National Grid Electricity Transmission
RIIO-T1: Initial Proposals consultation response
Supplementary information –
RIIO-T1 costs to deliver RIIO-T2 outputs

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Context

1 Our March 2012 business plan submission delivers the outputs agreed for RIIO-T1. Rather than limiting our forecast to the RIIO-T1 period, we also focussed on the longer term and considered delivery of the necessary primary outputs in RIIO-T2 such that the Gone Green scenario (which runs out to 2030) could be achieved.

2 This is consistent with the RIIO handbook which states that "we expect the network companies to focus on the longer term and consider whether it is appropriate to include costs in their business plans that are related to delivery of primary outputs in future price control periods and to long-term value for money" [RIIO handbook, paragraph 6.27]. The handbook goes on to state that "Assuming the network company presents a well-justified case for including such costs in the price control for the forthcoming period, providing coherent and comprehensive evidence to support the case, we expect to include costs of this type in the price control" [RIIO handbook, paragraph 6.28].

3 Our submission included a forecast spend of £462m during RIIO-T1 associated with the timely delivery of connection and reliability outputs during RIIO-T2[1]. This figure is broken down in table 1 below, and the investment costs and associated RIIO-T2 outputs are listed under the Gone Green scenario.

Table 1 – RIIO-T2 costs and outputs

Output Category	£m	RIIO-T2 Outputs	
Connection: Local entry (enabling) works	242.7	[text deleted]	2,000MW
		[text deleted]	165MW
		[text deleted]	3,600MW
		[text deleted]	3,340MW
Connection: Local exit works	184.8	[text deleted]	
		[text deleted]	
		Post-2020 Infrastructure	
Reliability: Wider works	34.4	Boundary 14e	200MW
		Pre-construction work for the new Grimsby West – Mumby – Walpole overhead line route	

[1] The figure of £462.0m is associated with expenditure that delivers outputs that are fully within RIIO-T2 and has been used by Ofgem in their assessment. This figure does not include outputs that straddle price controls and this is important due to the baseline proposed being higher than the 'Best View'. For the purposes of the 'Best View', the additional WIP value for outputs that straddle RIIO-T1 and RIIO-T2 for local entry (enabling) is forecast to be £149.8m. This can be compared to the uncertainty mechanism adjustment of £153.2m (using NGET's revised zonal UCAs).

4 In their Initial Proposals, Ofgem has stated that they have disallowed £462m of expenditure associated with the delivery of outputs in RIIO-T2 but have not explained why. Unlike the previous price control arrangements, Ofgem has not proposed a specific mechanism to fund expenditure that is required in RIIO-T1 to deliver outputs in RIIO-T2. Again, they have not explained why, but have proposed that any expenditure in this category would be reviewed as part of Ofgem's assessment for the next price control (RIIO-T2) on "the principle that NGET is fully remunerated, on a cost neutral basis for the efficient costs of delivering the RIIO-T2 outputs" ['Cost assessment and uncertainty Supporting Document', paragraph 4.35].

5 Ofgem go on to state that they "have looked at the potential level of works for RIIO-T2 outputs that NGET might be required to start in the latter years of RIIO-T1" and that they "consider that the potential level of such works would be fairly modest relative to NGET's overall asset base". Ofgem do not provide any further details of this assessment. Elsewhere in their Initial Proposals, Ofgem state that their 'Best View' of expenditure is based on the Gone Green scenario ['Cost assessment and uncertainty Supporting Document', paragraph 3.14]. As shown above, our forecast for the Gone Green scenario is that the expenditure required in RIIO-T1 to deliver outputs in RIIO-T2 is £462m. This is over 14 times greater than the effective materiality threshold that Ofgem have proposed for other uncertain costs (1% of average forecast base revenue following the application of the efficiency rate of 48% is approximately £30m). Ofgem have not explained the reason for this inconsistency in proposed treatment.

6 Ofgem "do not anticipate this [their proposals] would have any significant implications for NGET in terms of its cash flow or credit ratings to warrant any measures in addition to the totex sharing factor ahead of the efficiency assessment at the next price control" [Cost assessment and uncertainty Supporting Document, paragraph 4.37]. Ofgem has not provided any further details of this assessment and have not mentioned the potential charging volatility consequences. It appears that these costs have been excluded from Ofgem's assessment of NGET financeability.

7 During discussions with Ofgem that have taken place since the publication of Initial Proposals, they have indicated that they are open to the inclusion of a mechanism to fund spend which is required in RIIO-T1 to deliver outputs in RIIO-T2.

Base funding allowance

In this section, we set out the case for a base funding allowance in RIIO-T1 for outputs delivered in RIIO-T2, consistent with the Gone Green scenario.

8 There is considerable uncertainty around the level and type of new generation that will connect to the transmission system during the RIIO-T1 period. Ofgem state that their 'Best View' of the level of expenditure is based on the Gone Green scenario.

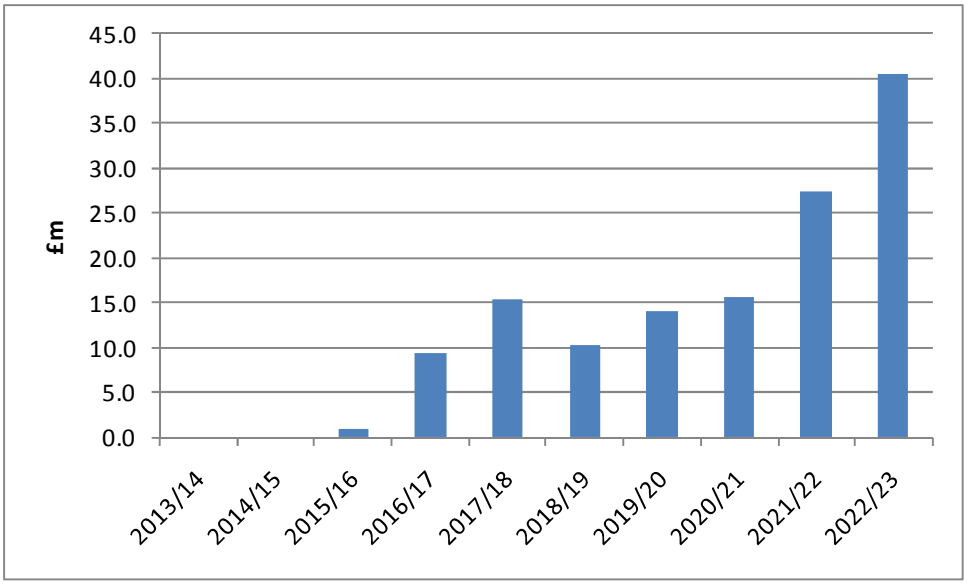
9 The provision of a RIIO-T1 base funding allowance as set out in our business plan would be consistent with the Gone Green scenario, and would therefore ensure that the essential work required in RIIO-T1 to deliver outputs in RIIO-T2 is funded. This will ensure that this work can be completed and the associated outputs (described in Table 1 above) can be delivered in a timely way.

10 This approach would be consistent with the RIIO principles as described in the RIIO Handbook. This is the best way to ensure adequacy of cash flow and credit ratings for NGET during the RIIO-T1 period and to maximise charging stability.

Charging volatility assessment

11 During our extensive RIIO-T1 stakeholder engagement activities, charging predictability, transparency and stability emerged as significant concerns, particularly amongst suppliers.

12 Given that Ofgem's 'Best View' of expenditure is based on the Gone Green scenario, we have estimated the within-period increase to our base revenue that will now be required if the Gone Green scenario outturns. These changes will come about as a result of the application of the efficiency incentive rate to our apparent RIIO-T1 overspend. The results of this assessment are shown in the graph below.



13 This will obviously impact directly on customer charges. Whilst the two-year delay associated with the operation of the efficiency incentive rate will allow charges to be predicted during the year ahead of the charging year, these changes will have a detrimental impact on the stability of customer charges.

Financeability

14 Ofgem argue that expenditure in this category will be reviewed as part of Ofgem's assessment for the next price control (RIIO-T2) "on the principle that NGET is fully remunerated, on a cost neutral basis, for the efficient costs of delivering RIIO-T2 outputs". This statement ignores the cashflow risk that this represents prior to the RIIO-T2 price control review.

15 Without an allowance as part of base funding, this represents a significant risk that has not been factored into Ofgem's credit metrics assessment. It is much more significant than the materiality thresholds proposed by Ofgem for other uncertainty mechanisms.

Mechanism

In this section, we set out the case for a mechanism to deal with differences between the base funding allowance and the actual spend in RIIO-T1 for outputs delivered in RIIO-T2. We describe the TPCR4 arrangements and develop an alternative approach for consideration.

16 We disagree with Ofgem's conclusion that the potential level of works completed in RIIO-T1 to deliver outputs in RIIO-T2 is 'fairly modest'. As mentioned above, our forecast for this category for the Gone Green scenario is £462m, which is considerably higher than the effective materiality threshold proposed by Ofgem (approximately £30m) for the re-opener windows associated with other uncertain costs. The implications for NGET in terms of its cash flow or credit ratings of spend in this category is exactly the same as other uncertain costs, such as Critical National Infrastructure.

17 It is also possible that the spend in this category could be considerably higher or lower than £462m. During the preparation of our business plan, we considered a number of different scenarios and our forecast of the spend required in RIIO-T1 for outputs fully delivered in RIIO-T2 for each of these scenarios is shown in the table below.

Table 2 – Forecast of spend in RIIO-T1 to deliver outputs in RIIO-T2

Scenario	Spend in RIIO-T1 to deliver outputs in RIIO-T2 (£m)
Slow Progression	712
Gone Green	462
Accelerated Growth	429

18 Our Gone Green scenario has a significant volume of generation (6GW) connecting to the England and Wales network in 2020/21, the last year of the RIIO-T1 price control. It is possible that due to the complexities of project delivery, including offshore development and the progress of new nuclear connections, the commissioning of a proportion of these schemes is delayed into the RIIO-T2 period.

19 We understand that Ofgem are seeking to link all RIIO-T1 costs with the outputs that are delivered for customers within the period. We share this aim, but clearly this is not possible for spend which is required to deliver outputs in RIIO-T2.

20 In order to address this issue, we have described a number of competing mechanism options below.

TPCR4 arrangements

21 The RPI-X arrangements included a mechanism to deal with expenditure in the TPCR4 period for the delivery of outputs in subsequent price controls. This mechanism is described below.

22 In TPCR4, allowances were adjusted for the volume of zonal additional generation entry capacity, the volume of zonal surplus (or deficit) and the amount of transfer capacity between Scotland and England differing from the deemed baseline or base scenario

values. The capital expenditure allowance in the Transmission Licence was adjusted by the term LVn which included a term for work in progress, LVWIPn. The work in progress term was for expenditure in the TPCR4 period expected to deliver outputs in the next price control periods.

23 The inclusion of the LVWIPn term in the calculation of LVn meant that in the subsequent calculation of capital expenditure incentive revenue adjustment, CxIncRAt:

(a) an allowance was provided for the depreciation and return associated with work in progress expenditure; and

(b) the work in progress costs were subtracted from any overspend such that work in progress did not form part of the TPCR4 efficiency incentive arrangements.

24 The value of work in progress was not automatic, and took the value zero unless otherwise directed by the Authority.

25 These arrangements allowed Ofgem to review the efficient cost of delivering outputs in the next price control at the next price control review. The work in progress spend against these projects could then be compared with these efficient costs and the difference (which could potentially be negative) could be included in the base funding for the next price control review.

Re-opener arrangements

26 An alternative approach would be to include re-opener arrangements for work completed in RIIO-T1 to deliver outputs in RIIO-T2. The use of these arrangements could be limited with a materiality threshold and the specification of re-opener windows.

27 During the re-opener windows, we would set out forward-looking forecasts of expenditure (that meet the materiality threshold) and the outputs that would be delivered. We would expect this process to be similar to that proposed by Ofgem for Strategic Wider Works projects.

28 The main issue with this approach is likely to be the level of resource required to assess applications during the price control period. In extreme circumstances, this may risk the late delivery of generation connections.

Unit cost allowance based arrangements

29 When we reach the end of the RIIO-T1 period, we will have forecast RIIO-T2 completion dates for the work in progress projects.

30 We will be able to count back to 2020/21 and calculate an allowance adjustment for the RIIO-T1 period based on the relevant unit cost allowance spend profile.

31 For example, if we have a 1000MW generation connection which is forecast to complete in 2022/23 and the relevant generation connection unit cost allowance is £30/kW with a four-year spend profile of 10%/20%/30%/40%, then the allowance adjustment at the end of RIIO-T1 would be:

1000,000kW × £30/kW × [10%+20%] = +£9m

Mechanism conclusions

32 Our preference would be for arrangements similar to the work in progress arrangements in place for the TPCR4 period. A work in progress mechanism would give clarity on the funding arrangements for expenditure that we will have an obligation to spend in order to deliver outputs in RIIO-T2 in a timely way. This mechanism also allows Ofgem to ensure that the allowances for the delivery of outputs in RIIO-T2 are efficient and take account of any spend from RIIO-T1.

33 If Ofgem do not support this mechanism, then the unit cost allowance based arrangements could be used. This mechanism sets an allowance for the work completed in RIIO-T1 to be calculated automatically based on the unit cost allowances, thus minimising the administrative burden.

34 Whilst the re-opener arrangements could also be used, the potential number of projects that could be initiated in RIIO-T1 for the delivery of outputs in RIIO-T2 is likely to make this approach administratively burdensome.

Conclusions

35 Disallowing our forecast of spend in RIIO-T1 to deliver outputs in RIIO-T2 and removing the TPCR4 arrangements to deal with this category of spend is not acceptable because it will reduce the stability of customer charges and expose National Grid to a significant cashflow risk before the RIIO-T2 price control review, which has not been factored into Ofgem's financeability assessment.

36 We have calculated the potential charging instability issues caused by the disallowance of base funding for this category of expenditure. Our preference would be for a base funding allowance, consistent with the RIIO Handbook, but in any case it is crucial that this category of expenditure is correctly modelled as part of Ofgem's financeability assessment.

37 We have presented a number of competing mechanism options which would address our mechanism concerns and we recommend a mechanism similar to that used in TPCR4.