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Dear Evan,

Response 2 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 follows on from NGET's initial response dated 15 December 2023.

As part of NGET's initial consultation response discussions, Ofgem agreed that it would supply evidence of where the 7.5% cap on risk had originated from. Once Ofgem supplied this evidence, Ofgem agreed that an additional response could be provided on the subject. On 6 February 2024, Ofgem supplied a spreadsheet called: 'Analysis_Risk_allowance_as_percent_of_other_direct_cost_allowance'. Ofgem has given NGET until 9 February 2024 to further respond. This second response is therefore focusing on risk.

The spreadsheet as provided was very heavily redacted, however NGET has been able to populate some columns from information published during the RIIO-T2 price review process. There are seven key issues that we can see.

1. Is this the correct spreadsheet?

Paragraph 5.28 of Ofgem's Draft Determination states (with our highlight added):

> *"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."*

The spreadsheet provided includes 283 projects with risk percentages. Of these, we have been able to populate 196 with Output Delivery Years. Of these, just two have Output Delivery Years in RIIO-T1. Both were 2021 which means that it is unlikely that Ofgem would have had 'outturn risk' on those projects at the time of Final Determination. RRP21 was submitted on 31 July 2021; Final Determinations were published on 8 December 2020.

Furthermore, the 'RIIO-2 Final Determinations Electricity Transmission System Annex' (dated 8 December 2020) refers to historical risk and contingency costs and states:

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Risk and Contingency Costs

3.21 When setting out their LR and NLR capex project cost forecasts, it is prudent for ETOs to include an additional amount, known as risk and contingency, to cover events outside of their direct control, e.g. significantly adverse weather, failure of suppliers to meet their contractual commitments, or late delivery of key components. Historically, these costs have tended to range from 5 – 25% of the final cost of a project, with a median close to 10% of the final cost.

The spreadsheet provided contains a range of 0-20% and a median of 8.6%.

2. Relevance of analysis to NGET projects

Now that the spreadsheet has been provided, we can see that all the input data is associated with Scottish ETO projects; there are no NGET projects. We know that ETOs submitted cost splits in a different way as part of the RIIO-T2 price control review process (via the Business Plan Data Template, BPDT), so it is not apparent that the spreadsheet (and hence the 7.5% cap) is relevant to NGET.

3. Failure to reflect NEC contract terms

As stated in our initial response, all NGET projects with a risk register have a review that 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 for reaching its 'minded to' position (as published on 17 November 2023) 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. Applying this cap inconsistently with its derivation would be an error therefore, unless Ofgem can provide evidence to the contrary, we believe that Ofgem should include the contractor risk and contingency value in the direct cost of the project, and assess NGET's risk register separately.

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

4. The use of an average risk % as a cap is mathematically wrong

It is mathematically wrong to use an average as a maximum because it will systematically result in the allowances being lower than Ofgem's assessed efficient level. To illustrate this point, NGET have used the spreadsheet provided by Ofgem titled 'Analysis_Risk_allowance_as_percent_of_other_direct_cost_allowance' to complete our own analysis of the data. It can be seen from Figure 1 that the allowed risk across all 283 projects ranged from 0% to just under 20%:

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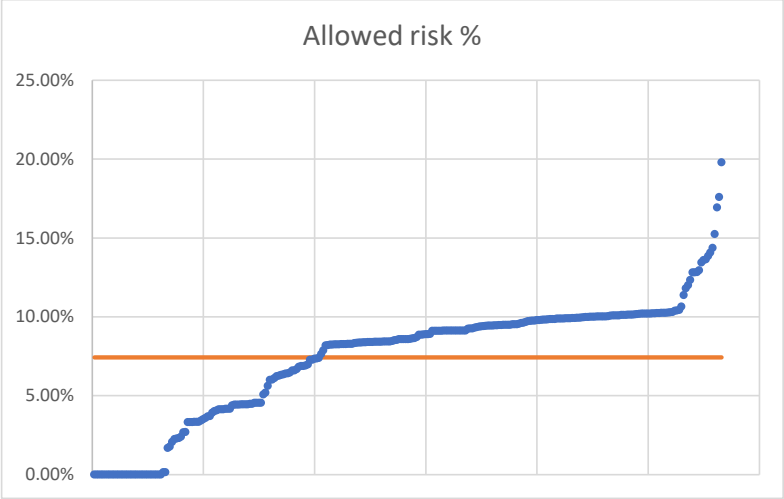

Figure 1. Spread of allowed risk making up Ofgem's 7.5% cap

The average of the above is 7.43%. By taking this percentage and using it as a maximum allowed percentage (as a cap), as though the above population of projects were being considered as re-openers, the average allowed risk would then be 5.95% (i.e. less than the level that Ofgem has defined as efficient). This is illustrated in Figure 2:

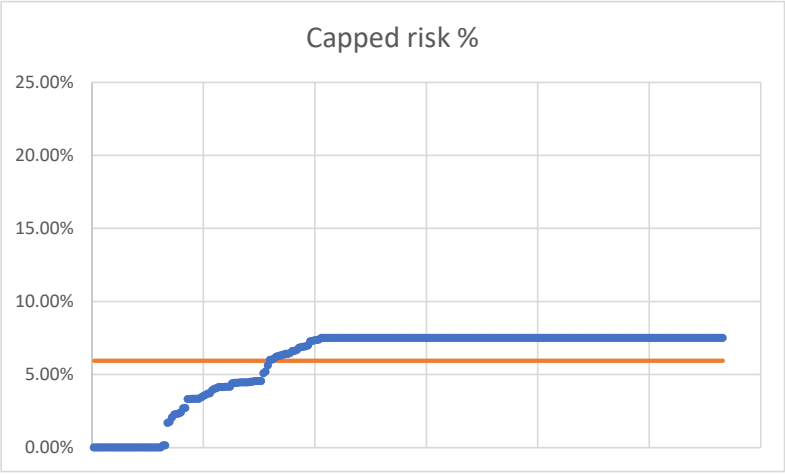

Figure 2. Effect of capping risk at an average

It does not matter what numbers are used, nor the number or type of projects; this will always be the case mathematically.

5. The calculated average risk % includes a number of data rows with costs but zero risk

Looking at Figure 1, it can be seen that a number of data rows have zero risk. From what we can piece together from publicly-available information, the data rows with zero risk are not projects that construct assets. The majority are provisions for pre-construction, plus there are rows of forecast spend for 'Servitudes', 'Community Fund T2' and 'Injurious affection'; they are 'non-asset' spend. These are therefore outliers not relevant to an assessment of project risk and should be excluded from the calculation. Removing all data rows with less than 0.5% risk (circled in red below) as outliers results in an average risk percentage of 8.4%:

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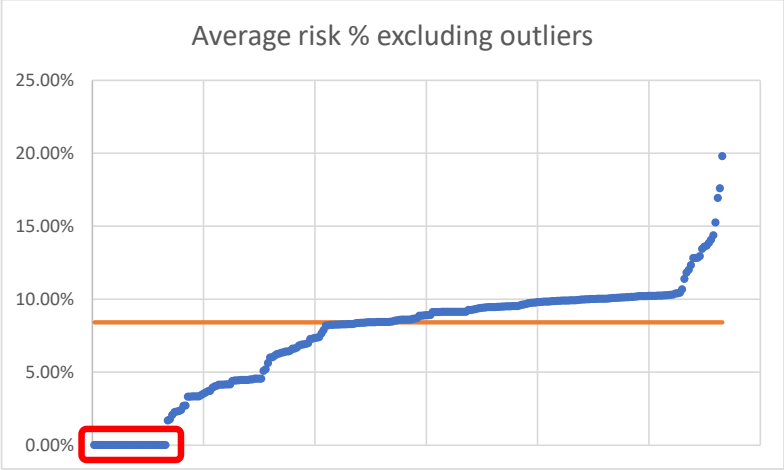

Figure 3. Effect of removing low outliers (i.e. those with <0.5% risk)

6. The calculated average risk % does not appear to include 'similar projects'

Paragraph 5.28 of Ofgem's Draft Determination states (with our highlight added):

> *"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."*

Looking at the spreasdsheet provided by Ofgem and adding publicly-available information, we cannot see any 'similar projects' in the data set. The closest projects we can identify are refurbishment or replacement of existing cables:

Project Name	Scheme Type
BRAEHEAD PARK-ERSKINE 132kV CABLE MAJOR REFURBISHMENT	Refurbishment - Major
GALASHIELS-HAWICK 132kV CABLE MAJOR REFURBISHMENT	Refurbishment - Major
PORTOBELLO-SHRUBHILL 275kV CABLE MAJOR REFURBISHMENT	Refurbishment - Major
SPD Driven 33kV Board Replacement (Cable Portion)	Replacement
Gorgie-Telford Road 132kV cable replacement	Replacement
N/r Diversions	Replacement
Redmoss - Clayhills Cable Works	Replacement
Elmwood - Glenagnes Cable Works	Replacement

The North Wessex Downs VIP project is different in the following ways:

1. It is an NGET project (not a Scottish ETO project) and we are aware that costs were stated differently as part of the T2 BPDT
2. It is new build (not replacement or refurbishment of an existing cable route)
3. It is a 400kV transmission circuit (not 275kV and below)
4. It is in a National Landscape (Area of Outstanding Natural Beauty) and adjacent to a known site of archaeology

We cannot identify all the project titles though, so please can Ofgem let us know if any of the Ofgem Scheme References are associated with new build 400kV cable projects?

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7. The calculated average risk % is based on total allowed spend, not T2 allowed spend

It is not clear from the heavily redacted spreadsheet whether the risk percentage is a percentage of the total project cost (i.e. all price control periods) or just the T2 portion however the format matches the BPDT template tab C2.2a_Scheme_Summary_CI. This collated 'Total Scheme Costs by Nature', i.e. not just the T2 portion. It would also be logical for the risk and contingency to be considered as a percentage of the total project cost because risk was not requested to be phased over price control periods. Therefore, we assume that the 7.5% is a percentage of total project costs. Please can Ofgem confirm if this is correct?

Based on this assumption, Ofgem has applied the 7.5% 'cap' incorrectly because it has only been applied based on T2 costs. For the purposes of testing whether the risk percentage is typical, Ofgem should take into account T1 and T3 costs in order to be consistent with its own methodology.

Conclusion

Due to the contracting strategy that has been chosen to be best value and lowest risk for consumers, Ofgem should allow the Contractor's risk and contingency as committed direct capex. We do not believe that it is correct to apply a risk cap of 7.5% to ETO risk for the reasons stated above however, if Ofgem is to persist with this approach, Ofgem should also include the T1 and T3 spend in the denominator in order to be consistent with the derivation of the risk benchmark.

Based on this and our previous response, we believe that the table below reflects the mathematically correct funding outcome.

Classification	Activities	NGET submitted costs	Ofgem proposed adjustments	Ofgem assessed efficient costs	NGET proposed T2 funding	NGET comments
Indirect	NGET – programme costs	0.64	-0.64	-	-	NB These figures include T1 and T3 costs
Indirect	NGET – project delivery costs	7.57	-7.57	-	-	NB These figures include T1 and T3 costs
Direct	Third party development costs	0.63	-0.63	-	0.63	These are T1 costs
Direct	NGET – Network operational costs	0.25	-	0.25	0.25	
Direct	Contractors' costs	64.57	-9.72	54.86	62.66	Based on reclassification of Contractor Directs per NGET consultation response 15Dec23*
Direct	Contractor's risk and contingency	2.46	+1.66	4.11	2.46	Value of risk & contingency transferred to contractor on a fixed price basis therefore should be funded as Direct
Direct	NGET risk and contingency	4.80	-4.79	0.02	4.80	
	Project total	**80.93 (Gross)**	**-21.69**	**59.24**	**70.80 (Direct)**	
Deduction	RIIO-T1 expenditure	-1.61	N/A	-	-0.00	Per 15Dec23 consultation response, NGET disagrees with disallowance of RIIO-T1 expenditure
Deduction	Existing RIIO-T2 volume driver allowances	-13.24 (Gross)	N/A	-11.46 (Direct)	-11.46 (Direct)	
Deduction	RIIO-T3 expenditure	-4.86	N/A	-1.11	-1.11 (Direct)	Indirect costs already deducted above
Direct	**RIIO-T2 re-opener allowances**	**61.22**	**-21.69**	**46.67**	**58.23**	Includes RIIO-T1 expenditure
Indirect	RIIO-T2 Opex Escalator				9.83	OE funding at 16.89%
Gross	**RIIO-T2 Funding**				**68.06**	
Gross	RIIO-T3 funding				4.86	Assuming no OE in RIIO-T3
Gross	**Total Project Allowance**				**72.93**	

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* Please note that the definition of contractor indirects is still being finalised. The figure above is based on NGET's understanding as of 15 December 2023. Once the new definition has been finalised in RIIO-T2 RIGs, this figure will need to be updated.

Confidentiality

NGET confirms that this response can be published on Ofgem's website.

Yours sincerely,

[By email]

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