and how compliance with it will be monitored.
Re-opener	RIIO-ET2 FDs	An Uncertainty Mechanism used in certain limited and pre-defined circumstances, which may amend revenue allowances, outputs and/or delivery dates within the price control period.
Return Adjustment Mechanism (RAM)	RIIO-ET2 FDs	Failsafe mechanisms to mitigate the future risk of companies earning materially higher or lower than expected returns in a changing system.

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Term	Reference	Definition
Totex Incentive Mechanism (TIM)	Electricity Transmission Special Licence Conditions	means the mechanism within the ET2 Price Control Financial Model which provides for the licensee to bear a specified share of any overspend, or retain a specified share of any underspend, represented in either case by a difference between: (a) the licensee’s Totex Allowance; and (b) the licensee’s actual totex expenditure.
Uncertainty Mechanisms (UMs)	RIIO-ET2 FDs	Uncertainty mechanisms allow changes to the ex ante base revenue during the price control period to reflect significant cost changes that are expected to be outside the company’s control. Common UMs apply to all or some of the energy sectors, whereas bespoke UMs apply to one network company.
Volume Driver	RIIO-ET2 FDs	An Uncertainty Mechanism allowing revenue to vary as a function of a volume measure (eg number of new connections).

Appendix 2: List of relevant Re-opener mechanisms

Under SpC 3.36, the OE applies to the following re-opener mechanisms within RIIO-ET2:

1. The Visual Impact Mitigation Re-opener and Price Control Deliverable and Enhancing Pre-existing Infrastructure Projects allowance (Applicable to all three ETOs: NGET, SPT and SHET)
2. Generation Connections volume driver (NGET, SPT and SHET)
3. Demand Connections volume driver (NGET and SPT)
4. Medium Sized Investment Projects Re-opener and Price Control Deliverable (NGET, SPT and SHET)
5. Wider Works Volume Driver (NGET only)
6. Fibre Wrap Replacement Re-opener (NGET only)
7. Civil Related Works Re-opener (NGET only)
8. Tower Steelworks and Foundations Re-opener (NGET only)
9. Tyne Crossing Project Re-opener (NGET only)
10. Bengeworth Road GSP Project Price Control Deliverable (NGET only).
11. Uncertain non-load related projects Re-opener (SPT only)
12. Subsea Cable Re-opener (SHET only)

The OE originally also applied to Large Onshore Transmission Investment (LOTI) Re-openers. However, the licence was modified on 12 November 2021 to remove LOTI from the scope of the OE.³²

³² <https://www.ofgem.gov.uk/publications/opex-escalator-licence-change-decision>

Appendix 3: Example to illustrate the effect of the assumption that application and calibration datasets are identically constituted

There are many reasons we know of (and likely others we don’t know of) why the datasets used for calibration and application are not identical. However in order for the OE mechanism to be implementable we need to assume that they are identical. For example we assume that the proportions of sub-activity costs are the same across both datasets.

The following example illustrates the potential implication of the requirement make this assumption. As is the case with all assumptions, including the assumption on the treatment of Contractor Indirects, the outcome as illustrated below is only valid if the assumption it is considered in isolation (i.e. if all other assumptions are perfect):

OE Calibration

- ETO has historically incurred Direct Activity Costs of £100m, divided between sub-activities A, B, C, D
- Direct Activity Costs are split equally between sub-activities:
 - £25m in A,
 - £25m in B,
 - £25m in C, and
 - £25m in D.
- We use this data along with CAI Activity Cost data to calibrate the OE at 20%.

CAI Activity Allowances set through the OE

- In order to implement the OE mechanism, we need to assume that the Direct Activity Costs are constituted the same as those used for calibration. This allows us to apply a single OE value to the Direct Activity Allowances we set directly.
- If we set Direct Allowances of on a reopener of £10m, the OE would suggest that the efficient CAI Activity Allowances should be:
 - **CAI Activity Allowances: £2.0m (£10m x 20%)**
- We get the same answer if we assume the same proportion of costs in each sub-activity as in the calibration dataset (i.e. 25% or £2.5m in each sub-activity):
- The correct efficient allowance should in fact be:

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- A ($£2.5m \times 20\% = £0.5m$)
+ B ($£2.5m \times 20\% = £0.5m$)
+ C ($£2.5m \times 20\% = £0.5m$)
+ D ($£2.5m \times 20\% = £0.5m$)
- **CAI Activity Allowances: £2.0m** ($= £0.5m + £0.5m + £0.5m + £0.5m$)

True efficient CAI Activity Allowances

- In reality the assumption that the calibration and application data sets is almost certainly not going to be true. This affects the accuracy of the OE because the efficient relationship between CAI Activities and Indirect Activities will be different for the different sub-activities. Rather than 20% for each, the true efficient relationship between CAI Activity Costs and Direct Activity Costs for the sub-activities might be:
 - 10% for A (i.e. for every £1 of Direct Activity Costs spent on sub-activity A, an efficient ETO will incur 10p in CAI Activity Costs),
 - 30% for B,
 - 25% for C, and
 - 15% for D,
- However, if rather than being split, 25% each between the sub-activity (as the calibration data was), the allowances are split:
 - £5m in A,
 - £1m in B,
 - £2m in C, and
 - £2m in D.
- The correct efficient allowance should in fact be:
 - A ($£5m \times 10\% = £0.5m$)
+ B ($£1m \times 30\% = £0.3m$)
+ C ($£2m \times 25\% = £0.4m$)
+ D ($£2m \times 15\% = £0.3m$)
 - **Efficient CAI Activity Costs: £1.5m** ($= £0.5m + £0.3m + £0.4m + £0.3m$)
- In the absence of the OE mechanism, and if we’d had the ability to robustly assess the CAI Activity Costs, then we would have set the allowances at this value.

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Funding outcome

- Funding provided through the OE is £2.0m,
- Whereas the true efficient cost is £1.5m,
- The OE has therefore actually **over-funded the ETO by £0.5m** (£2m - £1.5m) above the efficient value. This is because of the necessary assumption we made, in order to make the OE implementable, that the calibration and implementation datasets are identically constituted.

To re-emphasise, the over-funding in this example was not in any way due to the treatment of Contractor Indirects. Although we know that there is an impact of applying this assumption, it is unquantifiable but entirely necessary in order for us to have a workable mechanism.

Appendix 4: Illustration of ETO incentives under the two OE implementation options

As discussed in paragraphs 2.49 to 2.52, the ETOs proposed application of the OE would introduce perverse incentives to adopt an outsourced model and to pass on as much CAI Activity Costs to contractors as possible. This is illustrated in the scenarios shown in **Figure 5** and **Figure 6** below.

In these scenarios:

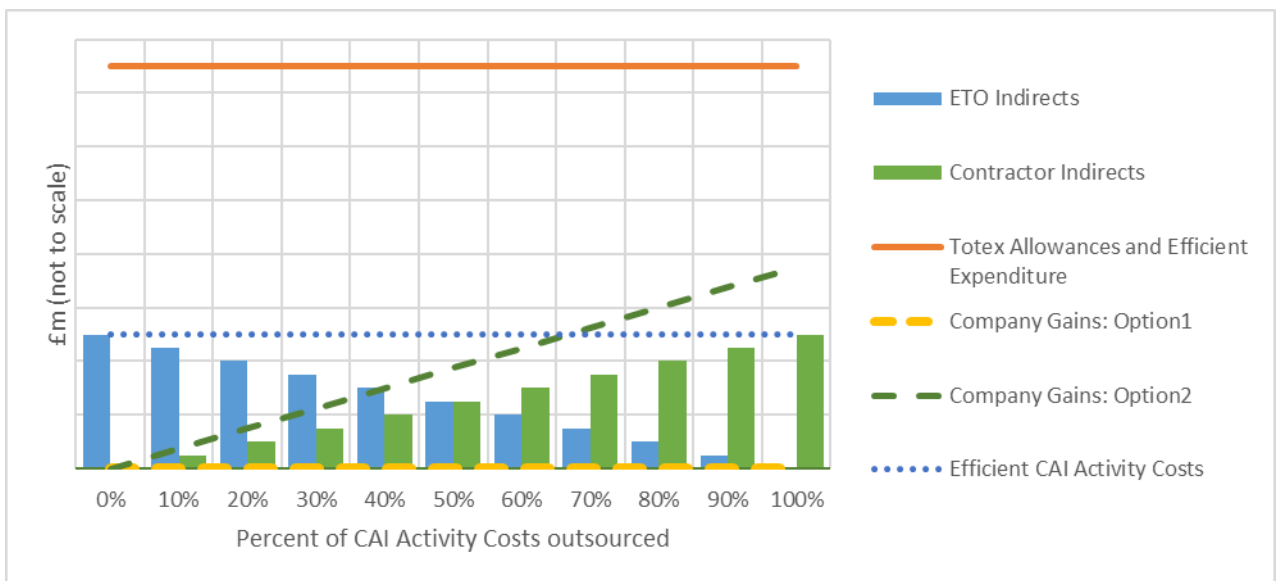
- Option 1 is Ofgem’s application of the OE mechanism, and
- Option 2 is the ETOs’ proposed alternative application

The level of efficient CAI Activity Costs is independent of the party incurring them. The proportion of CAI Activity Costs passed on to contractors is within the control of the ETO. Increasing the proportion of costs passed on to contractors will reduce the level of internal costs an efficient ETO will incur on the outsourced CAI Activities.

0% scenario (on the far left of the figure) represents a situation whereby the ETO is fully insourced, while the 100% scenario (on the far right) represents the other extreme, whereby the ETO has chosen to pass all of the CAI Activities on to contractors.

Scenario 1: Zero over-spend/under-spend scenario

Figure 5: Illustration of ETO gains for differing levels of CAI Activity outsourcing – zero over-spend/under-spend scenario



This illustrative example assumes that both the Direct Activity Allowances and ETO’s actual expenditure are the same and that both are efficient. It also assumes that the

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total expenditure on CAI Activities is at an efficient level (i.e. at the level the CAI Activity Allowances would have been set had they been set directly), while CAI Activity Allowances are set through the OE mechanism. For example:

Activity	Efficient Expenditure	Allowances	Actual Expenditure
Direct Activities	£100m	£100m	£100m
CAI Activities	£15m*	Set by OE	£15m

** The level that allowances would have been set had they been assessed directly*

In this scenario the ETO has not delivered any further cost efficiencies versus the original efficient level, and we would not expect it to make any gains as a result. If the mechanism is working correctly then the ETO should only make gains if it has earned them by delivering cost efficiencies versus the original efficient level.

This is the outcome that we achieve with Option 1. However, with Option 2 we have this outcome only in the fully insourced scenario. By passing CAI Activity Costs on to contractors, the ETO makes unearned gains, and these gains increase as the proportion of the CAI Activity Costs it passes on to its contractors increase.

Scenario 2: Over-spend scenario

Regardless of any level of over-spend or under-spend versus allowances, the gain or loss that the ETO makes with Option 1 application will be consistent (same level of gain or loss), whereas under Option 2 it will gain more by passing on more CAI Activity Costs to contractors. This is illustrated in **Figure 6** below.

In this example the outturn Direct Activity Costs are the same as in the previous example, but overall CAI Activity Costs have increased (so are no longer at the efficient level). For example:

Activity	Efficient Expenditure	Allowances	Actual Expenditure
Direct Activities	£100m	£100m	£100m
CAI Activities	£15m*	Set by OE	£30m

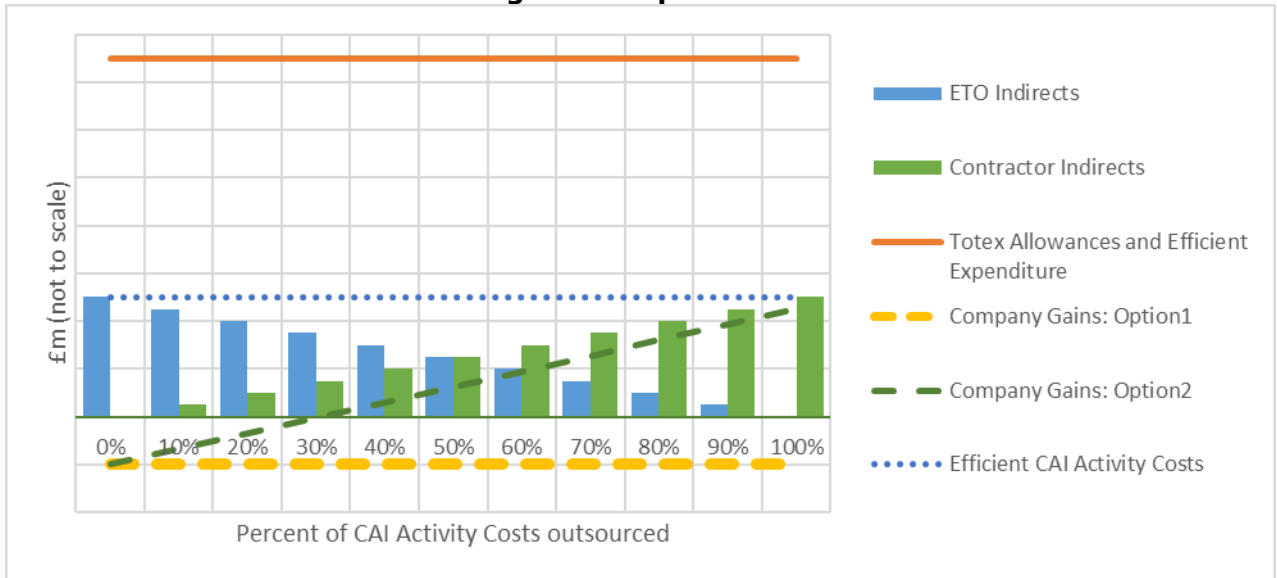
** The level that allowances would have been set had they been assessed directly*

With Option 1, we have the outcome that we would expect. The inefficient expenditure will lead to a loss on the part of the ETO, and the level of loss is consistent for all levels of outsourcing. The ETOs’ proposed application, Option 2, on the other hand, would lead to a situation whereby even though the ETOs’ expenditure was inefficient, it will still gain

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through the mechanism, provided in applying the OE a sufficiently high proportion of its CAI Activity Costs were passed on to contractors.

Figure 6: Illustration of ETO gains for differing levels of CAI Activity outsourcing – over-spend scenario



Above examples demonstrate the perverseness of the incentives that the ETOs’ proposed application would introduce.

Appendix 5: Principles for OE Review Mechanism

Principle 1: Purpose

The purpose of the automatic Opex Escalator (OE) is to ensure ETOs are funded for varying operational costs associated with capital investments delivered through Re-openers and other Uncertainty Mechanisms in RIIO-ET2. As is the case with all Volume Driver mechanisms, there is potential for funding provided through the Opex Escalator to differ from outturn efficient levels.

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

- Purpose: To ensure [ETOs are] funded through an automatic mechanism for varying operational costs associated with capital investments delivered through UMs.
- Benefit: Provides [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.

The ETOs have explained that, in their view, Contractor Indirects should have been treated differently to internal CAIs in the treatment of the Opex Escalator. This was not Ofgem's intention in designing or calibrating the OE. However, on the basis that the TOs are putting to us a different view in good faith, we are putting in place this review in order to understand whether this difference in understanding could lead to persistent underfunding of the TOs in respect of MSIP investments.

We agree that the treatment of Contractor Indirects in the calibration of the OE may make it more likely than it would otherwise have been had better data been available at the time, that CAI allowances provided to ETOs through the OE will not align with the efficient levels.

The purpose of this close-out OE Review Mechanism is therefore to identify ex post whether the OE mechanism has systematically provided lower Closely Associated Indirect (CAI) Allowances than ex post assessed efficient levels in accordance with the eligibility criteria (see section 6), and in such cases to adjust allowances to an efficient level once all costs are known with sufficient accuracy.

This proposed mechanism will seek to close out elements of the RIIO-ET2 price control by making adjustment to CAI RIIO-ET2 allowances.

Principle 2: Cost and allowance classification

For the purpose of implementing the OE Review Mechanism, all costs and allowance values must be classified in accordance with the relevant RIIO-2 electricity transmission licence definitions and RIGs activity definitions. ETOs should use all reasonable efforts to address the differences in reporting between Ofgem's expectations on the relevant RIIO-2 electricity transmission licence definitions, and the data provided to date.

We will continue our engagement with the ETO’s and work together to agree practical means by which they can comply with the current RIGs reporting requirements. In doing so, we will consider any necessary clarifications and practical distinctions between data reported by ETOs relating to projects that are now closed, and data relating to projects that close from this point forward.

Agreed reporting requirements will ensure that the data we receive from the ETOs demonstrates cost control and project governance oversight, and any subsequent decisions it informs, helping to further our principal objective to protect the interests of current and future energy consumers.

Principle 3: Implementation

The OE Review Mechanism will be implemented through the RIIO-ET2 close-out process. Provisions necessary to enable any subsequent adjustments to allowances will be included in the ETO licences for the next price control period. The licence condition will be drafted so that any decision under this mechanism, including a decision or effective decision to not award additional funding, will require a licence modification and will therefore be appealable to the CMA.

Principle 4: Scope

The scope of the mechanism is limited to:

- a. The following re-opener mechanisms (the “OE Review Re-openers”)
 - i. The Visual Impact Mitigation Re-opener and Price Control Deliverable and Enhancing Pre-existing Infrastructure Projects allowance (Applicable to all three ETOs: NGET, SPT and SHET)
 - ii. Medium Sized Investment Projects Re-opener and Price Control Deliverable (NGET, SPT and SHET)
 - iii. Fibre Wrap Replacement Re-opener (NGET only)
 - iv. Civil Related Works Re-opener (NGET only)
 - v. Tower Steelworks and Foundations Re-opener (NGET only)
 - vi. Tyne Crossing Project Re-opener (NGET only)

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- vii. Bengeworth Road GSP Project Price Control Deliverable (NGET only).
 - viii. Uncertain non-load related projects Re-opener (SPT only)
 - ix. Subsea Cable Re-opener (SHET only)
- b. and the CAI Activity Allowances under those re-opener mechanisms.

Principle 5: Burden of proof

If an ETO is of the view is that, subject to the eligibility criteria, net under-funding has occurred, then the burden of proof shall be on ETO to demonstrate that this is the case.

- a. This must include robust, objective, verifiable, and auditable quantification of the value of under-funding, and
- b. must be supported by empirical evidence.

Having fully considered any evidence provided Ofgem will determine the final value of any under-funding across the project portfolio, or on individual projects. Where Ofgem concludes that insufficient evidence has been provided, then Ofgem may determine a value of zero in that case.

Principle 6: Eligibility

In order for an ETO to be eligible to apply under this mechanism, it must demonstrate that there is systematic underfunding on projects as a result of the difference in treatment of Contractor Indirects. To demonstrate this underfunding there must be evidence of significant underfunding across the project portfolio and evidence of underfunding on a suitably large proportion of OE Review projects. Therefore, in order to be eligible the criteria below must be met. If the ETOs are correct and there is systematic underfunding close to their estimated levels (i.e. total £300m) then the thresholds below should be easily exceeded:

- a. an ETO’s outturn total RIIO-ET2 CAI expenditure (both internal and external) across all RIIO-ET2 mechanisms must be greater than all CAI Allowances,
- b. an ETO’s outturn total RIIO-ET2 CAI expenditure (both internal and external) on all OE Review Reopeners, must exceed the total CAI allowances provided through the OE by more than 15% (TBC), and
- c. must have overspent on more than 80% (TBC) of the re-opener projects covered by the OE mechanism.

In determining eligibility all expenditure and allowances must be correctly categorised in compliance with the relevant Direct Activity and CAI Activity RIGs definitions.

Principle 7: Determining the value of under-funding

To the extent that TOs have used responded to Ofgem's reasonable requirements for information, and based on the information provided by the TOs, Ofgem will consider

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whether these provide evidence that the allowances under Ofgem’s approach have underfunded the TOs. If so, Ofgem will then consider the level of underfunding, and make additional allowances to reflect that underfunding.

The value of under-funding, and adjustment to allowances will be determined in accordance with Equation 1 below:

Equation 1

$$OETU = \text{Max}(0, ECAI_{\text{DET}} - OECAI)$$

Where:

- OETU: is the total value of the Opex Escalator True-up allowance Adjustment.
- OECAI is the total of CAI allowances provided through the OE in RIIO-ET2
- $ECAI_{\text{DET}}$: is the Ofgem assessed value of total efficient CAI expenditure across the OE Review Re-openers, and calculated in accordance with Equation 2, below.

Equation 2

$$ECAI_{\text{DET}} = ECAI_{\text{ETO}} - ECAI_{\text{ADJ}}$$

Where:

- $ECAI_{\text{ETO}}$: is the ETO assessed value of total efficient CAI expenditure across the OE Review Re-openers.
- $ECAI_{\text{ADJ}}$ is the total of Ofgem determined adjustments to the ETO’s assessed values comprising $ECAI_{\text{ETO}}$.

Principle 8: Evidence

The ETO is required to provide suitable evidence in support of its estimate of $ECAI_{\text{ETO}}$.

This must include, as minimum:

- A. Outturn CAI expenditure in RIIO-ET2, broken down by:
 - i. Project
 - ii. CAI sub-activity (as per the RIGs), further broken down by:
 - i. Internally incurred
 - ii. Externally incurred
- B. A project-by-project schedule of costs incurred, including all invoices from any contractor where the total value of the invoices from that contractor on the project exceeds £100k. Invoices below this value may be aggregated into a single entry. The schedule must be reconciled to the company’s underlying

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accounting records and to any subsequent attribution and allocation to regulatory reporting categories in compliance with the RIGs.

- C. Reconciliation of total project expenditure to associated total allowances.
- D. For external spend, evidence must include, where available:
 - i. Project contract; schedule of works which includes the CAI functions being delivered by 3rd parties; project engineer sign-off for works delivered & project completion
- E. For Internal spend, evidence must include, where available:
 - i. FTE assigned to projects under review; nature of the CAI sub-category they have performed on the project; timesheets & salary rates of internal staff performing CAI activities for the projects reviewed where available; where timesheets are not available, evidence & justification of attribution methodologies for internal staff assigned to project, this should be at an appropriate level of granularity of both time & FTE rate
- F. Explanation of any methodologies and assumptions that it has applied in estimating the breakdown at A above, including any approaches necessary to attribute costs to different cost categories or to parties incurring them,
- G. Estimates and explanation of any areas of efficiency or inefficiency it has identified in A above, The ETO’s final view of efficient levels of CAI on its re-opener projects covered by the OE, having considered A and F above.