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Horley,
RH6 9HJ.

The Office of Gas and Electricity Markets,
9 Millbank,
London,
SW1P 3GE.

For the attention of: Paul O'Donovan

26 April 2018

Dear Sir or Madam,

Ref: Consultation on the Network Output Measures (NOMs) Incentive Methodology

I write on behalf of SGN with reference to the consultation on the NOMs Incentive Methodology published by the Authority on 26th March 2018.

In general, the methodology provides the clarity and guidance necessary for its implementation at the end of the respective price control periods as part of the reconciliation of primary outputs and secondary deliverables. The methodology is generally both practicable and measured and is substantively supported by my company.

We recognise that the scale and nature of the penalties and rewards detailed within the methodology are directly reproduced from the gas distribution networks' special condition 4H and are not subject to consideration at this time. However, such incentives need to be considered by each company in each sector alongside the whole package of measures as part of RIIO. We therefore consider that a consistent methodology across all gas and electricity sectors has the potential to compromise an individual sector's ability to negotiate a rounded package of incentives, rewards and penalties that reflect the unique circumstances of each sector and geography. This is especially true where this incentive methodology forms a greater contribution to the whole package.

You will be aware that the current price control period for gas distribution commenced on 1st April 2013 and we will be some 70% through our review period by the time 'Monetised Risk' (MR) targets are formally agreed. For much of GD1, we will not have had sight of the targets or awareness of 'risk trading' options. Therefore, while SGN fully anticipate meeting our obligations as part of this output based on our informed understanding and the discussions that we had to date. If there are differences caused by the late definition of targets then these must be acknowledged by Ofgem in it assessment.

Regarding references to previous targets and rebasing as part of NOMs, whilst it is not material to the content of the methodology, I must draw your attention to a letter to Ofgem from my Head of Network Management (Transmission) *dated 1st December 2017 and sent via email on that date*, who raises questions about the validity of the original targets in the absence of an accepted methodology.

I note that, in your letter, you highlight that the 'Capacity Measures' defined within special condition 4G and regularly reported in our annual returns are not subject to this incentive mechanism. We welcome that clarification.

Your letter also states that "*if a licensee were to deliver 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*". We disagree with this statement as it deviates from the wording set out in Special Condition 4H. Special Condition 4H states in table 2 that where delivery is identified as 'same or not materially different' then this should result in 'no action'. Then in 4h.3:

> "The Licensee shall also be deemed to have delivered a particular Network Output for the purposes of paragraph 4H.2 of this condition, notwithstanding a failure to meet the relevant specifications in the Workbook, if by the end of the Price Control Period:
>
> (a) it delivers an output or outputs which delivers an equivalent specification of risk mitigation to the Network Outputs specified in the Workbook"

In our opinion this directly refers to risk trading and we would not expect to provide justification of risk trading in the event of 'on target' delivery.

Please also find enclosed the following responses to individual questions:

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.

SGN support the flowchart detailed within figure 1 of the methodology. In particular, we note that where 'on target delivery' is confirmed, then the process ceases at stage 4.

SGN had anticipated that stage 3 would, in effect, be a rebasing exercise in order to take account of 'Material Changes' across all assets. Instead, it is noted that the Authority will "*adjust Licensee performance to strip out any non-intervention risk changes*". Of course, this will affect both planned and actual interventions and it is not clear whether any changes to the remaining assets would have a bearing on the justification of performance. We look forward to working with the Authority to clarify how this process will work in practice.

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.

SGN support the use of a materiality threshold. We also support the short-term specification of that threshold at +/-5%. However, the Monetised Risk methodology for gas distribution approved by the Authority does generate a wide variation in target values for change in Monetised Risk (also described as Δ MR) for specific interventions. Some further statistical analysis may be beneficial to demonstrate that the threshold is commensurate with workload volumes and relative MR returns.

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.

SGN support the exposure to the incentive being measured from the upper / lower materiality thresholds. Special condition 4H specifies that the application of penalties and rewards should be based upon "Material" over- or under-delivery. The methodology is therefore consistent with this condition.

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.

The proposal is generally consistent with licence conditions and is therefore supported by SGN. However, we would query the Authority's intention to base associated costs '*on Ofgem's view of efficient costs for the over-delivery element*'. While some of the applicable workload is generic in both nature and cost (for example service replacement), other elements of our business plan are unique in both nature and size (for example, PRS replacements can vary in cost from £1.4m to £6m). Deriving an efficient cost for such works may therefore not be possible. In any case, the efficiency of costs was determined as part of Final Proposals and this was the basis of the regulatory contract agreed at that time.

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.

SGN support the use of actual spend profile only for high volume works undertaken throughout the price control period (for example, service, mains replacement). In other cases, especially low volume / high costs projects, the expected or actual delivery plan should be used as the basis for analysis. For example, a large single project planned to be delivered late in the formula period as a result of operational constraints, but which then experiences unforeseen delays, should incur 'financing costs' only for the last year of the period.

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.

SGN accept the proposed timeline detailed in section 6 as achievable and realistic. It should, however, be noted that we have not previously experienced such a reconciliation process as the electricity distributions networks have with GDPCR5 and our current experience is limited to the process for rebasing of targets, which will take up to 16 months to complete and has involved onerous requirements for data templates. As such, the suggested timeline may need to be reviewed once the full extent of any reporting and analysis is fully understood.

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.

In our response to question 6, we highlighted our limited experience with such a process. Thus, while the content and expectations of special conditions 4G and 4H are well understood, we believe that an impact assessment may prove beneficial to properly understand the extent of any data requirements, assumptions and decisions.

Should you have any queries regarding this response, please do not hesitate to contact Stephen Skipp at Stephen.skipp@sgn.co.uk.

Yours sincerely

Stephen Skipp
Head of Network Management (Transmission)