

Sai Wing Lo
Ofgem
10 South Colonnade
Canary Wharf
London
E14 5EA

By email: Sai.Lo@ofgem.gov.uk

Date

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Contact / Extension

Lauren Logan

07385 346208

Dear Sai Wing,

Consultation on the assessment of three 2023 Medium Sized Investment Project (MSIP) from SP Transmission

This consultation response is from SP Transmission (SPT), which holds the transmission licence for the south and central Scotland. SPT is part of SP Energy Networks (SPEN) and the wider Iberdrola group. We welcome the opportunity to respond to the [consultation on the assessment of three 2023 MSIPs from SPT](#). The consultation covers three stage 2 MSIP applications: Coalburn Supergrid Transformer Number 4 (SGT4) project, Constraint Management Pathfinder – LEO and OTS Modifications project and Wishaw – Eccles – Torness – Smeaton OTS project.

Our response covers four key areas:

- (i) **Risk and contingency allowance**: Ofgem's use of an **average value to cap risk provision is arbitrary and non-project specific**, produces **only a downward bias and fails to consider the evidence presented**. This does not reflect the RIIO-T2 framework and Final Determinations (FDs), undermining the certainty provided in the price control framework. Notwithstanding our position on the use of a cap, there are significant flaws in the calculation and application of the cap which, as a minimum, should be rectified.
- (ii) **Contractor indirects**: for both **Surveys and Detail Design** there are elements, that should be classified as **Asset Specific Design**. In accordance with Ofgem's guidelines such activities would be recognised as Direct Costs. **Ofgem's approach, in this instance, has not properly recognised this due to the aggregation of costs that were submitted.**
- (iii) **Opex escalator**: as previously outlined to Ofgem in our responses to the consultations on National Grid Electricity Transmission (NGET's) 2022 MSIP Reopener applications, **we maintain that Ofgem's proposed application of the Opex Escalator (OE) represents an error and will result in underfunding across the portfolio of MSIP projects. We welcome Ofgem's proposed OE review mechanism to address this issue but still have significant concerns that, due to e.g. the eligibility criteria which Ofgem currently propose to apply, TOs will still face significant and inappropriate levels of financial exposure for these projects. We remain**

committed to working with Ofgem on the development of the OE review mechanism, while reserving our rights under the Electricity Act 1989.

- (iv) **Staged approach to MSIP application:** To ensure the timely MSIP delivery and to enable the investment needed to achieve the 2030 Net Zero target, **we strongly recommend retaining the current two-stage MSIP application approach.** We acknowledge that TOs' must continue to maintain high quality submissions to ensure an efficient assessment from Ofgem.

(i) Risk and contingency allowance

The principle of applying an arbitrary and non-project specific cap fails to consider the project-specific evidence presented and is not consistent with industry practice. This was a key conclusion of the independent review of Ofgem's risk and contingency methodology provided by SPT in response to the RIIO-T2 Draft Determination. While some elements of the methodology were changed at FD, the use of a portfolio average to act as a cap remains and we urge Ofgem to consider the independent report provided¹.

Notwithstanding the inappropriateness of the capping methodology, the derivation of the cap is significantly flawed and is not derived as stated in the consultation document. The FD states that a bespoke approach to risk and contingency costs was required and that this differs for each TO. Therefore, the use of a cross-TO average of 7.5% uses non-comparable costs and does not reflect the RIIO-T2 framework and final determination. If a portfolio average cap is to be applied, it should be based on the SPT data only and be consistent with the RIIO-T2 FD.

We would like to request Ofgem to share the methodology, with supporting evidence, and project base used to establish the 7.5% cap for the risk, as it is unclear on how such a cap was derived and is currently proposed to be implemented on the majority of the MSIPs and other UM projects.

Further, the costs which are used as the basis for the calculation of the cap (i.e. RIIO-T2 Business Plan costs) contained contractors' indirect costs. Therefore, applying the same percentage to costs which are net of contractors' indirects will systematically award inadequate funding to TOs and is inconsistent with the basis on which the cap percentage was calculated.

Following the MSIP applications, we have provided the responses to supplementary questions, where we reiterated the reasoning for requested risk allowances.

In summary, we do not agree with the use of a portfolio-average cap. **The analysis to arrive at the cap percentage incorrectly relies upon non-comparable data from other licensees. Further, if Ofgem retains the percentage cap approach to risk, the cap percentage needs to be applied to the project costs including contractors' indirects, not the costs which exclude them.** As outlined above, the cap percentage has been calculated on the basis of historic costs which included contractors' indirect costs. Ofgem's proposed approach will therefore lead to underfunding. We have set out the clear differences in the approach within the table below.

¹ Report provided after RIIO-T2 Draft Determination, conducted by Arcadis, RIIO-T2: Investment Plan – Engineering Risk Review, September 2020

Project	Requested allowance (£m 18/19 p/b / %)	Risk	Ofgem's proposed risk allowance (£m 18/19 p/b / %)	7.5% risk allowance with Contractor indirects included within Direct Costs (as per FD)
Coalburn Supergrid Transformer Number 4(SGT4) project	£1.186m/ 9.6% ²		£0.923m/7.5%	£1.048m
Constraint Management Pathfinder – LEO and OTS Modifications project	£0.143m/13.6%		£0.079m/7.5%	£0.097m
Wishaw – Eccles – Torness – Smeaton OTS project	£0.104m/14.5%		£0.054m/7.5%	£0.074m
Total:	£1.433m/10.2%		£1.056m/7.5%	£1.219m

(ii) Contractor indirects

Ofgem's initial proposal is to adjust the project cost in SPT's funding request by taking out the CAI costs from the direct project cost. Ofgem has categorised all **Surveys**, project management and **Detail Design** as Closely Associated Indirect (CAI) activities. It is our position that Ofgem's view is based on too broad an interpretation of the 2023 Regulatory Instructions and Guidance (RIGs).

Our disaggregated design and delivery model goes significantly beyond what would be recognised as “functional design” (the primary criteria to treat Network Design & Engineering activities as CAI). That is not to say that functional design does not occur; rather it is a part of the costs highlighted above.

In our submission, for both **Surveys** and **Detail Design** there are elements that should be classified as Asset Specific Design³. In accordance with Ofgem's guidelines, such activities would be recognised as Direct Costs. **Ofgem's approach, in this instance, may not have properly recognised this due to the aggregation of costs that were submitted.**

There are ongoing discussions with Ofgem on the reporting requirement of Contractor Indirect costs, hence the response to this consultation only concentrates on the MSIPs consulted upon.

The detailed responses are included for questions 2, 5 and 8.

(iii) Opex escalator

Throughout the consultation, there are references made by Ofgem to the OE mechanism as per RIIO-T2 FD⁴. Ongoing discussions are taking place with TOs and Ofgem on this subject matter.

The purpose of the OE is to provide TOs with an automatic/mechanistic “additional allowance for operating expenditure where additional capital expenditure was provided under particular

² Based on our calculations works out as 9.6%, instead of 9.5% included within the consultation

³ Asset Specific Design activities are those which the licensee does not have direct control over and the decisions on how to meet the specification in **function design** are for the manufacturer/contractor to determine.

⁴ RIIO-2 Final Determinations Electricity Transmission System Annex (REVISED) (ofgem.gov.uk)

uncertainty mechanism”⁵. The removal of Contractor indirects from the Direct cost allowance request, not only reduces the allowances to be awarded through application of the OE, but also systematically disallows the funding of Contractor indirects (as these costs are not recoverable directly through the MSIP reopener).

As part of the MSIP decision for NGET⁶, Ofgem has set out the principles for new OE review mechanism where the performance of the OE will be assessed, and a true up mechanism will be applied where the project Closely Associated Indirects (CAI) are underfunded based on the updated OE application. Whilst we continue to disagree with Contractor Indirect costs being disallowed as a Direct Costs allowance request and maintain that Ofgem’s proposed OE application results in systematically lower CAI allowance, **we welcome Ofgem’s acknowledgement that its proposed application of the OE could result in underfunding and its decision to introduce an OE review mechanism into the RII0-T2 licence.** However, as outlined above, we remain concerned with Ofgem’s current proposals as to how the OE review mechanism will operate. We welcome the opportunity to engage further with Ofgem on the detailed development of the OE review mechanism and eligibility criteria, and the associated required licence modifications in the next couple of months. For the avoidance of doubt, we reserve our right to appeal the licence modification which introduces the OE review mechanism, including if SPT considers this is not fit for purpose.

(iv) Staged approach to MSIP application

On 16th of October, we submitted our response to SHET’s 2023 MSIP initial needs case submission consultation⁷, where we reiterated that we strongly support that Ofgem retain the option to have a staged MSIP application approach (Stage 1 – Needs Case and Optioneering, Stage 2 – Full application). As Ofgem have acknowledged, the staged approach provides consumer benefit and facilitates delivery of TOs’ works required to meet binding Net Zero Targets including early engagement with Ofgem which the staged approach enables. Therefore, removing the staged option could have a detrimental effect on consumers and progress towards those targets. The following provides additional detail explaining our position:

- More certainty is required to ensure that challenging 2030 Net Zero targets are met.
- Ofgem’s agreement to the needs case and optioneering is essential to support consenting activities, which enable timely project delivery.
- As per provisional decision on the first stage assessment of SPT’s MSIP re-opener applications⁸: *“The MSIP framework allows ETOs to seek an Agreement in Principle of investment need and preferred design solution from us once there is more certainty about the drivers for the work, the optioneering of the chosen design and the proposed timing of delivery for qualifying projects. The arrangements enable us to apply proportionate scrutiny, on a case by-case basis, to our assessment of works proposed by the ETOs. This helps to manage uncertainty and helps ensure the timely and efficient progress of preparatory works. We consider it is in the interests of existing and future consumers to ensure that the scope of MSIP projects, reflecting the specific circumstances of each case, are justified, and can be progressed at the most appropriate time.”*
- As per the provisional decision on the first stage assessment of SPT’s MSIP re-opener applications⁹, Ofgem stated: *“Transmission projects can contain works that are dependent on factors outside the direct control of the ETOs, including the impact on customer-driven*

⁵ SPT Special Licence Condition 3.36, paragraph

⁶ Decision to modify the special conditions of the electricity transmission licence held by National Grid Electricity Transmission Plc | Ofgem, Appendix 5

⁷ SHET’s 2023 MSIP initial needs case submission | Ofgem

⁸ Provisional decision on the first stage assessment of SPT’s MSIP re-opener applications (ofgem.gov.uk), pages 6-7, paragraph 1.10, issued on 27th April 2022

⁹ Provisional decision on the first stage assessment of SPT’s MSIP re-opener applications (ofgem.gov.uk), pages 7, paragraph 1.9, 27th April 2022

requirements, or involve issues where project timescales do not necessarily align with the rigid regulatory structure (e.g., the fixed submission window of the MSIP submission framework). These factors create a potential problem where a lack of firm information can have a disproportionate impact on the development of activity and adversely impact work deemed necessary to deliver a connection in a timely manner. Delays to the works to progress connection of low carbon generation, which would contribute towards meeting the Net Zero target, may lead to additional costs for GB consumers."

- When costs are submitted for Ofgem's assessment, the majority of the contracts are already awarded. If the staged approach is removed, there would be significant increased risk associated with the project, as the needs case and/or optioneering could be rejected by Ofgem at a late stage. This risk could impact investor confidence and financeability. If removing the staged approach, Ofgem would need to confirm the need for MSIPs via an alternative route.
- For Accelerated Strategic Transmission Investment (ASTI) framework, Ofgem is proposing to have an early engineering engagement prior to the Project Assessment (PA) submission, to ensure that the review of the PA can be completed in a timely manner. The proposal to remove the staged approach from MSIP applications, seems inconsistent with the overarching policy which is set to continue into the next price control under 'Major Projects', both MSIP and ASTI projects made up the Holistic Network Design; therefore a level of consistency to ensure project certainty should be applied.

Appendix 1 contains the responses to the questions from the consultation, with subsequent appendices including supporting information.

Lastly, we would like to reiterate to Ofgem the importance of the diligence for the publications and would like to urge not to publish commercially confidential information. We welcome Ofgem addressing the publication of confidential information quickly, however this information may have been accessed by a number of parties prior to the update of original version of the publication.

Please do not hesitate to contact me should you wish to discuss any of the points raised within this response.

Yours sincerely,



Lauren Logan

Head of Transmission Regulation & Policy

Appendix 1: Consultation questions

Coalburn Supergrid Transformer Number 4 (SGT4) project

Q1: Do you agree with our view to confirm our provisional decision made in 2022 on accepting the needs case and the preferred option for Coalburn SGT4 project?

We agree with Ofgem’s decision to accept the needs case and the preferred option for Coalburn SGT4 project.

Q2: Do you agree with our draft determination on the efficient costs for the Coalburn SGT4 project?

We welcome Ofgem’s recognition that the disaggregated design and delivery model used by SPT, within which contracts are disaggregated and tendered separately, is helpful to drive cost efficiencies to the benefit of UK consumers.

Table below is taken from the consultation, paragraph 2.9¹⁰.

All Costs in 2018/19 prices (£m)	Direct Cost	Contractor Indirects	Total Project Costs
Surveys	-	0.195	0.195
Site Works	2.260	-	2.260
Supply, Installation and Commissioning	10.041	-	10.041
Project Management	-	0.990	0.990
Detail Design	-	0.487	0.487
Risk	1.186	-	1.186
Total	13.487	1.672	15.159

Contractor Indirects

Ofgem’s initial view is to adjust the project cost in SPT’s funding request by taking out the CAI costs from the direct project cost. Ofgem has categorised all **Surveys**, project management and **Detail Design** as Closely Associated Indirect (CAI) activities. It is our position that Ofgem’s view is based on too broad an interpretation of the 2023 Regulatory Instructions and Guidance (RIGs).

Our disaggregated design and delivery model goes significantly beyond what would be recognised as “functional design” (the primary criteria to treat Network Design & Engineering activities as CAI). That is not to say that functional design does not occur; rather it is a part of the costs highlighted above.

In our submission, for both **Surveys** and **Detail Design** there are elements, that should be classified as Asset Specific Design¹¹. In accordance with Ofgem’s guidelines, such activities would be recognised as Direct Costs. Ofgem’s approach, in this instance, may not have properly recognised this due to the aggregation of costs that were submitted.

The composition (and costs) of works categorised as **Surveys** are set out in Appendix 2. Ofgem have categorised £0.195m (c1%) as Indirect costs. Our analysis, based on further review of content and purpose stated in the relevant contracts, shows that approximately £0.043m relates to “functional design”. The balance of £0.152m would be more properly recognised as Asset Specific Design,

¹⁰ Consultation: 3 SPT 2023 MSIP applications | Ofgem, page 13

¹¹ Asset Specific Design activities are those which the licensee does not have direct control over and the decisions on how to meet the specification in function design are for the manufacturer/contractor to determine.

involving site works and activities which involve physical contact with transmission network infrastructure assets, thereby recognised as a **Direct Cost**.

Similarly, the composition (and costs) for **Detail Design** works are set out in Appendix 3. As stated in the table above, Ofgem have categorised £0.487m (c3%) as Indirect costs. Our analysis, based on further review of content and purpose stated in the relevant contracts, shows that approximately £0.027m relates to “**functional design**”. The balance of £0.460m would be more properly recognised as Asset Specific Design, hence, treated as a **Direct Cost**.

Risk

As per our response within Risk and contingency allowance section above, we do not agree with the use of a portfolio-average cap as **the process for arriving at the current cap percentage incorrectly includes non-comparable data from other licensees**. If Ofgem retains the percentage cap approach to risk, the cap percentage should be applied to the project costs including contractors’ indirects, not the costs which exclude them. To do otherwise, would be inconsistent with the basis upon which the percentage cap has been calculated and would result in underfunding.

Constraint Management Pathfinder – LEO and OTS Modifications project

Q3: Do you agree with our initial view on the needs case for the Constraint Management Pathfinder - LEO and OTS Modifications project?

We agree with Ofgem’s decision to accept the needs case for the Constraint Management Pathfinder – LEO and OTS Modifications project.

Q4. Do you agree with our initial view on the preferred option proposed by SPT?

We agree with Ofgem’s decision to accept the preferred option for the Constraint Management Pathfinder – LEO and OTS Modifications project.

Q5. Do you agree with our draft determination on the efficient costs for the Constraint Management Pathfinder - LEO and OTS Modifications project?

We welcome Ofgem’s recognition that the disaggregated design and delivery model used by SPT, within which contracts are disaggregated and tendered separately, is helpful to drive cost efficiencies to the benefit of UK consumers.

Table below is taken from the consultation, paragraph 3.18¹².

All Costs in 2018/19 prices (£m)	Direct Cost	Contractor Indirects	Total Project Costs
Surveys		0.002	0.002
Site Works	0.138		0.138
Supply, Installation and Commissioning	0.911	-	0.911
Project Management	-	0.056	0.056
Detail Design	-	0.190	0.190
Risk	0.143	-	0.143
Total	1.193	0.248	1.440

¹² Consultation: 3 SPT 2023 MSIP applications | Ofgem, page 20

Contractor Indirects

Ofgem's initial view is to adjust the project cost in SPT's funding request by taking out the CAI costs from the direct project cost. Ofgem has categorised all **Surveys**, project management and **Detail Design** as Closely Associated Indirect (CAI) activities. It is our position that Ofgem's view is based on too broad an interpretation of the 2023 Regulatory Instructions and Guidance (RIGs).

Our disaggregated design and delivery model goes significantly beyond what would be recognised as **"functional design"** (the primary criteria to treat Network Design & Engineering activities as CAI). That is not to say that functional design does not occur; rather it is a part of the costs highlighted above.

In our submission, for both **Surveys** and **Detail Design** there are elements, that should be classified as Asset Specific Design¹³. In accordance with Ofgem's guidelines, such activities would be recognised as Direct Costs. Ofgem's approach, in this instance, may not have properly recognised this due to the aggregation of costs that were submitted.

The composition (and costs) of works categorised as **Surveys** are set out in Appendix 4. Ofgem have categorised £0.002m (c0.1%) as Indirect costs. Our analysis, based on further review of content and purpose stated in the relevant contracts, shows that the total of the survey cost would be more properly recognised as Asset Specific Design, involving site works and activities which involve physical contact with transmission network infrastructure assets, thereby recognised as a **Direct Cost**.

Similarly, the composition (and costs) for **Detail Design** works are set out in Appendix 5. As stated in the table above, Ofgem have categorised £0.190m (c13%) as Indirect costs. Our analysis, based on further review of content and purpose stated in the relevant contracts, shows that approximately £0.028m relates to **"functional design"**. The balance of £0.161m would be more properly recognised as Asset Specific Design, hence, treated as a **Direct Cost**.

Risk

As per our response within Risk and contingency allowance section above, we do not agree with the use of a portfolio-average cap as **the process for arriving at the current cap percentage incorrectly includes non-comparable data from other licensees. If Ofgem retains the percentage cap approach to risk, the cap percentage should be applied to the project costs including contractors' indirects**, not the costs which exclude them. To do otherwise, would be inconsistent with the basis upon which the percentage cap has been calculated and would result in underfunding.

Wishaw – Eccles - Torness – Smeaton OTS project

Q6. Do you agree with our initial view on the needs case for the Wishaw - Eccles - Torness - Smeaton OTS project?

We agree with Ofgem's decision to accept the needs case for the Wishaw - Eccles - Torness - Smeaton OTS project.

Q7. Do you agree with our initial view on the preferred option proposed by SPT?

We agree with Ofgem's decision to accept the preferred option for the Wishaw - Eccles - Torness - Smeaton OTS project.

¹³ Asset Specific Design activities are those which the licensee does not have direct control over and the decisions on how to meet the specification in **function design** are for the manufacturer/contractor to determine.

Q8. Do you agree with our draft determination on the efficient costs for the Wishaw - Eccles - Torness - Smeaton OTS project?

We welcome Ofgem’s recognition that the disaggregated design and delivery model used by SPT, within which contracts are disaggregated and tendered separately, is helpful to drive cost efficiencies to the benefit of UK consumers.

Table below is taken from the consultation, paragraph 4.18¹⁴.

All Costs in 2018/19 prices (£m)	Direct Cost	Contractor Indirects	Total Project Costs
Surveys		0.001	0.001
Site Works	0.062	-	0.062
Supply, Installation and Commissioning	0.656	-	0.656
Project Management	-	0.051	0.051
Detail Design	-	0.215	0.215
Risk	0.104	-	0.104
Total	0.822	0.266	1.089

Contractor Indirects

Ofgem’s initial view is to adjust the project cost in SPT’s funding request by taking out the CAI costs from the direct project cost. Ofgem has categorised all **Surveys**, project management and **Detail Design** as Closely Associated Indirect (CAI) activities. It is our position that Ofgem’s view is based on too broad an interpretation of the 2023 Regulatory Instructions and Guidance (RIGs).

Our disaggregated design and delivery model goes significantly beyond what would be recognised as “functional design” (the primary criteria to treat Network Design & Engineering activities as CAI). That is not to say that functional design does not occur; rather it is a part of the costs highlighted above.

In our submission, for both **Surveys** and **Detail Design** there are elements, that should be classified as Asset Specific Design¹⁵. In accordance with Ofgem’s guidelines, such activities would be recognised as Direct Costs. Ofgem’s approach, in this instance, may not have properly recognised this due to the aggregation of costs that were submitted.

The composition (and costs) of works categorised as **Surveys** are set out in Appendix 6. Ofgem have categorised £0.001m (c0.1%) as Indirect costs. Our analysis, based on further review of content and purpose stated in the relevant contracts, shows that the total of the survey cost would be more properly recognised as Asset Specific Design, involving site works and activities which involve physical contact with transmission network infrastructure assets, thereby recognised as a **Direct Cost**.

Similarly, the composition (and costs) for **Detail Design** works are set out in Appendix 7. As stated in the table above, Ofgem have categorised £0.215m (c20%) as Indirect costs. Our analysis, based on further review of content and purpose stated in the relevant contracts, shows that approximately £0.031m relates to “functional design”. The balance of £0.184m would be more properly recognised as Asset Specific Design, hence, treated as a **Direct Cost**.

¹⁴ Consultation: 3 SPT 2023 MSIP applications | Ofgem, page 26

¹⁵ Asset Specific Design activities are those which the licensee does not have direct control over and the decisions on how to meet the specification in function design are for the manufacturer/contractor to determine.

Risk

As per our response within Risk and contingency allowance section above, we do not agree with the use of a portfolio-average cap as **the process for arriving at the current cap percentage incorrectly includes non-comparable data from other licensees. If Ofgem retains the percentage cap approach to risk, the cap percentage should be applied to the project costs including contractors' indirects, not the costs which exclude them. To do otherwise, would be inconsistent with the basis upon which the percentage cap has been calculated and would result in underfunding.**



Appendix 2 – Removed due to commercial sensitivity



Appendix 3 - Removed due to commercial sensitivity



Appendix 4 - Removed due to commercial sensitivity

Appendix 5 - Removed due to commercial sensitivity



Appendix 6 - Removed due to commercial sensitivity



Appendix 7 - Removed due to commercial sensitivity