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Dear Thomas,

**Ref: Consultation on the Network Output Measures (NOMs) Incentive Methodology**

I am writing on behalf of SGN with reference to the consultation on the NOMs Incentive Methodology published by the Authority on 7th May 2021.

We understand that some of the proposed changes are required to support the GD1 NOMs closeout process, however some of the changes proposed within the methodology go beyond this and alter established methodologies which the networks have based their investment strategies on during RIIO-GD1.

The evolution of NOMs during GD1 has been a challenging process with monetised risk targets only being finalised on a best endeavours basis during 2018. This was after having agreed the asset health and criticality measures at the outset of the price control period. The gathering and assessment of data now being sought for GD1 close out should be proportionate to, and mindful of, the significant process changes and data quality/interpolation challenges presented through the evolution of NOMs.

We would also like to place on record again our concern that a deadband was not formally set during the remaining period of GD1, although there was a clear expectation communicated that a deadband of 5% would be appropriate. Setting this range after the price control period has been completed, creates the opportunity for OFGEM to calibrate the penalty and reward licence mechanism after the event with no ability for the networks to anticipate or control the outcome. We would consider any move away from a 5% deadband in order to accommodate actual outcomes as ex-post regulation, this undermines the incentive properties of RIIO and is against the principles of good regulation.

As we prepare to deliver our NARMs target for GD2, we are concerned that a similar pattern is emerging and that development of the NARM handbook to date leaves too much uncertainty and a lack of clarity, for example the role and identification of 'clearly identifiable' projects.

We have addressed your specific consultation question in the attached Appendix.

If you have any questions regarding our responses, please do not hesitate to get in touch.

Yours Sincerely,

David Handley  
Head of Regulation, SGN



## Appendix A – 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.***

In general, the approach proposed in the document does address most of our concerns and provides further clarity in closing out NOMs. However, there are elements within this section which we have a different view on.

### **Application of Relevant Risk Changes (following rebasing)**

In 2018 SGN carried out a rebasing exercise to set our NOMs target, since then there have been minimal changes in SGN's asset base and therefore a majority of the fields within the data template will be left blank. In this consultation Ofgem places emphasis on networks to provide supporting evidence where 'zero' value has been entered. However, we believe robust evidence should be provided where changes are made as these could result in change to the target and delivery position, rather than the emphasis being placed on no-change.

### **Elements to which Relevant Risk Change should be applied**

In section 3.25, Ofgem proposes that the normalisation adjustment is applied to target value mainly to avoid the difference between GD1 close-out and GD2 starting position. However, as we have updated variables in developing the GD2 starting position which were fixed in the GD1 delivery scenario (e.g. Carbon cost, cost of death, etc.) this will not be the case for SGN.

Also, we disagree that the application of adjustment normalisation to either target or delivery would result in a similar outcome - this is true for select scenarios but doesn't apply to all. For example, if actual deterioration of an asset is higher than forecast but no intervention had taken place, the difference between the delivery and target positions should be zero. However, as a result of the flawed pre-normalisation comparison, detailed further in response to question four, the resulting difference between target and delivery positions is non-zero.

In the guidance provided by Ofgem, networks are only required to provide pre-normalisation values for delivery in tab 3.2. With no relevant risk adjustment identified, it is not clear how Ofgem would be able to make a like for like comparison between pre and post normalisation values. See further explanation in our response to question 4.

### **Approach to deriving associated costs**

In deriving associated costs SGN have concerns around the breakdown of Asset Categories, in particular for PRS and Offtake projects. As these large projects are typically a combination of multiple asset categories (pressure control, Preheating, etc), breaking out costs and allowances for each element individually would be very difficult and may lead to inaccuracies.

### **Interactions with other mechanisms**

The mechanism to deal with load-based growth appears to create an additional layer of complexity and data requirement. SGN's view is that the aim with NOMs close out is to show what has been delivered against the initial asset base at the start of GD1. Capturing growth would require a significant amount of additional data review and validation while presenting a very minor increase in monetised risk position which is then automatically normalised in the Closeout Data Template.



### **The materiality threshold (deadband),**

The process by which the deadband is being set puts a significant amount of uncertainty against the licensee's, including to those who had planned their investment strategies relying on the expected deadband of 5%.

Section 5.3 outlines that the deadband will "reflect the robustness of the data supporting the licensees' outputs" we don't believe the data submitted in stage 1 and 2 provides any additional information to determine the robustness of data. We believe the deadband could be determined based on our rebased and RRP data.

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

In general, the methodology has considered most areas of concern however, one element we feel is not addressed is the justification of the non-intervention risk change. For example, if the licensee identifies relevant risk change which Ofgem determines to be unjustified, what would be the mechanism for discounting this and how would the delivery and target position be adjusted?

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

We understand that some of the proposed changes are required to support the GD1 NOMs closeout process, however some of the changes proposed within the methodology goes beyond this by altering established methodologies which the networks have relied on in planning their investment strategies.

In addition, the data requirement has been changed after the RIIO-1 period has ended, these changes could have led us to have a different investment strategy if the rule set had been determined during RIIO-1. Therefore, it is important that lessons are learned from this so we can prevent repetition of GD1 process during the closeout of GD2. It is vital that companies have a clear understanding of the data requirement and the ruleset so companies can plan effective investment strategies from the beginning of the price control period.

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

SGN believe that further clarification is required around the use of the terms pre- and post-normalisation and their application in reference to targets and delivery. It is SGN's interpretation pre normalised targets refer to the original position at the start of GD1 and post normalisation is the adjustment to account for the non-intervention risk changes applied through the GD1 period. However, when used in reference to delivery, pre-normalisation refers the GD1 end (current network) position and post normalisation would refer to the GD1 start position after removing the non-intervention risk changes. Clarification of this language would greatly assist understanding and therefore consistency in population across the networks.

Further to the above issue, if SGN's interpretation of the methodology is correct, the methodology of applying normalisation to the target means that the pre-normalisation comparison between target and delivery in the pre-normalisation column of the Outputs table in tab 1.2 of the Closeout Data Template is flawed. This compares the target as set at the start of GD1, without non-intervention risk changes, against the delivery position, with non-intervention risk changes included, at the end of GD1.

Should any non-intervention risk changes have been applied by a company during the GD1 period to an asset that was not intervened on, the risk benefit delivered would be misrepresented in this comparison. SGN therefore proposes that Ofgem remove the pre-normalisation assessment from this tab or allow networks to include the delivery position based on the original dataset (rebased data) to allow Ofgem to compare pre-normalisation on a like-for-like basis.

The below graph outlines the issue. However, in the pre-normalisation outputs column on tab 1.2, the delta is measured between the without intervention position with no normalisation (i.e. without relevant risk changes) and the delivery position containing relevant risk changes. This causes an error in the calculation of the pre-normalisation risk benefit delivered, where, in the example below the actual deterioration of assets was found to be higher than targeted. This results in an increased monetised risk delivery position and therefore, when compared to a pre-normalised target, displays an under-delivery delta despite identical workload delivery to the target.

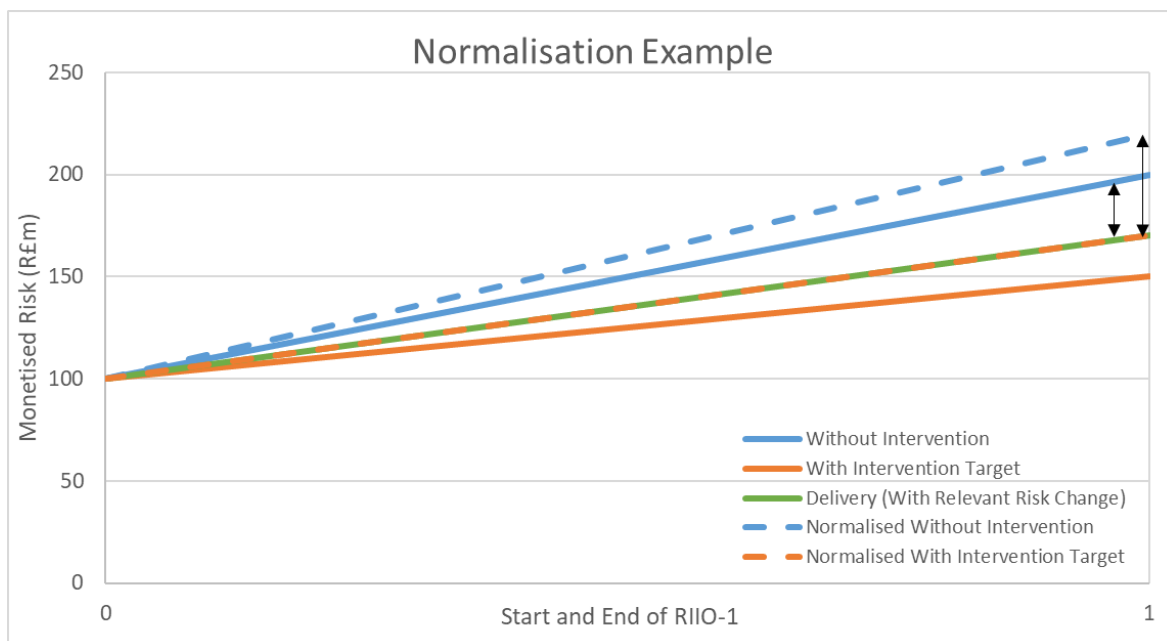


Figure 1 -Graph showing the difference between the pre-normalisation (left arrow) and post-normalisation (right arrow).

In addition, the guidance for completion of the Stage 1 and 2 narrative implies that relevant risk changes can be a 'free text'. We welcome the inclusion of a 'free text' categorisation for the non-intervention risk changes, as this provides a level of flexibility that we believe is required. However, the 'free text' is an omission from the methodology, especially with respect to its impact on the ordering of the non-intervention risk changes.

We have also identified other errors within the individual tabs of the data template, and how they link to the guidance, which are outlined in Appendix B of this document.

##### **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?**

There seems to be an error in the proposed timeline which suggest companies must submit the stage 5 justification report on 1<sup>st</sup> December a day after Ofgem has made their initial assessment. It is assumed that this is an oversight in the methodology as we do not expect that a single working day is suggested to respond to Ofgem's assessment of our delivery.

We broadly agree with the proposed timeline for stage 1 and 2 submission by 31<sup>st</sup> of July however, it should be noted this could only be possible if Ofgem can finalise the NOMs close-out template by end of June. Regarding stage 5 submission, we have not previously reconciled cost information as part of NOMs submission and our current process do not capture this information. As such, the suggested timeline may not be sufficient to produce a high-quality submission that would meet Ofgem's requirement as set out in this consultation.



## Appendix B – Issue within the Data Template

- Worksheet 1.2\_Performance\_Relative
  - States 1.1 not 1.2 multiple times in column A
  - As per our response to question 4 the pre normalisation comparison is flawed and should be removed from consideration and use in setting the deadband.
- Worksheet 3.1.1\_Target\_volumes\_GD
  - Units in column B are incorrect as all have km however, some asset class are captured as number of.
  - The total network risk rows are incorrect. They should be greyed out as it's a mixture of volume units for GD that shouldn't be aggregated.
- Worksheet 3.2\_Delivery\_GD
  - A12 Says RIIO-2 when it should say RIIO-1
- Worksheet 3.2.1\_Delivery\_Volume\_GD
  - A12 Says RIIO-2 when it should say RIIO-1
  - Units in column B are incorrect as all have km where some are number of.
  - The total network risk rows are incorrect. They should be greyed out as it's a mixture of volume units for GD that shouldn't be aggregated.
- Worksheet 3.3.1\_Normalisation\_Target
  - The units in column B are incorrect and should be 'R£m'
- Worksheet 4.1.1\_Expenditure\_Allowed
  - NOMs allowances for GD1 have never been provided by Ofgem and we have not captured that information.
  - Populating by year is going to be incredibly difficult, especially within the suggested timeframes. Suggest this is a total for GD1 rather than an annual breakdown.
  - The worksheet asks for links, but these are then summed in column C. More clarity is required on whether this should be a link or an equation?
- Worksheet 4.1.2\_Expenditure\_outturn
  - There is an error on units for pre-heating
  - Same challenge on the by year break-down. Would suggest a total for GD1 period as suggested for 4.1.1.
  - As per our response to question 1 in appendix A. For deriving associated costs SGN have some concerns around the breakdown of asset categories, in particular for PRS and Offtake projects.
  - Column C and row 16 sum the links in the table. More clarity is required on whether the table should contain links or equations.
- Worksheet 4.2
  - What is the data requirement 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
  - Should Column C link to 4.2 or is this something else? Expectation needs to be explicit in the guidance.
  - Cell B24 should be R£m