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Dear colleagues,

Our decision on National Grid's application under the RIIO-T1 Enhanced Security Costs Reopener

This letter sets out our decision on National Grid's (NG's) reopener application for Enhanced Security Costs which requested an increase in its baseline allowances of £125.3m.¹ In May 2018, NG submitted a joint reopener application for its gas and electricity transmission licensees under Special Condition 7D of National Grid Electricity Transmission plc's (NGET) electricity transmission licence and Special Condition 6D of National Grid Gas Transmission plc's (NGGT) gas transporter licence.

In August 2018, following our review of NG's joint application we published our consultation document setting out our initial view to allow £107.1m of additional funding as part of this reopener.² We received one confidential response from NG. A non-confidential version of NG's response has been published alongside this letter.³

This letter is a non-confidential overview of our decision. The sensitive nature of the application means that it is not appropriate to publish our full assessment in the public domain. We provided NG with a separate confidential letter alongside this one that sets out our full decision.

Our final decision

We have decided to increase NG's baseline allowance by £112.9m for Enhanced Security Costs. When making our decision we have considered NG's response to our consultation and taken account of our principal objective under the Gas Act 1986 and under the Electricity Act 1989 as well as our powers and duties under the Acts and under the licences. This decision is in accordance with Special Condition 7D of NGET's electricity transmission licence and Special Condition 6D of NGGT's Gas Transporter licence.

We have decided to allow:

- £76.5m of the £84.8m requested by NG for data centre investments. This is an increase of £1.6m from our initial view.

¹ All costs in this letter are reported in the 2009/2010 price base, unless otherwise stated.

² A confidential version of our consultation was provided to NG which set out our full assessment. A non-confidential overview of our initial views was published on our website: <https://www.ofgem.gov.uk/publications-and-updates/consultation-riio-1-price-control-reopeners-may-2018>

³ <https://www.ofgem.gov.uk/publications-and-updates/consultation-riio-1-price-control-reopeners-may-2018>

- £36.4m of the £40.5m requested by NG for cyber security enhancements. This is an increase of £4.2m from our initial view.

We have also decided to link the funding to the delivery of clear outputs to deliver the enhancements as set out in NG's reopener application and to report on the progress of delivery to the Competent Authority (CA). As part of the close out process for the RIIO-T1 price control, we reserve the right to recover any allowances provided as part of this reopener if the outputs set through this decision are not delivered. The specification of the output is set out in Appendix 1 of this letter.

The rest of this letter sets out the relevant background and reasons for our decision.

Background

At the time of setting RIIO-T1 allowances, there was uncertainty about the costs relating to compliance with future government recommendations and statutory requirements on the security of IT systems. We therefore included a reopener mechanism for Enhanced Security Costs in the RIIO-T1 price control. The reopener mechanism applies to both NGET and NGGT and includes two application windows, May 2015 and May 2018.

NG did not make an application for funding during the 2015 reopener window. In May 2018 we received formal reopener applications from NGET and NGGT requesting additional allowances of £71.8m and £53.4m respectively for Enhanced Security costs. An overview of NG's reopener application was provided in our consultation document.

We consulted on our initial view to allow £107.1m of NG's £125.3m requested expenditure allowance in August 2018. We received one confidential response from NG which we have reviewed and considered in arriving at our decision.

Our initial views

We commissioned an independent cyber-security expert from PA Consulting to inform our assessment. Our consultant's recommendations drew from his experience working on equivalent projects relating to cyber security. We considered and incorporated our consultant's recommendations into our proposals for consultation.

Data Centre Investments

In our consultation document, we had proposed to allow £75.0m of the requested £84.8m for enhancements to its data centres.

We proposed to reduce costs relating to resource and NG's risk allowance, which we considered to be too high. We also proposed to reduce the programme cost to 15% of the total project cost, after the other adjustments had been made. This was in line with our view of the efficient benchmark of project management costs for comparable large projects, and is consistent with our approach for the other reopeners.

Cyber Security Enhancements

In our consultation document, we had proposed to allow £32.2m of the £40.5m requested by NG for cyber security enhancements.

Our consultant advised that, based on benchmarks from comparable projects, additional efficiency savings could be made by applying lessons learnt. He also advised that risk level, resourcing and project management costs were high compared to similar projects, so we proposed to reduce the allowances in these areas.

We also thought that NG's proposals for cyber security enhancement overlapped with work on cyber security initiatives for which we had previously provided funding of £4.7m through NG's RIIO-T1 allowances. We proposed to reduce NG's requested allowances across the first three years of the programme by this amount.

Relevant regulatory outputs

While our initial view of the NG's cyber security programme was that it was a reasonable response to the current threat level and government recommendations and requirements, we thought that there is some delivery risk associated with these projects.

We therefore proposed to link the funding for the cyber security enhancements to the delivery of clear outputs, which we asked stakeholders for views on. Our consultation document included draft outputs which proposed to require NG to provide 6-monthly reports on progress and any changes to the programme to the CA for assessment. We also said that Ofgem could make appropriate adjustments allowances to RIIO-T1 allowances as part of the close out process to take account of non-delivery of the outputs.

NG's consultation response

We received one confidential response to our consultation from NG. NG also provided a non-confidential version of its response for us to publish alongside our decision. We have summarised the non-confidential elements of NG's consultation response below.

General views

NG agreed with our approach for the assessment. However, it thought that our proposals in a number of areas were based on assumptions or views and asked for these views to be further supported by evidence.

Data Centre Investments

NG asked for us to reconsider our adjustments to risk, licencing, and resource costs. It provided more information on its framework contracts and provided further clarification of the risk costs applied to the programme. NG also thought that if we decide to adjust the data centre investment allowances in our final decision, we should also adjust the allowed programme costs to reflect our final view.

Cyber Security Enhancements

NG disagreed with our view that further efficiency savings could be applied to projects that have already been implemented. It also identified an administrative error in the risk costs included in the submission for one project and provided an updated document for our consideration.

NG also said that some of the overlapping allowance of £4.7m that we had identified in our consultation was separate to the cyber security enhancement programme.

Outputs

NG agreed with our proposal to link the allowances for the Cyber Security Enhancements to clear outputs and welcomed the opportunity to engage with the CA. It also welcomed our proposal to take into consideration whether any appropriate alternative initiatives are delivered if it makes any changes to the programme described in its May 2018 reopener submission. NG said that it would expect its allowances to be appropriately adjusted (up or down) if any changes are made to the programme.

NG said that the proposed reporting requirements would lead it to incur additional costs and therefore it considered us to have overestimated the reductions made to the allowances for resourcing in our initial views on the Cyber Security proposals.

NG also requested for us to better align the proposed reporting timescales with the Enhanced Security plans or financial years (such as aligning with RRP). It also suggested some wording for the output relating to the data centre investments and cyber security enhancements.

Reasons for our final decision

Having considered NG's response to our consultation, we have come to a decision on all areas of funding requested as part of this reopener. The rest of this section sets out a non-confidential overview of our decision on each area, and our reasons for that decision.

Our response to NG's general views

NG asked for of our views on efficient costs to be supported by further evidence. Due to the sensitive nature of this area, cost benchmarks for data centre investments and cyber security projects are not available in the public domain. We have therefore based our assessment on advice received from our consultant (from PA Consulting). PA Consulting has carried out previous projects of a similar nature, and based on experience gained from these projects, our consultant has used his expert judgement to advice on what would be reasonable in the case of these projects. Projects involving secure data centres and cyber security initiatives are highly sensitive, and we therefore do not have direct access to the underlying information. While we would have preferred greater transparency, we think it is in consumers' interests that we take account of this advice.

This confidential information was used by us as the basis for approximately reducing the total requested amount by approximately 2% (i.e. approximately £2.5m). Where NG provided further justification for its request as part of its consultation response we have considered this when making our decision, as outlined in the remainder of this letter.

Data Centre Investments

We have considered the additional information NG provided regarding its framework contracts and its clarification of the level of risk included within the submission. We are satisfied that this new information justifies NG's requested costs in these areas.

We maintain our view that the programme costs should be reduced to 15% of the total project costs, which is in line with our view of the efficient benchmark of project management costs for comparable large projects, and is consistent with our approach for the other reopeners. We have amended the allowed programme costs to take into consideration the adjustments detailed above.

The impact of this decision is to allow £76.5m of the £84.8m requested by NG for data centre investments, which is an increase of £1.6m from our initial view.

Cyber Security Enhancements

We have decided not to apply further efficiency savings to some parts of the programme which have already been delivered. However, we maintain our view that further efficiencies can be achieved in other parts of programme by applying lessons learnt and that the internal resource costs for some parts of the programme have not been justified.

We considered the additional information that NG provided on risk costs for one part of the programme. We have decided to allow some additional risk costs relating to this new information. However, we maintain our view that some of the risks have been overestimated and have reduced the risk values in these areas.

In its consultation response, NG did not agree with the reduction of £4.7m that we had made to take account of overlaps with funding that we had provided as part of its RIIO-T1 allowances. We have considered this issue further.

NG's RIIO-T1 business plan submission had requested £6.2m of funding to cover three security initiatives. We provided the requested allowance of £6.2m in full as part of the RIIO-T1 price control baseline allowances. We think that the scope of works covered in NG's business plan is at a high level and sufficiently close to some of the cyber security initiatives described in NG's reopener submission. Therefore, we maintain our initial view that there is likely to be an overlap between the two sets of work. As a result, we have decided to consider the funding previously provided when assessing the efficient costs of the cyber security enhancement programme. We accept NG's position that the allowance for one of the programmes that was previously funded should be treated separately, as these are ongoing and parallel activities to the programmes included in the reopener submission. However, we have decided to make a reduction of £2.5m to NG's requested amount to take account of the allowance provided for the other two cyber security programmes, but has not been spent.

Outputs

We maintain our view that it is appropriate to link the funding to the delivery of clear outputs. In our consultation document, we proposed to link the funding to the delivery of cyber security enhancement initiatives as specified in the output. Having considered NG's consultation response, we have decided to expand the output to include the data centre investments.

We also note the expectation that NG expressed in its consultation response for its allowances to be appropriately adjusted if any changes are made to the programme. For the avoidance of doubt, we will only make downward adjustments, and not upward adjustments, to NG's allowances as part of our assessment of the output delivery at RIIO-T1 closeout. This is consistent with our approach to the RIIO price controls where we set outputs in return for price control allowances for certain large investments. We do not provide additional funding where costs increase except in cases where we set explicit ex ante mechanisms such as this reopener. We think this best serves consumers' interests as it incentivises efficiency and encourages network companies to proactively manage the risks that they face.

If an initiative has not been delivered as specified in NG's May 2018 reopener submission and consequently our regulatory output, we will consider whether NG has delivered an appropriate alternative initiative that provides similar benefits. If no alternative initiative is delivered, or if the alternative initiative delivers lower benefits, we will adjust the RIIO-T1 allowances downwards as appropriate. If any additional spending is required, we expect NG to request funding for this through its RIIO-T2 business plans.

We do not agree with NG's view that the additional reporting requirements will add a significant layer of costs to the projects. The information that will be requested will be standard management information that we would expect NG to capture and report internally as industry best practice. We will therefore not allow any additional resource costs for this requirement.

Taking account of views set out in NG's consultation response, we have amended the reporting timelines to align more closely with the financial year and NG's regulatory reporting.

Next steps

Our final decision for NGET and NGGT's allowances are set out below.

Table 1: NGET May 2018 reopener - Enhanced Security Costs proposed adjustment to annual allowance profile.

£m (09/10 price base)	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21	Total RIIO-T1
NGET Requested Expenditure	0.089	1.278	3.525	5.203	11.126	23.343	15.567	11.653	71.782
NGET Allowed Expenditure	0.000	0.000	3.247	4.690	10.524	21.546	13.876	10.730	64.612

Table 2: NGGT May 2018 reopener - Enhanced Security Costs proposed adjustment to annual allowance profile.

£m (09/10 price base)	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21	Total RIIO-T1
NGGT Requested Expenditure	0.072	1.041	2.495	3.417	7.839	14.830	13.056	10.726	53.476
NGGT Allowed Expenditure	0.000	0.000	2.343	3.141	7.495	13.681	11.770	9.871	48.301

Our decision will be implemented through the 2018 Annual Iteration Process, which will mean that any adjustments to NGET and NGGT's allowed revenues will take effect from 2019/20.

Ofgem, in its role as the CA, will provide a template that NG should use for its six-monthly reports as set out in Appendix 1. We expect to provide this by the end of November 2018.

If you have any queries about this letter please contact Rebecca Pickett at Rebecca.Pickett@ofgem.gov.uk.

Yours faithfully,

Geoffrey Randall
Deputy Director, Network Price Controls

Appendix 1: Regulatory outputs for Enhanced Security costs

We have decided to link the additional allowances for Enhanced Security costs to the delivery of the following outputs⁴ for the RIIO-T1 price control:

- Completion of the data centre investments set out in National Grid's (NG's) May 2018 reopener submission.
- Delivery of the cyber security enhancements as set out in NG's May 2018 reopener submission and supporting documents.
- For the remainder of the RIIO-T1 period, NG must submit six-monthly reports to the Competent Authority (CA), using a template approved or provided by the CA, on the progress made in the delivery of the data centre investments and cyber security enhancement initiatives as set out in the May 2018 Enhanced Security reopener submission. The report covering the period 1 October to 31 March should be submitted by 31 May of the same year, and the report covering the period 1 April to 30 September should be submitted by 30 November of the same year. The first report under this output should cover the period 1 October 2018 to 31 March 2019 and should be submitted by 31 May 2019.
- Where changes are made to the programme(s) described in NG's May 2018 reopener submission, these must be outlined and explained in NG's report, including a detailed explanation of the impact of the change on costs and benefits to consumers.

The CA will assess the report to determine whether NG has made appropriate progress on the delivery of its relevant outputs and provide a written view to NG on this.

As part of RIIO-T1 closeout, the CA will provide a final view to NG and the Ofgem RIIO Price Control team on whether the cyber security enhancement programme funded through this reopener mechanism have been delivered as set out in the May 2018 reopener submission. Where initiatives have not been delivered, the CA will provide a view to whether non-delivery was appropriate due to any:

- changes to the threat landscape; and/or
- appropriate alternative work has been done to deliver the same benefits; and/or
- the initiatives have been reprioritised based on NIS assessments and/or follow-up audits.

If Ofgem deems that:

- One or more of the outputs set out above were not delivered; and
- appropriate alternative initiatives were not delivered; and/or
- the non-delivery of initiatives has had, is likely to have, a detrimental impact on consumers;

then we reserve the right to make appropriate downward adjustments to RIIO-T1 allowances when making our final decision on RIIO-T1 closeout.

⁴ More detailed outputs for the programmes have been provided to NG in our confidential decision letter.