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Dear Faysal,

Statutory Consultation on the Network Asset Risk Metric Handbook: Clearly Identifiable Threshold

This response is from SP Transmission (SPT) which holds the electricity transmission licence for south and central Scotland. SPT is part of SP Energy Networks (SPEN) and the wider Iberdrola Group. Thank you for the opportunity to respond to the statutory consultation on the unit cost of risk threshold used for clearly identifiable over and under delivery under the Network Asset Risk Metric (NARM) Funding Adjustment and Penalty mechanism ("the NARM Mechanism").

We make detailed comment on each of the proposals set out in the statutory consultation document in response to the question asked within that document. Our detailed responses are contained in Appendix 1 while the main issues are summarised in this letter.

As set out in our response of 16th August 2024 to the consultation on the "qualifying criteria for Clearly Identifiable Over-Delivery and Clearly Identifiable Under-Delivery, under the NARM Funding Adjustment and Penalty Mechanism"¹ ("the Policy Consultation") we support the setting of the Unit Cost of Risk (UCR) threshold for the determination of clearly identifiable under delivery or over delivery (CIUD/OD) at $\pm 5\%$ to protect consumers' interests and ensure appropriate allowances for network companies to deliver work under the NARM Mechanism. We remain concerned at the lack of certainty around how allowance adjustments associated with these schemes will be undertaken given that almost all of our delivery variance will be handled under this mechanism. Our concerns around the lack of certainty in allowance adjustment are further detailed in Appendix 1 as part of our response to Proposal 1. We have again provided comment on the way in which allowances may be pragmatically adjusted as part of the RIIO-T2 close out process under our Further Comment section at the end of Appendix 1.

We are generally in agreement that the updates to the NARM handbook proposed under this statutory consultation are aligned with the policy decision of 8th November 2024². However, we remain of the view that the NARM Mechanism should be comprehensively reviewed, and its suitability assessed, before any application in the RIIO-3 period. This view is centred on the lack of certainty provided under this regulatory mechanism in the event of necessary plan changes in the Electricity Transmission sector. Relying on delivery variances being assessed and adjusted ex-post leads to uncertainty in our ability to meet the changing needs of our network. We provide further comment on this in our response

¹ <https://www.ofgem.gov.uk/consultation/consultation-qualifying-criteria-clearly-identifiable-over-delivery-and-clearly-identifiable-under-delivery-under-narm-funding-adjustment-and-penalty-mechanism>

² <https://www.ofgem.gov.uk/decision/qualifying-criteria-clearly-identifiable-over-delivery-and-clearly-identifiable-under-delivery-under-narm-mechanism>

to Proposal 1 in Appendix 1. SPT looks forward to further discussion on this topic ahead of final determination and the publication of the electricity transmission licence for RII0-3.

Ambiguity remains over the definition of the Clearly Identifiable Over-Delivery or Under-Delivery elements and the requirement to report on these which we address in response to Proposal 2 and Proposal 4 in Appendix 1. We request that further detailed definitions be provided. The calculation of the JUS terms is equally of concern given the decision to weight it by network risk, when certain terms in the calculation of the Penalty value for unjustified under delivery are not well correlated to the magnitude of the risk on which the justification percentage has been calculated. Detailed explanation on this matter is provided in response to Proposal 5 in Appendix 1.

We look forward to working constructively with Ofgem and other network companies in continuing to ensure that NARM remains an effective means by which the need for work is identified and justified and outputs reported against an appropriate mechanism, providing suitable allowances for network companies while considering the needs of consumers.

Yours sincerely,

Craig McTaggart
Head of Transmission Network

Annex 1 – Responses to Consultation Questions

Question: Do you agree that the draft NARM Handbook aligns with our amendments proposed under the document “Qualifying criteria for Clearly Identified Over-Delivery and Clearly Identifiable Under-Delivery under the NARM Mechanism”³? Where you disagree, please set out your reasoning and specify other considerations/factors we should take into account.

Given the number of proposals for change through the document we refer to the summary of proposed changed set out by Ofgem in Table 1 of the statutory consultation document and replicate it below, with numbering, for ease of reference.

Table 1 Numbered Summary of the Ofgem Proposed Amendments to the NARM Handbook

Proposal Number	Proposed Amendments	NARM Handbook Reference
1	UCR threshold for clearly identifiable, Over-Delivery and Under-Delivery: Sets the proposed threshold clearly identifiable, Over-Delivery and Under-Delivery at 95% and 105%, respectively, of a given risk sub-category	Para 10.5 (4) and 10.7(4)
2	Selection of projects for clearly identifiable mechanism: Clarifies that outturn NROs and costs should be provided on a project-by-project basis for ET and a programme-by-programme basis for GD and GT. As outlined to Licensees, detail guidance and templates will be provided by Ofgem ahead of RIIO-2 close-out	7.12
3	Clarification to qualifying criteria for clearly identifiable mechanism: Amends the second qualifying criterion for Clearly Identifiable Over-Delivery (CIOD) to ensure projects achieving an NRO over-delivery through a reduction in the scope of a baseline project and fewer physical asset interventions are captured as CI	10.5 (2)
4	Clarification on the CIOOD term and justification for clearly identifiable delivery elements: Clarifies that the 'delivery element' separated out is the portion of NRO representing an under- or over-delivery relative to BNRO, including the associated work and costs	7.14 (b) and Table 5: Clearly Identifiable Over-Delivery and Under-Delivery terms
5	Clarification on determining the justification percentage JUS: proposes the justification percentage for each project (or programme of work) should be weighted by its relative justified contribution to the NRO over- or under-delivery.	7.14 (g)
6	Updated worked examples: Appendix 4 has been updated with worked examples to help illustrate some of the main aspects relevant to the implementation of the NARM Funding Adjustment and Penalty Mechanism methodology.	Appendix 4

³ <https://www.ofgem.gov.uk/cy/decision/qualifying-criteria-clearly-identifiable-over-delivery-and-clearly-identifiable-under-delivery-under-narm-mechanism>

Proposal 1

SPT agree that the proposed amendments to the NARM Handbook enact the policy decision however our concerns around what this means for the NARM regulatory mechanism, particularly with regards ex-post assessment, remain. The updates provide clarity that the threshold for clearly identifiable under-delivery and over-over delivery as being an outturn UCR which is greater than 105% or less than 95% of the baseline UCR. As set out in our response to the Policy Consultation, SPT are supportive of the objectives of this decision.

The selection of a low value for the UCR threshold to protect consumers and to ensure fair outcomes for network companies delivering sound asset management decisions highlights a significant weakness in the NARM mechanism. This weakness is acknowledged in paragraph 3.7 of the Policy Consultation document. While there is a requirement to set a UCR threshold for use within the RIIO-T2 period, a high proportion of schemes have the potential to fall under the CIUD/OD element of the NARM Mechanism results in the potential for significant proportions of the NARM delivery programme to have their allowances set or adjusted ex-post. This ex-post assessment, against a set of criteria which is not defined, is not conducive to supporting network companies to make timely asset management decisions in consumers' interest given the level of uncertainty which surrounds the calculation of associated allowances. SPT believes that revision to the wider mechanism should be considered before the RIIO-T3 period.

Proposal 2

We note the change from referencing "project" in paragraph 7.12 to "Over-Delivery or Under-Delivery elements". In the Ofgem publication accompanying this statutory consultation it is stated that the wording update "Clarifies that outturn NROs and costs should be provided on a project-by-project basis for ET and a programme-by-programme basis for GD and GT." SPT find the drafting update attempting to give effect to this, is in an ambiguous manner as nowhere in the NARM Handbook is a definition provided which links the term "Over-Delivery or Under-Delivery elements" to either projects or programmes of work per sector. Paragraph 10.1 refers to "delivery elements (projects/schemes/programmes) are clearly identifiable as driving an Over-Delivery or Under-Delivery". We do not find that this reference brings clarity on the sector specific treatment and request that the term "Over-Delivery or Under-Delivery elements" be fully defined in the glossary of terms with reference to the sector specific treatment.

For clarity we note that there is a defined calculation term "DE" with the definition of "Delivery Element" within Table 7 of the Glossary and which is used within Formula 7. The use of this term is in the description of the five scenarios which categorise how delivery of risk within a Risk Sub-Category may be described. It is therefore important that when referring to the project, scheme or programme giving rise to "Over-Delivery or Under-Delivery elements" that the terms are well defined to avoid ambiguity.

In addition to the comments above we also suggest that the NARM Handbook reference for this proposal may be better served by referring to paragraph 7.10 where new text had been added by Ofgem. The new text sets out the requirements for licensees to report delivery terms by project, which we agree with. In line with our response to the Policy Consultation, and with reference to the requirements to identify a "reduction in the scope of a baseline project" in Proposal 3, we again suggest that it would be prudent for delivery of project volumes to be gathered as part of the RIIO-T2 Close Out reporting, in a manner that allows comparison with the Network Asset Risk Workbook.

The wording of Proposal 2 within the Statutory Consultation states that "... detail guidance and templates will be provided by Ofgem ahead of RIIO-2 close-out". We welcome the clarity on the intent of the necessary RIIO-T2 close out reporting within the NARM Handbook. We however request that the

detailed guidance and templates be issued after suitable consultation with licensees and in a timely manner to promote an efficient and transparent reporting of the necessary reporting parameters.

Proposal 3

As set out in our response to the Policy Consultation we are supportive of clarification on the qualifying criteria for Clearly Identifiable Over-Delivery. The proposed amendments in Proposal 3 in Table 1 of the Statutory Consultation refer to “fewer physical asset interventions” which is something which SPT highlighted as being of merit in our response to the Policy Consultation. We note in the Statutory Consultation that a rationale is provided whereby reference to scope reduction shall be made, instead of reduction in intervention volumes, to allow for the reporting metrics currently in place in the gas sector. While we understand that there are differences in the reporting metrics across the sectors, the ability to identify a scope reduction, without reference to volumes of delivery, has the potential to be ambiguous and rely on narrative to identify this. The ability to quantitatively identify a scope reduction, we believe, is best served by reporting of intervention volumes and this aligns with our comments on Proposal 2.

Proposal 4

It is our understanding that the proposal to clarify the CIO_{OD} term is better represented by the amended wording in paragraph 7.12 (b) in the NARM Handbook v4.0 than the wording in paragraph 7.14 (b) and as such the reference in the Statutory Consultation document is erroneous. In the statutory consultation document the intent⁴ of the proposed update is clear, while the wording in the NARM Handbook does not provide the same degree of clarity on the matter. The wording in 7.12 (b) now refers to “Network Risk Outputs from Over-Delivery or Under-Delivery elements that meet specified criteria”. As highlighted in our response to Proposal 2 there is insufficient definition within the NARM Handbook to make it clear that the “elements” referred to here are expressed as a variation from the BNRO for a given project/scheme/programme. We therefore believe that the proposed amendments fail to meet the policy intent. Feedback on the need to more clearly define these terms was provided by SPT in our response¹ to the Policy Consultation.

We remain of the opinion that while the CIO_{OD} term used in the calculation may be the variation between outturn and baseline risk, the risk benefit and cost associated with all projects, alongside their baseline equivalents should be reported to provide clarity and context for any under or over delivery as part of the RIIO-T2 close out reporting.

Proposal 5

It is our understanding that the proposal to clarify the JUS term is better represented by the new wording in paragraphs 7.12 (g-i) of the NARM Handbook v4.0 than the wording in paragraph 7.14 (g) and as such the reference in the Statutory Consultation document is erroneous.

SPT are concerned by the drafting which sets out the intention to weight the JUS term by network risk output rather than financial allowance. There is a clear linkage between the risk delivery and the allowance for the justification of delivery which is subject to the UCR adjustment, but this is not the case when the output is identified as being Clearly Identifiable Over-Delivery or Under-Delivery elements. For the calculated terms in Table 4 of the NARM Handbook the risk and allowance are linked and therefore the JUS term will provide similar outcomes regardless of the factor which it is weighted

⁴ The wording in Table 1 of the Statutory Consultation by Ofgem, against what SPT have identified as Proposal 4, states “that the ‘delivery element’ separated out is the portion of NRO representing an under- or over-delivery relative to BNRO, including the associated work and costs”.

against. However, when the JUS term is used in Formula 8 for the calculation of the PEN term, it is used to modify financial values of which CIX_{OD} will have been determined without direct correlation with the associated risk benefit term of the delivery element. That is to say that a large allowance value may have been determined in relation to a small risk benefit value for a Clearly Identifiable Over-Delivery or Under-Delivery element.

In the event of a Clearly Identifiable Under-Delivery or Over-Delivery element having a large determined allowance relative to a comparatively small risk output, this would only add a small percentage to the overall JUS term when all components are weighted together against the overall NRO. The JUS term is then used in the calculation of the PEN term which acts on allowance values and not risk. The total allowance would therefore incorporate the large determined allowance but only justify a relative small percentage based on the weighting of the risk benefit delivered. It is therefore our view that in weighting the JUS term by the outturn NRO that the PEN value wouldn't be reflective of the determined allowances Clearly Identifiable Under-Delivery or Over-Delivery elements. For completeness, the converse of this scenario is also possible.

SPT therefore remain of the view that the JUS term should be calculated in relation to the project allowance as set out in our response to the Policy Consultation. While we agree that the amended wording in the NARM Handbook reflects the policy decision made by Ofgem, SPT disagree with the policy decision on this matter for the reasons set out above.

Proposal 6

While SPT welcome the inclusion of additional worked examples to highlight the operation of the mechanics of the NARM Mechanism, we remain disappointed that the examples have been provided in a word format and that there has been no revision to the Excel workbook which forms part of the NARM Handbook as Appendix 3.

While the intent of the worked examples is helpful, we believe there is merit in more clear definition of the ways in which terms are calculated and the origin of those values which are determined by the Authority.

We present a list of observations on the worked examples which have now been incorporated into the NARM Handbook in Table 2.

Table 2 Observations on the NARM Handbook Worked Examples

#	Example	Observation
1.	1	In paragraph 1.5 the term UCR_{OAD} is stated as having a value of 0.57£/R£. When the term is used in the table below to calculate the Value of Final Allowed Unit Cost of Risk a value of 0.59 is used. It is not clear where this variance comes from.
2.	1	The term CIX_{OD} is stated as having a value of -£0.2m when the term is defined. This value appears to be a calculation between the expenditure and allowance in this example, which it should not be, as this is a term defined by the Authority. In the final allowed calculation, it is stated " $CIX_{OD} = -0.45$ in this example". We believe there is merit in having this term as different from the numerical calculation to signify that it is a determined not calculated value. We would welcome further clarity in the example as to the composition of the determined values.
3.	1	Paragraph 1.6 states there is an underspend by the licensee of £0.15m however this does not appear to align with a final allowed expenditure of

		£23.85m and an expenditure of £22.90m. Clarity on the origin of the value and/or correction would be welcomed.
4.	1	While the value of CIX_{OD} which is unjustified is determined by the Authority to be -£0.35m it would be helpful to show the calculation of the PEN term (Formula 8), particularly in relation to the weighting of the JUS term. See our response to Proposal 5.
5.	2	In example 2, the NRO_{OAD} term is stated as RE42.5m in the table which is part of paragraph 1.9. Within the description there is wording which states "Delivery of RE40.2m equates to ...". We are unable to correlate this value or calculate it based on the formulas. Clarity on the origin of the value and/or correction would be welcomed.
6.	3	The term CIX_{OD} is stated as having a value of £0.5m when the term is defined. In the final allowed calculation, it is stated " $CIX_{OD} = 0.25$ in this example". We would welcome further clarity in the example as to the composition of the determined values.
7.	4	In the table describing project baseline and outturn values we believe there to be a numerical error in the calculation of the Outturn UCR where an expenditure of £14.1 and a risk benefit of RE22.5m would equate to a value of 0.63 not 0.66 as shown.

Further Comment

SPT would like to take this opportunity to make general comment on the operation of the NARM Funding Adjustment and Penalty Mechanism as set out in the revised drafting of the NARM Handbook. Our comments are as follows:

NARM funding across regulatory periods

Using the NARM mechanism to adjust allowances downwards in the RIIO-2 period as a result of under delivery because a project completes a short time after the end of the period, assume 6 months, introduces a significant administrative burden to assess the justification and determine suitable allowance adjustment. We are of the view that a period following the end of the RIIO-T2 price control where works could be completed, before the submission of the close out report, would simplify this process for network companies and Ofgem, without acting against the interests of consumers.

The absence of a mechanistic approach for the rollover of schemes between RIIO-2 and RIIO-3 creates uncertainty in the recovery of allowance for fully justified works. Where a scheme does not complete in RIIO-2 an allowance adjustment appropriate to the amount of under delivery will be made. Given that this would have been justified as part of the setting of that allowance, the completion of the work should be considered necessary and justified. The funding of work which completes in a future price control period is reliant on a future funding adjustment mechanism which makes provision for justified over delivery. It is expected that even with such a mechanism in place, over delivery would not be funded until the end of the next regulatory period, creating a significant period where the network company carries the uncertainty of the investment which has already been determined to be justified. The uncertainty introduced may lead to unintended consequences where work is undertaken against the constraints of a fixed price control period resulting in less favourable outcomes than would otherwise be possible with greater certainty over work spanning price control periods.

Collectively TOs have engaged with Ofgem, and SPT provided comment as part of our Policy Consultation response, on the risks and regulatory burden associated with not having in place specific mechanisms to deal with funding of NARM interventions across price controls. We are disappointed

that the policy decision sets out the view that Ofgem believes this is not necessary given that SPT believe it will become increasingly important given the pace of change faced by the industry in coming years. Specific detailed treatment of the allowance adjustments associated with projects spanning price controls, we believe, would provide greater clarity and transparency. We continue to promote this idea ahead of RIIO-T2 close out and RIIO-T3 Final Determination. In any case we look forward to seeing the implementation of regulatory reporting on projects which it is believed there is a risk of delay as set out by Ofgem in paragraph 3.66 of their decision document⁵.

⁵ https://www.ofgem.gov.uk/sites/default/files/2024-11/Decision_on_Threshold_for_NARM_Clearly_Identifiable_Over_or_Under_Delivery.pdf