Centrica plc
Regulatory Affairs
Ground Floor, Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY
www.centrica.com

Min Zhu
Associate Partner, Networks
Ofgem
9 Millbank
London
SW1P 3GE

30 April 2018.

Sent by email to: paul.odonovan@ofgem.gov.uk

Dear Min,

Consultation on the Network Output Measures (NOMs) Incentive Methodology

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

In principle, Licensees may be rewarded for genuine outperformance. Licensees should not benefit from 'good luck' or be rewarded for over-forecasting expenditure requirements. We have concerns that elements of the methodology, and its application, could reward Licensees for reasons other than genuine outperformance. Our concerns are:

Monetised risk targets should be normalised to take account of non-intervention risk changes and non NOMs-related interventions:
The proposal to adjust Licensees' performance to take account of the impact of non-intervention risk changes and non NOMs-related interventions does not go far enough to protect the interests of consumers. Instead, monetised risk targets should be normalised to take account of changes in circumstances.

Licensees are expected to alter investment programmes in response to changes in circumstances, such as better-than-expected asset health, that were not envisaged when the price control settlements were agreed. For example, it is recognised milder winters have had a beneficial impact on gas distribution workloads and are one of the main causes of under-spend[1]. The proposed methodology as drafted distorts Licensees' true performance by allowing non-intervention risk changes and non NOMs-related interventions to contribute to Licensee performance. This makes it difficult to assess genuine efficiency and to assess whether over- or under-delivery is in consumers' interests. The proposal also makes it more likely that the Licensees will benefit from 'good luck' or over-forecasting expenditure requirements.

[1] "RIIO-GD1 Annual Report 2015-16", page 8 and appendix 2 para 1.12: https://www.ofgem.gov.uk/system/files/docs/2017/02/riio-gd1_annual_report_2015-16_0.pdf

The NOMs incentive should be 'switched off' for the ET1, GT1 and GD1 price controls:
As highlighted in the consultation, the electricity distribution sector is the only sector for which a common methodology for quantifying network risk has been developed and approved. It is also the only sector in which each distribution network operator's (DNO's) risk reduction targets, originally derived from individual risk methodologies, have been rebased according to the common sector methodology. Target rebasing was completed about two years after the ED1 price control started, thereby allowing DNOs the opportunity to respond to those targets over most of the ED1 price control.

Circumstances for the transmission and gas distribution sectors are different: target rebasing has not yet been completed with less than three years remaining of these eight-year price controls. As such, the NOMs incentive cannot be effective for those network operators because there will be little opportunity to respond to targets. The ineffectiveness of the incentive for the ET1, GT1 and GD1 price controls conflicts with the second proposed principle[2] – Licensees have not been '*appropriately incentivised*' as they do not yet have '*agreed targets*' and will have little time to respond once targets are agreed. Further, it is not appropriate for these network operators to be involved in the development in the incentive methodology at this late stage in the ET1, GT1 and GD1 price controls as it is likely outturn performance has already started to crystallise. These circumstances create a material risk of inappropriate gains.

Notwithstanding our views on the need to normalise targets, we believe the NOMs incentive should be 'switched off' for the ET1, GT1 and GD1 price controls. This is similar to the decision taken to 'switch off' components of the stakeholder satisfaction incentive in the RIIO-T1 price control[3]. This was done because of concerns about the ineffectiveness of the incentive:

> *"…Because the companies are unable to respond to any baseline we set for the first 3 years, we think there is a case for considering "switching off" the relevant components of the incentive for these years so that the companies neither receive a reward nor a penalty for these years…"*[4]

Materiality thresholds should be applied consistently:
It is proposed to use materiality thresholds around targets to determine whether Licensees have met their targets and to quantify the portion of performance that is exposed to the incentive. Instead, Licensees would prefer any deviation in performance from targets is exposed to the incentive. We disagree with their preference. If it is considered necessary to treat any level of performance within a defined range as 'on target' performance, it is not appropriate to expose performance within that range to the incentive. Such an approach, which could result in rewards or penalties simply for 'on target' performance, is not in consumers' interests. Materiality thresholds should be employed consistently. Alternatively, any deviation in performance from targets should trigger an assessment and financial adjustments are then based on the entire deviation from targets.

---

[2] The second proposed principle states:
A licensee should be appropriately incentivised to deliver the agreed NOMs risk target, including:
a. A reward when it justifies material over-delivery against agreed targets.
b. A penalty when it fails to justify material under-delivery against agreed targets.

[3] "Decision on values within the stakeholder satisfaction output arrangements (electricity transmission licence special condition 3D and gas transporter licence special condition 2C)": https://www.ofgem.gov.uk/system/files/docs/2016/08/ss_output_decision_final_to_publish_4_aug_2016.pdf

[4] "RIIO-T1: Consultation on values within the stakeholder satisfaction output arrangements", page 5: https://www.ofgem.gov.uk/system/files/docs/2016/04/si_consultation_apr_16_final.pdf

We note Licensees justify their preference on the basis they may be required to provide significant levels of justification for very little reward or penalty. We do not believe this is a valid concern. The RIIO framework encourages Licensees to proactively engage with their stakeholders and not just because of the potential size of rewards or penalties. We would expect Licensees to be keen to justify their performance to stakeholders regardless of the size of any financial adjustments, as we have seen with their annual performance reports.

The approach to valuing the associated costs of over/under-delivery is appropriate:
We agree with the differential approach to valuing the costs of under-delivery and over-delivery – valuing under-delivery based on allowed efficient costs while valuing over-delivery according to observed efficient costs. This approach provides a greater incentive to avoid under-delivery because of the higher value of unit of monetised risk. It is also necessary to avoid the perverse incentive to spend, even when unjustified, in the situation where observed costs are more than 2.5% lower than allowed costs.

Along with the above points, it would have been helpful if the scale of the potential financial impacts of the key issues was included in the consultation. An impact assessment should be conducted. We hope you find these comments helpful. Please contact me if you have any questions.

Yours sincerely,

Andy Manning
Director - Network Regulation, Forecasting and Settlements
Centrica Regulatory Affairs, UK & Ireland