

Date
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Dear Thomas,

RIIO-1 NOMs Incentive Methodology Consultation

I am writing in response to Ofgem's consultation on the RIIO-1 NOMs Incentive Methodology which was published on 07 May 2021.

The annex to this letter provides detailed responses to the specific questions set out within the consultation, however I have a limited number of points that I wish to highlight concerning:

- Where the changes proposed within the consultation will alter the incentive properties within the RIIO-1 NOMs methodology after the price control period has finished;
- Where key parameters within the methodology, that will impact reporting and assessment, have still not been confirmed; and
- How elements of the consultation could be detrimental to customers both now and through the transition to NetZero.

Underpinning these points are several specific areas of concern, with examples provided in this letter for the most material ones relating to:

- Confirming the materiality threshold;
- Deriving costs associated with over or under delivery at an Asset Category level; and
- Using outturn unit costs to calculate the value of any over or under delivery.

Changing the incentive properties within the RIIO-1 NOMs methodology

We understand the need to clarify some elements within the RIIO-1 NOMs Incentive Methodology, such as confirming the scope of relevant risk changes, to enable the end of period assessment and close out.

However, there are elements of the consultation that go significantly beyond clarification to in fact alter established methodologies and the incentive properties within the framework after the control period has finished.



Network companies have responded to these incentives in planning their investment strategies throughout RIIO-1. Some of the potential changes being consulted on would have driven different approaches to investment if set from the beginning of RIIO-1 and therefore should not be subject to change after the control period has finished.

An example of this is the potential change to deriving the costs associated with under or over delivery from being at a Network level to an Asset Category level. Companies' RIIO-1 NOMs targets and allowances were set at a network level with an implied average unit cost per risk point. As such, we have worked throughout the control period to deliver the overall risk reduction at a holistic network level whilst meeting our other legal and regulatory obligations, including with the safety regulator.

Following significant consultation, the RIIO-2 NARM targets, allowances and proposed close out methodologies have also been set at a network level. Therefore, this consideration of moving to Asset Category level to close out RIIO-1 NOMs is also misaligned to these decisions, as well as the rationale and evidence supporting them, for RIIO-2.

Overall, where any areas of the consultation are identified as changing established methodologies or the under-lying incentive properties within the framework then they should not be implemented in Ofgem's decision. The only exceptions to this should be where there is strong evidence of an unforeseen issue that needs to be mitigated; however, it is not clear to us that there is any evidence of this being the case.

Outstanding elements of the RIIO-1 NOMs Incentive Methodology

There are key elements of the RIIO-1 NOMs Incentive Methodology that the consultation document proposes to remain outstanding until after network companies have published their performance in July.

These outstanding areas include confirming that the materiality threshold will be set at +/-5% of the network level risk delta for Gas Distribution companies. This has been the working assumption during RIIO-1 and is the approach that has been confirmed for RIIO-2. As such, we can see no justifiable reason for deviating from this approach.

Ofgem has cited uncertainty over the robustness of the data supporting licensees' outputs as the reason for not confirming the scale and nature of the materiality threshold ahead of receiving companies' submissions. However, it was clear when NOMs was designed that there would be uncertainty in this new approach introduced for RIIO-1 and this is why the thresholds were devised.

Having received significant NOMs data through rebasing activities, through the business planning process and from seven years' of RRP data, if Ofgem had specific concerns over the robustness of companies' data we would also have expected this to have formed part of a RIGs consultation at an earlier point during RIIO-1 rather than waiting until after the control period had finished.

Therefore, we believe that Ofgem should confirm that the materiality threshold will be set at +/-5% of the network level risk delta for Gas Distribution companies.



Potential for customer detriment

At Cadent, we were supportive of the introduction of NOMs for RIIO-1 as well as its extension and development into NARM for RIIO-2. NOMs was introduced to incentivise network companies to make efficient and effective asset investment decisions that delivered good long-term customer outcomes. However, as well as changing the incentive properties in the methodology and creating uncertainty by proposing to leave elements outstanding some areas of this consultation also have the potential to be detrimental to customers both now and into the future.

An example is the consideration of using outturn unit costs, as opposed to baseline unit costs, to calculate the value associated with any under or over delivery. (This risk is amplified due to the uncertainty in confirming the scale and nature of the materiality threshold)

Our understanding of the RIIO principles has always been that Ofgem set an efficient allowance which represents the cost that customers are willing to pay. The Totex Incentive Mechanism (TIM) then provides an incentive for companies to innovate to drive efficiencies which are shared with customers within the control period and are passed on in full when the control is reset. Likewise, TIM also recognises that there are occasions where costs genuinely will go up and that customers will share these increases whilst maintaining an incentive for networks to mitigate them as much as possible by exposing their shareholders to a share.

For NOMs we have always seen the baseline unit cost, at a network level, as the maximum average unit cost per risk point that customers were willing to pay for. We have sought to innovate to drive this average cost per risk point down to share the benefits with customers and have recognised that if we overspent it, we would be exposed to a share of the increased costs.

By deriving the costs associated with under or over delivery using the outturn unit cost Ofgem would not recognise network companies' efforts to drive efficiencies and would, in the instance of over-delivery, expose customers to all increased costs.

This would not only be detrimental in the short term; it could also set a precedent that Ofgem could intervene to use outturn costs again in the future. This would weaken the efficiency incentives within the RIIO framework, which are vital now more than ever as the industry aims to deliver NetZero at the lowest possible cost to customers.

As such, we strongly recommend that Ofgem maintain the use of baseline unit costs in deriving the value of any under or over delivery.

Please do not hesitate to contact me should you wish to discuss any areas of our response further.



Yours sincerely,

[By email]

Stephen Hassall
RIIO-2 Regulatory Framework Development Manager

Annex: Cadent responses to specific consultation questions

1. Do respondents agree with our proposed approaches to address the areas for review in the methodology? If not, please specify the area(s) where you have an alternative view and the alternative approach you suggest is adopted in order to update the methodology.

Application of Relevant Risk Changes

Appropriate Relevant Risk Changes to consider

This has been a requirement of the NOMs Incentive Methodology since its original publication in December 2018. However, in the original publication it was not clear what changes were within scope and how it would work.

The updates to the methodology document in this area provide more clarity and in most areas we believe them to be reasonable and will improve the accuracy of performance measurement without changing the incentive properties within the methodology after the control period has finished.

Two Relevant Risk Change categories identified within the consultation should not be implemented; these relate to deterioration and load-related asset additions.

Introducing a Relevant Risk Change category for deterioration could change both a company's target and measurement of performance without robust evidence to base the change on. By this we mean that the remaining assets within a specific asset category may have a different deterioration rate to the complete original asset stock. So any changes will not be representative of the deterioration rate of the original asset stock. For example, a company may have intervened on the assets that were deteriorating at the greatest rate.

Changes relating to load-related asset additions should also not be included for Gas Distribution when assessing whether the NOM has been delivered. These additions are funded and reported outside of NOMs and as GDNs have relative risk targets these additions would not add value to the assessment of whether the company has achieved their target.

Order of considering Relevant Risk Changes

We agree that Data Cleansing should be undertaken first. For the remaining Relevant Risk types, as Ofgem's proposal is now to re-run the "with and without intervention" scenarios for each Relevant Risk Change, the ordering has become much less significant. The ordering becomes insignificant if each Relevant Risk Change is compared against the signed off rebased scenario. Overall, the order proposed by Ofgem appears pragmatic, excluding the inclusion of deterioration and load-related asset additions.

Elements to which Relevant Risk Changes should be applied

For Gas Distribution the Relevant Risk Changes should be applied consistently across both the targets and the actual performance.



For example, for Cadent Diversions should be removed from both our target and our outturn position. Our target was modelled on the assumption that all decommissioned length relating to diversions would be metallic and therefore significantly contribute towards the removal of risk. However, in reality not all of the decommissioned length relating to diversions has been or will be metallic and it is not within our gift to only divert metallic mains. As such, all diversions should be removed from our target and should also be removed from our outturn performance even where it was a metallic main decommissioned. This would also bring Cadent's calculations in line with all other GDNs, who do not have diversions included within their NOMs targets or performance outturn.

Treatment of slower/faster deterioration

As discussed earlier in our response, deterioration should not be considered as a Relevant Risk change for gas distribution companies. It would be very difficult to accurately implement a change, as it is likely that the deterioration rate of remaining assets will be different to those that were intervened on. As such, the change would not be reflective of the asset base at the beginning of the price control when companies were making their investment decisions. A key principle which should under-pin asset health work is that companies should be assessed on the investment decisions made with the information available at the time.

If uncertainty around the potential impact of deterioration is impacting Ofgem's confidence in the data under-pinning company targets and performance, then this further supports the materiality threshold being set at the +/-5% working assumption that has been used throughout RIIO-1.

Approach to deriving associated costs

Companies' RIIO-1 NOMs targets and allowances were set at a network level with an implied unit cost per risk point. This is also the approach that has been used for NARM in RIIO-2.

Any change in approach for NOMs in RIIO-1 would alter the incentive properties within the methodology after the price control period has finished and would be misaligned to the framework created, and the rationale for this framework, for RIIO-2.

A change to this element of the RIIO-1 NOMs methodology would represent ex-post regulation which should be avoided unless there is strong evidence of a material issue that needs addressing subject to a high bar. This position is aligned to the principles of better regulation which states that it is only proportionate to intervene when necessary and that the remedies should be appropriate to the risk posed. However, it is not clear to us from the consultation that there is any evidence of there being an issue that needs mitigating nor that the changes proposed are proportionate to any issue identified.

If the RIIO-1 NOMs targets and associated unit costs per risk point had been set at an Asset Category level rather than at a Network level there would be different incentive properties of risk trading between categories and companies are likely to have made different investment decisions.

As such, changing this element of the methodology after the price control has finished will lead to unjustified rewards or penalties for companies, through revenue adjustments, and



Ofgem's assessment will not reflect how companies responded to the incentive that was in place when they made their investment decisions.

We acknowledge that the NOMs incentive methodology, published in December 2018, set out that the decision was still to be made on whether associated costs would be derived by using either a baseline unit cost per risk point or an outturn unit cost per risk point. However, our working assumption from the beginning of RIIO-1 in 2013 has been that it would be based on the baseline unit cost per risk point and that this was the incentive to drive our approach to risk trading.

Our interpretation of the methodology is that Ofgem set, on behalf of customers, an average unit cost per risk point that represented what customers were willing to pay. If companies could innovate to deliver the risk reduction at a lower cost than this upfront average unit cost then they should be rewarded for this efficiency, which would be shared with customers in the current price control and passed on to them in future price controls. Likewise, they should not be rewarded for delivering additional risk reduction at a higher unit cost – which using the outturn unit cost per risk point could do and would be detrimental to customers.

As such, Ofgem should use the baseline unit cost per risk point in deriving the costs associated with any under or over delivery (a symmetrical approach).

The Materiality threshold ('Deadband')

Process and timetable for determining the deadband

We note Ofgem's proposal to confirm the thresholds that will be applied to NOMs after companies have published their performance in July. We also note that this consultation has sought to justify this continued deferral on the basis that there is some uncertainty in the quality of data. However, this is exactly why thresholds were devised when designing NOMs with the reasonable expectation that they would be set at +/-5% of target. This concern, in not confirming the materiality threshold, has repeatedly been raised by networks with Ofgem since 2018 with no credible or objective explanation provided.

Furthermore, GDNs have also sought clarification from Ofgem that it is not their intent to set the materiality threshold based on network companies relative positions to the targets and that they do not have a predetermined outcome that they are looking to achieve through ex-post changes to the RIIO-1 NOMs incentive methodology. However, we have not received any response to this request for clarification.

Level of network risk against which the deadband should be defined

For Gas Distribution there is a relative risk target set at a Network level. Therefore, we agree that the deadband should be based on the target risk delta at a Network level.

The deadband should be applied consistently on pre and post normalisation calculations.



Identification and treatment of changes to forecast deterioration

As stated earlier in our response, if uncertainty around the potential impact of deterioration is impacting Ofgem's confidence in the data under-pinning company targets and performance, then this further supports the materiality threshold being set at the +/-5% working assumption that has been used throughout RIIO-1.

Interactions with other mechanisms

We do not agree that there was uncertainty relating to licence reopeners relating to, or interactions with, the gas distribution mains replacement expenditure at the time the NOMs Incentive Methodology was published in 2018.

As such, this should not be considered as justification for changes to, or further review of, either the NOMs Incentive Methodology or any other existing RIIO-1 close out methodology.

The RIIO-GD1 Final Proposals clearly set out that:

- Any review of outputs or funding related to the HSE iron mains replacement programme would be undertaken as part of the mid-period review¹.
 - The mid-period review took place in 2017, in advance of the NOMs incentive Methodology being published in December 2018. As such, there was no uncertainty relating to the Iron Mains Replacement Programme that would have restricted Ofgem's ability to finalise the NOMs Incentive Methodology back in 2018.
- That the review of GDNs' performance against the Safety risk (MPRS) primary output will follow the proposed review of NOMs².
- That the end of period reviews will avoid doubling-up on rewards or penalties³, including with other regulatory bodies (i.e. the HSE).
 - As such, the end of period reviews will not allow network companies to be rewarded twice, or penalised twice, for the iron mains replacement programme.

Timeline

We agree that expenditure data should be provided as part of Stage 5 where a company is outside of the materiality threshold.

When setting the timelines for this process, Ofgem must ensure that they factor in to their proposed timelines not only time for companies to complete the relevant Data Template but are also able to complete full data assurance as per their obligations under Standard Special A55 (Data Assurance Requirements).

¹ RIIO-GD1: Final Proposals – Finance and uncertainty supporting document (Table 8.1)
https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/3_riiogd1_fp_finance_and_uncertainty_0.pdf

² RIIO-GD1: Final Proposals – Supporting Document – Outputs, incentives and innovation (para 1.36, p71)
https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/2_riiogd1_fp_outputsincentives_dec12_0.pdf

³ RIIO-GD1: Final Proposals – Supporting Document – Outputs, incentives and innovation (para 1.19, p67)
https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/2_riiogd1_fp_outputsincentives_dec12_0.pdf



2. Are there other areas of the methodology that require changes that have not been outlined in Section 3?

There has been some confusion and uncertainty introduced due to Ofgem's use of a different (four box) graphic in GDNs' RIIO-GD2 gas transporter licences (Special Condition 7.6 Close out of the RIIO-1 Network Outputs, Appendix 1) than that in the RIIO-GD1 licence or the NOMs Incentive Methodology without suitable consultation. We responded on this through the Statutory Consultation on the RIIO-GD2 licence and through various fora with Ofgem, however we have not yet received an adequate explanation or justification for this change.

This new graphic has removed the word "material" from the Incentives column and suggests a significant change to how companies will be remunerated through the close out process.

Where the interpretation of the word material is understood to be the materiality threshold, this change would mean that networks would receive cost adjustments for any over or under delivery (whether justified or unjustified) calculated on the delta between their NOMs target and actual outturn rather than the delta between the materiality threshold and actual outturn as set out in the RIIO-GD1 licence and NOMs incentive methodology.

This is at odds with network companies' understanding of the NOMs incentive, which is that the incentive revenue adjustment comprises of three elements:

1. The associated costs of over or under delivery;
2. The financing costs of the associated costs of the over or under delivery; and
3. A reward or penalty of 2.5% of the associated costs of the over or under delivery.

And that adjustments under these three elements would only occur if a network's delivery position is outside of the deadband and for items 2 and 3 where the over-delivery is justified or under-delivery is unjustified.

As such, we need Ofgem to confirm that:

- The graphic shown in Appendix 1 of SpC 7.6 of the GDNs' RIIO-2 licences is incorrect and that the graphic used in the RIIO-GD1 licence and the NOMs incentive methodology (shown below) is correct?
- If a network's delivery position is within the deadband that no adjustments will be made under the three elements of the NOMs incentive outlined above?
- If a network's delivery position is outside of the deadband any revenue adjustment will solely relate to the delta between the materiality threshold and the outturn position?



The RIIO-GD1 licence (Special Condition 4H) and the NOMs Incentive Methodology both contain this four-box graphic to outline the outcomes from the NOMs close out process.

Incentives	Justified	Unjustified
Material over-delivery	<p>Cost of over-delivery shall be included in the second price control period allowances.</p> <p>The financing cost incurred by the licensee in advancing the investment shall be reimbursed</p> <p>Reward of 2.5 percent of the additional costs associated with the material over-delivery</p>	<p>Cost of over-delivery shall be included in the second price control period allowances</p> <p>The licensee shall incur the financing cost of earlier investment.</p>
Material Under-delivery	<p>Cost of under-delivery shall be excluded from the second price control period allowances</p> <p>The licensee shall benefit from the financing cost of delayed investment</p>	<p>Cost of under-delivery shall be excluded from the second price control period allowances</p> <p>The benefit arising to the licensee from the financing cost of delayed investment shall be clawed back.</p> <p>Penalty of 2.5 percent of the additional costs associated with the material under-delivery</p>

3. Do you agree with the proposed modifications to the NOMs Incentive Methodology?

Further to our responses to questions 1 and 2, we have provided comments below relating to the updated NOMs Incentive Methodology document.

Area of methodology	Summary of change proposed	Cadent comment
Section 1.3	No change. However, uncorrected error present. Section states that mechanism will remunerate justified over-delivery of risk reduction and penalise unjustified under-delivery of risk reduction.	<p>This does not align with the (four box) graphics included with the GDN licence nor NOMs Incentive Methodology. The graphics show that the costs associated with over/under delivery (beyond the materiality threshold, see our response to question 2 and as per new 1.5 of NOMs Incentive Methodology) would be included/excluded from RIIO-2 allowances regardless of if they are justified or unjustified. However, the other two elements of the NOMs Incentive Methodology, relating to financing costs and rewards/penalties is subject to a justified/unjustified assessment.</p> <p>As such, this sentence should be updated within the NOMs Incentive Methodology or a Statutory Consultation should be</p>



		undertaken to change Special Condition 7.6 of the GDN RIIO-2 licence.
Section 1.5	Deadband not to be set until after Licensees' stage 1 and 2 NOMs submissions due to uncertainty around data.	<p>This is not a credible reason to defer setting the materiality threshold.</p> <p>Ofgem already has 7 years of RRP data relating to NOMs and if they have identified that the RIGs do not provide sufficient data have had several opportunities to consult on changing the reporting requirements.</p> <p>Ofgem also received significant data through rebasing exercises and through the RIIO-2 price control review process.</p> <p>There will always remain an element of uncertainty around such a complex mechanism and this is exactly why thresholds were devised with the reasonable expectation that they would be set at +/-5% of target. As they have been set for RIIO-2.</p> <p>See our response to question 1 for further comment.</p>
Section 1.5	Timeline for notifying licensee of materiality threshold.	Please see our response to question 1.
Section 1.6	Licensees to submit proposed methodologies for calculating costs associated with under or over delivery.	A consistent approach should be followed for each sector. For Gas Distribution this should be at a Network Level and using the baseline unit cost per risk point. See our response to question 1 for more details.
Section 3.1	In initial submission the Licensee should propose a methodology for determining costs associated with over or under delivery.	A consistent approach should be followed for each sector. For Gas Distribution this should be at a Network Level and using the baseline unit cost per risk point. See our response to question 1 for more details.
Section 3.2 (& Appendix 1)	Ofgem expect licensees to submit information on non-intervention risk changes including deterioration and load-related asset additions.	<p>See our response to question 1.</p> <p>The Relevant Risk Change categories identified relating to deterioration and load-related asset additions should not be implemented.</p>
Section 3.3	In initial submission the Licensee must propose a methodology for determining costs associated with over or under delivery.	A consistent approach should be followed for each sector. For Gas Distribution this should be at a Network Level and using the baseline unit cost per risk point. See our response to question 1 for more details.
Section 3.4	No details provided on how Ofgem will evaluate the relevant risk changes submitted by Licensees.	<p>Ofgem should provide a clear and transparent description of how they will evaluate the relevant risk changes submitted by Licensees. We propose that Ofgem use the first of the 4 Principles of NOMs which is that:</p> <ol style="list-style-type: none"> 1. A licensee's asset management decisions should be in the interest of consumers. <p>Each relevant risk change should be evaluated and assessed on the basis of the extent it demonstrates the asset management decision was in the interest of consumers.</p>



4. Do you have any views on the accompanying RIIO-1 NOMs Closeout Data Template and associated guidance?

As previously communicated by all GDNs, we are concerned by the proposal for a close out data template which is a significant departure from RRP table 7.3, that proposes data submission in a materially different format to that provided in the previous 7 years of RIIO-GD1 and which bypasses the established RIGs consultation process.

However, having reviewed the Data Template for stages 1 & 2 we do believe we have the capability to meet the data requirements if required. We have also found the associated guidance of use and recognise the changes that have been made following the working group sessions.

There are, however, still areas we believe should be changed to better represent the intent of the mechanism along with some minor errors that need correcting. In making any decision to implement the Data Template Ofgem should detail how all of the data will be used and why the existing reporting requirements do not enable this as well as assuring themselves that the network costs associated with this data request will provide value for money for customers.

Stages 1 & 2

The formulae built into the normalisation sheet 3.3.1 are not representative of what is stated in the consultation material. The material states that each Relevant Risk change will be evaluated by Ofgem to determine the treatment, however, the formulae sum each change together – we propose that the formulae here are left blank.

There are two tabs relating to volumes – 3.1.1 and 3.2.1 that are currently performing a population calculation rather than the volume of interventions. If the intention is for the disclosure of the volume of interventions, then we propose these tabs should state the target and delivery volumes for each asset category. The target volumes would be a sum of the different intervention types from the signed off rebased position.

Stage 5

As stated in our response to Question 1, the costs associated with over or under delivery should be derived at a Network level. As such, there is little or no value in undertaking an activity to back-work Ofgem's RIIO-1 NOMs allowances to an Asset Category. Our RIIO-1 allowances were not set an Asset Category level. In some instances, they were set at a more aggregated level and in others a more disaggregated level. As such, as well as adding little value this activity would require a wide number of assumptions to be made that are likely to introduce inaccuracies.

Specific errors

Worksheet	Description
Worksheet 1.2	States 1.1 not 1.2 within the worksheet
Worksheet 3.1.1	Units on the left hand side are incorrect as all have km where some are number of.



Worksheet 3.2	Says RIIO-2 when it should say RIIO-1
Worksheet 3.2.1	Says RIIO-2 when it should say RIIO-1 Units on the left hand side are incorrect as all have km where some are number of.
Worksheet 3.3.1	Units incorrect it should be R£m
Worksheet 4.1.2	Error on units for pre-heating
Worksheet 4.2	Not clear what data requirement is here. Is it risk or cost? Units imply that it's risk but this needs to be explicitly stated in the guidance and worksheet.
Worksheet 4.3	Column C – should this link to 4.2 or is this something else? Expectation needs to be explicit in the guidance. Cell B24 should be R£m

5. Do you have any views on the timelines set out in the NOMs Incentive Methodology, including the nature of the data to be submitted by licensees at relevant assessment stages?

Whilst we recognise that Ofgem has positively responded to network feedback from recent workshops in shaping the Data Collection Template, the consultation and supporting documents still do not explain how all of the data requested will be used to support the close out process.

The cost of acquiring this data is growing due to the specialist skills involved in calculating monetised risk values, carrying out assurance and transforming outputs from models and systems into predefined spreadsheets from Ofgem. The challenges of this become exacerbated when the data requirements are defined retrospectively after the control period has ended with only a short period of notice.

As such, in making any decision to this consultation Ofgem should detail how all of the data will be used and why the existing reporting requirements do not enable this as well as assuring themselves that the network costs associated with this data request will provide value for money for customers.

Any decision should also not include any further requirements other than those consulted on in this consultation. Meeting the proposed timelines will be extremely challenging for network companies, who have already begun their annual reporting processes, without any additional requirements being introduced only a few weeks before reports are due to be submitted.