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Dear Sai Wing,

NGET's response to Ofgem's Statutory Consultation dated 28 February 2024 on a proposal to modify the Special Conditions of the electricity transmission licence held by SP Transmission to give effect to its decision (also dated 28 February 2024) on three of SP Transmission's 2023 MSIP applications

Whilst we recognise that the decisions on SP Transmission's ("SPT") 2023 MSIP applications have been taken, the decision document[1] raised some important points of principle about the interaction of risk and contingency allowances and the Totex Incentive Mechanism (TIM). These points were not included in the consultation on SPT's MSIP applications and so we were unable to comment on them then, but as they are immediately relevant to NGET's North Wessex Downs Visual Impact Provision project MSIP application (and will also be relevant to subsequent re-opener applications where Ofgem intends to adopt the same approach), it is important that we provide the feedback contained in this letter.

[Please note that we have already commented specifically that we disagree with Ofgem's application of a 7.5% 'risk cap' when setting allowances for re-opener applications, for example most recently in our second response (dated 9 February 2024) to Ofgem's consultation on the Draft Determination on the North Wessex Downs Visual Impact Mitigation Reopener, and that we do not recognise the derivation of the 7.5% value. This letter does not repeat those arguments, which remain unchanged, but instead focuses on this new element introduced by Ofgem in its decision document.]

We think that there are fundamental misconceptions about the interaction of risk and contingency allowances and the totex incentive mechanism (TIM) as described in the SPT MSIP decision document. In that document, Ofgem provides a graph, Figure 1 (shown below), to illustrate how TIM and a risk and contingency allocation of 7.5% combine to share risk between the ETO and consumers.

[1] Decision on the assessment of three 2023 SPT's MSIP full applications (ofgem.gov.uk)

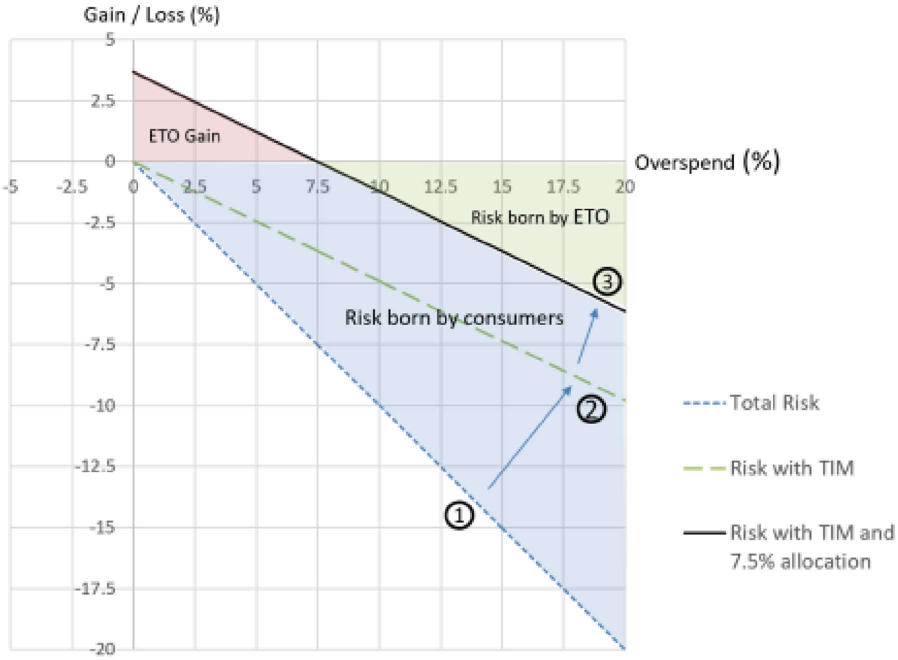

Figure 1. Risk sharing between ETO and consumers[9]

This chart, and the supporting explanation provided in the decision document, misrepresent both the purpose and effect of the 'risk and contingency allocation' [2], and the way in which the TIM operates.

Risk allowance

The explanation provided in the decision document seems to misunderstand what the risk allowance is and why it is provided. Figure 1 (above) presents all expenditure against such an allowance as overspend. This characterisation would only be correct if the expectation was that the allowances without the risk allowance covered the full expected efficient costs of the project. All projects come with risks and contingencies, and the central expectation is that some risks will materialise and costs will be incurred as a result. It is incorrect to classify all such spend as overspend.

Ofgem has a duty to have regard to the need to secure that licence holders can finance their activities. This includes providing a totex allowance to cover the efficient costs of a project, and a cost of capital to cover the efficient costs of finance. If either of these conditions is not met, the project is not adequately financed.

Ofgem's decision in respect of SPT's MSIP applications considers a risk allowance of 7.5% to be the appropriate level. This equates to taking a view that the average project will incur additional costs of 7.5% - some will incur higher costs and some will incur lower costs but:

- The expectation is that on average the risk costs will be 7.5%, and
- An additional allowance of 7.5% is required to fund the expected efficient risk costs of the project.

[2] Referred to as 'risk allowance' hereafter.

If the additional allowance is not provided, the project will not be adequately financed. More specifically, if the company incurs additional expenditure of 7.5% (or indeed anything in excess of a totex allowance which excludes an efficient risk allowance), it will underperform against its totex allowance for the project and fail to earn its allowed cost of capital.

Totex incentive mechanism

As explained in paragraph 2.12 of the SPT MSIP decision document, the TIM is designed to incentivise efficient spend by licensees by sharing under or overspend against allowances between the licensee and consumers.

Despite this explanation, Figure 1 and the supporting commentary outline that in the event that the licensee spends less than the 7.5% risk allowance, "consumers paid extra money but get nothing back."[3]

The TIM is an incentive that results in both the licensee and consumers sharing any underspend against the totex allowance. If the totex allowance is not set to reflect the full, efficient cost of the project, the incentive becomes skewed and (all other things being equal) efficient licensees would not earn their allowed cost of capital.

Updated charts

We believe that Figure 1 (above) constructs Line 2 (Risk with TIM) and Line 3 (Risk with Tim and 7.5% allocation) in the wrong order. The TIM compares totex costs with allowances; it does not compare costs to a subset of allowances, ignoring the risk allowance, and then provide a separate calculation including the risk allowance.

The chart below reproduces Figure 1 but using the correct order and purpose:

> Line 1: This is almost the same as Line 1 in Figure 1. However, rather than representing overspend, it represents spend incurred on risks and contingencies. This cannot all be described as overspend given that the expectation is that some risks and contingences will occur. The red 'expected outcome' line demonstrates that, on average, it is expected that an additional 7.5% risk cost will be incurred.
>
> Line 2: This shows the outcome of adding the 7.5% risk allowance. The impact of this is to move the break-even point to the company to 7.5%, i.e. the company is funded to incur the expected additional risk cost of 7.5%.
>
> Line 3: This shows the effect of the TIM[4] which shares the under or overspend between the ETO and consumers. The area between the x axis and the grey line is the ETO share, and the area between the grey line and the orange line is the consumer share. This is shown more clearly in the second chart below.

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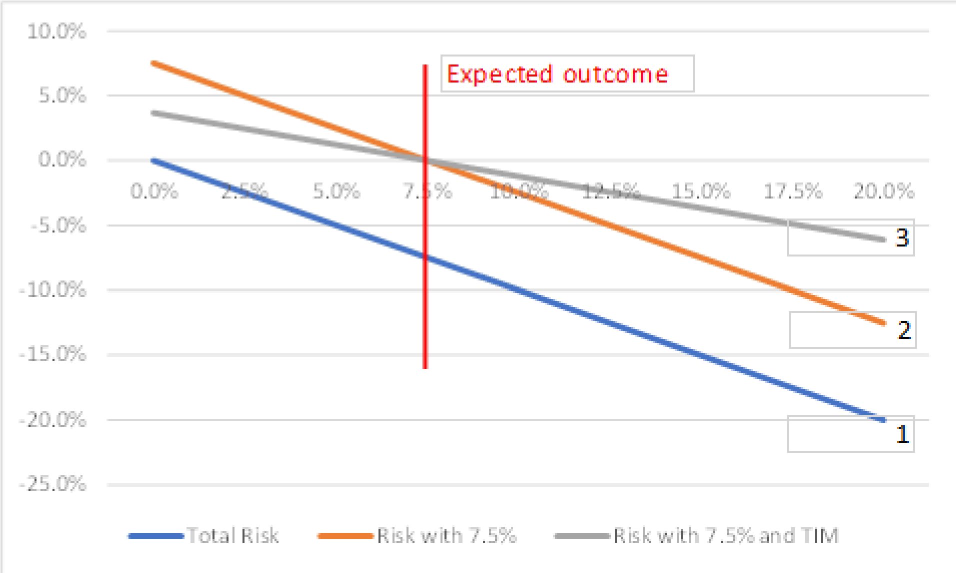
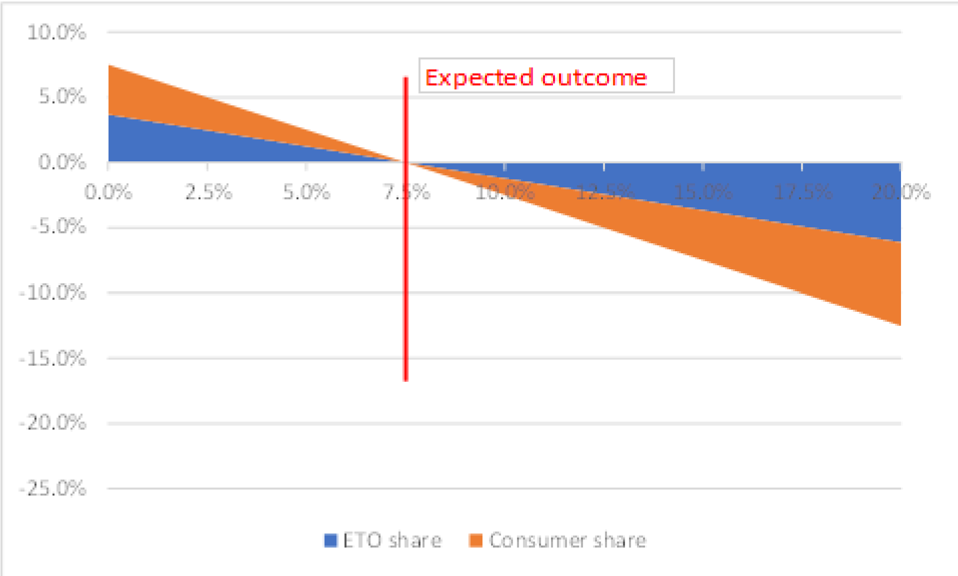
[3] Paragraph 2.15 of the SPT MSIP decision document.
[4] The charts use SPT's TIM rate of 49%.

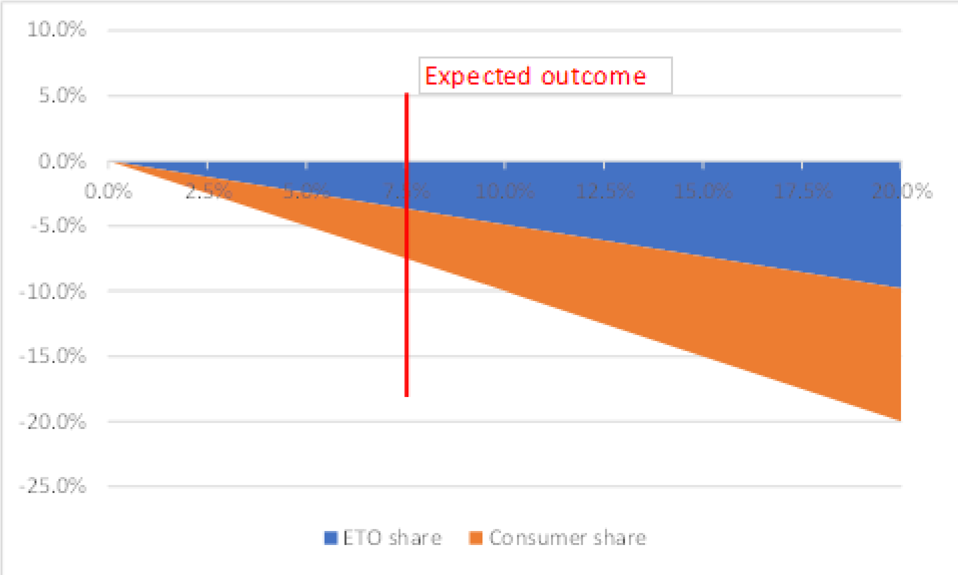




It is clear from these charts that:

- The company breaks even if actual risk costs match the efficient expected risk cost of 7.5%, and
- The ETO and consumers both share the benefit if risk costs are less than 7.5% and share the disbenefit if risk costs exceed 7.5%.

The chart below would be the outcome if Ofgem did not provide a risk allowance. It shows the ETO would suffer in all circumstances. The likelihood of no risks or contingencies being required can be considered almost zero. Such an outcome systematically fails to fund an efficient project adequately.



As outlined in the opening paragraph, these are fundamental points of principle and it is important that they be taken into account in all future re-opener applications. If it would be helpful to talk through the details in this letter, please do let me know.

Confidentiality

NGET confirms that this response can be published on Ofgem's website.

Yours sincerely

(by email)

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