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30 March 2023

Dear Mark,

National Grid Electricity Transmission plc: Response to Ofgem's Consultation under Standard Condition B15 and Special Condition 8.2 on proposed modifications to the Regulatory Instructions and Guidance and PCFM Guidance for RIIO-ET2

We welcome the opportunity to provide views on the draft set of data templates, associated instructions and guidance and draft glossary document for electricity transmission network companies to use when submitting RIIO-ET2 Annual Reporting submissions, as published on 28 February 2023. We have provided a record of our detailed comments in the attached excel document (Issues Log); this covering letter summarises our key points.

Our points can be summarised into the following key categories:

1) Legal Costs (Totex)
2) Definition of 'Indirects'
3) Level of granularity (phased scheme costs at asset level)
4) Glossary clarity
5) Revenue RRP / AIP changes
6) PCFM Guidance resulting in multiple RRP submissions
7) Other proposed data reporting amendments

1. Legal Costs (Totex)

Ofgem is proposing to amend the definition of totex in the RIGs to exclude any costs or legal fees incurred relating to an application for a judicial review or an appeal to the CMA in respect of a decision made by Ofgem.

The reason given for this proposed change is that, in Ofgem's view, legal fees incurred in challenging an Ofgem decision should not be recoverable through the price control and should not be subject to the sharing factor. Ofgem states that these costs should be borne by network company's shareholders rather than the consumer because any legal challenge against an Ofgem decision would be in the interest of shareholders rather than the consumer and hence Ofgem believes they should not be included in totex. We object to the principle of the proposal and believe that it is flawed for a number of reasons.

The apparent intent of this proposal is very concerning; it seems to be geared at limiting challenges to Ofgem's decisions and making it harder for licensees to exercise their legal rights to do so. Ofgem should be very cautious in considering such proposals.

In particular, the UK regulatory regime has in the past been viewed favourably by investors as a stable regime which applies the rule of law. Given the great need for investment in the transition to net zero, any perception by investors that this regulatory regime is changing could be very damaging to the UK transition. The ability to appeal to the CMA where Ofgem has made an error is a key part of why investors have confidence in the current regulatory regime. CMA appeals are therefore a legitimate cost of the regulatory regime.

The proposal is based on a premise that legal challenges against Ofgem decisions (whether that be through CMA appeals or through judicial review) are in the interests of shareholders rather than the consumer. This premise is false. Legal challenges against Ofgem are business decisions like any other. The licensee will bring a legal challenge where it considers that the Ofgem decision has a detrimental impact which is either unlawful or, in the case of licence modifications, appealable to the CMA on the basis that the decision by Ofgem is wrong on one or more of the statutory grounds.

Such legal challenges have covered a broad range of issues. In the case of price control appeals, if Ofgem has made a material error in setting allowances for the network to carry out its role efficiently and economically for consumers, it is entirely legitimate for networks to challenge this. The suggestion that legal challenges against Ofgem decisions are necessarily against the interests of consumers is therefore completely baseless. This shows why the proposal is flawed and why such costs should not be excluded from the Totex Incentive Mechanism.

The proposal will cover cases where a network wins a challenge brought against Ofgem. In a scenario where a challenge has succeeded before the CMA, the CMA will have reached its decision whilst taking on Ofgem's principal objective to act in the interest of consumers. There can be no argument that the challenge was not in the interests of consumers when the CMA reaches a conclusion that

Ofgem's decision was not in those interests. In other cases, it cannot be in the interests of consumers for Ofgem to act unlawfully.

The proposed change to the definition of totex in Appendix 2 of the ET RIGs acknowledges that Ofgem will still pay costs where ordered to do so through court or appeal processes. However, those processes allow recovery of only a proportion of costs. It cannot be right to say that the network's shareholders should be penalised for the remaining costs of a challenge which was successful.

When a legal challenge is brought, the claimant/appellant can never be certain that it will succeed. However, in both CMA appeals and judicial review proceedings there is a permission stage where a decision is made whether the case has sufficient merit to proceed to a full process. Where such permission is given, the case is sufficiently arguable that it should be heard and the network should not therefore be penalised for this.

The proposal also treats legal challenges against Ofgem as a special case. This has no rational basis. No issue is taken with, for example, a planning appeal being brought by a network over a major infrastructure project. It would be completely wrong to treat that as necessarily a decision only in the interests of shareholders and not consumers. The same is true for challenges against Ofgem decisions.

As any costs or legal fees incurred relating to an application for a judicial review or an appeal to the CMA in respect of a decision made by Ofgem are currently treated as totex this means that licensees share the cost with consumers through the Totex Incentive Mechanism. Conversely, any legal costs that a licensee recovers (e.g. from Ofgem) would be treated as negative totex. The symmetrical treatment means that consumers would share in the benefit of those recovered costs.

In addition to the points raised above in relation to the flawed nature of the proposal, we also object to the manner in which this proposal has been brought forward. The proposal represents a policy change and a change to the RIIO-T2 funding framework that warrants wider consideration and due consultation. The proposal should not be brought forward as a definition change within a routine RIGs consultation.

2. Definition of 'Indirects'

In the Notice, Ofgem state that the following clause has been removed from RIGs:

> *"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. However, where the indirect activity is explicitly costed and detailed in their invoice this should be recorded against the relevant indirect activity".*

The reason given is that:

> *"As a result of the granular reporting required for T2, all TO's have employed appropriate processes to attribute costs to activities and assets not specifically invoiced or categorised. As such, the section of the guidance quoted above has become redundant."*

We strongly disagree with this statement. The above clause was introduced to the T2 BPDT RIGs immediately following senior discussions between NGET and Ofgem (Min Zhu, then Deputy Director – ET Sector) on 28 March 2019 which concluded with the following action:

2. *NG raised a concern over the separation of indirect costs within the cost breakdowns in the Scheme Summary and Cost Summary tabs, NG highlighted that it could separate NG indirect costs on a reasonable basis but not the indirect costs of contractors. Ofgem agreed that they would ask either for NG to report only NG indirect costs in this category, or Ofgem will suggest another way forward. OFGEM ACTION: confirm guidance in this area and update the RIGs.*

Our reasons for raising our concerns then were that this was a new requirement with an unclear scope. Direct Activities were defined as those that involve physical contact with transmission network assets which was (and still is) an incomplete and unclear definition. We were being asked to retrospectively split out the 'indirect' cost of contractors for all RIIO-T1 projects (many of which would have been contracted ~seven years previously) and we had not collected this data, nor was it available due to the invoicing structure at that time. The lack of this data historically naturally means that we are also unable to reliably estimate the 'indirect' cost of contractors from the forecast for all RIIO-T2 projects because the unit costs we use for estimating are based on the total contractor cost for delivering assets.

This position has not fundamentally changed.

- The confusion around scope and interaction between Direct and Closely Associated Indirects has not been addressed, either through subsequent working groups or through the updated RIGs being proposed. This definitional point ideally needs to be resolved on a cross-sector basis because it is not clear that ED2 BPDTs were populated in a way that aligns with what Ofgem are now requesting, and we know from the RIIO-T2 price control review that Ofgem will seek to compare costs at asset level for voltages that are common to Transmission and Distribution (e.g. 132kV).

- Many of the projects currently in delivery (and hence being reported in RRP23) were contracted prior to the introduction of this new requirement to split out the 'indirect' cost of contractors. There is no indication as to how we should treat projects in flight (some of which may even be complete) where we do not have this data and cannot retrospectively acquire it.

- For projects which have been contracted in the period 2019 to 2022, we have not been able to split costs in the way that Ofgem are now requesting because we still do not have a robust and consistently understood definition for contractor 'indirect' costs. Until that is in place, we cannot ask contractors to report accordingly, and we cannot instigate "*appropriate processes to attribute costs to activities and assets not specifically invoiced or categorised*".

- There is no guidance regarding how we should report projects which are not yet in delivery and for which there are not yet any invoiced costs to attribute to activities and assets. We have taken representatives of Ofgem through our investment process on more than one occasion and been transparent about the fact that our cost estimation process is based on an average total delivered cost, i.e. is agnostic to how the work is ultimately to be delivered. This is a reasonable approach, given that annual reporting will include projects that only begin to be developed in 2025/26.

We are also concerned at the timing and lack of consultation on this proposed change. It appears to be linked to the ongoing discussions between all Electricity TOs and Ofgem regarding the application of the Opex Escalator (OE) to the funding of re-openers such as MSIP. For the avoidance of doubt, making this change for RRP23 will not change the way that the OE was determined during the RIIO-T2 price control review process, and therefore it will not change how the OE should be applied to re-openers. In simple terms, the OE as established funds a TO's indirect costs. It does not fund the contractor 'indirect' costs.

3. <u>Level of granularity (phased scheme costs at asset level)</u>

Having completed the first year of reporting under the RIIO-T2 framework, we remain unsure of the use for annually phased costs at asset level. Throughout the pre-delivery phases, TOs do not have a preference regarding in which order assets are delivered. Our initial cost estimation process is based on calculating a total estimated project cost through summing up a volume of assets and/or activities multiplied by a unit cost for each. This total cost is then phased across the forecast period of year through application of 'S' curves. These 'S' curves are taken from experience of similar projects, e.g. a two-year overhead line refurbishment or a five-year substation build. There is therefore no more insight to be gained from pro rating the total forecast project cost down to each of Ofgem's Asset Possibilities.

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As a project is delivered, costs are captured against assets such that – upon completion – we can allocate those costs correctly to the assets. While actual costs at asset level can be extracted at this stage, there is nothing to compare them to (neither a pre-construction forecast nor annually phased allowances at asset level) so there is no intelligence to be gained. Assuming costs at asset level are required for benchmarking purposes, it is a total cost that is required. Benchmarking data is generally derived from completed projects, but something can be learnt from projects in delivery (e.g. the emerging impact of market trends).

The current reporting template requires annually phased costs at asset level for all projects, regardless of maturity. It is a significant reporting burden to produce, populate and assure this data (even though it is mainly a mathematical exercise of data manipulation). It reduces the time we have available to undertake analysis and provide high quality narrative. We have therefore proposed an approach to reporting that provides annually phased costs at a project level (direct costs only) and also provides information for use in benchmarking that breaks project totals down into Ofgem's Asset Possibilities and their costs.

We made our full proposal to Kevin Tse (8 March 2023), using the restated Year 1 data and the current template. The revised template shows all projects with phased direct costs at a total level regardless of the stage of development and/or delivery. This will include a number of early stage projects where the scope delivery programme is not finalised. We are proposing that, once a project moves into 'Delivery' or is 'Complete', it would appear in the asset breakdown tab.

For example the anonymised project below would appear in the Project Yearly Breakdown as a single line with the annual phased spend:

Scheme Reference	Project Reference	Scheme Name	Scheme Sub Catego	License Term	Status	Volum	Total	Sub-tot	Sub-tot	Sub-tot	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032+		Asset Breakdown Total
NGT200101					Delivery	177	£14.29	£0.00	£1.29	£13.00	£0.00	£0.00	£0.00	£0.44	£0.85	£2.90	£9.94	£0.16	£0.00	£0.00	£0.00		£14.29

Because the project is flagged as in 'Delivery', it will also appear in the Asset Breakdown tab.

Scheme Referer	Project Referen	Scheme Name	Scheme Sub Cat	License Term	Asset heading	Asset Category	Asset Sub-Cate	Asset Sub-Cate	Voltage	Intervention	Volume Measur	Volum	Total
NGT200101					Assets	Circuit Breaker	CB (Air Insulated Busbar)		400kV	New Build	Addition	3	x.xx
NGT200101					Assets	Circuit Breaker	Switchgear - Other		<=33kV	New Build	Addition	36	x.xx
NGT200101					Assets	FACTS	FACTS Equipment		400kV	New Build	Addition	3	x.xx
NGT200101					Assets	Instrument Transformers	Current Transformer (CT)		400kV	New Build	Addition	9	x.xx
NGT200101					Assets	Instrument Transformers	Voltage Transformer (VT)		400kV	New Build	Addition	9	x.xx
NGT200101					Assets	Other switchgear	Busbar GIB (OD)		400kV	New Build	Addition	90	x.xx
NGT200101					Assets	Other switchgear	Disconnector (AIB)		400kV	New Build	Addition	6	x.xx
NGT200101					Assets	Other switchgear	Earth Switch (AIB)		400kV	New Build	Addition	9	x.xx
NGT200101					Civils	Buildings	Buildings			New Build	Addition	1	x.xx
NGT200101					Civils	Circuit Breaker	Circuit Breaker			New Build	Addition	1	x.xx
NGT200101					Civils	Substation Platform	Substation Patform			New Build	Addition	1	x.xx
NGT200101					Other	Other (Direct)				New Build	Addition	0	x.xx
NGT200101					Protection	Protection & Control	Low Impedance Busbar Protection		400kV	New Build	Addition	3	x.xx
NGT200101					Protection	Protection & Control	Reactive Equipment Mechanically Switched (		400kV	New Build	Addition	3	x.xx
NGT200101					Protection	Protection & Control	Substation Control Systems (SCS)			New Build	Addition	3	x.xx

If this improvement were accepted, we would need to undertake a similar exercise on allowances to mirror this approach. The net benefit would be a reduction in the number of cells requiring population by approximately 150,000, without losing visibility of project delivery vs allowances or unit cost benchmarking information.

Ofgem have recently rejected this proposal, but we still believe that it is more efficient. Given that what is being asked for is not aligned to the way we manage and control costs throughout the project lifecycle, and beyond what is reasonably required (as per licence condition B15 para.6), this is creating an additional reporting burden purely for regulatory reporting purposes. If the tables are unchanged, we will continue to use an allocation methodology for projects which are delivered (i.e. it is too late to change how their costs are reported) or are in development (because we do not phase costs at individual asset level when creating cost estimates). For RRP23, the capture of data in our core systems does not match Ofgem's reporting structure so we will still need to apportion a significant volume of our costs.

4. Glossary clarity

In February 2023, Ofgem held a meeting with the Electricity TOs to understand changes made by the Electricity TOs to the Glossary (Draft v1.3). In the meeting, the Electricity TOs highlighted to Ofgem that the hierarchy of activities is not helpful and that the guidance on allocation of costs to the highest cost category on the hierarchy should be removed. The Electricity TOs added TO-specific notes explaining how they carried out cost allocation for RRP22. Our expectation from the meeting was that Ofgem would rewrite the section such that it incorporates the TO comments, removing reference to the hierarchy. In the published Glossary, Ofgem has deleted the whole narrative referring to the hierarchy, including the Electricity TO comments, but left the hierarchy in place. This has rendered section 1.3 incomplete as guidance. Ofgem needs to rewrite this section to give guidance on cost allocation.

More generally, we note that the published Glossary version 1.3 is a 'work in progress' for Asset Possibilities. The Electricity TOs will be looking to collaborate further following RRP23 population to develop the Glossary to provide even clearer definitions that promote alignment in cost capture and reporting amongst the Electricity TOs.

5. Revenue RRP / AIP changes

NGET, together with the other Electricity TOs, has discussed and agreed in principle multiple proposed changes to the Revenue workbook element of the RRP tables with Ofgem. These changes were designed to result in more automated production of the Price Control Financial Model (PCFM) variable values and increased clarity of the audit trail between the RRP tables and PCFM.

We are disappointed to see that, despite the Electricity TOs submitting their detailed proposals to Ofgem on 10 February 2023, the changes have not been fully adopted. Ofgem agreed to certain corrections to the Revenue Workbook (specifically the Rev Workbook Linking Sheet) on 19 January 2023 and were provided with NGET's detailed proposal for the required updates on 31 January 2023. However, these corrections have not been made in the RRP tables under consultation and so the errors and inefficiencies identified remain. For example,

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- The calculation of the UMTERMBt element of the opex escalator is incorrect as it excludes forecasts captured within the ET Pipeline log (table E1.11).
- Ofgem agreed to increase automation of the "Rev Workbook Linking Sheet" through increased linkage to RRP tables. Exclusion of these links results in inefficiencies in the RRP reporting process and creates the opportunity for human error.

Ofgem has also not updated the RRP tables for updates proposed by NGET. Our key concern is the exclusion of a disposals table in RRP to ensure capture and treatment of disposal proceeds outside of a specific project as negative totex. Exclusion of this disposals table results in an error in the PCFM inputs and calculation of Allowed Revenue. We would also expect Ofgem to add a new table in RIGs Chapter 4 to explain the purpose of the disposals table and guidance on completing the worksheet. An example of this narrative was provided in the RRP issues log.

6. PCFM Guidance resulting in multiple RRP submissions

Ofgem has introduced a requirement to submit an updated copy of the ET2 RRP alongside each dry run submission of the PCFM (para 2.13 of the PCFM Guidance document).

Para 2.14 of the PCFM Guidance goes on to state that “For the submission due on 30 September and thereafter at each dry run, the variable values in the “PCFM inputs summary” sheet of the ET2 RRP should match the company-specific input sheets of the ET2 PCFM, where applicable”. It is unclear from these statements whether Ofgem is proposing a resubmission of the full suite of RRP tables or whether the PCFM inputs sheet summary only is required to be updated. We consider this to be neither a practical nor appropriate request.

The RRP is a 31 March view of the RIIO-2 costs, allowances and outputs which is used to inform the PCFM variable values and therefore Allowed Revenue. It is not clear why this view should be periodically revised. However, the Electricity Transmission licence requires licensees to include best estimate forecasts for PCFM variable values which are unknown at the time of RRP submission. If there are any significant and certain changes to the variable values since the 31 March view contained within the RRP tables, updates are made in subsequent dry run PCFM submissions. By proposing a full RRP update to sit alongside the PCFM submission, Ofgem run the risk of making a best estimate process extremely onerous.

We previously discussed RRP resubmissions with Ofgem both verbally and in an email dated 25 October 2022. We raised our concerns that a full resubmission would be a lengthy and complex process given the granularity of the RRP tables and the governance processes required to meet Data Assurance requirements. Also, in certain circumstances, the RRP tables do have appropriate functionality to include required PCFM variable values and so an update is unnecessary. For example, RRP tables cannot be updated for T1+2 values due to lack of appropriate functionality and there is no direct flow from re-opener inputs to the PCFM input for the opex escalator.

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In NGET's PCFM dry run submissions subsequent to the first submission, the narrative specifically included a description of the PCFM variable changes, both the reason for the change and the impact on the PCFM variable value table. We consider this creates a sufficient audit trail back to the original RRP submission.

7. Other proposed data reporting amendments

With reference to Table 1 of Ofgem's Notice (Notice Proposing Modifications to the RRP (version 2.1) and RIGs (version 1.6) Feb 2023), other than the matters which have been highlighted above, we support and welcome the remainder of the proposed amendments as summarised below.

RRP Reference	NGET Comment
Scheme_C&V_Load_Actuals Scheme_C&V_NonLoad_Actuals	We welcome the simplification of data entry introduced by replacing the scheme meta data, scheme volume and scheme cost tabs, and the provision of separate tabs for load and non-load schemes.
C2.22a Repairs	We welcome the separation of the Repairs & Maintenance table into two separate tables. As discussed with Ofgem and the TOs on 01 February, the licensees will need to apportion the allowances for the Baseline Memo tables as the allowances were set with Repairs and Maintenance combined.
Analysis tabs to replace previous Co Cost Output tabs	We welcome the visibility provided by sharing these analysis tabs. There are a number of detailed corrections needed; please see Issues Log.
RIGs – design activity definition clarification and its reporting	This is not providing clarity. Please see above section on 'Definition of Indirects'.
RIGs – removal of guidance which allows TO's to assign indirect costs to direct costs arising from activities and/or assets not explicitly costed in their invoice	We strongly disagree with this change. Please see above section on 'Definition of Indirects'.
Amending the definition of totex	This is not a matter for RIGs consultation. Please see above section titled 'Legal Costs (Totex)'.
Pass-through, Inflation update, and PCFM Input Summary	We welcome the removal of the inflation update within the RRP.
A2.1_Cost_Matrix_2022 to A2.1_Cost Matrix_2028, working 2	We welcome the updated cost matrix allowing easier linking to revenues, although are concerned that the treatment of customer contributions does not result in the correct entries for PCFM.

With reference to Table 2 of Ofgem's Notice (Notice Proposing Modifications to the RRP (version 2.1) and RIGs (version 1.6) Feb 2023), we welcome Ofgem's proposal to better align the AIP process to

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the tariff-setting date. However, NGET have previously raised some initial concerns with the proposed timeline and the inclusion of additional dry-runs. We welcome the opportunity to discuss the proposed changes further.

We would welcome further discussion on the key topics described above, plus any of the items within the NGET consultation issues log, to enable the appropriate treatment in this year's RRP. Please do not hesitate to contact either Michelle Clark (michelle.clark@nationalgrid.com), or Chris Hayward (christopher.hayward@nationalgrid.com).

We hope that you find this response useful and constructive.

Yours sincerely

A. M. Clark.

Michelle Clark
Policy and Performance Manager, UK Policy & Regulation, National Grid Electricity Transmission
(by email)