Network Output Measures (NOMs) Incentive Methodology

Northern Powergrid's response to Ofgem's consultation dated 26 March 2018

KEY POINTS

Ofgem needs to challenge its direction of travel for Network Output Measures (NOMs). Within the constraints of RIIO-1, and the relative freedom of RIIO-2, it needs to work hard to avoid micro-management of company decisions, as this would be detrimental to energy consumers. Beyond these over-arching points, much of the methodology is appropriate.

- Ofgem set the outline of its RIIO-1 policy for network output measures at the respective price reviews; Ofgem needs to respect these policy decisions, determinations and licence modifications. It has more freedom to set its direction for RIIO-2.
- The proposed methodology provides a suitable basis for implementing the data gathering and assessment phases of the incentive mechanism. There are however differences in the licence conditions of each sector which limit the common approach to defining process. The common methodology should also be made sub-ordinate to statements in the licence or relevant price control decisions for each sector (except where stated otherwise), to avoid the risk of unintended changes in policy.
- There have also been varying levels of development achieved by the different sectors as noted in Ofgem's consultation document. Development on a cross-sectoral basis may therefore have reached its natural conclusion.
- In developing the detail further Ofgem should be careful to avoid the risk of micro-management. Not only is Ofgem not resourced for the task, but responsibility for asset management decisions, and the associated risks, needs to lie with the network companies. In the evolving energy sector, these companies need to be far more than delivery bodies for publically made investment decisions.
- We are concerned that the design of the materiality threshold is not necessarily the simplest way of ensuring a proportionate level of assessment is undertaken as at the end of the regulatory period it may encourage licensees to amend work programmes to deviate away from the target. To this end the target should remain the target, not be effectively re-set to the upper or lower materiality threshold.
- We do not support the proposed approach for determining the associated costs of over- or under-delivery as it could penalise licensees that have made the best decisions with the information that they had at that time. We also consider the use of a "unit cost" to ascertain efficiency to be inappropriate; this is too sensitive to business decisions (such as the whether to use non-targeted high volume replacement to achieve low unit costs, or target assets more carefully to achieve lower total costs through lower volumes, at the expense of higher unit costs). The Electricity Distribution sector's alternative proposal based on a combination of allowed and actual costs provides a model that should be explored.
- We generally consider the timeline proposed to be achievable and realistic but suggest the deferral of submission of performance reports until after the Regulatory Reporting Pack submission interrogation process has been completed.
- We agree that the implementation of a common NOMs incentive does not require an impact assessment; especially if it Ofgem ensures it is not unintentionally changing any of the individual price control settlements (through the subordination we suggest above).

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1. Overview

1. In its consultation letter dated 26 March 2018, Ofgem outlined its intent for the RIIO-1 NOMs incentive mechanism methodology that is set out in the RIIO-1 Licences of each of the Onshore Transmission and Distribution Licensees.

2. Ofgem is currently considering network output measures for two reasons; firstly to set the close-out methodologies for the first round of RIIO price controls. Secondly, to define the framework for RIIO-2. This consultation relates to RIIO-1, which necessarily constrains Ofgem to implementing the policy decisions, price control determinations and licence modifications it made at that set of price reviews.

3. However, whichever mode Ofgem is operating in, it needs to remember the policy objectives for secondary deliverables within the RIIO framework, their strengths and weaknesses, and the manner in which they should be implemented. This is essentially set out in the RIIO-handbook.[1]

4. Wherever Ofgem has some discretion in its implementation of RIIO-1 close out, it ought to look back to these over-arching principles. Ofgem also needs to look more widely at the policy statements made in the run-up to the licence modification. These remain relevant (except where they were over-ridden by the licence modification).

5. Moving to the specifics of the consultation, we recognise that despite differences in some of the detail within each sector's licence conditions, the main elements of the Penalty and Reward mechanism for incentivising appropriate performance are consistent and that the methodology has achieved a suitable level of commonality.

6. This document sets out Northern Powergrid's detailed response to the consultation. In short:

    a. **Q1.** Inevitably there are differences in some of the detail within each sector's licence conditions and the methodology has therefore (necessarily) become very high level in terms of a defining process. However subject to developing the detailed design within each respective sector, and Ofgem ensuring that its methodology cannot unintentionally over-ride sector specific decisions that were already taken, we consider that the proposed methodology does provide a suitable basis for implementing the data gathering and assessment phases of the incentive mechanism.

[1] RIIO Handbook, page 40

b. **Q2.** In principle we consider that a materiality threshold / deadband is acceptable. However we are concerned that the design is not necessarily the simplest way of ensuring a proportionate level of assessment is undertaken. A simple target and appraisal based on that target would be a more proportionate approach.

c. **Q3.** We believe any over- or under-delivery should be measured as deviation from target and not the materiality threshold. There should be no changes to the licensees target depending on their performance (i.e. to change between lower deadband threshold and target if the licensee was within the deadband), as this could introduce perverse incentives.

d. **Q4.** We do not support the proposed approach for determining the associated costs of over- or under-delivery as it could penalise licensees who have made the best decisions with the information that they had at that time. We also consider that anything that uses a 'unit cost' to ascertain efficiency is inappropriate, as this is too sensitive to business decisions (such as the whether to use non-targeted high volume replacement to achieve low unit costs, or target assets more carefully to achieve lower total costs through lower volumes, at the expense of higher unit costs). We think the Electricity Distribution sector's alternative proposal based on a combination of allowed and actual costs is a good suggestion that warrants exploration and development.

e. **Q5.** Ofgem should profile the adjustments based on the allowances companies were set in the RIIO-ED1 control. NOMs were part of the justification for these allowances, and under-delivery on NOMs over the period, without justification, should lead to claw-back in proportion with those allowances. Use of actual expenditure could lead to perverse outcomes. We, and Ofgem (we understand), were clear in the DPCR5 close out process that profiling based on allowances was the first best approach. However, Ofgem was constrained to use actual expenditure at DPCR5 (by prior licence drafting) in a way that we do not believe it is constrained at RIIO-ED1.

f. **Q6.** We generally consider the timeline proposed to be achievable and realistic but suggest the deferral of submission of performance report until after RRP submission SQ process has been completed.

g. **Q7.** We would agree that the implementation of a common NOMs incentive does not require an impact assessment – especially provided that Ofgem makes it subordinate to the other relevant document in event of a conflict of meaning, to avoid unintentionally changing policy.

7. The rest of this document sets out our response to Ofgem's individual questions.

2. Responses to Ofgem's consultation 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?

8. We recognise that progress has been made within the four individual sectors (Electricity Distribution (ED), Electricity Transmission (ET), Gas Distribution (GD) and Gas Transmission (GT)) to develop methodologies to support the NOMs mechanism. There has also been varying levels of development achieved by the different sectors as noted in Ofgem's consultation document.

9. The elements of the Penalty and Reward mechanism for incentivising appropriate performance are consistent across all the four sectors including the use of end of period targets, the allowance for risk to be trading risk across asset categories, a reward for justified over- or under-delivery and a penalty for unjustified over- and under-delivery. Therefore we consider that the proposed methodology does provide a suitable basis for implementing the data gathering and assessment phases of the incentive mechanism and that the level of commonality is appropriate across all four sectors.

10. Inevitably though, there are differences in some of the detail within each sector's licence conditions since each sector have their own unique features (so different solutions may be appropriate) and each sector is at different stages of implementation of the RIIO framework. The methodology has therefore (necessarily) become very high level in terms of a defining process. For example the criteria by which over- and under-delivery will be assessed as justified or unjustified are not detailed in the methodology and therefore not within the scope of this consultation.

11. The differences between the sectors also mean that Ofgem must ensure it does not in-advertently change any of the decisions it took in the individual price control reviews, or the approaches it has set out in in the licence conditions for each sector. The document should be made subordinate to the relevant RIIO-1 policy decisions, determinations and licence modifications.

12. For example, Ofgem could not implement its process flow chart as set out on page 8 under the existing Charge Restriction Condition (CRC) 5D of the slow-track electricity distribution licence. This is because Part A of that condition requires electricity distribution licensees to submit a single report detailing everything, including justified under- and over-delivery, by 31 July 2023. The Authority would then be able to request any further analysis or information it reasonably required to make its determination. The process set out in Ofgem's flow chart, which separates the performance report from justification of under- and over- deliver, is thus incompatible with CRC 5D. This is not a

substantive issue, only procedural, since a process that has the same effect can still be achieved under the current CRC5D – it just requires that a slightly different route be taken from that set out in the flow-chart.

13. But given the differences across sectors we cannot rule out that there may be substantive issues where the methodology conflicts with a particular licence condition; in any such cases the licence condition should take precedence. We would be happy to discuss the issue of potential conflicts further with Ofgem, to identify any others on a sector specific basis. However, this issue can simply and easily dealt with in the context of the current consultation by making the methodology subordinate to the other pre-existing documents in the event of such conflicts.

14. The detailed design within each respective sector now requires further development to ensure that the methodology is effectively implemented. In particular we consider the Electricity Distribution (ED) sector to be well placed to deliver a Penalty and Reward methodology given:

    a. The Common Network Asset Indices Methodology (CNAIM) is now implemented;

    b. ED1 targets have now been rebased; and

    c. The associated regulatory reporting requirements under Annex D are now well aligned and well established.

15. Therefore further development should align to the significant progress already made within the sectors. For example:

    a. Assessment criteria should be built around data that is available through existing reporting channels (i.e. Annex D);

    b. Targets should be a risk delta associated with a clearly identified intervention activity; and

    c. Targets should be at a network level.

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?

16. In principle we consider that a materiality threshold / deadband would be acceptable since each sector has some form of reference to a reward and penalty where 'material' over- or under-delivery has occurred. For the ED sector, paragraph 4.40 of the Ofgem Strategy document for Outputs and Incentives states (4 March 2013) refers to this. Although Ofgem notes that the licence for the ED

sector does not set out a materiality threshold, the lack of the reference in the licence decision may not necessarily mean that Ofgem has determined that one ought not to be applied. This issue would need to be considered further.

17. We understand that Ofgem's real intent of having a materiality threshold is to ensure a proportionate level of assessment is undertaken. There are various ways that this could be achieved without the use of a materiality threshold but broadly using the approach described in Stage 6 of the proposed methodology.

18. For example, a range of quantitative assessments could be undertaken using data submitted as part of the annual Annex D – Secondary Deliverables submission to assess performance against target at both a network level and at a disaggregated asset category level. This may be appropriate for on-target delivery.

19. Where companies have material variances against target resulting in under- or over-delivery at the network level (and/or at an asset category level) additional assessments could then be undertaken, proportionately depending on the extent of the over/under delivery. This could include both quantitative and qualitative assessments using additional data to that contained within the Annex D workbooks.

20. A simple target and appraisal based on that target would be a more proportionate approach.

Question 3: Do you agree that the exposure to the NOMs incentive should be measured from the upper/lower materiality thresholds?

21. Further to our response to Question 2, measuring over- or under-delivery from the upper or lower materially thresholds may result in companies having to provide significant levels of justification for very little reward or penalty. This could easily lead to a situation that is not proportionate.

22. For example unless a company can be assured of delivering significantly in excess of the upper threshold (i.e. 105% for ED) the methodology would incentivise delivery of no more than 95% of the original target.

23. Therefore in the event of an over or under-delivery scenario, and assuming that Ofgem maintains the materiality threshold in the proposed form, we believe any over- or under-delivery should be measured as a deviation from target.

Question 4: Do you agree with our proposal for how the associated costs of over/under-delivery are derived?

24. In the methodology Ofgem proposes that "*the associated cost of over-delivery will be based on Ofgem's view of efficient costs for the over-delivery element*." We do not support this approach for three reasons:

    a. It could penalise licensees that have made the best decisions with the information that they had at that time;

    b. Anything that uses a 'unit cost' to ascertain efficiency is inappropriate, as this is too sensitive to business decisions (such as the whether to use non-targeted high volume replacement to achieve low unit costs, or target assets more carefully to achieve lower total costs through lower volumes while accepting that this may lead to higher unit costs). We think the ED sector's alternative proposal based on a combination of allowed and actual costs is a good one that should be explored and developed; and

    c. As Ofgem itself noted in the letter, we agree that the Licensees will not be able to explicitly identify the work that constituted any over/under delivery against its target.

25. The ED sector has developed an alternative 'hybrid' solution where over-delivery would be valued at the lower of Licensees own nominal rate or the original allowed nominal rate, thereby addressing Ofgem's concern about providing inefficient companies an excessive over-delivery reward. This approach was grounded in DPCR5 Final proposals and is therefore consistent with Ofgem's stated direction in its RIIO-ED1 strategy decision to continue with this policy approach. This ensures that the Licensees understand how an assessment of efficiency will be made up front and can then determine whether a particular investment is efficient to deliver.

26. Further, for the ED sector, the (network level) risk delta targets within each license area are only related to specific investment activities (specified asset replacement and refurbishment) and the associated allowances and incurred expenditure for this work can be derived. A methodology for doing so has already been created, and trialled, by representatives of the ED sector.

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?

27. Ofgem should profile the adjustments based on the allowances companies were set in the RIIO-ED1 control. These should be identified as closely as reasonably practicable to the allowances for cost categories for which NOMs targets are associated.

28. NOMs were part of the justification for these allowances, and under-delivery on NOMs over the period, without justification, should use the time profile of allowances for the time profile for any claw-back. Moreover, since there is no target for a certain profile of NOMs, just a closing level, there is no basis to use actual expenditure as a profile for any reward companies are granted for over-delivery.

29. We note that actual expenditure was used for profiling in the DPCR5 close out. This was extensively debated at the time. Northern Powergrid stood to benefit from the use of actual cost at the time (had the company triggered a NOMs adjustment). However we believed that this could result in perverse outcomes, and that it could undermine the intentions of other incentives in the price control. We, and we believe Ofgem, were clear that profiling based on allowances was the superior approach. However, prior licence drafting had already been implemented that stated actual expenditure would be used. We recognised that this placed Ofgem in a difficult position at DPCR5, and ultimately Ofgem retained the original licence drafting that specified the use of actual expenditure for profiling.

30. We do not believe Ofgem is constrained in the same way at RIIO-ED1 as it was at DPCR5. For this reason, and because Ofgem now has a free hand, it should use allowances for the profiling of any claw-back adjustments.

31. We would additionally note that Ofgem did not provide annual allowances by category (e.g. asset replacement, refurbishment etc. at the disaggregated asset category levels); it only provided the ED1 totals. Therefore Ofgem should use a reasonably practicable proxy in determining the profiles of the associated cost of justified or over- under-delivery.

32. Our preferred profiling method is based on profiling the allowances in accordance with the DNO's own Business Plan Data Tables (BPDT) forecast profile (except for the smart grids adjustment) – i.e. adopt a 75:25 split between Ofgem's view and the DNOs forecast at a category level. This is equivalent to Ofgem's approach to higher-level allowance setting and would be consistent with the method used by Ofgem to arrive at overall asset replacement and refurbishment allowances.

33. If the method is applied at a more disaggregated level and added up to produce a total as proposed, this does not give the same result as applying the method directly at the total level. This creates unnecessary differences in the derived allowances used for the purposes of determining the value of reward/penalty, compared to the allowances provided.

Question 6: Do you consider that the timeline proposed is achievable and realistic? Are there improvements that you can recommend?

34. We generally consider the timeline proposed to be achievable and realistic. However as noted our collective ED sector response to questions raised by Ofgem at the 19/10/2017 NOMs Cross Sector Working Group (NCSWG)[2] we would suggest the deferral of submission of performance report until after RRP submission interrogation process has been completed. An extension of three months would seem appropriate (i.e. move from 31st July 2023 to 30th Nov 2023) – this would require a change to license condition CRC 5D.2[3].

35. We consider that this would have minimal impact on the proposed completion date which we agree should align with the Annual Iteration process in November of the year following the end of the relevant RIIO-1 price control (e.g. in the ED sector, November 2024). This allows a year for the various stages of analysis and associated consultation which seems reasonable.

36. We would also note a reliance on all aspects of the methodology including the assessment and valuation elements to be clearly defined and reporting requirements to be in place in advance of the close-out process starting. That way, companies can collect the data required by the assessment process and develop an appropriate catalogue of justification material at the time relevant decisions are taken, rather than as a more time consuming and less efficient retrospective exercise.

Question 7: Do you consider that the implementation of a common NOMs incentive methodology should require an impact assessment?

With reference to chapter 2 of Ofgem's published guidance on Impact Assessments (IA)[4] we consider the proposed methodology should not undermine the interests of existing and future consumers.

[2] as referred to in Ofgem's consultation dated 26 March 2018

[3] CRC 5D.2 states that "The licensee must, by 31 July 2023, provide a report to the Authority setting out its performance against its Network Asset Secondary Deliverables over the Price Control Period."

[4] Ofgem's published Impact Assessment Guidance, October 2016

Therefore we would agree that the implementation of a common NOMs incentive does not require an impact assessment. This would certainly be the case if Ofgem makes the methodology subordinate to the relevant policy decisions, price control determinations and licence modifications (except where stated otherwise); since the methodology would then avoid any unintended changes in policy.