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Making a positive difference
for energy consumers

Onshore transmission and
distribution licensees, and any
other interested parties

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Dear Stakeholders,

Consultation on the Network Output Measures (NOMs) Incentive Methodology

This consultation relates to the draft methodology that Ofgem proposes to use to give effect to the NOMs incentive that sits in the Licences of each of the onshore transmission and distribution Licensees. It describes what we consider as the key choices we have made in deriving the draft methodology, and seeks views on the consequential issues. We also welcome comments on the specific detail of the draft methodology, which is published alongside this consultation letter.

Background

An objective of the RIIO (Revenue = Incentives + Innovation + Outputs) framework1 is to drive real benefit for customers by incentivising network companies to deliver a low cost, sustainable programme of work that will meet the current (and future) low carbon demands.

One of the key components of this framework is Network Output Measures (NOMs).

NOMs are mechanisms that provide a means to monitor and assess the network asset management outcomes that network companies deliver. They represent the service delivery resulting from companies' asset interventions, and can be considered as a forward-looking indicator of network performance. The methodology covers NOMs outputs (also called "secondary deliverables") related to asset health, criticality, and risk, as detailed in Table 1 below. There are other NOMs (e.g. those related to network capacity) are not subject to this incentive mechanism, and therefore are not covered in this draft methodology.

[1] RIIO: A new way to regulate energy networks: Final decision – October 2010
http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf

	Electricity Transmission (ET)	Gas Transmission (GT)	Gas Distribution (GD)	Electricity Distribution (ED)
Licence conditions[2]	• SpC 2L • SpC 2M	• SpC 7D • SpC 7E	• SpC 4G • SpC 4H	• Condition 51 • CRC 5D
Condition Risk related NOMs outputs under the licence	1. Network asset condition 2. Network risk 3. Replacement Outputs	1. Network asset condition 2. Network risk 3. Replacement Outputs	1. Network Asset Health 2. Network Criticality 3. Network Risk 4. Network Outputs	1. Health Index 2. Criticality Index 3. Risk Index

Table 1 Cross Sector Licence conditions and NOMs Outputs

As part of RIIO-1 it will be necessary to assess performance on the NOMs and calculate the value of any incentives that should apply in the RIIO-2 price control based on that performance. Although the incentives are set out in the licences, the manner in which these can be implemented is not specified in either the licences or the price control Final Proposals/Determinations for the different sectors3. Ofgem is looking to address this by establishing a methodology ahead of the RIIO-1 close-out process, so that Licensees will have certainty around the implementation of the RIIO-1 NOMs incentive mechanism. This consultation relates to the methodology for that close out process.

NOMs Cross Sector Working Group (NCSWG)

The NOMs Cross Sector Working Group (NCSWG) is a forum comprising Ofgem and representatives of all onshore network Licensees to discuss cross-sector issues related to NOMs implementation and development. Ofgem brought this group together and has used its combined expertise to inform the development of the NOMs incentive methodology. Following a series of meetings during the latter part of 2017 and early 2018, Ofgem has produced a draft methodology detailing a common framework for the sectoral close-out processes. This common methodology is the subject of this consultation.

Overview of methodology content

The draft methodology adopts a process that was detailed in sectoral Final Proposals. It specifies that Licensees must submit a report that details how they have performed against their NOMs risk targets[4] at the end of their control period. Ofgem will assess these reports; if Ofgem decides that the Licensee has either materially over or under-delivered against its target, Ofgem will calculate the incentive mechanism revenue adjustment. This adjustment will be implemented through the RIIO-2 price control allowances.

The majority of the draft methodology details the practical considerations of how this can be implemented, e.g., our expectations on the content of the end-of-period report, the nature of Ofgem's assessment process and overall process timings. We consider that since this was

[2] All Special Licence Conditions are available on the Ofgem document website (https://epr.ofgem.gov.uk/ use search term 'special conditions' and current version)
[3] Electricity transmission, electricity distribution, gas transmission and gas distribution
[4] Transmission companies have to achieve an absolute level of risk on their networks, while distribution companies have to deliver a specified amount of risk reduction through their interventions

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tested during development through the NCSWG, the process should be robust and implementable.

Question 1: Does the process as described in the draft methodology flow-chart represent a suitable means of implementing the data gathering and assessment phases of the incentive mechanism? Are there any improvements that you could suggest? Please state your rationale alongside any answers provided.

Key issues arising

There are two key decisions made by Ofgem during the origination of the draft methodology that impact on the materiality of the NOMs incentive mechanism. These are:

1. The use of a materiality threshold (deadband) around the delivery target
2. The valuation and profiling of the "associated costs" of under/over-delivery

Materiality threshold

Since the majority of sectoral licences refer to the incentive mechanism applying in the event of "material" changes to the delivery target, Ofgem has agreed in principle to the use of a threshold value around the target. If the Licensee's performance sits within the band of the target plus/minus the threshold level, the Licensee will have met its target and so the incentive mechanism will not apply.

The Electricity Distribution sector has undergone a "rebasing" exercise, whereby the specific schedule of asset interventions to reduce risk has been translated into a single "monetised risk" figure – that is, a monetary target value for the risk that is to be removed from the network during the control period, relative to the risk that would exist if the Licensee did nothing. This has allowed it to calculate the materiality of various options for the threshold, and it has proposed a range of plus/minus 5% of the overall network target risk[5], which has been incorporated into the current draft of the methodology. Although the Gas Distribution sector has yet to complete its rebasing exercise, it has also signed-on to using this same level of threshold. Neither of the Transmission sectors are near to being able to evaluate the impact that rebasing could have on the threshold, so the draft methodology states that Ofgem will consider this parameter for those sectors after completion of their rebasing.

Although the use of a threshold could mean that any over/under-delivery within that band would not be assessed by Ofgem, the requirement for the delivery to be categorised as justified or unjustified means that Ofgem will have a degree of overview of Licensees' activity. For example, if a Licensee were to delivery on target but had significant deviation from the work schedule that constituted the Final Proposals settlement, it would have to provide justification for choosing that alternative investment plan.

Question 2: Do you agree with the use of a materiality threshold around the NOMs network monetised risk target to assess compliance? Do you consider that the range proposed for the Distribution sectors is appropriate? Please state your rationale alongside any answers provided.

[5] On the basis that the materiality of this is comparable to that typically seen in reopener mechanisms (c.1% of total allowed revenue)

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A further issue in respect of the use of a threshold is to what extent the Licensee is exposed if its performance is judged to fall outside of the range around the target. We are proposing that under these circumstances, the Licensee should be exposed to the deviation from the edge of the threshold rather than the full deviation from the target. For example, if a Licensee has a risk target of 100 and a threshold of plus/minus 5, a performance of 110 would be assessed as an over-delivery of 5 rather than an over-delivery of 10. We consider this is appropriate as it avoids the possible perverse incentives to do less/more when on the cusp of the performance band. However, we note that several Licensees consider that this runs the risk of having to provide significant levels of justification for very little reward or penalty, and in the event of an over/under-delivery scenario they would prefer exposure to be measured as deviation from target.

Question 3: Do you agree that the exposure to the NOMs incentive should be measured from the upper/lower materiality thresholds? Please state your rationale alongside any answers provided.

Valuation and profiling of associated costs of over/under-delivery

The Licences set out how Ofgem will treat cases of over or under delivery against the NOMs target. For example, if there is a justified over-delivery, the Licensee is reimbursed for the additional costs incurred due to the over-delivery, and it will receive an additional reward of 2.5% of these costs.

The draft methodology details how Ofgem will determine the capex associated with the over/under-delivery against target, and provides an example of how this could be applied to the Electricity Distribution sector. The sector-specific detail of implementation will be worked out in subsequent discussions with the Licensees, but will be bound by the common methodology.

Question 4: Do you agree with our proposal for how the associated costs of over/under-delivery are derived? Please state your rationale alongside any answers provided.

For the majority of Licensees, it is likely that they will not be able to explicitly identify the work that constituted the over-delivery against target. Even where this is possible, it might not be possible to identify the timing of allowances related to specific risk-reduction work. Accordingly, we are proposing to allocate the associated costs of a justified over-delivery or unjustified under-delivery pro-rata to the profile of actual spend (as distinct from allowances) as input to the financial model.

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Question 5: Do you agree with the use of the actual spend profile for allocating the associated costs of a justified over-delivery or unjustified under-delivery? Are there other options that you consider would be more appropriate? Please state your rationale alongside any answers provided.

Timeline

We have proposed a process timeline of up to 15 months from the completion of RIIO-1 price controls within which Ofgem and Licensees will aim to complete the NOMs incentive assessment. It is our aim that the NOMs incentive methodology implementation process is completed in time for any output to feed into the second annual iteration process in RIIO-2.

Question 6: Do you consider that the timeline proposed is achievable and realistic? Are there improvements that you can recommend? Please state your rationale alongside any answers provided.

Impact Assessment

The NOMs incentive methodology sets out the framework to implement the RIIO-1 agreed policy and the NOMs incentives set out in Licences. We do not consider that it meets the threshold for requiring an impact assessment in its own right.

Question 7: Do you consider that the implementation of a common NOMs incentive methodology should require an impact assessment? Please state your rationale alongside any answers provided.

Next Steps

We are aware that the methodology has been developed without wider stakeholder involvement and we would welcome bilateral discussions with interested stakeholders ahead of receiving written responses. The closing date for responses to this consultation is Monday 30th April 2018**.** All responses should be sent to paul.odonovan@ofgem.gov.uk. We will publish all non-confidential responses on our website. If you do not wish all or part of your response to be made public, you should clearly mark your response as confidential. If you are submitting confidential material, it would be helpful if this could be confined to an appendix so that the main body of the response can be published.

Yours faithfully,

Min Zhu
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