Network Planning & Regulation

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Dear Paul

Consultation on the Network Output Measures (NOMs) Incentive Methodology

This response is from SP Energy Networks. SP Energy Networks holds three electricity network licences. We own and operate the electricity distribution networks in the Central Belt and South of Scotland (SP Distribution) which serves 2 million customers, and Merseyside and North Wales (SP Manweb) which serves 1.5 million customers. We also own and maintain the electricity transmission network in the Central Belt and South of Scotland (SP Transmission).

Thank you for the opportunity to participate in the NOMS Cross-Sector Working Group (NCSWG) and to respond to this consultation. This response is arranged in two sections – a single section with the responses on behalf of SP Distribution and SP Manweb and a second section on behalf of SP Transmission – reflecting the very different circumstances and more importantly, licence conditions of the distribution and transmission companies. We have identified these clearly throughout.

Overall we support the majority of the proposed methodology and believe the drafting is mostly reflective of the significant effort invested by all parties in the working group to produce a robust approach for RIIO-1 closeout. We have provided responses to the specific questions asked but have also provided comments on the methodology document. These are principally on sections which have been introduced or amended since the final draft issued to the NCSWG. We draw particular attention to three specific areas where we do not agree with the proposals in their current form.

Ex-Post Cost Assessment (All Licensees)

The NOMs Incentive Methodology document introduces the concept of an ex-post efficiency review for costs relating to over-delivery. This approach does not align with the fundamental RIIO principle of providing a predictable framework that appropriately rewards efficient delivery, as an ex-post cost efficiency assessment does not enable network companies to predict the financial consequences of their investment decisions. The mechanism fails to provide the financial certainty required to ensure that network companies will receive adequate funding for making the correct asset management decisions. The proposed approach could drive perverse behaviours by disincentivising Licensees from justifiably over-delivering when this represents the best possible outcome for the stakeholders. Equally concerning is the asymmetric nature of the proposal where allowed costs are proposed for the valuation of under-delivery.

The NOMs Incentive Methodology document references the original NOMs-related capex allowances, for the ED sector these were not identified in the RIIO-ED1 final determinations. Further work to define the scale of any potential adjustments and the baseline on which the adjustments will be applied is required.

Treatment of Asset Deterioration (SP Transmission Only)

The proposed requirement on the treatment of asset deterioration is, as we understand following further discussion with Ofgem, intended to avoid licensees benefiting from windfall gains and being exposed to losses outside their control due to inherent uncertainty in the understanding of asset condition at the time of final proposals. As written, it is not clear how a number of scenarios which may reasonably be expected to occur would be treated and therefore there is the risk of undesirable outcomes for consumers and licensees. As this provision was introduced very late in the NCSWG process, there has not been time to evaluate the impact that it may have. We outline in Appendix 3 an example that illustrates this point.

The proposal fundamentally alters the operation of SPT's licence special condition 2M and while we understand the issue that Ofgem seek to address and, for the avoidance of doubt, SP Transmission does not stand to gain or lose materially from it, it is part of the entire price control package that was agreed between the licensee and the authority. We are concerned at the way this proposal to make a change to the operation of a licence condition has been introduced and at the timing, so late in the price control period.

We therefore propose that this issue is deferred to the sector-specific methodology and that the text identified in Appendix 3 is replaced with a statement highlighting the potential issues with the existing licence condition and proposing that it be examined in detail in the ETO sector methodology.

Re-Expression of Licence Targets as Monetised Risk (SP Transmission Only)

As noted in section 1.5.1, the methodology depends on licence targets being expressed in monetised terms (or rebased). Given the relative timescales of the NCSWG and the re-basing working group, there remains a significant degree of uncertainty around the outcome of the rebasing process. SP Transmission welcomes the assurances given by Ofgem to date that the decisions made in accordance with the Replacement Priority methodology will not result in a loss or gain due to performance being assessed against the re-based rather than licence targets. Our participation in the NCSWG was, and our responses to this consultation are, based on the successful completion of re-basing on these terms.

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Conclusion

The proposed methodology should allow network companies to demonstrate to stakeholders the significant customer benefits that will be delivered in the RIIO-1 period. Following finalisation of the NOMs Incentive Methodology, further sector-specific work is required to clarify how the assessment of over/under-delivery is to be undertaken and the approach for calculating the baseline NOMs allowances.

As RIIO is an outputs-led framework, it is important that network companies understand the outputs they are expected to deliver throughout the entire regulatory period. For RIIO-2 the details of the output methodologies for every sector should be embedded into the price control framework, including the detailed arrangements for assessing output delivery.

Yours sincerely,

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APPENDIX 1: SP DISTRIBUTION AND SP MANWEB ANSWERS TO SPECIFIC 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.

SP Distribution and SP Manweb Answer:

Overall we support the process described in section 3 of the draft methodology as a suitable means of implementing the NOMs Incentive Methodology across all four sectors. There are certain areas that require further clarity prior to the implementation of the NOMs Incentive Methodology. We have outlined the main areas in the following sections.

Relevant risk changes and impact on performance against targets

We support the premise that Licensees with a delta target should be neither rewarded nor penalised under the NOMs Incentive Methodology for monetised risk changes not directly attributable to asset replacement, refurbishment or relevant High Value Projects activities.

Under the ED Regulatory Instructions and Guidance framework (RIGs) Licensees already record every individual non-intervention and non NOMs-related intervention risk movement. On average each ED Licensee has reported over 30,000 such risk movements in one regulatory year alone. In order to maximise the efficiency of the process network companies should identify the monetised risk changes that have not been delivered through NOMs activities and could significantly impact the delivery, in accordance with a predefined criteria.

Such risk changes only become 'relevant' if Licensees decide to alter their intervention plans in response to the identified non NOMs-related monetised risk changes. An example for ED could be:

- A non-intervention risk change moves all the health index (HI) 4 assets into the HI5 band, increasing the volume of HI5 units that were already available.
    - If the Licensee had plans to intervene on assets that were originally HI5 and such plans have not been affected, the Licensee should not be penalised for a greater volume of HI5 assets being available. The Licensee has delivered exactly according to plan. The monetised risk change is not relevant to the NOMs assessment.
    - Conversely if the Licensee takes the opportunity to address new HI5 assets then the monetised risk change becomes relevant to the NOMs assessment.

- For a given asset category a non-intervention risk change moves the entire population of health index (HI) 5 assets to the HI3 band.

- o Had the Licensee planned to intervene on HI5 assets, a reassessment of the plan would be required as the Licensee could not get the same outputs from its planned interventions. The monetised risk change becomes relevant to the NOMs assessment.
- o Conversely if the Licensee had no plans to intervene on HI5 assets the monetised risk change is not relevant to the NOMs assessment.

Our view is that the Stage 1 submission should focus on the non-intervention and non NOMs-related risk movements which are deemed relevant to the RIIO-1 delivery. The performance adjustment in Stage 3 should also follow the same principles.

RIIO-1 performance report

We agree with the proposed Stage 2 approach. This will set out the Licensee's performance against its delivery target, including consideration of the relevant risk changes identified in Stage 1. The report should also set out the rationale and justification for strategic decisions focusing in areas where it has not adhered to the original business plan.

Justification of over/under-delivery

Stage 6 should only be triggered if the Licensee is assessed as having materially over/under-delivered.

We support the view that the assessment of over/under-delivery will need to follow a combination of quantitative and qualitative assessments. Ofgem will undertake a review of the evidence provided to test the validity of the analysis. The level of disaggregation may differ between sectors and should be proportionate to the level of over/under-delivery. For sectors with lower volumes of interventions generally it would be appropriate to provide more granular justification on a scheme-by-scheme basis. For sectors with large intervention volumes justification is likely to be limited to strategic decisions made at asset category level.

We would welcome further guidance on Ofgem's expectations regarding the balancing between monetised risk at overall network level and monetised risk within individual asset categories.

Determination of incentive value for over/under-delivery

See response to Question 4.

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.

SP Distribution and SP Manweb Answer:

A symmetrical threshold level of monetised risk is useful to protect customers and network companies from the substantial resource costs required to run Stage 5 to Stage 7 in instances where the over/under-delivery is of such a scale that cannot be offset by the cost of running the process.

Our experience from DPCR5 closeout also supports that there is no benefit to be gained by customers from running the detailed over/under-delivery assessment for small deviations from target. The proposed +5/-5 percent threshold results in a magnitude that for ED equates to approximately 1 percent of allowed revenue, in line with other reopener mechanisms. We welcome the use of this threshold level.

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.

SP Distribution and SP Manweb Answer:

The incentive should be measured from the target, rather than the materiality threshold. The purpose of the materiality threshold is to avoid unnecessary administrative burden on both the Authority and the licensee for relatively small deviations from targets. However, excluding the elements up to the materiality threshold is not consistent with our interpretation of the intent of the thresholds. We do understand the concern regarding perverse incentives, however given that the intention is that the value up to the threshold is not material, we don't believe including this value in the assessment would be problematic.

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.

SP Distribution and SP Manweb Answer:

No, we disagree with the proposed approach for the valuation of over/under-delivery costs.

Step (a) of the proposed two-stage process is only relevant for sectors that are assessed against an absolute level of network monetised risk. For sectors with relative monetised risk targets, in particular ED, the monetised risk delivery is already disaggregated into non-intervention risk changes, NOMs risk changes and non NOMs-related intervention risk changes. Only the NOMs risk delivery feeds into the NOMs Incentive Methodology from a performance assessment perspective.

Step (b) suggests an asymmetrical valuation approach for the delivered monetised risk that is outside of the threshold range. Under-delivery is valued at the RIIO-1 allowed efficient costs. The consultation document introduces the additional concept of an ex-post efficiency review to determine Ofgem's ex-post view of efficient unit costs. This approach does not align the fundamental RIIO principle of providing a predictable framework that appropriately rewards efficient delivery.

An ex-post assessment of cost efficiency does not allow network companies to adequately anticipate the financial consequences of their investment decisions. The mechanism fails to provide the financial certainty required to ensure that network companies will receive adequate funding for making the correct asset management decisions. The proposed approach could drive perverse behaviours by deterring Licensees from justifiably over-delivering when this represents the best outcome for customers.

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.

SP Distribution and SP Manweb Answer:

We agree the use of the actual spend profile represents a valid option to allocate the cost of any justified over-delivery or unjustified under-delivery.

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.

SP Distribution and SP Manweb Answer:

The proposed timescales appear to be challenging but feasible. One of the most onerous tasks is for network companies to provide full Stage 1 and Stage 2 submissions by the end of July. If resubmissions of any such reports are required as part of the Stage 3 assessment there is a risk that the Stage 3 timescales might be overrun. To mitigate the risk a clear indication of the timescales when resubmission is practical should be incorporated.

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.

SP Distribution and SP Manweb Answer

We do not believe that the implementation of a common NOMs Incentive Methodology merits an impact assessment for ED. Unlike in other sectors the monetised risk targets in ED have been rebased at the start of the price control using a sector-specific methodology to assess monetised risk. Undertaking this exercise at an early point in the price control period has enabled the ED sector to understand Ofgem's expectations from the beginning and respond with their intervention plans accordingly.

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Therefore we do not anticipate the implementation of a common NOMs Incentive Methodology to affect the ED sector to a degree that would require a full impact assessment to be undertaken.

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APPENDIX 2: SP TRANSMISSION ANSWERS TO SPECIFIC 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.

SP Transmission Answer:

Please see the specific comments on the methodology in Appendix 3. While we have been fully engaged in the development of the methodology, elements have been introduced or amended since the final draft shared with the NCSWG that have a significant impact which need to be resolved during this process.

The proposed requirement on the treatment of asset deterioration is, we understand following further discussion with Ofgem, intended to avoid licensees benefiting from windfall gains and being exposed to losses outside their control due to inherent uncertainty in the understanding of asset condition at the time of final proposals. As written, it is not clear how a number of scenarios which may reasonably be expected to occur would be treated and therefore there is the risk of undesirable outcomes for consumers and licensees. As this provision was introduced very late in the NCSWG process, there has not been time to evaluate the impact that it may have. When considering that the provision fundamentally alters the operation of SPT's licence special condition 2M, we propose that this issue is deferred to the sector-specific methodology and that the text identified in Appendix 3 is replaced with a statement highlighting the potential issues with the existing licence condition and proposing that it be examined in detail in the ETO sector methodology. The following example illustrates this point.

An asset with an expected end-of-period risk of Replacement Priority 3 (RP3) deteriorates faster than expected to RP1. Our understanding of the proposal is that for the consideration of the incentive mechanism, the asset will be considered to be returned to RP3 and that there is no associated cost fed into the valuation mechanism. However, realistically, an intervention would be required to manage the asset's condition. This, for an RP1 asset, is likely to be a replacement which would result in an RP4 asset, that is, over delivery against target. As the proposal removes the incremental risk and sets any costs to zero, there is no provision to consider the lower-than-target remaining risk or to include the costs of that over delivery in the valuation of the revenue adjustment. This is contrary to the provisions of Licence Special Condition 2M and would effectively remove the ability of the licensee to make the appropriate asset management decisions in the interest of consumers that is outlined in section 1.2 of the methodology. We don't believe that this is Ofgem's intended outcome but illustrates that further detailed examination of this issue is required and that the new provisions should be removed to allow the licensees and Ofgem to work together to find a resolution.

For stage 6, we would welcome clarity regarding Ofgem's assessment process such that it is fully transparent.

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.

SP Transmission Answer:

While the reasons for the inclusion of a materiality threshold are understandable (avoiding unnecessary burden on both Ofgem and the licensee), the intent is somewhat undermined by the proposal (see Question 3) to measure the value of over/under delivery from the thresholds rather than the target. Given the relatively large programmes of work in RIIO-T1, the range proposed could result in a variance to the target but only a small proportion falling outside the threshold. In our view, the threshold may be unnecessary for electricity transmission as the individual elements of work which would constitute over or under delivery will themselves justify undertaking the process detailed in the methodology.

As the re-basing exercise is not yet complete for electricity transmission, it is not yet possible to determine if the DNO threshold is appropriate were thresholds to be applied. As noted throughout the NCSWG process, it will be necessary to review the methodology when this information becomes available. However, if a materiality threshold were to be applied, it is our view that it should be set lower than the 1% of allowed revenue proposed for Electricity Distribution.

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.

SP Transmission Answer:

The incentive should be measured from the target, rather than the materiality threshold. The purpose of the materiality threshold is to avoid unnecessary administrative burden on both the Authority and the licensee for relatively small deviations from targets. However, excluding the elements up to the materiality threshold is not consistent with our interpretation of the intent of the thresholds. As we have previously stated in our comments on draft v0.5, we believe that the thresholds are ‘hurdle rates’ to be exceeded before consideration but that the full value is then applicable. We do understand the concern regarding perverse incentives, however given that the intention is that the value up to the threshold is not material, we don’t believe including this value is the assessment would be problematic.

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.

SP Transmission Answer:

We believe that the approach should be symmetrical for under- and over- delivery, fair in its application and substantively neutral in its outcome. As proposed, Ofgem believe that it is not appropriate to use allowed costs for the derivation of the costs of over-delivery but that these costs are appropriate for the calculation of under-delivery. This is neither symmetrical nor fair.

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Allowed costs have been assessed and set by Ofgem at final proposals; as part of the process they should be considered alongside use of actual costs to ensure neutrality of outcome. This may necessitate a case-by-case review, depending on circumstances (e.g. level of variance). We do not agree with the proposal as currently worded and seek further dialogue with Ofgem on this approach as part of the sector specific engagement process.

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.

SP Transmission Answer:

The use of the actual spend profile may not be reflective of actual delivery of outputs but benefits from simplicity in its application. It is acknowledged that it is complex to precisely identify the individual elements contributing to over/under delivery and that the proposed approach is reasonable.

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.

SP Transmission Answer:

As agreed at the NCSWG, timely conclusion of the process is a common interest. The timeline proposed is a reasonable balance of this aspiration with the need to allow sufficient time for an appropriate process to be performed.

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.

SP Transmission Answer:

We believe that an impact assessment is only necessary if the new requirements for the treatment of asset deterioration are not deferred to allow full consideration of the consequences of its introduction.

APPENDIX 3: SP TRANSMISSION COMMENTS ON THE METHODOLOGY DOCUMENT

Ref	Section	Page	Text	Comment
1.	3.2	9	Differences in asset degradation profiles (as compared with forecast degradation in the rebased targets)	Please see the response to Question 1 relating to asset deterioration. We believe that further consideration of the impacts of this on ETO licensees is required and that the wording should be amended appropriately. We also note the use of 'rebased targets' and, notwithstanding the need to defer consideration of this element for ETOs, this should be modified to 'Licence Targets'. It should be noted that similar wording appears in Appendix 1, page 40 referring to 'at target setting' which is acceptable as rebasing is not setting targets but expressing the licence targets in a different form.
2.	3.2	9	Licensees are required 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	The concept of relevant risk changes has only been introduced for SP Transmission as part of this work and as such will not have been explicitly identified in submissions to date. It is expected that future years' reporting templates, following approval of a methodology, will explicitly identify these to allow this requirement to be met.
3.	3.8	15	a. all risk changes delivered through data cleansing or through non-intervention asset health improvement/deterioration, which have not been stripped out of actual performance at stage 3, will be assigned a zero associated cost, and the risk benefit/deficit will be netted off the delivered risk;	Please see the response to Question 1 relating to asset deterioration. We believe that further consideration of the impacts of this on ETO licensees is required and that the wording should be amended appropriately. The statements highlighted also contradict the description of Stage 1 in Appendix 1 on Page 20 (see comment 7)
4.	3.8	15	maintaining (albeit at a	It is not clear whether or not the

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			reduced level) efficiency incentives for Licensees	statement in brackets in pre-determining the outcome of the efficiency review. Can clarification on the intent of this statement be provided?
6	Appendix 1	20	Ofgem will adjust Licensee performance to strip out any non-intervention risk changes that were not explicitly identified as being at the Licensee's risk	Please see the response to Question 1 relating to asset deterioration. We believe that further consideration of the impacts of this on ETO licensees is required and that the wording should be amended appropriately.
7	Appendix 1	20	For a licensee with an absolute target, higher degradation will lead to an overall higher network risk, which may not be possible to be addressed within the scope of the NOMs allowances, leading to an under-delivery.	This statement is consistent with the definition of targets in SP Transmission's licence. However, it is contradicted by the statements on pages 9 and 15 and by the 3rd bullet on this page.
9	Appendix 1	21	Ofgem expects that the justification would be supported by the following types of data: • Cost Benefit Analysis (CBA) on an intervention lifetime basis including relevant TOTEX changes and benefits as captured by the NOMs methodologies and relevant benefits beyond this;	Repeating the comments made on previous drafts, it is to be expected that, as noted, licensees will provide the appropriate level of justification to support their finishing position. However, we do not agree with the expectation of the retrospective application of justification criteria which has been notified at such a late stage the in the ET price control. (We note that this expectation is repeated on page 25 but is inconsistent with the position on page 11 which that Ofgem would expect licensees to *consider* such types of justification). In the case of CBAs, it is noted that DNO guidance is provided and this, and a calculation template, were available at the time those price controls were set. However, there has been no equivalent guidance or agreed template for ETOs which would have allowed us to meet this expectation.
8	Appendix 2	22	The following examples demonstrate how associated costs for over- /under-delivery could be valued for the purposes of the NOMs incentive	While the worked example notes that it is based on an ED licensee, the statement quoted here infers that this approach is valid for all licensees. It was clearly agreed by all parties in the NCSWG that the £/risk point approach

	is unlikely to yield robust outcomes for ETOs and that pending completion of the ET rebasing exercise, the proposed approach was to make the assessment on a scheme by scheme basis. This sentence could be re-worded to clarify the different approaches agreed at the NCSWG.

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