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Network Price Controls  
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Dear Thomas,

### **SSEN Distribution response to Ofgem's consultation on Network Output Measures (NOMs) Incentive Methodology**

On behalf of Scottish Hydro Electric Power Distribution plc and Southern Electric Power Distribution plc, we welcome the opportunity to respond to the Network Output Measures (NOMs) Incentive Methodology consultation for RIIO-1 ('RIIO-1 NOMs IM consultation').

Ofgem's consultation is focused primarily on Gas Distribution (GD), Gas Transmission (GT) and Electricity Transmission (ET). However, we recognise that Ofgem may consider certain principles and aspects of approach relevant to the NOMs incentive methodology for Electricity Distribution (ED). We note that any further changes to RIIO-ED1 methodology must be subject to its own consultation process.

We consider that ED is at a more mature stage than the other sectors in terms of closeout methodology in general, and NOMs incentive methodology in particular. Extensive closeout arrangements have already been developed for ED, and NOMs and the Common Network Asset Indices Methodology (CNAIM) have been in place longer in ED. We also consider that some of the methodology approaches set out in the RIIO-1 NOMs IM consultation are not relevant for ED, reflecting on the established parameters under which ED is performing, and reporting its performance.

We set out our thoughts on these key aspects of Ofgem's proposals included in the RIIO-1 NOMs IM consultation below. Reflecting the sector focus of this consultation, and that ED is at a different stage, we have not included detailed responses to the specific questions raised.

### **Established ED closeout methodology approach**

The NOMs incentive methodology for RIIO-ED1 has already been consulted and determined on through Ofgem's Consultation on the Methodologies for RIIO-ED1 Closeout ('RIIO-ED1 closeout consultation') which ran from March to May 2019, and was followed by Ofgem's decision on the methodologies in December 2019.<sup>1</sup> This consultation addressed closeout methodologies

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<sup>1</sup> [Decision on the methodologies for RIIO-ED1 closeout](#), December 2019

for six key elements of ED1 performance, including NOMs / Network Asset Secondary Deliverables (NASD).

In developing its approach for ED1 closeout, Ofgem confirmed that it had looked to build on the approach developed for closing out NOMs in DPCR5, building on and/or simplifying it where necessary, following a set of overarching principles, and developing it in alignment with the requirements of the associated licence conditions, and the approach indicated in the ED1 Strategy Decision and Final Determinations. This consistency with the wider ED framework and clarity applied during ED1 has been critical in enabling DNOs to understand the parameters within which they are performing, has facilitated that performance, and has also driven how DNOs have reported on performance on an annual basis.

In particular Ofgem's decision on the RIIO-ED1 closeout consultation set out that:

- DNOs will submit the relevant changes in the risk factors impacting their performance against NASD targets, along with a Performance Report. Ofgem will assess these as well as delivery against the NASD targets and, if necessary, DNOs will need to provide further justification for their position.
- Ofgem will assess the evidence provided and determine the value of any adjustment that should be made. This adjustment will be spread across each year of RIIO-ED1, mirroring the timing profile of the incurred expenditure, and have Time Value of Money adjustments applied to reflect deferral to 2023/24.
- This value will then be divided into two portions – one to adjust the DNO's RAV, and one to adjust the DNO's RIIO-ED2 revenue. Any adjustments to the DNO's RIIO-ED2 revenue on account of 'catch up' for RIIO-ED1 revenues will be spread equally across the five years of RIIO-ED2.

In conclusion, Ofgem confirmed that "As all respondents broadly agreed with our approach, we will implement the methodology as set out in the consultation, subject to some updates to reflect the comments and suggested changes provided in the responses. We have, therefore, decided to proceed with the methodology as provided in Appendix 1." As such, and distinct from the GD, GT and ET processes, the approach for the ED1 NOMs incentive methodology has already been established, and it is our view that further consultation on these aspects is not required.

The one item which was highlighted for further consideration in relation to ED1 NOMs was the associated deadband. We set out our views on this point below, in light of the related proposals set out in the RIIO-1 NOMs IM consultation.

### **Consistent, proportionate and fair assessment of ED1 performance**

Ofgem's decision on the RIIO-ED1 closeout consultation set out that when and how the deadband associated with the NOMs would be set should be addressed separately, when Ofgem expected to have a better understanding of the data supporting performance against outputs. It was confirmed that the deadband should be set as soon as possible to provide certainty to the overall mechanism, as well as seeking clarity on how the closeout adjustment will be profiled (based on actuals, allowances, or the difference between the two).

In the RIIO-1 NOMs IM consultation Ofgem notes that, as set out in the earlier RIIO-ED1 closeout consultation, the level the deadband is set at should reflect the robustness of the data supporting licensees' outputs and that, just as the robustness of data may vary by sector, the level of the deadband may also vary by sector. Ofgem goes on to state that it has not yet received sufficient data from licensees to allow it to assess how well this supports their outputs, and in the absence of sufficient data Ofgem is not yet able to set deadband values.

We do have some concerns about the setting of the deadband towards or at the end of the price control period when performance through the price control is substantively complete. Ideally, clarity should be provided as early as possible to drive the correct behaviours and performance during the price control to the extent possible.

As a starting point in considering a deadband, as set out in our response to the RIIO-ED2 Sector-Specific Methodology Consultation, we believe that network licensees should retain the full Totex Incentive Mechanism (TIM) benefits of any genuine efficiencies achieved during the price control. If Ofgem were to introduce downward adjustments to unit costs then this should happen by exception only, where company performance deviates significantly from the target and any associated deadband, and companies are unable to provide evidence that they acted in consumer interest.

We understand that some of Ofgem's proposals in the RIIO-1 NOMs IM consultation are intended to address the concern that the current mechanism may allow licensees in some sectors to make unjustified windfall gains. We consider that the framework, parameters and controls already in effect for ED, including the impact of NOMs methodology and CNAIM having been in place for some time, do not permit the same outcome. In particular, ED is operating to meet a relative risk target, the deadband for which we would expect would be based on a target risk delta, and ED licensees have been reporting on their performance towards meeting this target throughout the price control – there is no scope for unexpected, unjustified windfall in this context.

Our view is therefore that any future consultation on the ED NOMs incentive methodology should be limited to the definition of the deadband, which we believe should be proportionate, consistent with ED parameters to date, and unequivocal in its application, in terms of

rewarding performance to deliver efficiencies and acting in consumer interest, adjusting defined parameters by exception, and defining the deadband specifically, e.g. 0% to +10% (100% to 110% of target), rather than stating an ambiguous overall deadband figure of, for example, 10%.

We welcome further engagement with Ofgem on these significant principles as Ofgem progresses the NOMs incentive methodology for the other sectors and in particular as we move towards RIIO-ED1 closeout, to help ensure determinations for RIIO-ED1 which are consistent with the parameters and decisions already established. With reference to the ongoing work to develop the ED2 Network Asset Risk Mechanism (NARM), we note that the methodology developed for other sectors should not be automatically applied to ED2 - this should be subject to its own process and consultation.

In the meantime, please do not hesitate to contact us about our response.

Yours sincerely,

Rachel Kettles  
Regulation, SSEN Distribution