Appendix 5: response to RIIO-2 Draft Determinations NARM Annex questions

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1 Overview

ENWL has been part of the work sponsored by Ofgem to look at the Network Asset Resilience Measure (NARM) for the RIIO-2 period under the Cross-Sector Working Group. Within this group Ofgem have promoted the concept of commonality across the energy sector in applying the NARM framework. As a result of this aspiration, the concepts in the DD of Transmission (Gas and Electricity) and Gas Distribution has the potential to impact on the outcome of the RIIO-ED2 review to be carried out after the end of the current GD/T reviews.

Whilst there are similarities between all operators within the energy sector in GB, the fact that there isn't a single common methodology that is applied by all actors in the sector means that there is potential that decisions made for GD/T could set precedence for ED which may not be appropriate or deliverable and this should not be the case.

Additionally, the manner in which the other sectors calculate their monetised risk values can be complex, and when compared to the DNO's Common Network Asset Indices Methodology (CNAIM) outputs, may require significant additional activities in ED2 at a cost to customers which we do not feel is justified or warranted compared to the perceived benefits. We look forward to ongoing dialogue to share our evidence as part of the ED2 process.

Whilst we welcome the continuation of the principles established in measuring asset risk and developed over the period from 2010 to date we believe that any requirements should be simple and transparent to all interested parties. These principles should also apply to the Closeout principles for the RIIO-ED2 period. We therefore welcome the fact that the DD contains proposals as to the RIIO-2 closeout process for the incentive which is a significant improvement from the position the sector has found itself in for the start of RIIO-1. The Closeout proposals should be clear and transparent to aid understanding by all interested stakeholders.

2 Monetised risk calculation and setting outputs

We welcome the fact that the principles that are set out in the recently published ED2 SSMC to be applied to the NARM methodology for the RIIO-ED2 period are built upon those in place for RIIO-ED1 and draw less obviously from GD2/T2 equivalents. We consider that the development of risk-based approaches is considerably more advanced in the ED sector and that we now have a number of years of experience of implementation of CNAIM within the Network Asset Secondary Deliverables (NASD) framework which gives an excellent grounding for the development and implementation of NARM in RIIO-ED2.

Our comments below relate to the specifics proposed for GD/T in the context of the above statement.

NARM Model Structure: The Model structure detailed in Appendix 3 to set the Total Monetised Risk Reduction Target potentially has problems which depends upon the way the submissions have been made. For very large projects on specific plant types or circuits/pipelines where funding is requested specifically within the RIIO-2 period, then the process is logical as delivery should occur in the period. For high volume asset interventions however, there is a risk that at the time of the submission then the exact mix of work to be delivered will not be clear. This is because of the flexibility required to define and negotiate delivery (such as wayleaves etc.). This therefore may introduce errors in the determination of the Total Monetised Risk Reduction Target.

The process Ofgem has used derived unit costs and allowed volumes has precedent from previous regulatory reviews and it seems appropriate to use this again for the RIIO-2 period.

As the assessment of Total Monetised Risk Reduction Target has been carried out prior to the end of the RIIO-1 period it is possible that the planned interventions for the rest of RIIO-1 (especially for the GD sector) may vary significantly from those in the submitted business plans. The impact of COVID-19 is clearly a factor that could cause this, therefore the stated target should be promptly restated post the closure of the RIIO-1 period for the benefit of both customers and the companies involved.

Output Setting: We are concerned that the output required for RIIO-2 has been set prior to the end of that period with no proposal to review this once the end of RIIO-1 period has occurred. Whilst this may not be as appropriate for the transmission sector, it is appropriate (for the reasons already stated) for GD and later the ED companies.

For these reasons we believe the targets should be indicative and subject to potential revision post -negotiations which will take place between the DD and Final Determinations and the end of the RIIO-1 period, thus permitting the initial baseline to represent the actual position, and not a predicted activity.

We welcome the clarity as to the assumption that all interventions are treated as occurring in the last year of the period.

Whole Life Risk versus End of Period Targets: We note the proposal to exempt the GD companies from a Whole Life risk approach for the RIIO-2 period, due to uncertainties in that part of the sector. We welcome this acknowledgement of sector-specific considerations and assume that this will also be the case for RIIO-ED2 NARM treatment.

3 Baseline network risk outputs and baseline funding

NARMQ1. Do you agree with our proposals on the scope of work within each of the NARM Funding Categories and on the associated funding arrangements?

In general, the proposal seems to be logical and we welcome the clarity that this level of detail has brought. However, the development of the mechanism associated with NARMs to be implemented in RIIO-2 has resulted in the creation of a series of mechanisms which overcomplicates the way in which the period will be governed. Further comments are provided below:

Scope of work within Table 2

Category A1 – This category relates to the core activities associated with assets within the NARMs methodology and aligns to the practices allowed in RIIO-1. We welcome the ability to continue to risk trade between the asset types within this area of the allowances as this is a fundamental feature of the risk framework.

Category A2 – This category relates to areas of consequential risk reduction because of drivers other than those in Category 1. We note that within table 2 there is no specific reference to risk trading, but this is alluded to later in the same section. We support the view that the risk reduction target should be considered in the context of the overall network risk and that changes in the latter from forecast may legitimately support changes in the former.

Category A3 – Where it is not possible to carry out risk trading within the mechanism we believe it is right to implement a different mechanism to those associated with Categories A1 and A2. We support the exclusion of these projects from the NARM Risk Management assessments in RIIO-2.

Category B – We agree that as part of further potential cross-sector alignment that more asset types should be included in future NARM iterations. We also welcome Ofgem's commitment not to revise the RIIO-1 NARM targets because of the potential to introduce these in RIIO-2.

There is insufficient data in this appendix to comment on the reason for the specific treatment of certain projects as detailed in sections 3.5 to 3.17.

We note the intention to align the Baseline Network Risk output costs to include both Direct and Indirect costs and the timescale to publish the proposals (with the Final Determination). This may have issues for the RIIO-ED2 review and believe that the DNOs should be kept appraised of the proposals in this area.

4 NARM funding adjustment and penalty mechanism

NARMQ2. Do you agree the funding adjustment principles and our proposals for applying funding adjustments?

The principles of the funding adjustments methodology are in line with the principles outlined in the RIIO-2 Decision document but are overly complex in their execution. In addition, there is still a lack of detail in some areas of the methodology as proposed, which we would have like to have seen at this stage in the process. We welcome the following aspects of the proposed methodology:

- NARM Methodology Changes: The Company targets will be held neutral should these occur.
- Consequence of Failure (CoF) changes due to organic growth: The Company targets will be held neutral. We note that changes not associated with organic growth will potentially incur an adjustment in the targets.
- Reduction of CoF by indirect investment: That this will be treated as neutral thus permitting projects to specifically target a CoF risk reduction will be allowed.
- Data Cleansing: Reasonable levels will be permitted and will not impact the targets.
- Cost savings will only be allowed in TIM if proven to be genuine efficiencies.

We however note that several expressions in the DD are undefined currently making further analysis of the potential consequences for the sector difficult.

NARMQ3. Do you agree with our proposed approaches to calculating funding adjustments and to application of penalties?

We agree that any adjustments should occur at the end of the period as part of the closeout mechanism. Closeout mechanisms need to be defined ideally before the period commences.

We are concerned that the level of complexity that appears to be being proposed for the mechanisms that will enact these principles is so high as it effectively eliminates the principles of the risk-based approach in the first place. The conditions for assessing changes to the forecast programme look to virtually eliminate risk trading and revert to an assessment of input volumes masquerading as a risk output. The rationale appears to be to prevent excessive windfalls which suggests to us that the fundamental underlying methodology is not fit-for-purpose and its application needs to be reviewed ahead of Final Determinations.

That notwithstanding, we do not believe it sets a precedent for RIIO-ED2 where the approach is far more mature and the risk consequently lower.

NARMQ4. Do you agree with our proposals in regards to requirements for justification cases?

We support the need for companies to provide robust justification where delivery is either over or under the target rate, however suggest a degree of pragmatism is required both in terms of the assessment of targets (e.g. introduction of a materiality deadband) and also clear and concise evidence requirements.