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Dear Duncan,

Proposed Directions to fund SGN's LTS Futures project

Thank you for the opportunity to respond to the above-mentioned consultation. This response is provided on behalf of National Grid Gas Transmission (NGGT), and I confirm that it can be published by Ofgem as required.

The consultation seeks views on the wording of the draft directions to SGN and NGGT to implement Ofgem's decision to fund the SGN LTS Futures project through the RIIO-2 Net Zero Pre-Construction Work and Small Project Re-opener.

In summary, our view is that the directions should clarify how general inflation is to be treated for the purposes of the funding distributions to ensure parity between the amounts transferred to SGN by NGGT, and the amounts that NGGT will recover through transportation charges. The background and our proposed solution to this is explained in further detail in the annex that follows.

If you have any questions or comments or would like to discuss any aspect of this response in further detail, my contact details are provided above.

Yours, sincerely,

[by email]

Craig Neilson
Future Regulatory Frameworks Manager

Annex: Distribution of funds to SGN in nominal terms

Annex 1 of both draft directions show an expression of funding to SGN in 2018/19 prices. These reflect the values that will be input into NGGT's Price Control Financial Model (PCFM) for the purposes of setting allowed revenue and transportation charges in respect of funding for the project. The PCFM will apply general inflation indexation to translate 2018/19 based inputs into a nominal expression. For any formula year, the nominal expression will be based on forecasts for general inflation which are subsequently trued up to actual positions through future iterations of the PCFM. In this regard, general inflation is a dynamic component when determining the allowed revenue positions that feed into transportation charge setting.

As the draft directions note, NGGT is required by licence to transfer project funding to SGN. Funds should be transferred to SGN on a nominal basis; however, the directions do not specify how general inflation should be treated for this purpose and imply a fixed nominal expression of total funding. Without clarification of the treatment of general inflation for funding distributions, there is a risk of mismatch between the amount of funds NGGT will recover through charges, and the amounts distributed to SGN.

Our suggestion is that the distribution of funds to SGN are initially based on the 2018/19 based values included in the directions and converted to nominal using the general inflation indices included in the PCFM. In practice, distributions to SGN will need to be made before actual inflation for any formula year is known, with the nominal expression based on forecasts for inflation. The same is also true for allowed revenue determination and charge setting, however the PCFM automatically trues up historical revenues for inflation updates through annual revisions.

The general principle of inflation true up can be adopted for funding distributions. When agreeing a profile for the distributions of funds between NGGT and SGN, these could be based on the inflation forecasts included in the latest published network PCFMs. Inflation indices will be the same for both parties so should not be a source of contention. Because funding for the LTS Futures project straddles multiple formula years, there would be an opportunity to update inflation indices both prospectively and retrospectively, with any required adjustment playing into forward funding distributions.

The need for a final true up is inevitable because actual inflation for the final year of project funding will not be known until the following year. Consequently, we think that Ofgem will need to build this into its project / funding closure processes. However, dealing with inflation true ups as far as possible through annual revision and NGGT's and SGNs mutual agreement to funding distribution profiles should help to minimise the size of any end of project adjustment, and align revenue collection and funding distributions in nominal terms as far as practically possible.

We propose that the following drafting (or similar) could be inserted to paragraph 8 of the draft SGN direction and paragraph 7 of the draft NGGT direction:

“For the purposes of the distribution of funds to SGN, the 2018/19 based values included in Annex 1 will be converted to a nominal equivalent using the general inflation indices contained in NGGTs and SGNs Price Control Financial Models (as formally published by Ofgem). The inflation indices for the relevant formula years will be reviewed annually as part of NGGT and SGNs mutual agreement of funding distribution profiles. Where updates to inflation indices give rise to a historical restatement of nominal funds distributions, adjustments will be made to forward distribution profiles where possible. NGGT and SGN will maintain a record of actual funding distributions to enable any required final price basing adjustment at the end of the project.”