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Dear Graeme,

RIIO-2 Medium Sized Investment Project (MSIP) Re-opener Consultation

This response is prepared on behalf of Scottish Hydro Electric Transmission Plc (SSEN Transmission), part of the SSE Group, responsible for the electricity transmission network in the north of Scotland.

We welcome the opportunity to respond to Ofgem's minded-to position on National Grid Electricity Transmission's (NGETs) three Medium Sized Investment Project (MSIP) reopeners; Melksham Operational Tripping Scheme Phase 2 Project, Cellarhead Customer Connection and Frodsham Customer Connection and Lister Drive Customer Connection.

Our response is limited to Ofgem's cost assessment methodology and application of the Opex Escalator (OE) mechanism. We previously raised similar points as part of our response to Ofgem's consultation on modifications to Special Condition 3.36¹ and NGET's extreme weather MSIP consultation². Our concern is centred on Ofgem's application of direct and indirect costs that are inconsistent with the definitions used by the Transmission Owners (TOs) when OE rates were set as part of the RIIO-T2 settlement. Inconsistency in approach could lead to under-recovery of indirect project costs.

Historic cost definitions will determine how indirect costs have been captured and thus informed the RIIO-T2 OE value and Ofgem must maintain consistency when defining cost categories to ensure the OE delivers on its policy intent for RIIO-T2. It is important to note the original purpose of the OE. It is designed to provide licensees with automatic allowance adjustments for operational costs (closely associated indirects and network operating costs) associated with capital expenditure required through our RIIO-T2 uncertainty mechanism projects. This was intended to provide both regulatory certainty and proportionate regulation. We note the OE for each Transmission Owner (TO) is different and based on the efficient capital and operational costs set for each individual TO's baseline allowance for RIIO-T2. These costs are in turn based on the Regulatory Instruction and Guidance (RIGs) and Business Plan Data Table (BDPT) Guidance³ as to the allocation costs as direct or indirect.

It should be noted that the TOs allocated contractor indirect costs as direct capex in RIIO-T1 reporting, given that contractor schedules did not provide the level of detail required to split these costs out. This approach was also used

¹ <https://www.ofgem.gov.uk/publications/notice-statutory-consultation-modify-special-condition-336-opex-escalator-electricity-transmission>

² <https://www.ofgem.gov.uk/publications/consultation-extreme-weather-resilience-medium-sized-investment-project-national-grid-electricity-transmission>

³ As at the time of submitting the RIIO-2 Business Plan.

for submission of the RIIO-T2 business plan submissions and is consistent with the RIGs and BPDT guidance. Within the RIIO-T1, RIIO-T2 BPDTs Guidance and RIIO-T2 RIGs under the Direct Activities definition⁴ Ofgem note that “where contractors have recharged the licensee **for the primary purpose of performing direct activities which include costs for indirect activities but these are not explicitly costed in their invoice, all costs will be treated as direct**”. Due to the level of cost breakdown information within the invoices in RIIO-T1 meant we were unable to split out contractor indirect costs which required the allocation of indirect contractor costs against the direct activities and were not included within our indirect costs.

When setting indirect allowances for RIIO-T2, Ofgem’s multivariate regression analysis was used to determine the RIIO-T2 baseline allowances for indirects and the opex escalator “*used only historical data to avoid undue dependency on network company view*”⁵. This highlights that the historic data which included contractor indirect costs as direct capex formed the basis on the baseline indirect cost submission and the subsequent allowance and escalator. Therefore, it is clear that the opex escalator only provides allowances for the TO’s closely associated indirects only and cannot include contractor indirects.

Ofgem’s view is that moving these costs from direct to indirect will remove the potential for double funding. However, the actual outcome will be a double reduction to project allowances as the TO would lose the direct capex allowance, and the associated indirect opex allowance would also be reduced as it is calculated on the basis of the residual direct capex. This would leave the TO with insufficient total project allowances to cover the cost of economically and efficiently delivering the project. The alternative would be to recalibrate the OE for each of the TOs which is not proportionate or practical. Ofgem must be consistent with the approach set out for RIIO-T2 when defining cost categories to ensure the OE delivers on its policy intent for RIIO-T2. Table 1 below sets out what the required Opex Escalator would be, based on a range of scenarios, if contractor indirect costs are reallocated as indirect.

Capex (£m)	Indirects (£m)	£m from Direct to Indirects	Opex Escalator
1719.8	253.4	Baseline	10.8%
1619.8	353.4	£100m	16.0%
1569.8	403.4	£150m	18.9%
1519.8	453.4	£200m	21.9%
1419.8	553.4	£300m	28.6%

Table 1: Opex Escalator Impact

Ofgem must ensure that the assessment of costs is consistent with how the TOs have defined and captured direct and indirect elements when setting the OE. It is inappropriate to impose a different view of definitions, as the OE has been set based on the methodology each TO has adopted in the T2 business plan submission. Another potential option would be if Ofgem were to provide these disallowed “indirect costs” as additional indirect allowances above the OE as part of the MSIP. The only alternative would be to recalibrate the OE for each of the TOs which is not proportionate or practical. Ofgem need to be consistent with the approach set out for RIIO-T2 when defining cost categories.

Yours sincerely

David Manson
SSEN Transmission

⁴ RIIO-T2 RIGS - Page 145

⁵ RIIO-2 Draft Determinations: ET Annex – Paragraph 3.50, p60