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For the attention of: Min Zhu & Paul O'Donovan

Consultation on the Network Output Measures (NOMs) Incentive Methodology

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

The NOMs approach is a significant step forward for the industry and we are committed to working with Ofgem to ensure that it is appropriately and effectively implemented.

We support the work that has been done in producing a methodology which can be used by all sectors during RIIO1. We feel that a balance has been struck between uniformity and sector specific requirements. There are clear differences between the high volume low cost activities delivered by distribution networks and the 'lumpier' high cost stand-alone projects delivered by transmission networks. It is important that these differences are reflected in the final version of the methodology.

We are in broad agreement with the approach outlined, subject to some specific issues highlighted below. We would, however, stress the importance of proportionate oversight, allowing companies which have delivered their targets to progress rapidly through the described process.

We are mindful that this is a new way of working, and as such a review date should be set for the Incentive Methodology document to ensure that it is updated for RIIO2.

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.

We feel that the proposed implementation process is adequate, and we would not suggest any improvements. It is important to maintain a clear, low complexity, approach.

We note that there is reference in the methodology to reporting templates, it would be helpful for the methodology to give more details on what information these would collect, how they will be developed, how they will be structured and when they will be available.

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.

We support the use of a materiality threshold around the NOMs target.

The licences for Gas Distribution state that incentives would apply for ‘material over deliver’ and ‘material under delivery’; therefore we must apply a threshold to demarcate material from none material. The Gas Distribution sector has signed-on to using this proposed range in GD1, which is broadly consistent with the 1% base revenue materiality threshold for UMs.

However, we would disagree with the language used by Ofgem within this section of the letter. Specifically, ‘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.’ We agree that a commentary should be provided, and this requirement is included in the methodology, but whether deviation from the original plan is significant on not, licensees do not need to justify decisions which deliver the agreed overall target. The methodology is clear ‘The Licensees are therefore incentivised to deliver the targets, but have the flexibility to amend work programmes and to make appropriate asset management decisions that are both based on the latest information and in the interest of consumers.’ Asset management decisions are the responsibility of the licensee and regulatory oversight should be light when overall performance is on target. The GD Licence (condition 4H) does do not allow for ‘on target’ delivery to be unjustified.

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.

We agree that exposure should be measured from the upper/lower materiality thresholds. The rational for this is linked in part to what Ofgem describe as perverse incentives at the cusp of the performance band. There is also a link back to the position on materiality, in that incentives should only be applied to ‘visibly different’ performance. That is to say changes within the threshold, although measurable, are not making a material difference to customers and as such should not be counted towards the incentive

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.

Although we agree with the proposal in general, being in line with licence conditions, we do not agree with the following element, ‘The associated cost of over-delivery will be based on Ofgem’s view of efficient costs for the over-delivery element’.

We maintain that the costs set by Ofgem in their Final Proposals are efficient and simple to work with. Ofgems proposed approach has a number of failing:

- Efficient costs were established at the start of RIIO 1, re opening the efficiency debate ex-post, without prior signalling undermines previously agreed regulatory figures and contradicts Ofgems position at FP (see RIIO-GD1: Final

Proposals - Supporting Document – Outputs, incentives and innovation, p68, para 1.23[1]).

- The mechanism for an ex-post efficiency review is undefined, but is likely to be burdensome, complex and protracted - extending the time taken to close out the period. The burden would be particularly unfair if companies who have delivered on target are involved in extensive work to facilitate the calculation of payments for others.
- The data required to support the exercise may not be readily available. Identifying costs for individual elements, as discussed at working meetings, is not always extractable from company accounts. Furthermore, the lack of consistency between companies' records could lead to unfair 'cherry picking'.
- Unless a company knows its costs are efficient it will be dis-incentivised from over delivery. As companies do not know their costs relative to others, even an efficient company would not choose to invest due to the uncertainty of cost recovery.

We would also like further clarification on the statement made in the methodology that: 'In the case of a unjustified over-delivery or justified under-delivery for GD, ET or GT it will also be necessary to make an assumption on the timing with which costs will be or would have been incurred in RIIO-2.'

This clause appears to be addressing a scenario in which work is required, but has been delivered to early (without justification) or has been legitimately deferred to another period. We suggest that this approach is not applicable to GD as the majority of our work is low cost, high volume, and this type of re phasing is generally not part of our asset management approach. The complications of implementing such an approach would only be justified in the case of highly material variations, as the burdensome analysis and reporting required would produce little change to financing.

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.

For gas distribution networks we do not agree with use of the actual spend profile. Precedent was set in the adjustment to Cadent's London networks allowances for its medium pressure mains replacements output, which was reduced due to stakeholders requirement to defer elements of work into RIIO2. This took the principle that it was the later stage of work that was deferred, so adjustment was applied to later years.

In addition, given gas distribution work is materially flat profile, for simplification purposes and to ensure minimal customer bill impact, we would propose that over / under spend is assumed to be within year 8 if less than 12.5% (1/8th) and year 7&8 for 12.5% to 25%, etc.

[1] "1.23. As with the other ex post reviews of outputs, our review of GDNs" performance in relation to NOMs will not consider GDNs" cost efficiency; our assessment will focus only on output performance. For example, a company that meets the output target but underspends will retain the benefit of such outperformance subject to the IQI incentive rate (there will be no ex post clawback)."

These changes would then also simplify the process for adjustment to timing in RIIO2. We would propose that it should be applied within Year 1, up to 20% (1/5 – assuming RIIO2 reverts to a 5 year control), etc.

We expect the PCFM tool to be used to ensure consistency

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.

The timeline is realistic.

Delivery against the timeline will be assisted by the NOMs work which will have to be completed as part of agreeing the GD2 settlement.

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.

An impact assessment is not required.

The foundations of the approach have been written into company licences and there has been extensive work between Ofgem/GDNs in developing this methodology. However, in the delivery of the methodology we need to ensure that a flexible and progressive approach is adopted to avoid inadvertently impacting other areas agreed through our operating licence, legislative requirements or the terms of our FP.

Should you have any queries regarding this response, please do not hesitate to contact me at colum.goodchild@cadentgas.com.

Yours sincerely

Colum Goodchild
Regulatory Investment Planning Manager