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Date
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Contact / Extension
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Dear Thomas,

RIIO-1 Network Output Measures (NOMs) Incentive Methodology Consultation

This letter and its Annex 1 are not confidential, and we are happy for them to be published by Ofgem. The enclosed excel workbook which provides examples of our proposed funding adjustment mechanism is confidential and should not be published by Ofgem.

This response is from SP Transmission (SPT) which holds the transmission licence for the south and central Scotland. SPT is part of SP Energy Networks (SPEN) and the wider Iberdrola group. We thank Ofgem for the opportunity to respond to the RIIO-1 NOMs Incentive Methodology Consultation. Annex 1 of this letter contains SPT's responses to the specific consultation questions raised by Ofgem in the RIIO-1 NOMs Incentive Methodology Consultation.

As communicated in SPT's response, dated 19 January 2021, to the RIIO-2 licence statutory consultation published on 17 December 2020 and as subsequently communicated by SPT by email and in the working groups, we remain greatly concerned that the delay in publishing this revision of the RIIO-1 NOMs Incentive Methodology and the gaps that remain within it (as described in the responses to the consultation questions in Annex 1) impair SPT's ability to complete the report that SPT is required to provide to Ofgem by 31 July 2021, in order to comply with SPT's Special Licence Condition 7.10.3. Despite the open issues as referred to by Ofgem in the RIIO-1 NOMs Incentive Methodology Consultation Document as being outstanding since December 2018 (Paragraph 1.2), this is the first revision of the RIIO-1 NOMs Incentive Methodology to be consulted upon since then.

The remaining gaps in the RIIO-1 NOMs Incentive Methodology are material and fundamental to the assessment of SPT's performance in the NOMs expenditure category. Of particular note are the following, but our more detailed position is set out in Annex 1:

- The confirmation of a materiality threshold is fundamental to the remainder of the process and it is essential that it is defined, prior to the stage 1 and 2 submission, required by 31 July 2021. Further significant difficulties are also created by the guidance stating that the deadband should be set to 0.0% (Appendix 6, paragraph 3.3) for stage 1 and stage 2. This means that whilst companies will be able to set out why they consider that they have delivered RIIO-1 Materially Equivalent Outputs as required by Special Licence Condition 7.10.3 (b) on the basis of precise on-target delivery (which is unlikely to be the case), this will mean they will have to declare over-delivery or under-delivery, which potentially risks being incorrect when the materiality threshold is set.
- It is unclear in both the RIIO-1 NOMs Incentive Methodology and Special Licence Condition 7.10.4 that the report due to be submitted by 1 December 2021 (the stage 5 report) is only

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necessary where there has been RIIO-1 Justified Material Over-delivery or RIIO-1 Justified Material Under-delivery. This should be clarified in both the RIIO-1 NOMs Incentive Methodology and Special Licence Condition 7.10.4, since it would not be desirable for licensees nor Ofgem to require licensees to simply issue a report on 1 December 2021 confirming that there has been neither RIIO-1 Justified Material Over-delivery or RIIO-1 Justified Material Under-delivery in order to avoid a technical breach of Special Licence Condition 7.10.4.

- No progress has been made on the mechanism for revenue adjustment since 2018. Network companies will have no knowledge of how this mechanism will operate until one month before a stage 5 performance report submission is due, which is wholly unsatisfactory.
- The proposed timeline for setting the materiality threshold (proposed to apply retrospectively and be set some 6 weeks after the Stage 1 and Stage 2 submission on 16 September 2021), means the network companies are in the invidious position of having to undertake significant work to generate a stage 5 report that may never need to be submitted. Such needless effort is an inefficient use of resources, which should be focused on the delivery of the RIIO-T2 framework.

Again, we urge Ofgem to set the deadband in advance of the Stage 1 and Stage 2 submission date (i.e. 31 July 2021).

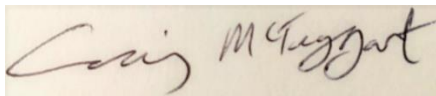
These gaps must be resolved as soon as possible, in order for SPT to provide the report required from it, in our licence, by 31 July 2021. We remain committed to working with Ofgem to resolve these remaining gaps in the RIIO-1 NOMs Incentive Methodology at the earliest opportunity.

We have provided, as requested, an excel workbook with examples of our proposed funding adjustment mechanism. This workbook is confidential as it uses source data which is preliminary and is commercially confidential.

Our comments and this letter are submitted to Ofgem entirely without prejudice to SPT's rights, including those under the Electricity Act 1989, and SPT's ongoing appeal of the RIIO-T2 licence modifications to the Competition and Markets Authority. All of SPT's rights are reserved.

Please don't hesitate to get in touch with me should you have any questions in relation to this response.

Yours sincerely



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ANNEX 1

SPT's response to Consultation Questions

Question 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.

The two critical elements which were identified for further development in the 2018 Methodology (and detailed below) have not been addressed by this revision, which represent a significant impediment to the completion of the stage 1 and stage 2 performance reports (i.e. those required by SPT's Special Licence Condition 7.10.3 by 31 July 2021) and impose unnecessary time constraints and potentially wasted effort with respect to stage 5 reports (i.e. those required by SPT's Special Licence Condition 7.10.4 by 1 December 2021).

Firstly, the issue of a materiality threshold is fundamental to the remainder of the process and it is essential that it is defined, prior to the stage 1 and 2 submission, required by 31 July 2021. Its absence and the guidance that the deadband should be set to 0.0% (Appendix 6, paragraph 3.3) for stage 1 and stage 2 means that companies will only be able to set out why they consider that they have delivered RIIO-1 Materially Equivalent Outputs as required by Special Licence Condition 7.10.3 (b) in the unlikely event of precise on-target delivery. This means companies will need to state that they have under-delivered or over-delivered when, ultimately, this may not be true once the materiality threshold has been fixed. This is an unsatisfactory position which can be avoided by the setting of the materiality threshold in sufficient time for the 31st July 2021 submission.

As we discuss in our response to Question 5 below, the proposed timeline for setting the materiality threshold could lead to wasted effort in the preparation of the stage 5 report.

Specifically, with regard to the fixing of the materiality threshold, we disagree with Ofgem's statement that "*we have not yet received sufficient data from licensees to allow us to assess how well it supports their outputs.*" (paragraph 2.15). Ofgem have had full sight of the risk and volume data during the re-basing process and similar levels of data during the RIIO-T2 business plan assessment. It is not clear to us what additional data Ofgem deem necessary to set the deadband, how the robustness of the data would be measured nor why it has not been requested already, if Ofgem believe it to be necessary.

We believe that it is necessary to clarify in the RIIO-1 NOMs Incentive Methodology the requirement or otherwise to submit a stage 5 report. The RIIO-1 NOMs Incentive Methodology states that a report is only necessary in the event of over-delivery or under-delivery outside a materiality threshold (paragraph 3.6) or where there are justified over-delivery or under-delivery (paragraph 5). Firstly, the definitions of over-delivery or under-delivery and of justified over-delivery or under-delivery are inconsistent and should be amended to correct the ambiguity. Secondly, the revised definition should clarify that the requirement of Special Licence Condition 7.10.4 to submit a (stage 5) report only applies should there be no material under-delivery or material over-delivery as determined by the stage 4 assessment. The absence of explicit reference to this licence condition in the RIIO-1 NOMs Incentive Methodology introduces ambiguity in the interpretation of the licence. Further it is necessary to modify Special Licence Condition 7.10.4 to make it clear that the (stage 5) report is only required in the event of material over-delivery or under-delivery.

The second area which is not addressed is the mechanism for revenue adjustment. No progress of any kind has been made on this since 2018 and companies will have no knowledge of how this mechanism will operate until one month before a stage 5 performance report submission is due.

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

We have not identified any other areas which require to be changed.

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

We have carefully reviewed the proposed modifications and offer the following comments.

Relevant Risk Changes (RRCs)

While we agree with the seven categories of relevant risk changes, we have concerns relating to the proposals.

In relation to the order proposed for the application of the RRC, we believe it should be a differentiation between the changes impacting the risk remaining target and the risk delivered. Data cleansing pre-RIIO 1 changes, Methodology or COF changes could have an impact on the target and therefore those should be applied first, the order of those would be irrelevant as long as they are applied consistently. The deterioration changes should only impact the risk delivered and it should be applied after the normalisation of the target to ensure the asset base and calculation are consistent with those used to establish the target. Finally, the changes covered by other mechanisms and load related additions should be applied last, since they do not have an impact in the definition of the NOCOt, which is the purpose of the assessment.

We agree the normalisation for relevant risk changes could be applied to the NOMs target element or the out-turn delivery. Both approaches are equivalent mathematically, however the proposal to apply all relevant risk changes to the monetised risk target reduces the transparency of the process, preventing stakeholders from comparing outputs with the targets as set out in the T1 Special Licence Condition 2M. We propose that the risk changes impacting the target should be applied to normalise the target, those being: data cleansing, pre-RIIO1 changes, Methodology and COF changes, while the deterioration changes should be applied to the out-turn risk delivered. The other risk changes as a consequence of other mechanisms or load related additions will be expressed in a different table and do not need to be compared to the target, therefore these risk changes should not be included in the calculation of the deadband upper and lower threshold as currently proposed in the latest version of the RIIO-1 NOMs Closeout Data Template v1.1. Further comments on the proposed template are provided in our response to Question 4.

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Approach to Deriving Associated Costs

We remain of the opinion that the ideal approach to deriving the costs associated with under-delivery and over-delivery is a scheme-by-scheme assessment. However, there are two aspects of the NOMS targets and the incentive methodology that prevent this ideal approach from being applied.

Firstly, SPT's target is one of risk remaining on the network at the end of RIIO-T1. Therefore, there is no direct association between variance from the target and costs of individual schemes. This is exacerbated by those assets which were not subject to intervention deteriorating faster or slower than forecast.

Further, the methodology's technique of measuring over-delivery and under-delivery from the (as yet undefined) materiality threshold completely decouples the costs of schemes delivered from the risk values associated with over-delivery or under-delivery. It is notable that this is different from the RIIO-T2 NARM funding adjustment and penalty mechanism which measures performance from the target.

Therefore, while being the ideal approach, the modified risk remaining target and the provisions of the methodology prevent its application to SPT's RIIO-T1 NOMS performance.

We therefore propose that a Unit Cost of Risk (UCR) technique is applied, derived at a scheme category level¹, therefore assigning all risk outputs and cost to the scheme category defined by the main driver and consistent with the RIIO-T1 reporting to date. This technique is similar to that which Ofgem have proposed in the RIIO-T2 Network Asset Risk Workbook for scheme allocation to Risk Sub-Categories with the difference that the scheme category allocation in RIIO-T2 is defined by the highest risk contribution asset category. The cost associated with over or under delivery is proposed to be calculated at an asset class level instead, therefore the justified and unjustified risk outputs outside the deadband would be defined at an asset class level following Stage 5 submission by the Licensees and the associated cost derived by applying the previously calculated UCR values to the asset class. We propose to use the UCR outturn values for the Over delivery scenario since they are more representative of the cost of Over delivery. For the under delivery scenario, it is proposed the use of the UCR baseline values in order to claw back the allowances at a consistent rate. The worked examples in the enclosed excel workbook provided to Ofgem on a confidential basis demonstrate that this approach is reasonable.

In summary, our position remains that a scheme-by-scheme assessment is the theoretically ideal technique but its use is prevented by the form of the targets and Ofgem's decision to measure performance from the edge of the dead-band. Our reservations regarding the general application of UCR techniques remain, however the specific RIIO-T1 NOMS dataset produces reasonable outcomes.

Materiality Threshold

We agree that the deadband should be set around the risk remaining (or absolute) target for Electricity Transmission, consistent with the form of the target. The reference value for the target should be the post-normalisation value as a result of the application of the relevant risk changes, as per our proposal above on this matter. If other mechanism risk changes and load related additions are applied to the post-normalisation value in the target, as proposed currently by Ofgem, any percentage applied to this value would not be relative to the NOMS related target.

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Further to our response to Question 1, it is not clear why the data currently available to Ofgem is not considered robust enough to set a dead-band, nor how this situation will be resolved by the data (which is specified by Ofgem) submitted on 31st July 2021.

Interactions

For electricity transmission, it is important to make the association between the funding provided to achieve the risk remaining target (stated in T1 Special Licence Condition 2M) and the interventions that delivered the target. This requires Ofgem's definition of 'load-related' in the ET sector to be extended to encompass all other interventions which have an impact on risk values but are funded by other mechanisms in the RIIO-T1 framework. This safeguards consumers by preventing risk benefits funded by other mechanisms inadvertently being 'double-counted' and potentially rewarded by the NOMS Incentive Mechanism.

Timeline

We comment further on this issue in our response to question 5 but we note from paragraph 3.69 of the RIIO-1 NOMs Incentive Methodology Consultation Document that while asset risk outputs are defined at an asset category level, costs and allowances are defined according to the asset category that is the primary driver of the scheme.

We agree with the proposal to provide incurred and allowed cost data at Stage 5.

Performance Report

There are two sets of guidance provided for the content of the Performance Report, Appendix 1 of the Methodology and section 8 of the Closeout Submission Guidance. The two sets of guidance are inconsistent in the required structure and content of the Performance Report and it is not stated if they are complementary or whether one has precedence. To avoid confusion and to assist in delivering high quality reports, these should be combined into a single guidance document.

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

We have noted and advised Ofgem of issues regarding previous versions of the template and guidance and are grateful for the speedy resolution and issue of revised files. With regards to the latest version of the RIIO-1 NOMs Closeout Data Template v1.1, we have noted that the tab 1.1 Performance Absolute Target is considering the Post-normalisation target as the basis of the calculation of the Upper and Lower thresholds in the application of the deadband. As aforementioned in response to question 3, those values are skewed by the 'Impact of Change in Asset Base Over RIIO-1'. The calculation of the Risk benefit (delta) delivered pre-normalisation in cell D19 is wrong as well as the application of the deadband to the post-normalisation value in cells E28:E29 since that includes the effect of the Impact of Change in Asset Base Over RIIO-1.

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Question 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?

The provision of the necessary data and commentary for Stages 1 and 2 is impeded by the lateness of this consultation. In practical terms, it is unlikely that a final decision on this consultation will be available until one month **after** the necessary date for the completion of the Stage 1 and 2 report (which is due by 31 July 2021) to permit proper assurance to be carried out. This must be acknowledged by Ofgem and taken into account in their assessment.

Given Ofgem's position on the retrospective definition of the materiality threshold (with which we disagree), and the proposal to advise the TOs of this value some 6 weeks after the Stage 1 and Stage 2 submission, the TOs are in the invidious position of having to undertake significant work to generate a stage 5 report that may never need to be submitted. This is simply due to the lack of time to wait for the deadband to be defined on 16th September 2021 to begin what is a significant exercise. Such needless effort is an inefficient use of resources so we again urge Ofgem to set the deadband in advance of the Stage 1 and Stage 2 submission date (i.e. 31 July 2021).

Notwithstanding the point above, given the significance of the 16th September 2021 date, it should be explicitly referenced as a discrete stage in the methodology timeline.

We welcome the addition of dates to the staged diagram on page 10 of the methodology and are therefore now able to identify that Ofgem's determination of whether a company has over-delivered or under-delivered (stage 4) and the company's deadline for submitting the associated justification are on consecutive days (stage 5). As the need to submit a justification stage 5 is determined by the outcome of stage 4, we assume that this is an error. We have interpreted stage 4 as concluding on 16th September 2021.

Regarding the provision of justification, we note the revised guidance on the compilation of Cost Benefit Analysis and request confirmation that Ofgem will provide a suitable template which captures these requirements, permitting all companies to submit information in a consistent way.