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Dear Evan,

Response from National Grid Electricity Transmission plc (NGET) to Ofgem's consultation (dated 17 November 2023) on the Draft Determination on the North Wessex Downs Visual Impact Mitigation Reopener

This is NGET's non-confidential response to the Draft Determination consultation document published by Ofgem on the North Wessex Downs Visual Impact Mitigation Reopener. The supporting document, Appendix 1, should be treated as confidential due to the commercially sensitive nature of some areas of our response.

We welcome the publication of the Draft Determination consultation in respect of NGET's North Wessex Downs Visual Impact Mitigation Reopener submission made on 27th February 2023. We welcome Ofgem's acceptance of the need to progress the project. Please find below our responses to your specific consultation questions.

Q1. Do you agree with our draft view that NGET has fulfilled its VIP policy commitments?

Yes, we agree that we have fulfilled our VIP Policy commitments in progressing the North Wessex Downs project.

Q2. Do you agree with our draft view that the North Wessex Downs project is the valid outcome of NGET working with stakeholders on the selection of visual impact improvement projects?

Yes, we agree that the North Wessex Downs project is a valid outcome of our work with both national and local stakeholders. This project has been carefully considered and prioritised by the Visual Impact Provision Stakeholder Advisory Group, and subsequently developed in consultation with local stakeholders for more than three years.

Q3. Do you agree with our views on the option appraisal carried out by NGET?

We agree with Ofgem's views on the appraisal of potential options, and specifically its approval of the option selected (Option 5) as the best option to achieve the required outcome and fulfil the five guiding principles of the VIP Policy.

Q4. Do you agree with our view on the technical scope of the North Wessex Downs project proposed by NGET?

We welcome Ofgem's Draft Determination that the scope of the North Wessex Downs project is appropriate given the characteristics of the area and the complexity involved in an underground cabling project.

Q5. Do you agree with our cost assessment of NGET's proposed North Wessex Downs project for its Visual Impact Mitigation PCD?

No, we do not agree with Ofgem's cost assessment of the North Wessex Downs project. We disagree with the proposed total funding level and have set out below why Ofgem should reassess the funding proposed in the Draft Determination. A more appropriate level of funding will help make the North Wessex Downs project a success.

1.0 Risk and Contingency

Paragraph 5.28 of Ofgem's Draft Determination states:

"We have assessed the reasonableness of NGET's proposed contingency costs for the North Wessex Down project. We note that both NGET and the contractor's risk and contingency total value, as a proportion total direct costs, exceeds 7.5%. Our draft view is that this is too high and does not align with similar projects. Our RIIO-2 determinations capped average risk across projects at 7.5% of our assessed efficient direct project cost, following a review of outturn risk on a number of RIIO-1 projects. We do not believe we have seen sufficient reason to apply a different approach in this case and propose to cap using the same 7.5% risk provision for the North Wessex Downs project. This 7.5% risk provision will be applied to the efficient total Direct Cost following the proposed adjustments in table 2 as set below."

1.1 Conflation of Risk and Contingency

In Ofgem's cost assessment, no distinction has been made between 'risk' and 'contingency'. These are different, and it is not clear that the 7.5% cap on 'risk' (as it has been described by Ofgem) should also apply to identified 'contingency' costs. For reasons set out later in our response, this may not have an effect on the determined funding for this project. However, as a point of principle, please can Ofgem clarify the scope of the 7.5% cap (i.e. whether it covers risk and/or contingency) and ensure that (if it is to be applied) it is applied consistently with its derivation?

1.2 Top-Down Approach

NGET projects of sufficient size and complexity (such as the North Wessex Downs project) are analysed for their project-specific risks. A risk register is created, reflecting the specific engineering and locational characteristics of the project.

Ofgem's assessment of the North Wessex Downs project applied a top-down cap of 7.5%, asserting that the 'proposed contingency costs' were 'too high and' do 'not align with similar projects'. We have requested previously that Ofgem share the derivation of this 7.5% cap however Ofgem has not yet provided supporting analysis. It has been agreed by Ofgem that NGET will be able to respond further on this point once the supporting analysis has been provided.

In the meantime our ability to respond robustly is limited, however, our concern is that the 7.5% is not actually based on similar projects. In fact, given the unusual nature of Visual Impact Mitigation projects (which, by definition, require us to work in some of the most protected designated landscapes in England & Wales) it seems highly unlikely that similar projects were included in the derivation of the 7.5% cap. The North Wessex Downs project requires us to cable within an Area of Outstanding Natural Beauty, in the vicinity of a Site of Special Scientific Interest (SSSI) and a civil war battleground.

Consequently, NGET disagrees with the approach of assessing risk (and potentially contingency) on a top-down basis as such an approach does not recognise specific project challenges, and we request that Ofgem assess the risk register that has been provided for the North Wessex Downs project on a bottom-up basis.

1.3 Failure to Reflect NEC Contract Terms

On all NGET projects with a risk register, a review is undertaken to decide whether each risk is best managed by the client or the contractor. This position is negotiated carefully with the contractor and assessed against estimates and market benchmarking to ensure it is the appropriate decision, i.e. that it is likely to drive the best outcome for project stakeholders (including, ultimately, consumers). Fundamentally, the risks that the contractor owns are more suitable for the contractor to manage,

providing consumers and NGET with greater cost certainty and avoiding the possibility of those risks (if they subsequently occur) adversely impacting the price to be paid for the project.

Ofgem's assessment approach combined the NGET forecast risk cost with the risk and contingency costs of the Main Works Contractor. The Main Works Contract (MWC) is a fixed price NEC Option A where all costs are payable to the contractor. Specifically, the specified risk and contingency have been transferred to the contractor and the agreed price will therefore be paid regardless of whether each risk occurs or not.

It is not evident that the 7.5% risk cap includes such a fixed sum for contractor risk and contingency. In fact, it is probable that such costs were submitted and assessed as direct capex as part of the RIIO-T2 price control review and therefore applying this cap inconsistently with its derivation would be an error. Therefore, Ofgem should include the contractor risk and contingency value in the direct cost of the project, and assess NGET's risk bottom-up (please see 1.2).

If Ofgem were to retain the risk capping approach, because the contractor risk and contingency is a fixed sum under NEC Option A, the risk percentage should be based on the NGET risk value which is £4.8m. This equates to 5.9% of the total submitted project cost (£80.9m).

2.0 Contractor Indirects

2.1 Opex Escalator

On the matter of the application of the Opex Escalator (OE), we fundamentally disagree that the OE was established in such a way as to fund contractor 'indirects' as Ofgem has stated. As a result, Ofgem's approach to reclassifying contractor 'indirects' and removing them when determining direct capex allowances is flawed and is a significant and clear departure from the RIIO-T2 price control settlement. We do not repeat here the points that we have previously made (both individually and in joint letters from the TOs) in relation to Ofgem's application of the OE in the context of NGET's 2022 MSIP submissions. However, we note that Ofgem's recent NGET licence modification decision (dated 6 October 2023¹) in relation to these submissions states that "*there is potential for outturn funding provision to differ from efficient levels*" and (in the draft principles for the proposed OE review mechanism forming part of the decision) that: "*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.*"

Ofgem and the Transmission Owners (TOs) are currently in dialogue to define an Opex Escalator Review Mechanism (as contemplated by the 6 October 2023 MSIP licence modification decision), which is intended to apply appropriate adjustments to the TO's RIIO-T2 allowances to rectify any systematic underfunding as a result of the application of OE. However, it would be preferable to disapply the OE from this and future Visual Impact Mitigation projects and assess both TO and contractor indirects bottom-up on a project-specific basis.

2.2 Direct / Indirect Categories

Paragraph 5.25 of Ofgem's Draft Determination states:

"We have assessed tendered costs against our reporting protocols we have for RIIO-2 price control. Our RIIO-2 reporting guidance instructs the TOs on defining costs of Direct or CAI. In summary, Direct costs are those which include expenditure attributable to physically delivering works on assets on site. Although we acknowledge NGET has already classified some Indirect costs in its submission, we note that its contractor estimates include an amount for project cost management and detail design activities. Under current RIIO price control arrangements, contractor's project management and design work are not classified as Direct activities but are CAI activities and covered by the OE."

¹ https://www.ofgem.gov.uk/sites/default/files/2023-10/NGET_2022_MSIP_Licence_Decision_FINAL.pdf para 4.3

There are ongoing live discussions between Ofgem and the TOs seeking to clarify the reporting protocols and what is categorised as Indirect and Direct under RIIO-T2 price control arrangements. Following the most recent discussion held on 6 December 2023, it was agreed that elements of closely associated indirect costs as defined by the Regulatory Instructions and Guidance (RIGs) should be treated as direct costs when incurred by a contractor to deliver assets on behalf of the TOs. It was also agreed that further discussions were required to review the treatment of ‘detailed design’ as this was not defined clearly in the RIGs.

Therefore, Ofgem’s conclusions in this area in the Draft Determinations will need revisiting once the definitions have been updated to correctly reflect Ofgem’s intentions regarding the split between Direct and Indirect costs incurred by contractors. Our current understanding of the split between Direct and Indirect contractor costs is presented in section 2.3.

2.3 Categorisation of NWD VIP Directs / Indirects

Paragraph 5.26 of Ofgem’s Draft Determination states:

“NGET has incorrectly categorised contractors’ project management and detailed design subcategories under Direct costs instead of CAI costs. Accordingly, we are proposing to remove the cost for these specific elements from the NGET’s proposed contractors’ cost for the main construction work programme. Instead, NGET will receive an automatic uplift via the OE for its CAI activities. Removing the cost for these for these specific elements reduces NGET’s proposed contractors cost for the main construction works by approx. 13.7%.”

In arriving at the Draft Determination being consulted on, we do not believe Ofgem has reviewed the full information provided. Within both the project management and detailed design subcategories, further breakdowns have been provided. Our interpretation of reporting classification, supported by ongoing discussion with Ofgem and previous MSIP decisions for NGET and SPT, shows that in some instances contractor’s costs have been incorrectly categorised as Closely Associated Indirect (CAI). When reviewing at the lower levels provided, there is a mix of direct and CAI costs.

The table below shows the mix of classification within the Project Management of our contractors’ breakdown. By classifying the lines beneath Project Management according to our current understanding, the value of the element classified as ‘contractor indirect’ will reduce.

L3	Contractor Project Management	Mix (see below)
L4	Contractor’s Project Management	Mix (see below)
L5	Site Accommodation	Direct
L5	Logistics	Direct
L5	Staff/ Admin	Mix (see below)
L6	Project Management Staff	Indirect
L6	Engineering & Technical Staff	Direct
L6	Commercial/Financial Staff	Indirect
L6	Administrative/Clerical	Indirect
L5	SHESQ	Direct
L5	Third Party Costs - Non Statutory Bodies	Direct

Detailed Design has been removed from the proposed direct capex funding on a similar basis. Reviewing the more detailed activity lines beneath the ‘Detailed Design’ header and applying the current RIGs which state that manufacturing configuration design is treated as a Direct cost, we believe that these asset-specific design works should be treated as Direct.

L3	Detailed Design	Direct
L4	Access Design	Direct
L4	Surveys	Direct
L5	Archaeological	Direct
L3	Civils & Containment Design	Direct

L3	Detailed Design	Direct
L4	Technical Design	Direct
L4	Tower Design	Direct
L4	Access Design	Direct

Notwithstanding the ongoing discussions over the application of the Opex Escalator, when reviewing the detailed activities beneath Project Management and Detailed Design, the reduction to gross capex funding to reflect what Ofgem now classify as ‘contractor indirects’ should be £1.92m over all price controls in 2018/19 prices.

3.0 RIIO-T1 Funding

Paragraph 1.10 of Ofgem’s Draft Determination states:

“We have disallowed NGET’s RIIO-1 expenditure as well as expenditure expected to be incurred in RIIO-3 from its funding request. This is because SpC3.10 only provides for allowances in RIIO-2. Should the project go ahead, then the remaining RIIO-3 allowances may be provided as part of NGET’s RIIO-3 settlement.”

We disagree with the use of the word ‘disallowed’. The draft determination is proposing that these costs should not be funded as part of the RIIO-T2 price control; this is different to ‘disallowed’.

In addition, we disagree with Ofgem’s rationale for not funding the RIIO-T1 activities. We can see nothing in the applicable Special Condition (SpC3.10) which states that funding cannot be granted for works completed prior to the RIIO-T2 price control. We also observe that SpC3.10 does not limit funding to costs incurred or expected to be incurred on or after 1 April 2021 in the same way that SpC 3.2 and SpC3.3 expressly do (e.g. at 3.2.15c and 3.3.15c). We agree that the funding can only be provided by an amendment to the RIIO-T2 licence, but there are situations where such adjustments are required to reflect RIIO-T1/RIIO-T2 funding interactions such as the imminent changes required to enact RIIO-T1 ‘close-out’.

Not funding preliminary works because they fall in a previous price control will set a precedent for future projects which span multiple price controls, and could potentially lead to delivery delays due to the actual or perceived risk of such works being underfunded. This is not in consumers’ interests nor supportive of TOs working at pace. We have provided a breakdown of the RIIO-T1 spend in Appendix 1 due to it being commercially sensitive.

It is an important regulatory principle that all efficiently incurred costs are funded. Ofgem’s proposed approach is contrary to this, and is therefore unacceptable. As these preliminary works were required to progress the project efficiently, we ask Ofgem to hold us whole for funding.

4.0 RIIO-T3 Funding

Paragraph 5.27 of Ofgem’s Draft Determination states:

“The delivery of the North Wessex Downs project will span throughout the remainder of RIIO-2 and into RIIO-3 price control period. As a result, a small portion of NGET’s indirect and direct activities on the main construction works will proceed beyond the end of RIIO-2. We are proposing to remove the costs that are programme after March 2026 from NGET’s funding request for the North Wessex Downs project. This is because SpC 3.10 only permits the

awarding of allowances for costs in RIIO-2. Costs incurred after March 2023 may be provided as part of NGET's RIIO-3 settlement."

We understand that funding for works delivered as part of the RIIO-T3 price control will be received as part of the RIIO-T3 settlement. This is consistent with previous Visual Impact Provision (VIP) projects which spanned multiple price controls, such as Dorset, Snowdonia and Peak East. However, the language used does not give us comfort and certainty that the funding required to complete the North Wessex Downs project will be received in RIIO-T3.

NGET asks that Ofgem provides assurance that funding will be provided in respect of efficient costs incurred after 31 March 2026. (There appears to be a typographical error in the document, with the date captured as 'March 2023'.) In summary, please can the sentence "*Costs incurred after March 2023 may be provided as part of NGET's RIIO-3 settlement.*" be amended to "*Costs incurred after March 2026 will be provided as part of NGET's RIIO-T3 settlement.*"?

5.0 VIP projects in RIIO-T2 and beyond

Paragraph 5.8 of Ofgem's Draft Determination states:

"Considering this, NGET state that it does not plan to submit any new Visual Impact Mitigation Re-Openers in RIIO-2 as it deems projects necessary to meet Net Zero targets to be of higher priority in RIIO-2."

Paragraph 5.22 of Ofgem's Draft Determination states:

"Considering the above factors, our draft determination position is to approve this application for funding. However, we also agree with NGET, that going forward, given it is unlikely that market conditions will stabilise in the short term, it would not be in the consumers interest to prioritise visual impact improvement funding applications in RIIO-2."

These sections appear to be based on a statement that has been misunderstood by Ofgem. NGET does intend to continue with the Cotswold Visual Impact Provision (VIP) project, of which Ofgem is aware. This has been in the public domain for three years, is part of our RIIO-T2 Visual Impact Mitigation Re-Openers portfolio, and a submission is due to be made in 2024.

For the avoidance of doubt, under the process required by Ofgem, the ongoing need for Visual Impact Mitigation projects is driven by external stakeholders and is subject to willingness-to-pay by household billpayers.

6.0 Mathematical Errors

The phasing of the forecast spend over the three price control periods and the order that subtractions are applied is important because it can result in unintended mathematical errors, specifically in this case double removal of some of the submitted cost elements. We estimate that the impact here is an over-estimate of the reduction in funding required such that Ofgem's conclusion should have been £47.35m rather than £46.67m.

In order to help reduce the likelihood of such issues, NGET would be willing to fact check for accuracy a final version of consultation documents just before they are formally published.

7.0 Next Steps

For the reasons set out in this letter, we do not agree with Ofgem's cost assessment as set out in the Draft Determination. We look forward to engaging further with Ofgem on the appropriate allowances in respect of North Wessex Downs in order that an appropriate direction under SpC3.10 can be given in due course. For the avoidance of doubt, we also do not agree with the proposed allowances set out in the Draft Direction in Appendix 1 to the consultation.

Confidentiality

We confirm that this response can be published on Ofgem's website. For avoidance of doubt, Appendix 1 is confidential and should not be published along side this response.

Yours sincerely,

[By email]

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