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Dear RIIO-2 team,

### **RIIO-2 tools for cost assessment**

We enclose below the Electricity System Operator (ESO) response to three questions in your RIIO-2 consultation on tools for cost assessment. These are on real price effects and efficiency.

There is also a National Grid response that answers questions on business support costs – this provides views on a National Grid Group level as it refers to shared costs, and so reflects ESO views on that topic. We have chosen to submit a separate response focusing on real price effects and efficiency because of the different considerations that should be taken into account for the ESO in these areas, in comparison with the RIIO network companies.

### **Real price effects**

**Question 18: What RPEs should we account for, how should we gauge materiality, and what criteria should we use for index selection?**

We expect ESO costs over the RIIO-2 period to be affected by real price effects (RPEs). The material impact will be on our labour costs due to the specialised nature of our workforce and because, as a service-based organisation, our labour costs make up around 80% of our direct operational expenditure (opex) cost base. The move from Retail Price Index (RPI) to Consumer Prices Index including owner occupiers' housing costs (CPIH) indexation in RIIO-2 is expected to increase the gap between indexed labour costs and actual costs based on future real pay growth.

The level of materiality for the ESO can be best demonstrated by considering the significant proportion of the opex cost base that relates to labour costs, and therefore is affected by real price effects.

As in RIIO-1, we would expect to use a mix of general and specialised labour indices which reflect the skills and capabilities of our future workforce to support our RPE indexation for RIIO-2.

**Question 19: What common input and expenditure categories are appropriate for structuring RPEs?**

As in RIIO-1, the labour and contract labour input categories are most relevant for the ESO. This applies to both the direct opex cost base and our business support costs.

### **Ongoing efficiency**

**Question 20: How should we identify an appropriate ongoing efficiency assumption?**

We would expect an ongoing efficiency assumption for the ESO to be different from that used for the RIIO network companies. The ESO's activities are broad, and vary over time to meet the changing needs of industry and consumers; change that is more prevalent as we continue to transform the energy system in GB. This limits the learning and efficiencies that can be applied when a company is undertaking similar activities on an annual basis, such as the construction of fixed assets.

Our October business plan will set out the efficiency savings embedded in our cost proposals for RIIO-2, and any further assumptions that can be made given our relatively short (two-year) budget cycle.

Yours Sincerely,

[By email]

Claire Tuckman