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By email only to: paul.odonovan@ofgem.gov.uk

UK Power Networks Response to Ofgem's consultation on the 'Network Output Measures (NOMs) Incentive Methodology'

Dear Paul,

Thank you for the opportunity to comment on this consultation outlining Ofgem's proposed methodology for the Network Output Measures (NOMs) incentive mechanism. We are the UK's largest electricity Distribution Network Operator (DNO), dedicated to delivering a safe, secure and sustainable electricity supply to 8.2 million homes and businesses across London, the East and South East of England. Our response should be treated as consolidated on behalf of UK Power Networks' three distribution license holding companies: Eastern Power Networks plc, London Power Networks plc, and South Eastern Power Networks plc.

The NOMs Cross Sector Working Group (NCSWG) has been a useful group to ensure input from all sectors has been possible during the development of this document and this methodology is a fair and balanced representation of the positions established through those meetings. However, it has been noted that arriving at this position of a common high-level framework has not been straightforward given the different positions across the electricity and gas transmission and distribution licensees. We suggest that following Ofgem's final decision on this methodology, and as attentions turns to the sector specific financial handbooks, that individual sector groups are formed so that they can more easily focus on the issues pertinent to their sectors and allow Ofgem to proceed with its intended timeframes.

We have set out our responses to the questions from the consultation in Appendix 1. If you wish to discuss any part of our response, or indeed wider issues, myself, or members of my team would be happy to discuss.

Yours sincerely

Suleman Alli
Director of Safety, Strategy and Support Services
UK Power Networks

Copy James Hope, Head of Regulation & Regulatory Finance, UK Power Networks
Max Taylor, Distribution Policy Analyst, UK Power Networks

Appendix – Response to Questions

<u>Question 1</u> – 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 flowchart, and the steps within, represent a sensible means of gathering the appropriate information required and ensures the process has suitable structure. Whilst it is clear to us who the colours in the diagram (orange and blue) refer to (Ofgem and licensees respectively), it may not be so obvious to external stakeholders. We recommend the introduction of a key when the diagram is used in future documents would remove this concern to aid all stakeholders.

<u>Question 2</u> – 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.

The use of a materiality threshold around the monetised risk target is appropriate. With such large asset management programmes in progress and as a result large monetised risk targets, (LPN 9.1million, SPN 8.4million, and EPN 11.5 million risk points), forcing companies to hit their target exactly is impractical and would lead to perverse behaviours by licensees to ensure they hit their targets which would not be in the interests of consumers. Furthermore, any deviation from the target, no matter how small would result in licensees having to spend dis-proportionate amounts of time justifying the movement along with an inappropriate burden placed on Ofgem for assessment. This is not in the interests of consumers, licensees or Ofgem and thus the use of a materiality threshold ensures that justification is only required for material movements away from the target.

For electricity distribution, we deem the size of the threshold proposed by Ofgem as appropriate. 5% of the allowance associated with NOMs related work is of a similar magnitude to the materiality threshold in other reopener mechanisms within RIIO-ED1.

<u>Questions 3</u> – 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.

The term materiality threshold does suggest that the measure of the over/under delivery should be judged against the initial target and not of the portion that is outside the threshold as stated in the methodology. This is akin to how materiality thresholds has been applied in similar re-opener mechanisms in the RIIO/DPCR frameworks. For example, a good definition for materiality tests is present in the '*Supplementary Annex 1 – Changes to Part 3 of the RIIO-ED1 Financial Handbook for the DPCR5 Close Out'*:

> *"15.239. The following steps will be carried out to apply the materiality test referred to in paragraph 15.230:*
>
> *Materiality test*
>
> *(i) The licensee's efficient expenditure amount for each Regulatory Year in DPCR5 will be obtained. The values will be restated in 2012/13 prices.*
>
> *(ii) The values obtained at step (i) will be totalled, and the total will be multiplied by the DPCR5 IQI Incentive Rate for the licensee.*

(iii) The materiality test value will be calculated as one percent of the DPCR5 Revenue Allowance for the licensee for Regulatory Year 2010/11, restated in 2012/13 price.

15.240. If the value calculated under step (ii)…… is less than the materiality value calculated in under step (iii), then the calculated value of the …… adjustment for the licensee will be zero.

15.241. "If the value calculated under step (ii) is greater than the materiality test value calculated under step (iii), then the [whole value will be used] to calculate the ……. adjustment value for the licensee'.

Furthermore, a question remains on how Ofgem will assess justification of over/under delivery. For example, if a licensee has a target of 10million risk points, but delivers 12million, the methodology states that Ofgem will only assess the justification of 1.5million points, i.e. the portion above the 5% materiality threshold. If in this example, the licensee has within the total 2million points over the target, has 500,000 points that it has self-assessed are likely to be deemed unjustified – the licensee could structure the over delivery in such a way that these unjustified points are captured within the materiality threshold and such Ofgem only assess the justification of points the licensee deems to be justified. An illustration of this is provided below in Figure 1.

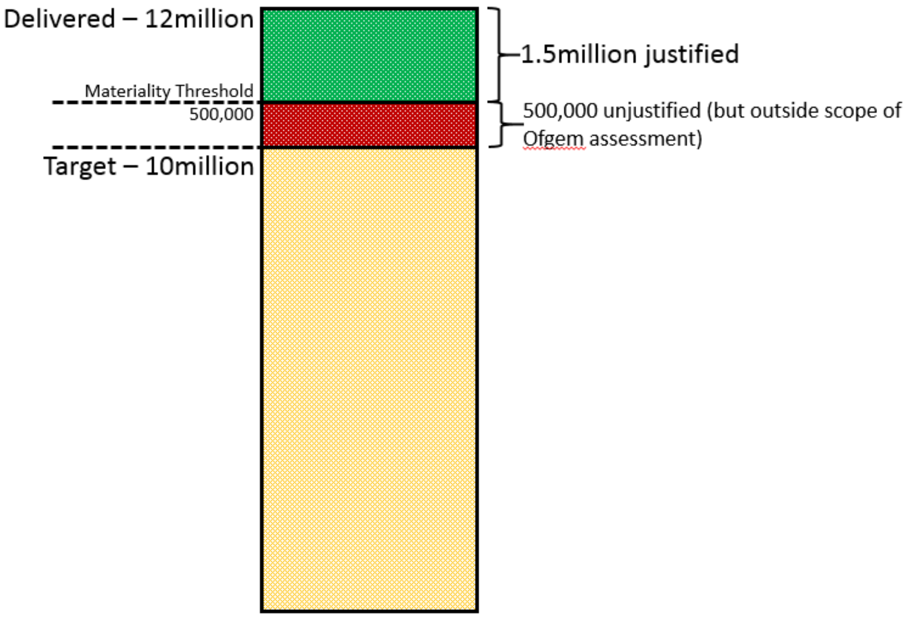

Figure 1 - Materiality Assessment Example

We would welcome Ofgem's clarification on this type of scenario occurring and how it intends to guard against it. We believe that to avoid this occurring, once the materiality threshold has been breached, justification and assessment should be applied to the whole delivery above or below the target. Where the over delivery portion of a licensee's programme of work cannot be readily identified, then justification / assessment may need to be applied to the whole programme of work.

<u>Question 4</u> – 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.

We agree with the notion that any risk changes as a result of non-intervention changes should not be assigned an associated cost – network operators should not be penalised or rewarded for risk movements that do not involve physical work and are outside of their control.

Similarly, we agree that the associated cost of unjustified under-delivery should be based on the RIIO-1 allowed efficient costs as the removal of this from the next price control period should be based on those allowances originally provided for RIIO-1.

We do however have reservations on the limited definition of '*Ofgem's view of efficient costs*' for any justified over-delivery. We believe that the definition should be strengthened so that it clearly states that Ofgem's assessment should use the licensee's allowed unit cost, this will ensure consistency with the allowances set for ED1 and the calculations the licensee has undertaken to determine the case for such an over delivery investment. If the revealed costs prove to be lower than the allowed unit cost then this value should be used to ensure the only reward for over delivery is the 2.5% of the incremental costs associated with delivery.

For example, a licensee could choose to undertake work that will take it over its monetised risk target but believes it is important and in the interests of customers. It is right for that licensee's decision to be based on the anticipation that it will be financed appropriately to undertake this activity (should it prove to be justified). If Ofgem, through an ex-post efficiency review set an associated allowance less than the allowed or revealed value needed to cover the costs of the work, the licensee could find itself being penalised for carrying out work it, in good faith, deemed to be in the interests of consumers. We would welcome more clarity around this area as, as it stands, it will lead to behaviours where licensees choose never to over deliver on risk points, even if it feels it is justified in doing so, due to the fear of being unduly penalised at the end of the period.

<u>Question 5</u> – 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.

We believe that it is sensible to apply the associated costs of justified over-delivery or unjustified under-delivery at the time in which they were incurred so as not to unduly reward/penalise licensees. Where this associated delivery cannot be easily attributed to a particular time period – spreading the costs across the price control in line with licensee spend is the most suitable method to employ.

<u>Question 6</u> – 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.

On the whole, the 15-month window is a realistic timeframe that will allow both licensees and Ofgem to provide sufficient evidence and assessment for the NOMs incentive mechanism to be applied. However, we do have the following additional observations:

- We question the need to be so specific/break down certain activities as they have been, i.e. Stage 3 has a three month period, whilst Stage 4 only one month. Whilst two distinct phases, in reality this would probably occur at similar periods. We suggest a four-month window could be applied to both activities concurrently;
- The same could be said for Stages 6 and 7 – applying a two-month window to both activities concurrently;
- For the final three stages: '*Ofgem to initiate formal consultation, …to provide notice of its decision and …to provide finalised view*' – it would be useful to understand at what points in this timeline Ofgem is publishing documents and at what time Ofgem is undertaking analysis of any responses it has received, i.e. consultation live for one month, review for two months etc.;

- The diagram would benefit from clearer identification of the months that activities are undertaken in. At the moment the limited labelling of months does not provide as much clarity as there could be; and
- In line with our response to Question 1, the diagram would benefit from a key to highlight Ofgem and licensee activities to aid external stakeholder understanding.

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.

Given the high-level nature of this methodology to allow commonality across licensees, we do not believe an impact assessment is necessary.

General observations on the consultation

We have listed areas below that we feel are worth pointing out, but do not naturally sit against the questions answered above:

- The whole document would benefit from numbered paragraphs to aid the reader;
- The document throughout references network operators' programs of work as '*risk reduction*' – suggesting that the level of risk at the start of the period will be less than that at the end. Licensee's in electricity distribution are funded to remove risk on the network through delivering a target delta. It needs to be noted that removing the risk associated with the delta does not necessarily correlate to a risk reduction in the overall level of risk on the network. We believe it would be more appropriate to reference work as '*risk mitigation*' as specific asset management strategies may look to maintain or even allow the level of risk to increase on areas of the network where this will not be to the detriment of its operation, i.e. the level of risk on the network across the price control is deemed efficient by companies and as a result customers do not pay for the 'gold plating' of networks.
- On page 11, we would welcome the added clarification that the list Ofgem provides for '*types of justification*' is not exhaustive and that the licensee has the ability and freedom to supply whatever evidence it feels is necessary to justify its position;
- Furthermore, on page 11, the methodology highlights Appendix 2 as referencing where Ofgem '*has included initial guidance on how key parameters*' should be applied when conducting a cost benefit analysis. This should be Appendix 3, not 2;
- On page 12, the five-point list that details what Ofgem will determine as part of its '*qualitative and quantitative assessments of justification'* should be a four-point list, not five. The 5th numbered item is not part of the list and should be a separate paragraph;
- On page 17, '*Interaction with other licence mechanisms*' – we appreciate the complex nature of the many mechanisms and incentive interactions that operate within a price control. Whilst we do not advocate benefit or penalty from unintended operation of this methodology, we are cautious a broad statement such as Ofgem having the ability to make '*correcting adjustments*' could be misconstrued as Ofgem having an almost unlimited ability to make changes as they see fit. These interactions must be sounded out and guarded against in developing the sectoral Financial Handbooks work that will follow the finalisation of this methodology.