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27 September 2021

Opex Escalator – Statutory Consultation on Licence Changes (Special Condition 3.36)

Dear Mark,

This response is provided on behalf of National Grid Electricity Transmission (NGET).

Summary

During the RIIO-T2 process, NGET raised concerns with the formulation and application of the Opex Escalator that were not addressed. We welcome the fact that Ofgem now recognises the problems associated with the Opex Escalator and the underlying CAI assessment methodology but have the following concerns.

1. There is not enough information contained with the consultation for consultees to respond adequately. The issue is not fully explained, nor is the root cause, and nor is the proposed alternative method for assessing operating costs.
2. We are concerned that this consultation offers an incomplete resolution. The resolution proposed does not seek to address the underlying errors on which this Licence condition is based; it merely addresses the symptoms observed by Ofgem for one category of investment funding. (However, referring back to point 1, evidence of these observed symptoms has not been shared with all impacted parties, so we are unable to comment on the veracity of, or factors that may lead to, these observations.)
3. It seems likely that other consultations to deal with the shortcomings of the Opex Escalator are likely to arise if this change is made without addressing the root cause. However, change undermines confidence in the stability of the price control framework and it may be preferable to make no change rather than enact a partial fix.
4. Having assessed how the Opex Escalator was likely to operate over the coming years alongside the treatment of baseline Closely Associated Indirect allowances, we accepted the RIIO-T2 framework in the round; this proposed amendment affects that decision. In making this proposal, it is not clear from Ofgem's documentation that any assessment of the wider implications has taken place. Throughout the development of the RIIO-T2 price control, Ofgem made reference to the interlinkages that exist within the price control framework and how it is not possible to make a change in isolation in one area without considering the resulting implications for other aspects of the price control package. We are of the view that full consideration of these wider impacts is needed, given this is not a separable decision.

We acknowledge that price controls are complex and sometimes pragmatic solutions are required to simplify frameworks. We support the principle of creating an ex ante mechanism for setting the costs of managing capital projects to reduce the administrative burden for Ofgem and improve transparency for Licensees. However, we feel that this is a more substantial issue than the consultation suggests – and there is no evidence presented to dispute this.

We therefore request that Ofgem undertakes further consultation on these proposals, and one of the options to be considered should be to retain the status quo; we look forward to being party to these discussions. Alternatively, we believe that the proposed modification to Special Condition 3.36 should be rejected and not proceed so as not to change the basis upon which we accepted the RIIO-T2 framework; this is not a separable decision.

We explain our concerns in more detail in the attached Annex.

Confidentiality

I confirm that this response can be published on Ofgem's website.

Yours sincerely,

Hêdd Roberts [by email]
Director of Regulation, NGET

ANNEX: Detailed response

The underlying errors in the Opex Escalator relate to the separation of total investment costs into direct and indirect costs for separate assessment in determining allowances, and the approach taken to determine Closely Associated Indirect (CAI) Allowances. Our concerns regarding these errors were set out in our response to Ofgem's consultation on RIIO-2 Draft Determinations (for example, in our response to Question 11, page 41 of the NGET Annex, and in our response to Question 16, page 138 of the NGET Annex).

Our concerns regarding this statutory consultation on the proposal to make changes to the Opex Escalator are set out over the following points. Our response includes an explanation of how Ofgem's approach to cost assessment is flawed, and hence why it is important to correctly consider total investment costs when reaching a funding decision.

1. <u>There is not enough information provided in the Consultation for stakeholders to respond</u>

Ofgem's published documents contain just two paragraphs under 'Reason and effects' to explain the proposed change that is being consulted on. From those documents, it appears that Ofgem has reached the conclusion 'that the bespoke nature of LOTI projects makes them unsuited to a mechanistic CAI/NOC uplift' on the basis of a single LOTI project (the Shetland HVDC Link Project) within less than six months of the new RIIO-T2 framework coming into force. Only Ofgem and SHET are party to the details of the issues that have been uncovered with respect to that project. Neither the statutory consultation notice nor the Opex Escalator Licence Amendment document that it refers to explain either the problem with the Opex Escalator that the proposed Licence modification is seeking to address (for example does the Opex Escalator provide too much funding or too little with respect to LOTI projects?) or the root cause of such problem. Furthermore, Ofgem has not provided an impact assessment of the wider consequences of the proposed change, nor explained what the alternative cost assessment approach will be for LOTI projects if this proposed modification is implemented. In the interests of transparency and ensuring effective consultation, Ofgem should provide such additional information for consultees to consider as part of their statutory consultation responses. (Recognising that SHET's cost data is commercially confidential, it may be necessary for this to be done using illustrative examples.)

Given that such information has been omitted from the statutory consultation notice, we are unable to adequately respond to this consultation. We cannot support this change until we are provided with sufficient information in order to understand the issue (including the root cause) that the modification is seeking to address and how Ofgem will determine CAI/NOC funding for LOTI projects in future (and hence the materiality of the proposed modification on the wider price control).

We therefore request that Ofgem undertakes further consultation on these proposals and we look forward to being party to these discussions. In the meantime, as we have not seen the detail of the Shetland HVDC Link Project, please can Ofgem clarify what these atypical costs are in order that we can consider how often they will be seen in other major projects and whether they were indeed "*not present in the historical capex programme and associated CAI costs that our RIIO-ET2 baseline allowances were predicated on*".

2. <u>This consultation offers an incomplete resolution</u>

In determining RIIO-T2 baseline allowances for capital investments, Ofgem has separated an investment into direct and indirect costs. Direct costs are defined as those costs incurred in undertaking activities which involve physical work on high voltage network assets, i.e. installing the asset, whereas indirect costs include network design and engineering, planning, procurement, project management and engineering management and clerical support.

Ofgem has then added these to Licensees' operational indirect costs and carried out a regression based on Modern Equivalent Asset Value (MEAV) as a measure of the size of asset base, capex as a measure of the planned investment and totex as a measure of size and scope of the licensee.

There are at least three ways in which Ofgem's treatment of CAI costs for RIIO-T2 is flawed. The following three points reflect the situation for NGET; we cannot confirm if the position is the same for other Licensees.

- *Merging of opex and capex in the CAI regression*

The fact that the regression modelled total indirect costs (capitalised and operational) means that the CAI element of the Opex Escalator gives (or takes away, when operating to claw back allowances for under-delivery) a proportion of indirect operational expenditure as well as the element of capitalised indirect cost that is traditionally associated with delivering a project. Therefore, when this is compared to the capital costs set out for a project in a re-opener submission, it will look like it is giving too much because we do not include an estimate for indirect operational activities (such as having an asset management function). However, this is offset by the fact that baseline allowances were set in the same way and therefore, every time the allowed unit cost associated with an undelivered Deliverable is clawed back, that will also take away some of our indirect operational allowances.

For example, if the large volume of customer-related work now associated with the UK Government's targets of 40GW of offshore wind generation by 2030 and 'net zero' by 2050 impacts our ability to deliver asset replacement as originally envisaged, every undelivered asset intervention (replacement, refurbishment, etc) covered by a PCD will result in a reduction in indirect operational cost allowances for our asset management function – even though we still have the same size of asset base. The difference between baseline allowances for T2 PCDs and what would be clawed back based on allowed unit costs that were calculated using the Opex Escalator is £24m, i.e. the Opex Escalator claws back an extra 1.3% (effectively from our indirect operational cost allowances) even though our asset base remains the same size.

We previously advised Ofgem that we did not believe this was correct, but no changes were made as a result and we accepted the RIIO-T2 deal in the round.

- *Realistic ability to consistently split direct and indirect costs*

Throughout the RIIO-T2 submission process, from the earliest stages of BPDT design, the Licensees explained that the ability to split direct and indirect costs was dependent on the delivery model chosen (in-house delivery, external delivery by contractors or a hybrid delivery model) and therefore this new approach for RIIO-T2 would yield inconsistent results. Indeed, the definitions set out by Ofgem (where contractor project management costs count as direct if not separately invoiced, but indirect if separately invoiced) would automatically result in inconsistent results.

Ofgem now acknowledge this:

"We are also aware that under certain procurement models, particularly those utilised for large atypical projects such as the Shetland HVDC Link Project, it can be difficult to separate out direct and indirect costs. Allowing for a more bespoke assessment of these costs enables Ofgem to take an holistic view of how and where costs are allocated within the project so we can ensure they are not being funded twice."

However, this is not unique to LOTI projects. There are valid procurement reasons for choosing different contracting models for a range of different-sized projects (for example, electing to have a Tier 1 contractor who manages all the subcontractors vs the Licensee taking on the coordination of subcontractors which will increase the Licensee's indirect costs and client-side risk). In seeking the most efficient delivery model to drive value for customers and consumers, Licensees need freedom to choose the best fit for each project and the regulatory framework should focus on the total cost to consumers rather than assessing each element separately and potentially creating unintended regulatory consequences.

- *Consequences of assessing direct and indirect costs separately*

Ofgem's approach to assessing costs separately is mathematically flawed. Below is a hypothetical example showing four projects of identical scope (for example, a substation extension to add a new transformer and associated assets). In each case the total cost of delivery is identical, but the delivery model chosen means that the proportion of direct and indirect cost varies (as the Company retains more responsibility for contractor management in the case of in-house and hybrid models), and the client-side risk varies accordingly (with Companies retaining more risk in the case of in-house and hybrid models).

The way that Ofgem's project assessment process works for T2 is to take the lowest of the submitted and the efficient sector cost (the orange row, which is a weighted average) in each category of direct cost (in this case, Asset and Civils) and then add on the outcome of the regression for indirect costs plus the lowest of the submitted and an average value for Risk & Contingency (taken from a portfolio of projects). The effect of this is shown in the Allowed table below. It can be seen that, although all companies submitted at what would objectively be an 'efficient frontier' cost of £10m, the approach used means that Companies receive a 6-11% efficiency challenge through the allowance-setting process.

Example 1

Submitted	Assets £	Civils £	Indirects £	Risk & Contingency £	PROJECT TOTAL	
Company 1 (EPC contract)	4.7	3.6	1.2	0.5	**10.0**	
Company 1 (EPC contract)	4.6	3.7	1.1	0.6	**10.0**	
Company 2 (in-house)	4.1	2.9	2.0	1.0	**10.0**	
Company 3 (hybrid model)	3.0	4.0	2.2	0.8	**10.0**	
				TOTAL	**40.0**	
Efficient sector cost (assuming volumes of 1 for simplicity)	4.1	3.6	1.6[1]	0.7	**10.0**	
Allowed	**Assets £**	**Civils £**	**Indirects £**	**Risk & Contingency £**	**PROJECT TOTAL**	**%ge of Request**
Company 1 (EPC contract)	4.1	3.6	1.2	0.5	**9.4**	**94%**
Company 1 (EPC contract)	4.1	3.6	1.1	0.6	**9.4**	**94%**
Company 2 (in-house)	4.1	2.9	1.6	0.7	**9.4**	**94%**
Company 3 (hybrid model)	3.0	3.6	1.6	0.7	**8.9**	**89%**
				TOTAL	**37.0**	

In addition, this approach is unstable. If Company 1 now changes their delivery model for their second project from EPC to in-house, they lose £1m of allowances for those two projects while Company 2 gains £0.3m and Company 3 gains £0.1m. Even though the total submitted costs remain at £40m, total allowances decrease by £0.6m. It should be noted that the scope of these projects has not changed.

Example 2

Submitted	Assets £	Civils £	Indirects £	Risk & Contingency £	PROJECT TOTAL	
Company 1 (EPC contract)	4.7	3.6	1.2	0.5	**10.0**	
Company 1 (in-house)	3.5	2.5	2.5	1.5	**10.0**	
Company 2 (in-house)	4.1	2.9	2.0	1.0	**10.0**	
Company 3 (hybrid model)	3.0	4.0	2.2	0.8	**10.0**	
				TOTAL	**40.0**	
Efficient sector cost (assuming volumes of 1 for simplicity)	4.1	3.6	1.6	0.7	**10.0**	
Allowed	**Assets £**	**Civils £**	**Indirects £**	**Risk & Contingency £**	**PROJECT TOTAL**	**%ge of Request**
Company 1 (EPC contract)	3.8	3.3	1.2	0.5	**8.8**	**88%**
Company 1 (in-house)	3.5	2.5	2.0	1.0	**8.9**	**89%**
Company 2 (in-house)	3.8	2.9	2.0	1.0	**9.7**	**97%**
Company 3 (hybrid model)	3.0	3.3	2.0	0.8	**9.0**	**90%**
				TOTAL	**36.4**	

[1] Ofgem's view of an efficient cost for Indirects is generated from regression across the full population of projects submitted in a sector; for the purposes of this illustrative example, an average has been used.

In effect, this approach to setting allowances combines 'lowest of' costs from mutually exclusive delivery models to arrive at unjustified, unpredictable and unstable capex efficiency challenges at total investment level.

3. Stability of regulatory framework

Stability of regulatory frameworks is important for investor confidence, leading to lower costs for consumers (via a lower Cost of Capital). It seems likely that other consultations to deal with the shortcomings of the Opex Escalator are likely to arise if this change is made without addressing the root cause. Can Ofgem please provide confirmation that this change for LOTI is the only one being considered, or will other Special Conditions such as that for Medium-Sized Investment Project (MSIP) re-openers be subject to the same change? If there is a possibility of other re-openers being affected, the materiality of the change in terms of its impact on the overall risk and reward balance that is represented by the RIIO-T2 regulatory framework increases proportionately.

Change undermines confidence in the stability of the price control framework, and it may be preferable to make no change rather than enact a partial fix.

4. Separability of decision (accepting the RIIO-T2 deal in the round)

We acknowledge that price controls are complex and sometimes pragmatic solutions are required to simplify frameworks. We support the principle of having an ex ante mechanism for setting the costs of managing capital projects to reduce the administrative burden for Ofgem and improve transparency for Licensees. We can also see that removing LOTI from Special Condition 3.36 could look like a simple fix to a specific problem arising from Ofgem's assessment of a single LOTI project (which could be an outlier, but we are unable to determine this from the limited information provided in the consultation). However, we feel that this is a more substantial issue than the consultation suggests - and there is no evidence presented to dispute this.

Throughout the development of the RIIO-T2 price control, Ofgem has made reference to the interlinkages that exist within the price control framework and how it is not possible to make a change in isolation in one area without considering the resulting implications for other aspects of the price control package. Specifically, the Opex Escalator term does not operate in isolation; it was derived via the overall mechanistic calculation undertaken by Ofgem in arriving at their view of efficient CAI (Closely Associated Indirect) allowances. It was embedded in the majority of the baseline allowances and allowed unit costs stated in the RIIO-T2 Licence, including those for Price Control Deliverables (PCD).

Therefore, if LOTI projects are removed from the scope of the Opex Escalator, the coefficient ought to be recalculated and amendments made to all affected baseline allowances and Price Control Deliverable values. The Licence terms that would need to be restated include:

- Non-variant allowed load related capex expenditure
- Non-variant allowed asset replacement capex expenditure
- Non-variant allowed other capex expenditure (net of disposals)
- Wider Works Price Control Deliverable
- Baseline Network Risk Output
- Generation Related Infrastructure Price Control Deliverable (NGET only)
- SF6 asset intervention Price Control Deliverable (NGET only)
- Substation Auxiliary Systems use it or lose it allowance (NGET only)
- Instrument Transformer Price Control Deliverable (NGET only)
- Bay Assets Price Control Deliverable (NGET only)
- Protection and Control Price Control Deliverable (NGET only)

- Overhead Line Conductor Price Control Deliverable (NGET only)
- Pre-Construction Funding Price Control Deliverable

We are accordingly of the view that full consideration of the wider impacts is needed because this is not a separable decision. We accepted the RIIO-T2 deal in the round based on our understanding and modelling of the consequences of the Opex Escalator, and it may be better to make no change than to upset the symmetry of the framework.

Conclusion

We therefore request that Ofgem undertakes further consultation on these proposals, and one of the options to be considered should be to retain the status quo; we look forward to being party to these discussions.

Alternatively, we believe that the proposed modification to Special Condition 3.36 should be rejected and not proceed so as not to change the basis upon which we accepted the RIIO-T2 framework; this is not a separable decision.