30 April 2018

Min Zhu
Associate Partner Networks,
Ofgem
9 Millbank London
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Dear Min:

Northern Gas Networks response to Ofgem Consultation: Network Output Measures (NOMs) Incentive Methodology.

Thank you for the opportunity to respond to your consultation regarding the proposed Incentive Methodology for Network Output Measures (NOMs).

Northern Gas Networks (NGN) considers that the implementation and measurement of NOMs provides a robust framework that enables a consistent and transparent basis upon which to measure asset health, criticality and risk. We are committed to working with Ofgem to ensure that the application of the NOMs incentive mechanism is appropriately and effectively implemented.

We support the work that has been undertaken in producing a methodology that can be used by all sectors during RIIO1. We consider that the working group has delivered a good balance across the four sectors, however, we note that there remain differences across the sectors both in the defined licence requirements, investment profiles and the requirements outlined in Final Proposals for RIIO1. It is important that these differences are appropriately reflected in the final version of your methodology.

We are in broad agreement with the approach outlined in your consultation and consider that it provides an appropriate starting point for the RIIO1 assessment. In a number of instances, our response refers back to the process for assessing NOMs that is outlined in Appendix 3 of Final Proposals for Gas Distribution Networks (GDNs). Throughout the development of this methodology, the GDNs repeatedly pointed back to this document and the licence as the means to apply the NOMs incentive methodology. We remain adamant that the assessment process for GD1 should be applied consistently with these proposals, as this is the basis upon which we have delivered our RIIO1 outputs to manage asset health. Our response to the questions that you have raised in your consultation are provided below.

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.*

We consider that the proposed implementation process is adequate, and is broadly consistent with the approach outlined in Appendix 3 of our Final Proposal for GD1. We consider that the process as outlined, should be applied consistently with what was outlined in Final Proposals; specifically in relation to on target delivery as outlined in paragraph 1.26 and 1.27 of Appendix 3, page 69.

In addition, we understand that a retrospective assessment of performance can be an arduous task, both in terms of data collection and submission by the industry and also assessment by Ofgem. We would advocate early engagement from Ofgem on the data requirements and template format in submitting the required information to ensure an efficient process. To this end, we consider the methodology should outline the level of detail and format of information that Ofgem would require, how they will be developed and when they will be available.

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 support the use of a materiality threshold around the NOMs target. This will ensure that companies are able to challenge their decision making processes and make the best decisions in the interest of the customer, as opposed to the best decision to meet a defined regulatory target. The nature of risk trading is inherently variable and we consider that a dead band offers the flexibility to manage asset risk more effectively and efficiently.

In addition, Special Condition 4H.12 of the Gas Distribution Operating licence clearly states that incentives would apply for 'material over delivery' and 'material under delivery', therefore a threshold should be applied to delineate material from non-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.*

We agree that exposure to the NOMs incentive should be measured from the upper/lower materiality thresholds. The rational for this is linked, in part, to what Ofgem describe as perverse incentives at the cusp of the performance band. There is also a link back to the position on materiality that we reference in our response to Question 2, in that incentives should only be applied to 'materially different' performance.

We would also refer to Ofgem's reference in Final Proposals related to "catch up" in Appendix 3, 1.24 page 68. We consider that Ofgem should clearly outline in the methodology for how this will be applied consistently through the methodology, especially in relation to a deadband. For example, according to Final Proposals, if a company was to miss their GD1 target, at GD2 they would still be required to achieve this target but would not be funded for the catch up, Ofgem should be clear as to whether this applies to the full risk benefit that has not been delivered, or only the deviation from the upper and lower threshold.

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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.*

NGN agrees with the proposal in general and considers it is in-line with licence conditions, however, we would again reference Ofgem's Final Proposals for Gas Distribution Networks, page 68, 1.23, where it clearly states that "As with the other ex post reviews of outputs, our review of GDNs performance in relation to NOMs will not consider GDNs cost efficiency;". The statement by Ofgem within the proposed methodology that 'The associated cost of over-delivery will be based on Ofgem's view of efficient costs for the over-delivery element' contradicts the Final Proposals for GDN's and we consider that it should be specifically stated that performance against targets will not be subject to an efficiency assessment.

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 consider that Ofgem's proposal for determining the NOMs incentive and related adjustments to allowed revenue is a relatively standard and straight forward methodology. Our assessment indicates that at a high level it involves:

- Calculating an allowance adjustment to reflect the extra or reduced 'justified' work we have done in the period;
- Allocating this allowance over the RIIO1 period using the actual spend profile in RIIO1 – (subject of this question);
- Running the Price Control Financial Model (PCFM) again for the period with these revised allowances in. This version of the PCFM is then used to start off the next price control as it will contain a new trued up RAV;
- Comparing this run of the PCFM to the ones carried out each year by Ofgem as part of the annual iteration process;
- The difference in Revenue is then collected in the next price control to reflect MOD-t.

However, this methodology reflects the Electricity Distribution licence condition and not the equivalent Gas distribution licence condition. We consider that there are some key differences that need to be addressed in your proposed methodology and a similar straightforward methodology should be developed for gas. NGN will of course work with Ofgem to develop this. The key differences that we note and associated impacts are:

- The Electricity Licence Condition (ELC) references adjusting Revenue in the next price control whilst reflecting the revenues already received via MOD-t in the current price control;
- The Gas Licence Condition (GLC) references adjusting Cost Allowances in the next price control, not Revenue;
- Consequently, you can still calculate an allowance adjustment as above, but the GLC says that this should be used to adjust the Cost Allowances in RIIO2 not RIIO1 – either up or down – rather than looking back at RIIO1.

Intrinsically we do not have an issue with this GLC proposal as it still provides an allowance adjustment, and hence any under/over performance. Materially this should deliver the same impact, but this will be subject to the sharing factors, tax etc. from RIIO2.

Given that actual costs for RIIO2 will not be known at the point you make the NOMs adjustment we do not consider that you can use this to allocate the allowance variance over RIIO2. RIIO2 looks like it will not be eight years in length either, therefore it would not be straightforward to use RIIO1 actuals. As a result, we consider that it would seem logical to use RIIO2 allowances to allocate the allowance variance.

We note that the GLC also treats financing costs differently to the ELC, where they will be managed through the re-running of the PCFM, we consider that this will also need to be worked through for a gas specific methodology.

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 consider that the timeline is realistic. As implied in our response to Question 1, we consider that the assessment should be an ongoing exchange of information through the RIG process up to 2021 and not a one-off assessment. We look forward to working with Ofgem to achieve this.

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 do not consider that an impact assessment is required, however, in the delivery of the methodology we need to be prudent to ensure that a flexible and progressive approach is adopted to ensure that the methodology does not inadvertently impact other areas agreed through our operating licence, legislative requirements or the terms of our Final Proposals.

We look forward to working with Ofgem in developing and delivering against this methodology. Should you wish to discuss our response to this consultation in more detail, please do not hesitate to contact Greg Dodd, Head of Asset Strategy by email gdodd@northerngas.co.uk or phone 07966887355.

Kind Regards

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Northern Gas Networks