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Dear Paul

Network Outputs Measures (NOMs) Incentive Methodology
We welcome the opportunity to respond to this consultation. This response is on behalf of National Grid Electricity Transmission plc (NGET) and it is not confidential.

General Comments
The development of the NOMs Incentive Methodology and establishment of translated targets based on 'monetised risk' in place of the current targets in our Transmission Licence is a highly complex area. We have been happy to work with Ofgem and participate in the cross sector working group on the development of this incentive. Despite our involvement in this process there remain areas where we do not feel that we yet have the necessary understanding to be confident about the implications of some of the detailed proposals. In part this position stems from the fact that we have not completed the process of translating targets based on monetised risk. Given this, there is therefore some uncertainty regarding the practical outcome of how the proposed methodology will be applied in practice. We therefore welcome Ofgem's recognition of this and the need for sector specific consideration once the new targets have been finalised. Elsewere in a couple of places (e.g. stages 3 and 7 in relation to asset degradation rates) the wording used in the methodology could be interpreted as implying a reopening of issues settled at Final Proposals (which would not be appropriate) and so we would welcome improved clarity in such areas.

We signed on to the RIIO-T1 price control and the outputs set out in our Transmission Licence along with the explicit risks (such as asset degradation) and other implicit risks that are inherent to asset management more generally. The targets set at the beginning of RIIO-T1 provided us with a starting point for our investment plans and we have been working hard over the last 5 years to deliver those outputs – modified where it is in our customers interests to reflect the evolving picture we see influenced by e.g. the availability of new intervention options, changes in the generation and demand background etc.. We have plans in place for the remainder of T1 to continue to ensure that network risk at the end of RIIO-T1 is at a level which reflects our customers' interests and our Licence obligations. Our plans have been developed against the 'replacement priority' based targets in our Licence and we are happy to be judged on our performance against those targets. However we recognise that Ofgem wish to assess performance of all networks against a common framework, and that this will involve translating exiting targets to a 'monetised risk' target; we welcome Ofgem's commitment to implement this process without any material affect. Nevertheless Ofgem will recognise that the changing of targets this far into a price control is something we naturally view with a degree of concern since we do not yet know what impact, if any, will result from the process.

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We are comfortable regarding Ofgem's proposals for the NOMs Incentive Methodology in respect of the RIIO-T2 price control as we can develop our plans against a clear framework known in advance.

In summary, we are broadly comfortable with Ofgem's proposals subject to the satisfactory clarification and resolution of the areas of uncertainty that we have highlighted here. We trust you find these and the following more detailed comments helpful; and we are keen to continue to engage further to more fully understand Ofgem's proposals.

<u>Detailed Responses</u>

Ofgem ask 7 specific questions in their consultation which we address in the table below. We then include more general comments regarding the methodology in the subsequent section.

Question	Outline response
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.	Yes, we believe that the flow chart depicts a suitable means for implementing the mechanism.
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.	Yes, we agree that this is necessary. Without it, any deviation from the target no matter how small would trigger an assessment of whether the over or under delivery was justified. This would represent an inappropriate regulatory burden in response to minor deviations from the individual asset category targets which in aggregate might not be material.
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.	For assessing our performance in T1 we do not agree with this. We believe that in the event we are outside the upper/lower materiality thresholds then our RIIO-T1 performance should be assessed against the target. We believe this is consistent with normal regulatory principles, and – assuming that the upper/lower materiality thresholds are symmetrical around the target – more appropriate mathematically. Given that we are in the 6th year of RIIO-T1 and we do not yet know the impact of the translation exercise, it is not possible for there to be a 'perverse incentive'. By the time the result of the translation exercise is known there is unlikely to be sufficient time to change investment plans to any material extent in response to any potential 'perverse incentive'. For RIIO-T2 we are less concerned about this point so long as we have clarity at the outset - but fundamentally that is a matter for the development of the next price control.

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.	We are concerned that the arrangements set out are not symmetrical. The wording in sub-paragraph (a) on page 15 is not clear regarding how this process treats risks that explicitly sit with the network – it could imply a change to Final Proposals which would not be acceptable – however the wording is unclear. Where over delivery arises as a result of non-intervention then the cost is not zero but the savings foregone in relation to other interventions that could have been avoided so as to thereby hit the target (assuming that hitting the target was judged to still be in customers' interests). We believe further work / explanation is needed in this area to help understanding regarding the proposed operation of the mechanism.
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.	We support Ofgem's proposed approach. It is pragmatic given the difficulties involved in identifying which specific interventions (or non-interventions) constituted the over or under delivery, and hence the timing of those interventions (or non-interventions) and the corresponding impact they might have had on the overall spend profile.
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	We believe the timetable is tight but it is deliverable. We note that the process for transmission companies and gas distribution is likely to be taking place during the electricity distribution RIIO-2 process.
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.	We are content that we have been appropriately involved in the development of this process and we do not feel the need for an impact assessment. However we are conscious that this is a highly technical area and Ofgem may wish to consider whether an impact assessment might be beneficial for stakeholders that have not been so closely involved in the process to date.

General Comments on the Covering Letter

At the bottom of page three Ofgem state:

> *"Although the use of a threshold could mean that any over/under-delivery within that band would not be assessed by Ofgem, the requirement for the delivery to be categorised as justified or unjustified means that Ofgem will have a degree of overview of Licensees' activity. For example, 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 already provide very significant volumes of data relating to our non-load investment plans via the RRP process. The SQ process provides a mechanism for Ofgem to seek further information where they judge it necessary. Our plans have constantly evolved (since the RIIO-T1 business plan was submitted in July 2011) reflecting a range of factors including load related developments, changes in asset condition compared to that which was forecast, and changes due to load related projects not being progressed due to customer needs etc.. We therefore do not support a requirement for an additional justification process.

<u>Comments on the Network Output Measures (NOMs) Incentive Methodology</u>
We do not yet have monetised risk targets in place. We are shortly about to consult on the methodology necessary to translate our asset risks and current Licence based targets to a monetised risk basis. Only once we have undertaken the 'translation process' will we understand the full implications of this process, and so we welcome Ofgem's commitment to undertaking a further review of the applicability of the NOMs methodology once monetised risk targets have been established (final paragraph of 1.5.1 refers). This should ensure that if unexpected results emerge from the translation process they can be identified and appropriately addressed.

We agree with Ofgem's proposal to apply monetised risk targets at a 'network level' (second paragraph of 1.5.2 refers) because this facilitates trading of interventions between different asset categories. This was one of the stated intentions of the RIIO-T1 Final Proposals and is reflected in our Transmission Licence and it will be in consumers' and customer interests because it will allow more efficient delivery of the appropriate level of network risk.

For the assessment of our performance in RIIO-T1 we agree with the principles 1, 2 and 3 set out in Section 2 of the methodology; in particular the recognition that Licensees have discretion to revise their intervention plans. The RIIO-T1 business plan covered a 10 year period and while it represented our best assessment of the overall volumes and costs involved in efficiently meeting the target level of network risk over the RIIO period at the time, there will inevitably have been considerable uncertainty over asset-specific interventions. The plans will constantly change reflecting new information; be it about the condition or criticality of individual assets or asset families, or reflecting new intervention approaches which may alter the economics of specific interventions.

However, we feel that for RIIO-T1, principle 4 needs to be accompanied with a clarification that the translation process from our existing targets to the new monetised risk targets does not have a material impact. For RIIO-T2 we are content with all four principles stated in Section 2.

<u>Section 3.2 – Licensees submit relevant risk changes and impact on performance against targets</u>
We have some concerns regarding this part of the process – some examples would assist us in better understanding what is proposed. However our understanding is that the process is intended to determine the level of network risk and Licensee's performance against this by taking into account information that has become available since the start of RIIO-T1. It is separate from the process of assessing whether networks have met their targets (stage 3).

In the fourth paragraph of section 3.2 Ofgem states that:

> *"The Licensee should submit notice to Ofgem of any such changes the Licensee considers are likely to impact on the nature of the work required to achieve its monetised risk target, along with evidence of how these risk changes have arisen."*

Is this a reference to submission via the RRP process, or some stand-alone process – and if the latter then we would welcome clarification on the proposed timing and content of this submission.

Given the range of changes that have taken place as our investment plans have evolved in response to the latest information, we are concerned this proposal appears to imply a line by line review of the original business plan – such an exercise could represent a disproportionate regulatory burden (especially as it would be at a time when we would be working on implementing the RIIO-T2 investment plans) and it is unclear what benefit it would provide.

Later on in section 3.2 Ofgem states:

> *"Ofgem will consider the impact of any such changes on the ability of the Licensee to deliver its targets as part of stage 3 and decide <u>whether any adjustments are needed to the Licensee's NOMs performance</u>. …."* *[Emphasis added]*

The implication of this is that Ofgem would modify the Licensee's performance in some way rather than modifying the target to reflect the relevant risk changes. If the risks have changed due to e.g. data cleansing then would it not be more appropriate to revise the target? We would welcome clarification on this point.

Furthermore, the above adjustment process is proposed to apply in relation to changes in asset degradation (the third bullet point states "…Differences in asset degradation profiles (as compared with forecast degradation in the rebased targets)…". However RIIO-T1 Final Proposal made clear that NGET would be exposed to the risk of differing rates of degradation compared to those forecast at the start of RIIO and so it appears that this proposal is seeking to un-pick RIIO-T1 Final Proposals. If this is the intention then it would not be acceptable to us. However it may be that Stage 1 is solely about understanding the impact of all the changes that have taken place since the start of RIIO-T1. This view is supported in section 3.4 where Ofgem note that they do not intend stripping out of any non-intervention risk changes explicitly identified as being at the Licensee's risk. We would welcome clarity on this potentially significant point.

In section 3.4 (Stage 3) we note that asset risk is not the only factor to consider – asset criticality is also highly relevant. When Ofgem refers to 'risk' does it in fact mean 'monetised risk' (which will incorporate the impact of criticality), or network risk?

<u>Section 3.6 – Stage 5</u>

The proposed approach to justification of material over/under delivery against the monetised risk targets appears to be problematic.

Firstly, Ofgem recognise on page 4 of the cover letter that:

> *"For the majority of Licensees, it is likely that they will not be able to explicitly identify the work that constituted the over-delivery against target…."*

We agree with this assessment.

Secondly, throughout RIIO-T1 to date we have been operating against the Replacement Priorities specified in our Licence as we did not have (and still do not have) monetised risk targets.

Thirdly, once the monetised risk targets have been established these may show unexpected levels of over or under delivery (i.e. that were not previously visible with the replacement priority targets).

Given this it is unclear that the analysis that Ofgem propose is possible. How can a Licensee be expected to carry out a CBA analysis when it cannot identify which specific intervention(s) relate to the over or under delivery? We believe a more pragmatic high level approach may be needed where we focus on key areas of investment which have changed from the business plan. In addition, any CBA evidence carried out at the time changes to the plan were being considered will likely not meet the ED1 requirements as we were unaware that this approach was to be required in relation to decisions on the non-load related transmission investment plan.

Section 3.7 – Stage 6
Once again, the analysis referred to assumes that it is possible to identify the specific interventions, or non-interventions, that led to the over, or under, delivery. This may well not practicable and as a result the analysis may need to be restricted to a qualitative or volumetric basis.

Section 3.8 – Stage 7
In paragraph (a) Ofgem state:

> *(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;*

Lower or higher rates of asset degradation than assumed at the start of RIIO-T1 were explicitly identified as being at our risk. We understand the Stage 3 process[1] to mean that only those non-intervention risks that were not specifically identified will be stripped out. But our reading of paragraph (a) above suggests that at Stage 7 even those risks that were specifically identified to sit with us will now be stripped out, and as such implies a change to the position set out in Final Proposals. Such a change would not be appropriate and so we request clarification of the wording of this paragraph.

Furthermore, our view is that if say over-delivery were to be achieved solely through a lower rate of asset degradation than was assumed at the start of RIIO-T1 then, all other things being equal, the cost of this over delivery is not zero, but is the saving foregone from not undertaking some other asset intervention(s). Our reasoning is that a corresponding increase in network risk resulting from those non-interventions offsets the reduction in network risk arising from the lower rate of asset degradation, and results in the overall target still being met (this all assumes it remains in customer's interests to meet the network risk target).

In paragraph (b) Ofgem suggest an asymmetric approach to attributing the cost of over or under delivery.

> *(b) if the remaining delivered risk is outside of the threshold range, then:*
> *i. The associated cost of over-delivery will be based on Ofgem's view of efficient costs for the over-delivery element. This may be different to allowed efficient costs used when RIIO-1 allowances were set ex-ante, …….*
> *ii. The associated cost of under-delivery will be based on the RIIO-1 allowed efficient costs….*

We believe that a consistent symmetrical approach should be used here. Either the 'efficient cost' or the 'allowed cost'. We have no strong preference on which of these should be used but whichever is adopted it should be used consistently.

Section 6 - Timeline
We note that the supplementary question process will be undertaken from July to January 2021. From a resource perspective the staff likely to be involved in addressing NOMs SQs will already be fully engaged in the delivery of that years' RRP (due 31 July) and that this RRP will be report on the

[1] Stage 3 (page 10) states:

> *At this stage, 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.*

last year of RIIO-T1 and so may be more extensive than the RRPs for 'normal' years. Both Ofgem and Licensee staff will be engaged in the RRP SQ process during August / September.

Any NOMs data requirements that are over and above the RRP should be notified in the previous RIGs development process (late November 2020 – February 2021) so we can make the appropriate preparations, develop data assurance requirements and undertake any necessary dry runs.

In the event that performance is outside the thresholds resulting in a reward / penalty adjustment then the timetable envisages this will be implemented via the September 2022 Annual Iteration Process. The resulting changes to T2 allowances will then take place in April 2023. Assuming a 5 year price control this would mean any adjustments are made over the last 3 years of RIIO-2. In the event the assessment is delayed then it implies any adjustments will be applied over the last 2 years of RIIO-2. Depending on the size of any such allowance adjustments they could lead to a significant variation in network charges. It will be important for our customers to understand this in advance given the potential impact on them.

<u>Appendix 3</u>
We are happy to adopt the approach proposed in respect of CBA as a decision support tool for the remainder of RIIO-1 and for RIIO-2. However, it may not be practical to apply such an approach retrospectively – particularly in situations where it may not be possible to identify the specific interventions (or non-interventions) that resulted in over (or under) delivery.

We hope you find the above comments helpful. Many relate to the detail of the methodology or clarifications of it. We look forward to continuing our work with Ofgem and other network colleagues to clarify the many remaining details so as to establish a working methodology.

Yours sincerely,

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