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30 April 2018

Consultation on the Network Output Measures (NOMs) Incentive Methodology

For the attention of: Min Zhu & Paul O'Donovan

Wales & West Utilities welcome the opportunity to respond to the Consultation on the Network Output Measures (NOMs) Incentive Methodology. We acknowledge the efforts made to engage all sectors throughout the development of this methodology and the ambition to produce a common methodology that can be applied across sectors.

We would request acknowledgement that there remain key differences across the sectors both in the defined licence requirements and the investment types. It is important that these differences are appropriately reflected in the final version of the methodology.

There is a significant challenge with timing of this methodology and RIIO-GD1. The Gas Distribution Networks (GDNs) and Gas Transmission (GT) are in year 6 of our 8 year control with work-plans in place through to 2021. We have operated within the terms of the Final Proposals (FPs) we accepted in 2012 and would not expect any changes introduced through this methodology to supersede FPs given the timing. This would obviously not apply in GD2 where the methodology would be in place from the start.

We are also mindful that this is a significant change to previous assessment methodologies of asset health and risk and the associated impact of investment so stress the importance of learning from GD1 and we would support conducting a significant review for GD2

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 feel that the proposed implementation process is adequate and broadly consistent with the approach outlined in Appendix 3 of our Final Proposal for GD1.

We note that there is reference in the methodology to reporting templates and data collection. It would be helpful for the methodology to give more details on the process to develop these including timings and what information these would collect. This will need to reflect the data currently held by the companies and the ability to address any new data requirements where data is not currently collected.

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 support the use of a materiality threshold around the NOMs network monetised risk target. This will enable companies to manage risk more effectively and efficiently, preventing investments being delivered to hit an exact target number or investment projects stalling when the target is hit.

In addition, the licences for Gas Distribution Networks state that incentives would apply for 'material over delivery' and 'material under delivery' so there needs to be a mechanism to define 'material' and a threshold is a simple and pragmatic approach to this.

We would like to make reference to the comment in the Ofgem letter '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 would challenge this language as the GD Licence (condition 4H) does do not allow for 'on target' delivery to be unjustified.

The methodology states 'The Licensees are therefore incentivised to deliver the targets, but have the flexibility to amend work programmes and to make appropriate asset management decisions that are both based on the latest information and in the interest of consumers.' We fully support this statement and would expect to provide a commentary to explain the rationale to changes in work programmes, but 'justification' implies that Ofgem could decide that work contributing to the target could be discounted. Given we are 6 years into an 8 year control with work packages in place through to 2021, there is little opportunity to react to an Ofgem assessment of justification that is not yet defined.

Networks are held to account in many other ways such as law of the land, HSE Safety Case, stakeholder requirements, other output targets etc. As such, asset management decisions need to be the responsibility of the licensee and regulatory oversight should be light when overall performance is on target.

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.*

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We agree that exposure should be measured from the upper/lower materiality thresholds. This approach would help avoid what Ofgem describe as perverse incentives at the cusp of the performance band.

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 consider the proposal is broadly in line with licence conditions. We do however have concerns with the statement 'The associated cost of over-delivery will be based on Ofgem's view of efficient costs for the over-delivery element'. We would 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;".

We maintain that the costs set by Ofgem in their Final Proposals have been rigorously tested for efficiency through the RIIO-GD1 allowance setting process and are appropriate for the NOMs incentive mechanism.

The process for redefining efficient costs would have some significant challenges that should be considered against the value if Ofgem go down this route

- The burden could be particularly unfair if companies who have delivered on target are involved in extensive work to facilitate the calculation of over delivery payments for others.
- The data required to support the exercise may not be readily available. Identifying costs for individual elements, as discussed at working meetings, is not always extractable from company accounts. Furthermore, the potential lack of consistency between company's records could lead to unfair outcomes.
- Unless a company knows its costs are efficient it will be dis-incentivised from over delivery. As companies do not know their costs relative to others, even an efficient company would not choose to invest due to the uncertainty of cost recovery.
- If the mechanism becomes purely 'cost recovery', then there would be little incentive to outperform or innovate.

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 believe that the approach needs to balance materiality and complexity of application. It should consider the spend over the control and not individual performance in any particular year,

We expect the PCFM tool to be used to ensure consistency.

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 process timeline of up to 15 months from the completion of RIIO-1 price controls within which Ofgem and Licensees will aim to complete the NOMs incentive assessment is challenging but realistic. We would not want to see the process go beyond this timescale.

This assessment process should be an ongoing exchange of information through the price control as part of the RRP submissions and not a one off assessment at the end

Delivery against the timeline will be assisted by the NOMs work which will have to be completed as part of agreeing the GD2 settlement.

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 foundations of the approach have been written into company licences and there has been extensive work between Ofgem/GDNs in developing the approach. However, there are still areas that are not clear, mostly relating to the financial assessment.

We would welcome an impact assessment on these areas. This would limit the risk of falling into complex assessments and evaluations that add little value. We would be keen to support Ofgem in any such assessment

Yours sincerely,

Steve Edwards, Director of Regulation & Commercial

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