

# SSEN Transmission - Totex Incentive Mechanism (TIM)

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## 1 Introduction: Our position

Ofgem elected not to include a specific consultation question seeking views on cost confidence and associated impact on the Totex Incentive Mechanism (TIM) within its Draft Determinations for RIIO-2. Given the significance of the mechanism in RIIO-T2, we have drafted this supplementary paper to outline our position on the TIM and our response to the level of cost confidence within our Business Plan submission.

We strongly disagree with our TIM Sharing Factor being set at 30.9%. As we note in the Main Response we believe our Sharing Factor should be set at 50% as it is in RIIO-T1. A strong Sharing Factor has been proven to drive in-period efficiency that will keep costs down for current and future consumers; to move away from successful practice makes no sense for consumers. Further a 30.9% is:

- an outcome at odds with our track record and with Ofgem’s Business Plan Guidance “to consider proposals for the RIIO-2 period in the context of each company’s past performance”<sup>1</sup>.
- a perverse outcome where we, a network with relatively low RIIO-1 underspend, are punished with a low Sharing Factor and other networks with relatively high totex RIIO-1 underspend are rewarded. At the very least, we should have a Sharing Factor on par with the other TOs (NGET and SPT at 39%).

Setting aside the policy reasons above for a fairer and higher Sharing Factor, this paper provides clear evidence that Ofgem has made an error in setting our “blended” Sharing Factor at 30.9% and that correctly applying Ofgem’s methodology our Sharing Factor should be set at a minimum of **41.3%**<sup>2</sup>.

We attach our Cost Confidence Analysis workbook which provides unambiguous evidence for this. It details of our view of cost confidence, that can be traced back to the cost items which can in turn be traced to our Rate Book.

## 2 Errors in Ofgem Assessment

Ofgem did not consider all the evidence provided and made errors in its assessment. We note the following:

<sup>1</sup> [https://www.ofgem.gov.uk/system/files/docs/2019/10/riio-2\\_business\\_plans\\_guidance\\_october\\_2019.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/10/riio-2_business_plans_guidance_october_2019.pdf) page 9.

<sup>2</sup> This is our best estimate following our own corrections of errors in Ofgem’s Project Assessment Model (PAM).



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**Ofgem has not considered all cost information provided in Project Cost & Efficiency Reports (PCER):** In table 2.4 of each PCER we provided the cost category and the source of the cost estimation for each (e.g. returned tendered, rate book, RIIO-T1 metrics), which is not reflected in the cost confidence results from Ofgem. For instance, we have a number of schemes where costs have been derived through market tenders, but Ofgem has not classed these as High Confidence, e.g. Port Ann to Crossaig.

**Misclassification of Cost Categories based on Ofgem’s high confidence criteria:** Ofgem has misclassified certain cost categories as Low Confidence when they should in fact be High Confidence. Ofgem define High Confidence costs as<sup>3</sup>:

- **realised actual costs** in RIIO-1;
- evidence that cost forecasts have been arrived at via a competitive process or other **market testing**;
- other **independent benchmarking** (e.g. industry or international benchmarks);
- costs where we [Ofgem] are able to determine a unit cost allowance with a high degree of confidence and where an appropriate volume driver or **other uncertainty mechanism** will be implemented and applied to a volume drawn from a baseline scenario.

Ofgem has failed to follow this approach for:

- Risk & Contingency (our costs are based on outturn RIIO-T1 projects (realised costs) and Ofgem has benchmarked these at Draft Determinations); and
- Pre-construction for Large Strategic Schemes (these are based on a mix of tenders and T1 outturn rates and are subject to an uncertainty mechanisms where we return any unspent allowances to consumers).

**Modelling errors and adjustments:** the mechanics of Ofgem’s models fail to account for any manual adjustment of cost confidence. This has a negative impact when calculating our TIM Sharing Factor. For example, Ofgem categorise FACTS as high confidence but this is not reflected in Ofgem’s calculation of the TIM Sharing Factor.

**Excluding approved projects from the BPI & TIM assessment:** we strongly believe that the East Coast 400kV upgrade should be subject to the TIM (see our Main Response, section 3.4 and our supporting document “True-Up, Logging up and Re-openers: SHE Transmission RIIO-T2 Proposals”) therefore its removal has a negative impact on our final TIM Sharing Factor.

<sup>3</sup> RIIO-2 Sector Specific Methodology Decision, paragraph 11.37 [https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2\\_sector\\_specific\\_methodology\\_decision\\_-\\_core\\_30.5.19.pdf](https://www.ofgem.gov.uk/system/files/docs/2019/05/riio-2_sector_specific_methodology_decision_-_core_30.5.19.pdf)

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### 3 Our Approach

Following Ofgem’s principles set out in the SSMD, our approach is summarised as follows reviewing our entire baseline request:

**Table 1 - Principle approach and proposed movement in confidence categorisation**

Principle/Process	Value moving to High Confidence	Conclusion/comments
1. Projects subject to a <b>recent tender</b> are high confidence	>£246m  (some Ofgem had as high-confidence but all should be high-confidence)	<b>Elements</b> within each project is high confidence. These projects are: <ul style="list-style-type: none"> <li>• North East 400kV – Reinsulating &amp; Reconductoring (SHT2001)</li> <li>• North East 400kV – Peterhead Busbar (SHT2004)</li> <li>• East Coast Onshore 275kV Upgrade – Alyth</li> <li>• Kinardochy Reactive Compensation</li> <li>• Port Ann - Crossaig 132kV OHL Works (SHNLT200)</li> </ul>
2. <b>Assets</b> identified through our <b>rate book with T1 outturn</b> rates or <b>utilisation of recently tendered rates</b> are high confidence where there is minimal variance across the asset unit rate	£137.6m	Ofgem incorrectly categorise areas of high confidence as low confidence. This includes: <ul style="list-style-type: none"> <li>• earth wire (all voltages) - £9.48m</li> <li>• earth wire fittings (all voltages) - £2.9m</li> <li>• overhead line conductor (all voltages) - £48.51m</li> <li>• Overhead Line Fittings (all voltages) - £7.5m</li> <li>• protection (all voltages) - £69.24m</li> </ul>
3. Activities/Assets subject to an <b>uncertainty mechanism</b> that protects consumers from underspend (and windfall gains for company) are high confidence	£122m excluding Landowner	This includes: <ul style="list-style-type: none"> <li>• large strategic scheme pre-construction funding - £109m</li> <li>• Dynamic Line Rating - £13m</li> <li>• Landowner compensation*</li> </ul>

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<p><b>4. Indirect costs are benchmarkable</b> and all are therefore high confidence</p>	<p>£0 (As agreed with Ofgem)</p>	<p>This includes BSCs and CAI costs and is in line with Ofgem view.</p>
<p><b>5. Network Operating Costs</b> are either based on <b>T1 outturn rates or on tenders</b> and therefore high confidence (principle 2)</p> <p><i>Exception:</i> Operating protection measures and IT capex as bespoke (except for DLR which is subject to a UM as above)</p>	<p>£13m* (already accounted for in point 3)</p>	<p>This is in line with Ofgem (although DLR should move to high confidence).</p>
<p><b>6.</b> Non-operational capex are all high confidence as based on <b>T1 run rates</b> and can be reasonably subject to <b>expert review</b> with confidence on costs.</p>	<p>£52.5m</p>	<p>Agree with Ofgem broad approach and should now move warehousing and wider property costs to high confidence as this too has been subject expert cost review.</p>
<p><b>7. Risk</b> is based on <b>T1 outturn projects</b> and is therefore high confidence</p> <p><i>*Ofgem has also benchmarked risk</i></p>	<p>£119.9m</p>	<p>Ofgem wrongly categorise risk as low confidence and should be corrected.</p>
<p><b>8. Civils</b> starting position is low confidence due to locational factors</p> <p><i>Exceptions:</i> civils associated with assets (point 2) where there is a core historical unit costs i.e. replicable and repeatable unit costs.</p>	<p>£82.4m</p>	<p>Disagree with Ofgem. This high confidence applies to:</p> <ul style="list-style-type: none"> <li>• Civils for Switch Gear &amp; Support Structures - £13.87m</li> <li>• Transformer Bunds - £8.7m</li> <li>• Transformer Buildings - £28.0m</li> <li>• GIS Building - £15.9m</li> <li>• Oil Separator Equipment - £0.17m</li> <li>• Control Building - £2.4m</li> <li>• Building Other – Asset Specific - £13.2m</li> </ul> <p><i>This would not include OHL foundations, access tracks, site clearance and bulk earth works as these are highly likely to be impacted by external factors.</i></p>

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<b>9. Other direct costs</b> (decommissioning, regulatory consents) are difficult to benchmark and are low confidence  <i>Exception:</i> except where this applies to cross over schemes as close to construction	£0m  (As agreed with Ofgem)	This is in line with Ofgem.
<b>Total movement to high confidence category</b>	<b>£760.4m</b>	

\*Note: this is not in the PAM as the costs are not yet approved by Ofgem and therefore do not feature in our TIM Sharing Factor calculation.

## 4 Revision to SHE Transmission Sharing Factor

The tables below set out the outcome of our principle approach on how the TIM sharing factor should be calculated and provides us a sharing factor of 41.3%.

**Table 2 – SHE Transmission View of Breakdown of Low & High Confidence Costs**

Cost area	DD Baseline Allowance		Stage 4 of BPI: independent benchmark costs (SHET view)
	Low Confidence	High Confidence	High Confidence
Load Related Capex	275.8	566.4	611.9
Non-Load Related Capex	329.1	495.1	490.4
Indirect	0	360.3	401.0
Non-Op Capex	0	112.4	112.4
Network Operating Costs	59.4	148.6	148.6
<b>Total</b>	<b>661.9</b>	<b>1,682.9</b>	<b>1,764.4</b>



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**Table 3 – Sharing Factor Calculation**

Overall Baseline £m (subject to BPI)	2,344.7
High Confidence Cost £m	1,764.4
High Confidence Cost %	75%
Low Confidence Cost %	25%
<b>Sharing Factor %</b>	<b>41.3%</b>

### Modelling Assumptions & Inputs

The assumptions and inputs that were used to derive our view of the Sharing Factor are summarised below.

1. We have used our own view of which cost categories should be deemed as High Confidence, manually updating cost category assumptions/errors within the PAM to reflect this.
2. We have included all schemes submitted as part of our Business Plan – we seen no logic to exclude individual projects.
3. We have corrected Ofgem’s Independent Benchmark methodology, as it does not capture all high confidence costs, only those with a unit cost.
4. We have used our view of project specific costs as we believe these are efficient and justified. For example, short run cable in existing substations. We have removed the benchmarked unit cost to capture this cost.
5. The data does not account for updated costs in newly submitted EJPs but uses existing costs. This will not have a material impact on the outcome.

We acknowledge that this analysis and assessment is not without assumptions, given we are still at the Draft Determination stage of the RIIO-T2 process. However, we believe that this results in a more appropriate Sharing Factor by capturing all high confidence and low confidence costs through a bespoke, bottom-up assessment – a true/fairer reflection of the cost confidence.

We provide further evidence and justification in the sections below and supporting excel workbooks<sup>4</sup>, that validate our view on the Sharing Factor.

<sup>4</sup> T2BP-DD-SHE-011 - SHET\_TIM\_Cost Confidence Workbook & T2BP-DD-SHE-017-SSEN Transmission Rate Book

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## 5 Cost Evidence to Support Revision to Sharing Factor

We have well-established estimating procedures supported by our Large Capital Project Governance process<sup>5</sup>. In this paper we outline how these procedures ensure project costing accuracy and result in confidence in our submitted costs. Primarily these are:

- **Current market tested costs:** where possible, we have carried out market wide tender events so that significant proportions of our key RIIO-T2 project estimates are using actual tender return information.
- **Recent market tested costs:** where applicable have utilised recently returned tenders for Projects of a similar nature.
- **Market / procurement derived costs:** for projects where we were unable to utilise recent tenders, we have based the remaining estimates on existing competitively tendered project rates and Frameworks.

There were several reasons for selecting this approach:

- Supply Chain feedback (Resources required, security of work load and other demands)
- Portfolio Review (Complexity variations between Project work streams & Work Categories)
- Limited Specific Cost Knowledge in certain technologies (FACTS Non SF6 Switch Gear etc.)
- Other External Factors (Brexit, Supply chain capabilities and approach to risk).

Both our costing process and the rates and estimating template (“Rate Book”) used in estimating our Business Plan projects have undergone a third-party consultant review to determine best practice and helped us identify specific cost drivers.

*“Arcadis commends the approach taken by SSEN to attain improved estimate accuracy levels through; early site assessment visits, improved technical optioneering, standardised cost templates and early contractor engagement.”*<sup>6</sup>

For every project within our Business Plan the project cost source information (as highlighted already) was provided in each Project Cost and Efficiency Reports.

<sup>5</sup> As set out in our Costing Methodology paper SD7 T2BP-MET-0004 submitted as part of the December 2019 Business Plan.

<sup>6</sup> Arcadis Review of RIIO-ET2 Cost Estimation Process – May 2019

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### Project by project costing

In preparing cost estimates for RIIO-T2, we sought to develop as robust costs as possible for each of our individual projects therefore enabling as much certainty as possible to our costings. We therefore developed a Pathway to Cost Certainty approach for all of our projects. The purpose of the Pathway to Cost Certainty exercise was to look at all projects on an individual basis and determine for each project how we could develop as robust an estimate as possible for each project estimate.

The benefit of this approach is improvement in the accuracy and robustness of our estimates by being proactive and innovative in developing our projects as far as reasonably practicable from a cost perspective. The process also allowed us to have a greater understanding of regional factors and cost drivers that may impact the project estimates. Another significant benefit in taking this approach is that by focusing on project specific details, it puts into a more balanced context metric comparisons which could on their own be subjective.

If we had not taken this approach our risk evaluation would have likely been higher and therefore detrimental to the consumer.

Amongst the activities that we initiated/accelerated were bespoke tender submissions, utilising tender rates from recent tenders, and more detailed evaluations/assessments than would normally have been applied at the natural project gate status. In taking this approach we were able (for our main work components) to prepare many of our project cost estimates by utilising a significant amount of project tender values, and/or utilisation of tender values or framework rates as opposed to a high-level metric analysis. These costing approaches were set out in the Cost & Efficiency Papers and are summarised below.

### Tendered Projects

As highlighted above, we believe that Ofgem has not considered the cost source information within the PCERs that we submitted. This is specifically true in relation to load and non-load projects which had a significant portion of costs being from a returned tender. These projects should be marked as High Confidence in their entirety, or at the very least those project components that are tendered. The tables below set out the projects that have been costed through a market tendered process but have not been deemed as High Confidence by Ofgem.

**Conclusion:** these tendered costs detailed below provide the highest level of confidence possible and therefore Ofgem must reflect this in its Final Determination.

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	Category	Description	Total Cost	Costing Tool
<b>North East 400kV – Reinsulating &amp; Reconductoring (SHT2001)</b>	Overhead Lines	All in rate including steelwork strengthening, fittings & access	29.415	Returned tender
	Overhead Lines	-	3.408	Returned tender
	Civils	Foundation works and access	9.113	Returned tender
	<b>Total</b>		<b>41.936</b>	

	Category	Description	Total Cost	Costing Tool
<b>North East 400kV – Peterhead Busbar (SHT2004)</b>	Overhead Lines	Conductors	0.688	Returned tender
	Underground Cable	Non-pressurised	1.87	Returned tender
	Underground Cable	Non-pressurised	4.19	Returned tender
	Substations	Equipment	6.474	Returned tender
	Substations	Switchgear (Bay)	0.447	Returned tender
	Substations	Switchgear (Bay)	10.05	Returned tender
	Civils	Civil	28.85	Returned tender
<b>Total</b>			<b>52.57</b>	

	Category	Description	Total Cost	Costing Tool
<b>East Coast Onshore 275kV Upgrade – Alyth</b>	Substations	MSCDN	4.553	Returned tender
	Substations	STATCOM	16.411	Returned tender
	Substations	Transformer (purchase as part of STATCOM package)	2.779	Returned tender
	<b>Total</b>			<b>23.6</b>

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	Category	Description	Total Cost	Costing Tool
<b>Kinardochy Reactive Compensation</b>	Substations	MSCDN	4.879	Returned tender
	Substations	STATCOM	17.044	Returned tender
	Substations	Transformer 400kV	2.772	Returned tender
	<b>Total</b>		<b>24.695</b>	

	Category	Description	Total Cost	Costing Tool
<b>Port Ann- Crossaig 132kV OHL Works (SHNLT200)</b>	Overhead Lines	Tower Conductor	19.868	Returned tender
	Overhead Lines	Towers	19.963	Returned tender
	Substations	Substations upgrades	1.107	Returned tender
	Civils	Access tracks, foundations etc	54.112	Returned tender
	Substations	Alterations works to existing substations	8.273	Returned tender
	<b>Total</b>		<b>103.323</b>	

These tables show that there is up to **£246m** of tendered costs that should, by Ofgem's definition, should be High Confidence and considered as such for TIM calculations.

### Utilisation of Recently Tendered Rates & Frameworks – Rate Book

A large proportion of our RIIO-T2 costs were derived from recently tendered rates and frameworks. Which we contain and update via our cost "Rate Book". This has been constructed using a range of cost sources that include:

- The utilisation of recently tendered projects to derive well evidenced and market tested unit costs for assets.
- Recently tendered Framework information which provides significant detail for both top down and bottom up project costing based on requirements
- Bespoke rates for infrequently required activities



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### Rate Book: Overview

Where possible, we have selected projects that give a robust representation of the works carried out by SHE Transmission. Project Tender Returns are analysed for use and specific rates derived and recorded. Significant anomalies will be identified and may be discounted as a result.

The aim of the Rate Book is to provide cost certainty on a large range of repeatable costs giving a base platform for the Estimator to then identify and assess specific project requirements, regional or site-specific factors and external considerations. This process leads us to derive a high cost confidence on a project by project basis.

Given this process, there are a number of categories where we can show that Ofgem should, by their own definition, have allocated as High Confidence.

### Rate Book: Specific Categories

**Civils associated with Assets:** a large proportion of the rates in our Rate Book deal with the Civils elements of projects. These can be asset specific like foundations for overhead lines or rates for forming platforms, installing drainage and fencing. Whilst each rate in our rate book is based on tendered projects, has undergone analysis and is suitable for accurate project pricing, we recognise that there are distinctions to be made between:

- rates that can be subject to many external factors which would affect movements in costs and;
- rates where these factors are negated, and a high degree of cost certainty can be asserted. These rates are:
  - **Switchgear & Asset Plinths** - once the platform has been formed, all ground risk has been mitigated and the standardised designs allow for a highly repeatable and consistent method of construction, allowing for High Confidence cost allocation
  - **Transformer Bunds** – again, the platform having already been formed and standardised designs and sizes based on transformer voltage allow for a High Confidence cost allocation.
  - **Buildings** – We adopt a very standard design for our substation buildings and have strong cost data analysed into sizing bands by m2 footprint of the building. Again the ground conditions will not be a factor and even internal layout alterations have a negligible effect on costs.

**Overhead Line:** Although there will be project by project variables in certain elements of our overhead line overall cost (towers that will vary due to terrain requirements as will the corresponding foundations (Civils Costs)), there are also elements which we cost with a high degree of cost certainty. These are the:

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- Earth wire
- Conductor
- Fittings (both Earthwire and Conductor)

For these elements we utilise our tendered framework rates and expect a High Confidence categorisation in our estimated to outturn certainty as there are very few external factors that will impact the cost of these assets.

**Protection:** Our Protection costs have been derived from our T2 Protection Rate Book which gives us a high degree of confidence on pricing the specific requirements for each individual project. Protection Engineers have reviewed the project scope and where applicable the, the existing site and developed the specific protection activities required for the site. These activities As a result, the rates are:

- Informed by a robust process
- Quantified on the specific needs of the projects
- Priced using a rate book which is populated from market rates.

#### **Rate Book: How it supports our Costing Methodology**

In our Business Plan submission, our Business Plan Data Table (BPDT) information incorporated a total of 69 separate projects across load, non-load and non-load non-core schemes. Within our Business Plan submission, we included a Costing Methodology document that details how the Population of Business Plan Data Tables is Step 6 of our Costing Methodology (refer to Page 1 of Costing Methodology Document).

These Steps are detailed below.

Steps	Description
Step 1	Establishing Final Output Deliverables
<b>Step 2</b>	<b>Preparation Activities</b>
<b>Step 3</b>	<b>Estimate Creation</b>
Step 4	Estimate Review and Assurance
Step 5	Project Cost and Efficiency Papers
Step 6	Population of Business Plan Data Tables

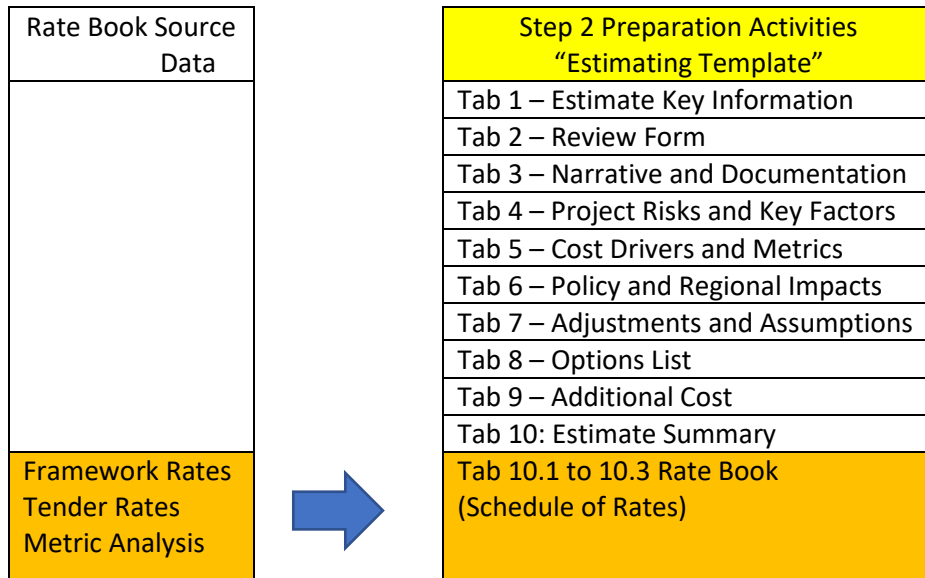
The Rate Book plays an integral part of **Step 2 and Step 3** of the Costing Methodology.

#### **Developing our Rate Book to Support Step 2 of Costing Methodology**

The development of 69 different schemes involved a number of different project teams. It was therefore important to maintain our consistent approach to estimating and to ensure that the project teams utilised a consistent set of estimating norms. To meet this requirement, we

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developed an enhanced estimating template as detailed in Section 3.1 of our Costing Methodology document. Within the enhanced estimating template are tabs 10.1, 10.2 and 10.3 which contains our typical estimating norms (the “Rate Book”).



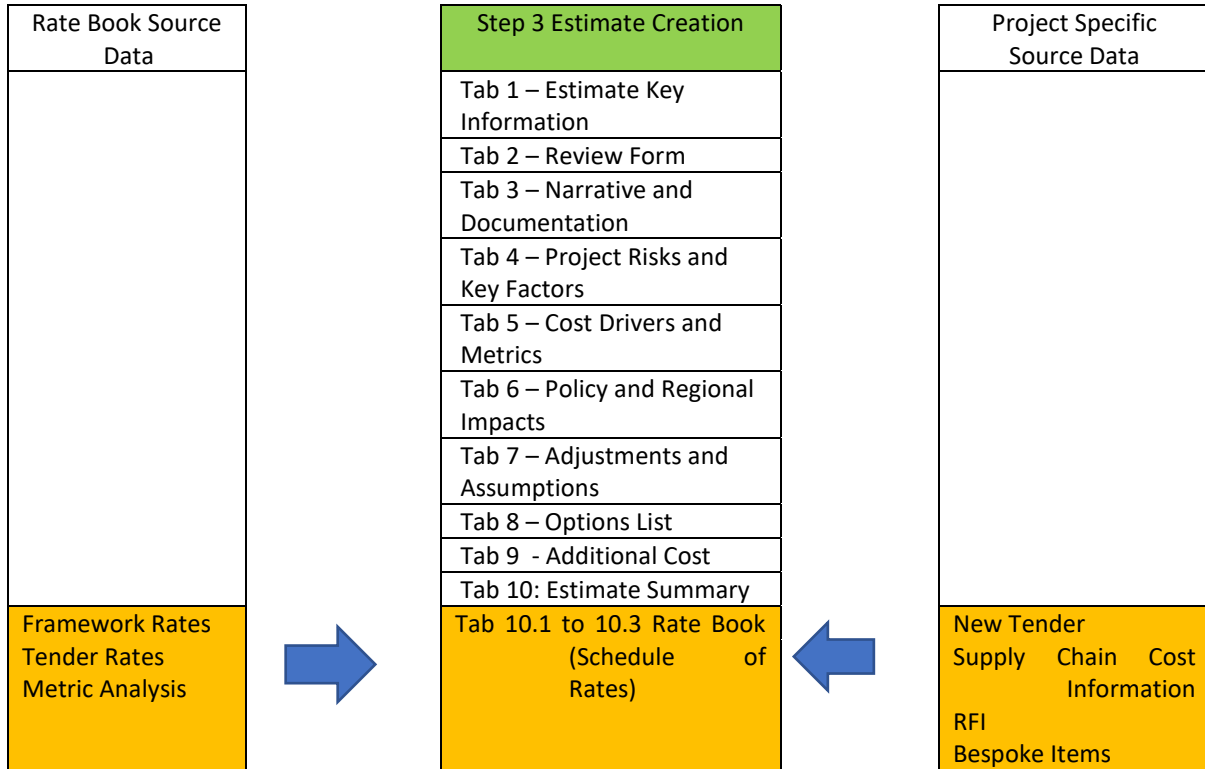
As detailed in the above diagram, the rates that we have used for the Rate Book are based on Source Data including framework rates, historic tender rates, and metric analysis (for items such as Risk etc).

As detailed in tab 10.3 there are hundreds of rates utilised. The Source Data, in particular the framework rates will have considerably higher volume of data.

### Utilisation of the Rate Book within Step 3 of the Costing Methodology

Following the production of our Rate Book within our estimating template, the project teams would work through the various sections of the estimating template, including project documentation, cost drivers, regional impacts etc. If required the project teams would assess the data, and if it was possible to obtain even more current cost information, they would endeavour to obtain a new tender, engage with the supply chain, or ask the Supply Chain for further information by use of a Request For Information (RFI). Therefore, we believe that we have went beyond the levels of a standard Rate Book by identifying project specific items and obtaining if possible, project specific source data as detailed in the diagram below.

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### Risk & Contingency

Ofgem has also made an error in classifying risk and contingency costs as Low Confidence. They should be High Confidence and not subject to a BPI penalty. This is because our risk costs were based on RIIO-T1 outturn projects and Ofgem note that realised actual costs as the “strongest evidence a company could provide” in classifying baseline costs as high-confidence. Moreover, Ofgem has indeed benchmarked risk and contingency and by its own methodology these costs could not be subject to the stage three BPI penalty.

### Preconstruction Funding

Ofgem’s definition of cost confidence sets out that costs where a unit cost allowance with a high degree of confidence and appropriate volume driver or other uncertainty mechanism will be determined to be High Confidence.

Our pre-construction funding within our proposed Totex has been derived using a significant dataset of returned tenders, rates based on recent tenders and realised actual costs are all clearly specified in Ofgem’s Sector Specific Methodology Consultation and Sector Specific Methodology Decision as evidence in classifying baseline costs as high-confidence. Further, as

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we propose an end of period symmetric true-up as well as PCDs for pre-construction this adds weight to the ability of Ofgem to deal with uncertainty, a key principle in allowing costs to be set as high confidence, which Ofgem has failed to acknowledge at Draft Determinations.

## 6 Other Cost Categories

### Operational Expenditure (Opex)

We agree with Ofgem that all Opex costs should be deemed as High Confidence, as these can be benchmarked against industry comparators. For the purpose of our analysis/assessment we used Ofgem's benchmarked view of our Closely Associated Indirect (CAI). We have reincluded all the work reductions proposed by Ofgem as those associated schemes have been included.

### Non-Operational Capex

We have submitted a revised Engineering Justification Paper for our Warehouse proposal we have included this as High Confidence as part of our view on the Totex Incentive Mechanism calculation. This is because it has been subject to independent expert costing review.

### Network Operating Cost

Ofgem's position is that all Network Operating Costs (NOCs), except for Operational Protection Measures and IT Capex should be High Confidence. We agree with this in general but there are exceptions.

As part of the resubmitted EJP for Dynamic Line Rating (DLR) we propose that the costs are subject to an end of period true up and therefore these costs should be deemed High Confidence costs. There are also some costs that are subject to tenders (£20m) and as such should be categorised as High Confidence costs.