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Dear Min

Consultation on the Network Output Measures (NOMs) Incentive Methodology

Thank you for the opportunity to comment on your proposals for an overall NOMs incentive methodology for the RIIO-1 price controls.

We believe that NOMs are a fundamental part of the Outputs framework of a RIIO price control as they serve as the key leading indicator of asset health and hence longer-term serviceability, to complement shorter-term lagging performance indicators such as the IIS regime for Electricity Distribution (ED).

In RIIO-ED1, the identification of a risk 'delta' to be achieved through a planned programme of replacement and refurbishment activities clearly links investment aimed at longer-term asset stewardship with a quantifiable impact on network risk. The introduction of a common methodology for assessing asset risk in the guise of the Common Network Asset Indices Methodology (CNAIM) gives DNOs the ability to assess the best value risk reduction options and 'risk trade' across asset categories previously deemed not comparable. In addition, DNOs have been innovating to expand the intervention options available on asset types, eg through refurbishment, life-extension and regeneration options.

These developments mean that DNOs will be actively looking to deliver a different portfolio of interventions on network assets than those envisaged at the time of original RIIO-ED1 plan submission in 2013. These revised portfolios offer better value risk reduction for customers and may result in either over- or under-performance of the of the original NOMs targets. The requirement to justify these deviations from target is quite rightly included in the proposed methodology.

We have worked with Ofgem and the other network companies on the design of the NOMs incentive framework since May 2017 through the NOMs Cross Sector Working Group. This process has highlighted to us that despite superficial similarities, the NOMs requirements of the Gas Distribution and Transmission price controls are substantially different from those in ED, and as such, a desire for a common cross-sector incentive framework needs to be balanced with the substantial sector differences in the design of the NOMs incentives embodied in the respective licences.

The process has also highlighted to us that the ED sector is many years ahead of the others in having an approved methodology, published re-stated targets and a supporting annual reporting regime in place before the end of the second year of the RIIO-ED1 price control. In contrast, the Transmission sector has entered year six of their price control and has not even started the process of re-basing its targets. This puts the ED companies at a very different starting point when appraising the proposals.

As such, it is important that the incentive properties envisaged in the original design of the ED NOMs mechanism are retained in any cross-sector framework, rather than sacrificed due to issues arising from other sector licences. Although it contains many sensible practical proposals, our key concern with the proposed methodology is that it essentially destroys any NOMs outperformance incentive for ED, and effectively becomes a penalty-only regime.

It does this through two key design features; the ex-post application of a view of efficient costs (question 4) and the discounting of the first 5% of outperformance through application post the deadband (question 3).

The combination of these factors means that it is not possible to construct a CBA analysis for any outperformance as it is uncertain as to what the discounting effect of these factors will be. This is likely to compel companies to forgo potential 'justified' outperformance and simply aim for performance within the deadband at lowest cost.

It is important that the discussion on ED NOMs and the step from the cross-sector framework to ED licence handbook modification proceeds apace as part of the wider RIIO-ED1 Closeout discussions. It is also important that the result of these discussions is consistent with the intent of the ED licence conditions. As such, we suggest that the cross-sector framework sets out the options for remunerating outperformance, with an undertaking that the details are worked out on a sector-specific basis.

We look forward to working with Ofgem on this and the equally urgent discussions on the role of NOMs in the RIIO-2 price controls over the coming months.

Responses to the detailed questions are included in the appendix to this letter. If you require any clarification on the points raised, please contact Jonathan Booth at jonathan.booth@enwl.co.uk or me at paul.bircham@enwl.co.uk.

Yours sincerely

Jonathan Booth

Digitally signed by Jonathan Booth
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Signed on behalf of
Paul Bircham
Commercial Strategy and Support Director

Appendix – responses to 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.

We broadly agree with the proposed process. It is important to step through a sequential series of stages, aligned with the current RIG reporting requirements, Annual Iteration Process (AIP) and ED licence requirement for a Performance Report to be submitted in July 2023. It is also important that the process is proportional to the quantum of variance under consideration; as such we agree both with the use of a deadband and the option to conclude the process after Stage 4 if delivery is 'on target'.

Further work will be required in sector specific discussions regarding the application of stage 1 and the process around 'relevant risk changes'. Due to the established nature of the NOMs regime in ED, we suggest that it is appropriate to carry out a dry run of this process following submission of the 2019 Performance Report stipulated in licence condition SLC51 part H.

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 that this is appropriate. The function of the threshold is to identify where non-material variances to target have been delivered and remove the requirement to undergo a 15 month process as outlined in section 6 of the proposal for minimal adjustments.

The 5% quantum is appropriate as this approximates to a 1% allowed revenue level which is a precedent set in the other ED uncertainty mechanisms, as set out in the proposal. In addition, over an eight year price control, this approximates to a six month contingency in delivery which appears an appropriate consideration of delivery risk.

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 do not agree that this is appropriate for the ED controls. As per the ED matrix on page 14 of the consultation document, unlike GD and T, the ED licences do not stipulate 'material' over- or under-delivery. We agree that a materiality threshold is appropriate for ensuring that minor variances from target do not have to go through a costly and time-consuming settlement process (as per our response to question 2 above), however for material variances, the subsequent revenue adjustments should be applied across the totality of the over- or under-performance, in line with the licence requirements. To correctly reflect the current proposal in a CBA, the quantum relating to the first 5% of outperformance would effectively have to be discounted down to zero.

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 do not agree with the use of an ex-post efficiency review to set the costs of justified over-delivery. The ex-post application of a view of efficient costs effectively destroys any incentive properties of the outperformance mechanism.

To justify any outperformance, Ofgem requires details of the evidence-based decisions that underpinned this strategy; however these decisions cannot actually be made if there is uncertainty on the remunerated costs of any subsequent outperformance. As an example, it will effectively be impossible to put costs in a CBA as the rate of remuneration of those costs will not be known at the time of the decision whereas the allowed and actual costs will.

We do agree with the use of the efficient allowed costs in the assessment of the extent of under-delivery as this reflects the allowances on which the NOMs targets were based. We suggest for reasons of symmetry and predictability, that the efficient allowed costs are also used to value over-delivery to preserve the incentive properties of the mechanism.

We propose that the cross-sector framework identifies the three potential options for valuing outperformance that were discussed as part of the NOMs Cross-Sector Working Group, namely allowance, actual and ex-post efficiency assessment, and defers the decision on which is to be used to the sector-specific discussions. This will enable each sector to develop a mechanism consistent with its own licence requirements within a common overall framework.

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.

This appears appropriate. The ED NOMs targets apply at the end of the period and are not annually profiled hence there is no target profile against which to match actual performance. In addition, for the ED NOMs with many thousands of interventions, it is arbitrary to attempt to identify the specific quantum of investment which led to the over- or under-delivery hence the use of the actual spend profiles serves as a sensible proxy.

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 proposed appears realistic for implementation within the ED sector. Achieving this will rely on the timely continuation of the NOMs incentive discussions with the Ofgem ED team in the guise of the RIIO-ED1 closeout work, such that the envisaged process can be trialled in association with the 2019 NOMs Performance Report requirement noted earlier.

In particular, it will be important to agree with Ofgem the ED-specific details around the operation of stages 1-3 of the process, ie the identification and subsequent assessment of any relevant risk changes to ensure a definitive view is reached at the end of Stage 4 in November 2023.

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 believe that an Impact Assessment should be undertaken on the implementation of a common NOMs incentive methodology, in part due to there being still a significant uncertainty over its potential operation and subsequent impact. In particular, the assessment should examine prospective extreme outturn scenarios and look at their potential impacts on company financeability.