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Dear James,

SSEN Shetland HVDC Link project – consultation on Project Assessment

This response is provided on behalf of National Grid Electricity Transmission (NGET). Whilst we have no direct interest in the Shetland HVDC Link project, in our role as Transmission Owner (TO) in England and Wales we are bringing forward several projects under the same Large Onshore Transmission Investment (LOTI) re-opener mechanism being used to fund the project.

These LOTI projects are linked to enabling the delivery of the UK Government's targets of 40GW of offshore wind generation by 2030 and net zero by 2050, the meeting of which requires the timely development of a significant amount of onshore works to reinforce the GB electricity network. It is therefore vital that Ofgem works with the TOs to ensure an efficient LOTI assessment process that provides sufficient certainty to the TOs, the energy industry and other stakeholders. It is in this context that we have some general points to make about the approach outlined in Ofgem's consultation on the Shetland HVDC LOTI project. In summary, these are:

- **Disallowance of tendered costs:** We are concerned that Ofgem appears to have disallowed market-tested civils costs based on the application of benchmarks. Market-tested prices resulting from a competitive tender event should therefore take precedence over benchmarking data because they reveal the true market price. This is wrong as a matter of regulatory principle and a troubling precedent for future LOTI submissions.

- **Project Delay Charges:** We remain concerned that the application of one-sided Project Delay Charges linked to consumer detriment will encourage TOs to take an overly risk-averse approach to project programmes and tendering and that they are likely to add significant costs to consumers through far greater Liquidated Damages arrangements with contractors, or even prevent suppliers from participating in our tender events.

- **Approach to risk and contingency:** We welcome Ofgem's proposal to create a new, no-threshold reopener mechanism to cover Covid costs, but we consider this should apply to all high impact, low probability and difficult to quantify risks under the Cost and Output Adjusting Event (COAE) mechanism. Applying a 10 per cent materiality threshold to these risks without any upfront funding leaves TOs with a significant degree of exposure to risks that are generally beyond their control. As a principle this is unacceptable; where TOs are exposed to a risk this must be funded, either ex ante through contingency, or ex post if it eventuates. It is also unacceptable to disallow all interface risk given that interfaces are an inherent feature of multi-contract procurement approaches, regardless of the extent of project management resource funded. Ofgem's approach disincentivises the use of multi-contract approaches, which may often offer significant benefits to consumers relative to single-supplier turnkey arrangements.

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Taken together, we are concerned that Ofgem's position undermines confidence in the LOTI mechanism, at a time when certainty over the regulatory regime for these investments is critical to deliver the UK's decarbonisation ambitions. We explain our concerns in more detail below.

Disallowance of tendered costs

Ofgem appears to propose disallowing a significant portion (£12.4m) of tendered costs for civils activities (environmental mitigation, temporary platform and compound and site enabling and access works) based on comparison against benchmarks. Unless Ofgem finds fault with the tendering process itself or believes the scope is not justified – neither of which appear to be the case on the face of the consultation document – we consider this to be wrong as a matter of regulatory principle and a troubling precedent for future LOTI submissions.

Benchmarks, whilst being a useful tool to compare and scrutinise estimated costs, are necessarily an average, which cannot fully take account of project-specific issues, especially given the relatively small cohort of similar or comparable projects as the LOTI projects. Market-tested prices resulting from a competitive tender event should therefore take precedence over benchmarking data because they reveal the true market price, based on the specific issues involved.

In undermining TO confidence that market-tested elements of cost submissions will be fully met, the disallowance of market-tested prices lends weight to our concerns that contracts should not be finalised until after the Project Assessment phase of the LOTI process, contrary to Ofgem's expectation that contracts can be entered into after Final Needs Case approval.

Large Project Delivery (LPD) mechanisms

Ofgem intends to apply a Project Delay Charge to the Shetland Link project. We recognise the need to incentivise the timely delivery of projects to minimise the risk of delay and consequent costs to consumers. However, we have previously made clear our concerns that Project Delay Charges linked to consumer detriment could encourage network companies to overcompensate and take an overly risk-averse approach to project programmes and tendering, given that the charges are likely to significantly exceed existing Liquidated Damages arrangements with contractors. RIIO-T2 is intended to be a 'low risk – low reward' price control and one of the few levers TOs have to adopt is to de-risk project programmes, including for key net zero investments, with a likelihood of project delays as a result.

Seeking high Liquidated Damages from suppliers will likely significantly increase tendered costs and may also limit the number of suppliers willing or able to compete. Some suppliers may not gain internal approval to participate due to the level of exposure expected. This would risk suboptimal procurement events that would potentially further increase costs, or even mean that competitive tender events are not possible at all, especially in view of the buoyancy of the European and global markets in which our suppliers operate.

With respect to the Shetland Link project specifically, it is concerning that Ofgem appears to be seeking to apply the penalty after main works contracts have already been signed, giving the TO no ability to factor the charges into its contractual arrangements. This is unacceptable, and further demonstrates why it is necessary to obtain Project Assessment approval (the point at which Ofgem determines any delay penalties) prior to entering into contracts.

We are also concerned that the date after which the penalties apply appears to be the same as the intended delivery date, leaving no float. Again, this approach will incentivise TOs to set risk-averse Earliest in Service Dates (EISDs) for future projects. If delay charges are to apply, there should be recognition that, in aiming to meet an optimal EISD, delays may be possible due to the many delay risks likely exist, especially if TOs are not funded to manage some of these risks.

Ofgem also intends to disallow £1.1m of early completion incentives. This approach compounds the above concerns because such incentives are likely to be a key tool in ensuring that contractors complete works on time. Further, for LOTI projects required to reinforce the network to enable the delivery of the UK Government's targets of 40GW of offshore wind generation by 2030, there is likely to be significant consumer benefit in early delivery through avoided constraint costs, and therefore a very clear consumer case for these incentives.

Cost and Output Adjusting Event (COAE) treatment

We welcome Ofgem's proposal to create a new, no-threshold Cost and Output Adjusting Event (COAE) mechanism to cover Covid costs. This should act as a model for the treatment in the LOTI mechanism of all 'high impact, low probability' (HILP) and 'difficult to quantify' risks outside of the control of TOs, especially in view of the low risk – low reward nature of the T2 price control.

Ofgem's approach to setting a materiality threshold – 10% in the case of Shetland Link, equating to £62.9m of exposure before the Totex Incentive Mechanism sharing factor is applied – on the treatment of such costs (other than for Covid costs), without providing any ex ante funding, means that TOs bear significant risk outside of their control with no commensurate allowance. This is clearly inconsistent with Ofgem's previously stated principles for COAE, which are that 1) consumers should not unnecessarily pay for risks which are highly unlikely to eventuate or are difficult to robustly quantify before they occur; and 2) TOs should have comfort that if a high impact risk, beyond its control occurs, it will be funded for efficient costs.

Ofgem should either 1) provide a no-threshold COAE reopener for HILP and difficult to quantify risks, to be defined on a project-specific basis, or, if that approach is unacceptable, 2) provide ex ante funding for the COAE risk on a P50 confidence basis, which would result in relatively low contingency values given the low probabilities and low minimum and most likely values, in combination with a COAE threshold. Ofgem's current approach leaves TOs with an unacceptable degree of exposure to risks that are generally beyond their control.

Interface risk and implications for contract strategy

We are also concerned that Ofgem proposes to disallow all interface risk on the basis that adequate project management costs are provided, which in Ofgem's view would significantly reduce the likelihood and potential impacts of these risks. Whilst there is an interaction between the level of project management resource and the ability to manage interface risk, no level of project management resource will fully mitigate interface risk, and it is therefore wrong in principle to disallow it in its entirety. Interfaces between contractors are an inherent feature of a multi-contract approach, and, by not funding interface risk as a matter of principle, Ofgem will disincentivise TOs from using such an approach in favour of single-supplier Engineering Procurement Construction (EPC) turnkey contracts. In some circumstances, EPC may be the optimal contract strategy, but, where a multi-contract approach might offer better value for consumers, Ofgem's approach discourages TOs from pursuing such an approach as its likely costs will not be fully met. It is also possible that the market may be unable to offer a single-supplier EPC turnkey.

Opex escalator

Contrary to the T2 Final Determination, Ofgem confirms that it does not intend to apply the Opex Escalator to closely associated indirect (CAI) costs and network operating costs (NOCs) on LOTI projects, including Shetland Link. These costs will be assessed project-by-project under the LOTI reopener. We have responded separately to Ofgem's consultation on changing the licence to facilitate this. In summary, we do not consider it appropriate to 'cherry pick' elements of the RIIO-T2 settlement for revision without assessing the broader impact of these changes in the round. We therefore do no support these licence changes in isolation.

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Confidentiality

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

Yours sincerely,

[By email]

Hêdd Roberts

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