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30 April 2018

Dear Paul

Scottish Hydro Electric Transmission plc (SHE Transmission) welcomes the opportunity to comment on Ofgem's consultation on the Network Output Measures (NOMs) Incentive Methodology published on 26 March 2018. We have actively engaged with Ofgem and the other network companies via the NOMs Cross Sector Working Group (NCSWG) to help Ofgem develop the incentive methodology which is also consistent with Special Licence Condition (SpC) 2M.

We acknowledge that Ofgem is attempting to establish a consistent methodology across all the sectors of the energy industry ahead of the RIIO-1 close-out process. However as expressed during the NCSWG meetings, we do have concerns that there are significant differences in the progress and development of the NOMs mechanism across the different sectors. In particular, the Electricity Distribution sector NOMs mechanism has developed based on the DPCR5 price control methodologies, and a rebasing exercise during the second year of the RIIO ED1 price control. In comparison, this is the first price control in which the NOMs mechanism has been introduced in Transmission and we are still to finalise the NOMs Common Network Asset methodology. There is also a need to undertake the rebasing exercise in year six of an eight-year price control. We believe it is not possible for the rewards and penalties mechanism to be fully concluded until the methodology is closer to being finalised. We also feel that the application of a deadband and the treatment of material change would be more appropriately concluded after the completion of the NOMs work including rebasing.

The final concern we would highlight is regarding the value of incentive for over/under-delivery. The transmission sector is generally made up of lower volumes of large high value projects. Whilst we agree that the Ofgem proposal for any over-delivery to be valued based on Ofgem's view of "allowed efficient costs", we would welcome clarity on the approach and timing for Ofgem to determine the "efficient costs". As discussed in the NCSWG, it is not yet possible to benchmark standardised costs using a mechanistic, unit cost based approach while considering project and region specific factors. Any approach would need to be developed openly for the electricity transmission sector.

We have answered the specific questions posed by Ofgem in the consultation document in the appendix below.

We would welcome the opportunity to discuss these concerns with Ofgem in more detail.

Yours sincerely

Sam Torrance
Transmission Regulation

[via email only]

Appendix 1 – NOMs Incentive Methodology specific questions

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

SHE Transmission agrees that the draft methodology flow-chart represents a suitable means of implementing the data gathering and assessment phases of the incentive mechanism. This flow-chart has been developed through the NCSWG which we have actively participated in over the last 12 months. However, we do have concerns on certain stages of the process which we would welcome clarification on. Some of these concerns are outlined below:

- We suggest that Ofgem should provide a definition for the term "non-intervention risk changes" to ensure that both Ofgem and the network licensees are clear as to what risk changes contribute to "non-intervention risk changes". The term is similar to the term "Material Changes" which was a defined term used within the DPCR5 price control.
- Under stage 1 of the process "licensees submit relevant risk changes and impact on performance against targets", we would welcome clarification from Ofgem on how this stage will work in practice for the Electricity Transmission sector given the absolute targets which are specified within the licence.
- Stage 3 of the methodology also infers that any "non-intervention risk changes" which are explicitly identified as being at the Licensee's risk will not be stripped out at this stage, instead they will be considered in the valuation of over/under-delivery at stage 7. We would welcome clarification from Ofgem as to what "non-intervention risk changes" are explicitly identified at the Licensee's risk.
- The draft incentive methodology requires licensees to "identify relevant risk changes through annual Regulatory Instructions and Guidance (RIGs) submissions, thereby enabling Ofgem to respond to the data ahead of the end of the price control period". This is not currently a requirement on TOs and would require an amendment to the RIGs which realistically will not be introduced until 2019. We would welcome further clarification from Ofgem as to its expectations around this new requirement for the ET sector and the intended timescales for making such a change?

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 Distribution sectors is appropriate? Please state your rationale alongside any answers provided.*

As Ofgem outlined in section 5 of the incentive methodology (page 18) "…because the NOMs methodology… is still under development, it is not currently possible to evaluate the materiality of any proposed threshold". We would suggest that Ofgem considers the use of a materiality threshold for the Transmission sector following a rebasing exercise which is due for completion on 31 October 2018, after which the level of any materiality threshold can also be agreed upon.

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.*

As per our response to question 2, we are unable to fully evaluate the impact of a materiality threshold around the NOMs network monetised risk target to assess compliance for SHE Transmission whilst the NOMs methodology is still under development. We believe that any decision around the measurement against target being assessed against the upper or lower materiality thresholds should be considered and agreed as part of the rebasing exercise. The transmission portfolio is made up of lower volumes of high valued schemes which means any over or under delivery measured against the upper/lower materiality thresholds could result in significant and disproportionate losses or gains.

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.*

Generally, we agree with the principle that Ofgem will assess the associated cost of any over/under-delivery to ensure the licensees are operating efficiently and in the best interests of consumers. However, we believe that further work is required to determine how this works in practice and we have submitted some scenarios to Ofgem directly regarding our understanding/interpretation of how this will work in practice, we would welcome further engagement with Ofgem to ensure that a satisfactory methodology is derived.

We believe that the methodology for how the associated costs of over/under-delivery are derived is unclear and further clarity is required, particularly around how material change will be treated. The first stage of the two-stage process which Ofgem is undertaking for the consideration of the associated costs for justified over/under delivery is essentially assigning zero associated costs to any non-intervention asset health improvement/deterioration which has not been stripped out at stage 3 of the process. As outlined in our response to question 1, we would welcome clarification from Ofgem on the definition of "non-intervention risk changes", both which are and are not explicitly identified as being at the Licensee's risk.

We believe the treatment of material changes on the delivery of targets needs to be clarified. It would be premature to conclude how these are treated financially in their entirety in the absence of a finalised NOMs methodology.

We acknowledge and generally agree with Ofgem's approach to assessing the associated cost of over-delivery through an ex-post efficiency review, however we require further clarity on how this will work in practice, especially as the Electricity Transmission sector do not have unit costs agreed upon across the various work and asset types.

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 answers provided.*

We believe that the identification of an accurate cost profile associated with any over- or under-delivery may be difficult. At this stage, it appears that utilising the expenditure profile for allocating the associated costs of a justified over-delivery or unjustified under-delivery would be appropriate. As we have set out, it would be preferable to conclude this element as part of concluding the methodology and drafting of the relevant close out methodologies into the Financial Handbook.

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.*

We are generally comfortable with the proposed timeline and feel they are achievable and realistic, although still potentially stretched given the substantial level of work that is still required to finalise NOMs work across several of the sectors, and rebasing exercises that still require to be done in both the Electricity Transmission and Gas Transmission sectors.

As we have previously established, the level of expert resource required in this area to ensure a satisfactory conclusion should not be underestimated, and this level of ongoing work is acknowledged by Ofgem throughout this consultation document.

While there are likely to be considerable pressures across both Ofgem and Licensees in the NOMs area until the end of the price control, we feel that a 15-month period from the end of the RIIO-1 price controls for both Ofgem and Licensees to complete the NOMs incentive works should be sufficient. However, Ofgem may want to consider including a 12-month extension if the licensee's cannot provide the justification which Ofgem requires within the required timescales, similar to the process which was built-in for the DPCR5 close-out.

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.*

We believe that the implementation of a common NOMs incentive methodology would require an Impact Assessment. Chapter 2 of Ofgem's impact assessment guidance document[1] published on 4 October 2016 outlines when Ofgem will do an Impact Assessment. The NOMs incentive methodology is a new incentive for the ET sector which could potentially have significant impacts for the network licensees and consumers and therefore we believe it would be appropriate and in line with regulatory good practice for Ofgem to undertake an Impact Assessment.

[1] https://www.ofgem.gov.uk/system/files/docs/2016/10/impact_assessment_guidance_0.pdf