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Min Zhu
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Our ref	*Your ref*	*Date*
-		30 April 2018

Dear Min,

Consultation of the Network Output Measures (NOMs) Incentive Methodology

I am writing on behalf of Western Power Distribution (South Wales) plc, Western Power Distribution (South West) plc, Western Power Distribution (East Midlands) plc and Western Power Distribution (West Midlands) plc in relation to Ofgem's consultation on the Network Output Measures (NOMs) Incentive Methodology.

In general terms, the overarching assessment framework appears to be workable and the proposed timetable for post-price control analysis and close out appears to be practical.

We are, however, deeply concerned about the use of ex-post efficiency assessment for the valuation of over-delivery. During RIIO-1, licensees will be making investment decisions based upon existing price control parameters; which includes a view of efficient costs as defined at the time of setting price controls. Investment decisions will be influenced based upon whether activity can be delivered against these efficient values. The use of ex-post efficiency assessment to determine revised efficient values will potentially under-fund this additional activity even though it would be considered to be efficient when compared to the original allowances. Using ex-post assessments introduces uncertainty and regulatory risk into the incentive mechanism.

Ofgem states that it wants NOMs performance assessment to be carried out using monetised risk values, but some sectors (e.g. electricity transmission) have not yet converted their existing replacement priority targets into monetised risk targets. They are currently five years into their eight-year RIIO-1 price controls and will soon be submitting business plan proposals for RIIO-2. Conversion of targets adds complexity and the value of changing the target measures at a late stage into RIIO-1 price controls has to be questioned.

The proposed methodology seeks to provide a common framework for the assessment of NOMs across different energy network sectors (i.e. gas distribution, electricity distribution, gas transmission and electricity transmission). Whilst the aspiration to have a common approach is reasonable, there has to be recognition that the RIIO-1 price control arrangements for NOMs across the four sectors have fundamental differences. For example, in electricity distribution NOMs targets are based upon a risk reduction delta associated with specified investment activities, whereas in the transmission sectors the targets are based upon an absolute value, which can be influenced by a range of activities. This means that the drafted NOMs incentive methodology can only provide the framework for the assessment of NOMs and that there is a need to develop sector specific implementations of the methodology.

Good progress has been made by the Cross Sector Working Group in developing the NOMs incentive framework, but having established this framework, it is important that each sector moves on to developing the detailed application of the methodologies so that there is clarity on how the methodology will be applied to the bespoke situations in each sector. These rules will need to be incorporated into financial handbooks and calculation spreadsheets that link to the Price Control Financial Models. We see that this is sector specific work, rather than cross sector work, due to the different targets and licence arrangements in place.

In parallel with the sector specific work for RIIO-1, we urge Ofgem to consider the framework(s) for RIIO-2. Ideally these should be finalised for inclusion in the sector specific guidelines being produced for RIIO-2 business plan submissions. These frameworks should take the learning from RIIO-1 and consider:

- The definition of the risk metric (e.g. monetised risk and how this is derived)
- The form of the targets (e.g. absolute or delta)
- The reporting requirements to track progress against targets
- The incentive methodology to be used to assess delivery against the targets and consequential rewards/penalties

Establishing the framework ahead of the RIIO-2 price controls will make the mechanism transparent from the start and negate the need to retrospectively create methodologies and restate/rebase targets, as has been the case in RIIO-1. In Appendix B we provide a view on the elements of a RIIO-2 framework.

In Appendix A we provide answers to the specific questions posed in the consultation.
In Appendix C we provide comments on specific elements of the methodology document.

Should you wish to discuss any aspects of this response please contact amichalowski@westernpower.co.uk.

Yours sincerely

PAUL BRANSTON
Regulatory & Government Affairs Manager

APPENDIX A – ANSWERS TO QUESTIONS POSED IN THE CONSULTATION

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. No amendments proposed.

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 agree with the use of a materiality threshold (deadband) around the targets, so that only material deviations lead to financial consequences.

We also agree that the materiality thresholds should be applied to the overall target and not to individual asset categories, to enable risk trading across asset categories.

Ofgem has set a precedent of using materiality thresholds for re-openers based upon 1% of revenue. Setting the deadband materiality thresholds on NOMs to be an equivalent amount to 1% of revenue makes the thresholds in the NOMs incentive methodology consistent with thresholds in re-openers.

WPD notes that the current proposal is to use 5% for the deadband thresholds. Comparison of the material amounts specified in WPD licences and the Totex allowances associated with NOMs suggests that the deadbands should be around 2.5% (for them to be equivalent to the material amounts used in re-openers). The following table shows the calculations.

(£m 12/13 prices)	Material Amount (e.g. from CRC 3G)	Pre-TIM material amount (i.e. material amount/TIM rate)	NOMs related expenditure (inc RPEs)	Percentage of NOMs that is equivalent to Material amount	Percentage of NOMs that is equivalent to Pre-TIM Material amount
WMID	5.7	8.1	306	1.9%	2.7%
EMID	5.7	8.1	291	2.0%	2.8%
SWALES	2.9	4.1	169	1.7%	2.4%
SWEST	4.2	6.0	243	1.7%	2.5%

A further consideration for the use of a deadband should be the recognition that monetised risk measures based upon sector specific common approaches are being used for the first time. The NOMs targets for RIIO-1 were originally based upon licensees own methodologies and during RIIO-1 have been (or in some sectors will be) rebased to be in line with sector specific common methodologies. Although the common methodologies have undergone extensive review and approval, they may contain unidentified deficiencies and may not fully represent the inherent asset risks. These issues may be revealed over time as the methodologies are applied and results evaluated. It is therefore appropriate to recognise that the methodologies may not be 100% representative and allow a deadband around delivery.

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.

Having established the deadband, it should operate as a "dead" band (i.e. there should be no reward or penalty applied to performance within the deadband); all performance within the deadband should be deemed to be on target.

It follows that only performance outside the materiality thresholds should attract a reward or a penalty. Ofgem's current position of only adjusting for delivery outside the materiality thresholds is appropriate.

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.

Valuation – Under-delivery

We agree with Ofgem's proposal for valuation of under-delivery.

For NOMs, allowances have been set based upon the delivery of intervention activity. Under the scope of the NOMs incentive mechanism, if a licensee does not deliver part of that activity and cannot justify its position, then the whole allowance associated with that under-delivery should be valued at the rate the allowances were provided.

Valuation – Over-delivery

We do not agree with Ofgem's proposal for using an ex-post assessment of efficient costs to value over-delivery. This introduces uncertainty and regulatory risk into the price control. We propose an alternative below.

For over-delivery there are three potential options:

- Use original ex-ante allowance rates, deemed to be efficient when the price control was set
- Use incurred costs
- Use ex-post efficient costs, determined once the price control has concluded (Ofgem's currently specified option)

Option 1 - Using original ex-ante allowances

For licensees, the ex-ante allowances are known reference values of efficient costs. These allow licensees to seek intervention improvements and innovation to outperform the allowed costs; a fundamental objective of the Totex Incentive Mechanism (TIM).

Where licensees choose to over-deliver, these decisions will be informed (in part) by reference to the original costs per activity. For example if a licensee develops a lower cost technique that can deliver more risk reduction that benefits consumers, the licensee's decision to go beyond the targets would be informed by a view that they should benefit from the TIM outperformance opportunity afforded by the lower cost technique.

Valuing over-delivery at allowed rates, would maintain the TIM incentive, providing licensees with the outperformance opportunity for efficient activity. However, this approach could drive a licensee to significantly over-deliver, especially where that licensee has adopted a much lower cost solution for the delivery of NOMs.

Option 2 - Using incurred costs

The original price control settlement established the costs of delivery and the volumes of delivery (and consequently the NOMs targets). Licensees should therefore be incentivised to deliver the NOMs targets, rather than exceed them, because the activity volumes associated with the NOMs targets was deemed appropriate.

There may, however, be changes to circumstances during the price control, which lead to licensees delivering more NOMs outputs. Where these additional outputs are justified, it is appropriate to cover the costs of the licensees.

Using incurred costs (provided they are lower than allowed costs) for the valuation of over-delivery would lead to these extra activities being treated as a "pass through" cost where the licensee does not get any benefit (or detriment) under the TIM.

Option 3 - Using ex-post efficient costs

The use of an ex-post review at the end of the price control to establish revised views of efficient costs introduces additional uncertainty and risk for all parties. This is particularly significant where such intentions were not pre-signalled at the time of setting the price control.

The cost references available to the licensees during the price control are the ex-ante efficient values used to set allowances. These ex-ante allowances are derived from benchmarking and analysis and are the basis of allowances against which the TIM operates. Licensees that develop more efficient approaches to delivering NOMs activity, outperforming the allowance rates, should not suffer a penalty if their efficient solutions are subsequently deemed to be inefficient as a result of an ex-post review of efficiency.

Consider, for example, a licensee that is allowed a value of £100k per unit. If that licensee then seeks efficiencies and delivers at £95k per unit, it would expect to see a reward under the TIM. However, an ex-post efficiency review suggests that the new benchmark should be £90k per unit; this would lead to the licensee suffering a loss under the TIM.

It is inappropriate to penalise licensees that outperform ex-ante efficient costs, but don't meet the values derived in an ex-post assessment. Ex-post assessments should be used to inform future price controls, not revise existing established arrangements.

WPD's proposal

WPD suggests that using option 2 (i.e. incurred costs) provides protection for both customers and licensees. It protects customers from licensees obtaining additional TIM benefits that could be obtained if original allowances were used. It also protects licensees from ex-post under-recovery of costs and removes the uncertainty risk associated with an ex-post cost review.

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 do not agree with Ofgem's proposal to use incurred NOMs expenditure to profile the associated costs of over-deliver/under-delivery.

Ideally, the profiling would be related to difference between a profile of NOMs targets and a profile of NOMs delivery, but the absence of a NOMs target profile for RIIO-1 means that allowances/expenditure need to be used as a proxy.

Ofgem proposes to use incurred NOMs related expenditure to profile the adjustments resulting from the valuation of over/under delivery.

There are various options that could be considered (the following is not an exhaustive list):

- 1/8th per annum. This average approach is the simplest and could be viewed as representing allowances (because in most cases the allowance profiles over the RIIO-1 period are generally flat)
- NOMs allowances. This would require the derivation of the NOMs related allowances, which for some sectors is not readily available
- Total allowances. This would be seen as a proxy for NOMs, but NOMs only make up a proportion of the full allowances and the profile for full allowances may not be representative of NOMs allowances.
- Incurred NOMs expenditure
- Incurred price control expenditure. This again would be proxy for NOMs expenditure, but may not be representative of NOMs activity.
- Difference between NOMs allowances and incurred NOMs expenditure. This would represent the profile of variation to the allowances.
- Difference between total allowances and incurred total expenditure. This may not be representative of NOMs activity

Ofgem's proposed position suggests that the adjustment is related to the incurred expenditure. The same approach is proposed for both under/over-delivery.

Under-delivery represents the amount of activity not carried out. This is the difference between the target (lower materiality threshold) and the actual delivered value. Using the difference between NOMs allowances and incurred NOMs expenditure would be a more consistent profiling approach for under-delivery.

Over-delivery valuation represents the additional allowance that would have been provided had the activity been factored into the original price control settlement. This suggests that the profiling of over-delivery should be in-line with allowances.

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 provides a pragmatic view of the time that will be taken to analyse licensee performance assessment submissions and reported data; determine the performance results; calculate the financial adjustments and consult on the conclusions.

As observed by Ofgem, it is not practical to complete this by the annual iteration processes that will take place in the first November following the end of the price control. This means that the NOMs incentive adjustments will be implemented through the second annual iteration process in RIIO-2 affecting revenues from the third year.

There are two specific amendments that we suggest to the timeline:

Supplementary Questions (SQ)

At present the SQ process is shown to continue from periods 1-7. In reality this will not be able to start until period 2 (after licensees have submitted performance reports) and would stop at period 5 (when Ofgem concludes NOMs performance and determines whether licensees should provide justification under stage 5).

The SQ process should start again after licensees have provided justification (currently period 8), because Ofgem may wish to seek clarification of details provided in the justification. This would terminate once Ofgem determines the value of over-under delivery (currently period 9).

Provision of Justification

At present the provision of justification is in periods 6 (December) and 7 (January). This period spans a holiday season and therefore more time should be provided for licensees to provide appropriate levels of justification that limits the need for too many SQs.

We suggest that the provision of justification should span periods 6-8. This would move the following activities back a month, which we suggest is possible within the overall timetable.

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.

The implementation of the overarching framework does not need to have an impact assessment, but the rationale for certain aspects should be assessed.

For example the following should have an assessment to determine whether the elements have a material effect.

Using ex-post efficiency assessment

The use of an ex-post efficiency assessment for the valuation or over-delivery introduces uncertainty and regulatory risk. Licensees may not be fully funded for the additional activities that they carry out, even though the cost of these is more efficient than allowed values.

Using a deadband

The use of a deadband means that licensees are protected from the downside in the deadband (where customers only obtain a partial refund for under-delivery) and licensees are exposed to the costs of over-delivery in the deadband (where they have to fund a TIM proportion). This is especially the case under Ofgem's current proposals where the valuation of under-delivery and over-delivery is based upon the excursion outside the deadband threshold.

APPENDIX B – ELEMENTS FOR A RIIO-2 FRAMEWORK

During the development of the NOM Incentive Methodology, the Cross Sector Working Group has revealed significant inconsistencies across the sectors in the type of targets and how allowances have been associated with NOMs delivery. We urge Ofgem to learn from and consider these differences, when the NOMs framework for RIIO-2 is established.

WPD's observations suggest the following as the basis of a RIIO-2 framework.

- Targets should be a risk delta associated with clearly defined intervention activity;
- The targets should be at a total level, specified in terms of monetised risk, to allow risk trading across asset types and interventions categories;
- NOMs measures should be based upon using common methodologies; it is anticipated that these will remain sector specific due to the different types of assets used in different sectors.
- The totex allowances associated with the delivery of the NOMs targets should be clearly defined;
- The arrangements for assessment of delivery and any associated financial adjustments should be clearly specified in RIIO-2 strategy documents, implemented into licence conditions, methodologies established in financial handbooks and calculations embedded into Price Control Financial Models ahead of the start of the RIIO-2 price controls;
- The approach to valuation of under/over delivery should be clearly defined ahead as part of RIIO-2 strategy; this is important so that it gives visibility and clarity of the financial treatment to both licensees and stakeholders. Licensees need this so that they can make good judgements during the price control and stakeholders need this so that they understand how future costs will be impacted by licensee performance.
- Reporting requirements for NOMs delivery should be established ahead of the start of the RIIO-2 price control;
- Reporting of NOMs related expenditure should be separately identifiable within annual RIGs reporting;

We would encourage Ofgem to work on establishing the RIIO-2 framework for NOMs alongside the development of wider RIIO-2 framework activities.

APPENDIX C – SPECIFIC COMMENTS ON THE METHODOLOGY DOCUMENT

Section 3.4

The third paragraph 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. Where such adjustments are not being made, non-intervention risk changes will be taken into account in the valuation of over/under-delivery at stage 7."

This paragraph applies specifically to sectors where an absolute target exists, because for sectors with a delta associated with specified activity the measure of delivery is not influenced by non-intervention risk changes.

We suggest, therefore, that the wording needs to be revised. A suggestion is provided below:

"At this stage, where non-intervention risk changes impact the delivered NOMs, Ofgem ~~will~~may adjust Licensee performance to strip out any non-intervention risk changes that were not explicitly identified as being at the Licensee's risk. Where such adjustments are not being made, non-intervention risk changes ~~will~~ may be taken into account in the valuation of over/under-delivery at stage 7."

Furthermore, for sectors with a delta target, non-intervention risk changes may lead to licensees carrying out a different mix of activities. For these situations, the licensees will be using non-intervention risk changes as part of the justification for revisions to work programmes. These will need to be assessed as part of stage 6.

We suggest that the following additional sentence is required at the end of the above paragraph.

"In some cases non-intervention risk changes can influence the activities carried out by a licensee and therefore non-intervention risk changes may also be considered as part of the evaluation of justification in stage 6."

We also suggest that the sentence starting "The outcome from this stage…" should be a separate paragraph that concludes the results from stage 3.

Section 3.7

Minor typo in second sentence of point 2 (repetition of that that).

The final sentence incorrectly uses the terms unjustified. The licensees are providing evidence to justify their resultant outcomes and so Ofgem's assessment determines whether this justification is acceptable. The reference to unjustified should be changed to justified:

"It should be noted that Ofgem may determine that only part of an over delivery is ~~un~~justified or that only part of an under-delivery is justified. In these cases, the valuation of the relevant incentive will be treated accordingly."

Section 3.8

Page 15 starts with three elements of revenue adjustment. The elements make reference to allowances which could be confused with the activity allowances determined as part of the price control settlement. We suggest that it is made clearer that the adjustments related to revenues in RIIO-2 with the following amendments:

"1. The **associated costs** of the over/under delivery – to be provided/excluded from RIIO-2 revenue allowances;
2. The **financing costs** of the associated costs of the over/under delivery – where 1 takes place there may be a related adjustment to compensate for the later/earlier timing of the delivery~~allowances~~; and
3. A **reward or penalty** of 2.5% of the associated costs of the over/under delivery. "

Subpoint "a" suggests that all risk changes delivered through non activity will be set to zero. This point only relates to where an absolute target is used. This point is illogical for ED. To make the NOMs methodology applicable to all sectors we suggest the following minor change:

"a. all risk changes (that are included as part of the delivered outputs) 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; "

The last paragraph on page 15 states the following, but the methodology does not specify why this is the case. None of the licence conditions across the sectors suggest consideration of timing of costs in RIIO-2. It should be made clearer why it is necessary to do this.

"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."