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Onshore transmission and
distribution licensees, and any
other interested parties

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Dear Stakeholders,

Decision on the Network Output Measures (NOMs) Incentive Methodology

On 26 March 2018, we[1] consulted on the draft methodology that Ofgem proposed to use to give effect to the NOMs incentive that sits in the Licences of each of the onshore transmission and distribution Licensees[2]. We received 17 non-confidential responses[3] and one confidential annex, which we have considered in coming to our decision on the methodology. This letter discusses the key issues raised by respondents, our views on those and how these have been taken into account in the methodology published alongside this letter.

Consultation questions and responses

The consultation posed seven questions, and asked respondents to provide their rationale for any answers provided. We also offered respondents the opportunity to provide general observations on the NOMs incentive methodology and make comments on the drafting of the methodology itself. The following sections set out the responses received and Ofgem's view on the issues raised.

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.

Consultation responses

All respondents who commented on this question agreed that the process was fit-for-purpose. A number of these respondents requested clarification on how specific aspects would work and noted that there remains an amount of detail to be firmed up through the sector-specific work groups that are due to meet once the general methodology is decided upon. Some others asked for clarification of definitions and details on the data collection templates that are to be developed.

[1] The Gas and Electricity Markets Authority. Ofgem is the Office of the Authority. The terms "Ofgem" and "the Authority", "we" and "us" are used interchangeably in this letter.
[2] Consultation on the Network Output Measures (NOMs) Incentive Methodology - https://www.ofgem.gov.uk/system/files/docs/2018/03/180326_cover_letter.pdf
[3] The responses can be found here - https://www.ofgem.gov.uk/publications-and-updates/consultation-network-output-measures-noms-incentive-methodology

Ofgem view

The process outlined in the methodology was developed in conjunction with the Network Cross-Sector Working Group (NCSWG) over a period of about 9 months. We consider that it constitutes a pragmatic approach to facilitating implementation of the incentive mechanism at the end of the RIIO-1 control. We agree that there are still important issues to be resolved at the sector-specific level. We give our views on these and other issues raised by respondents in the later part of this decision letter.

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.

Consultation responses

The majority of respondents were in favour of the use of a materiality threshold around the target, noting that otherwise, Licensees could be subject to a disproportionate regulatory burden in response to minor deviations from target. Some electricity distribution (ED) respondents also noted that a threshold was consistent with their sector's licence, which provides that incentives would only apply for 'material over-delivery' and 'material under-delivery'. Those in favour generally agreed with the level of the threshold being consistent with the level of a typical reopener, i.e., c.1% of allowed revenue, though one ED respondent noted that for it, a threshold of 1% of allowed revenue would equate to a NOMs materiality threshold of +/-2.5%, rather than the +/- 5% level proposed in the draft methodology. This respondent also noted that since the NOMs rebasing has not been fully tested in practice, the use of a threshold provides extra security for both Licensees and consumers against unforeseen adverse outcomes.

However, a couple of respondents did not agree with the use of the threshold as proposed. One considered that while it agreed with the principle of a threshold, it would be just as easy to assess performance against the target level. Another stated that the measurement of exposure to the incentive from the upper/lower threshold (see Question 3) rather than the target would mean that Licensees could still be subjected to a significant regulatory burden to justify a small deviation from the threshold levels, and that the proposed level of a threshold of c.1% of revenue (which equates to a +/-5% NOMs materiality threshold) was too great.

Ofgem view

We maintain our view that the use of a materiality threshold is appropriate. The calculation of monetised risks contains various uncertainties and assumptions about the probability of asset failure and monetary value of consequences of failure. We have observed some movements of asset data which we are in the process of reviewing. Furthermore, licensees' delivery of outputs, when measured in terms of monetised risks, can be achieved with a greater degree of flexibility such as trading off between asset categories. The actual work on individual assets is likely to deliver large steps of risk reductions. All of these give rise to a greater need for caution when dealing with the numerical deviation from a precise monetised risk target. We acknowledge the possibility that a Licensee that just deviates from the materiality threshold could be subject to a regulatory burden. We expect the majority of Licensees to be aiming for close to their targets, so the risk of this occurring in practice is low, and certainly less than if we were assessing performance against targets without a deadband.

As regards the level of the materiality threshold, we stated in the consultation that the ED sector had proposed a range of +/- 5% of the overall network target risk as the materiality threshold for that sector, and that the Gas Distribution (GD) Licensees had also supported

using this same threshold. We incorporated this threshold into the draft methodology for these two sectors.

The level of the threshold needs to reflect the quality of data and information supporting the Licensees' outputs. We consider that the decision on the level of the materiality threshold should be left open at this stage for all sectors, until we have a better understanding of the degree of robustness of the data that will support Licensees' performance on NOMs outputs. We will examine the robustness of input data, the range of uncertainty around this data, its dependency on assumptions and the extent to which any numerical value of outputs over the entire RIIO-1 period reflects the Licensees' effort to deliver consumer value.

Finally, we note that as the relevant factors discussed above are likely to affect individual sectors differently, we do not consider that the materiality threshold has to be uniform across sectors.

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.

Consultation responses

Respondents were split equally between those who agreed that exposure to the incentive should be from the upper/lower materiality thresholds and those who disagreed, considering that it should be from the target values. Those in favour considered the threshold to constitute a deadband and that it would therefore be inappropriate to treat it otherwise. They also agreed that there would be scope for parties to "game" the system if they were close to either of the thresholds as they approach the end of the period, which may result in sub-optimal spend.

Those against the proposal considered the materiality threshold to be an administrative arrangement to avoid undue regulatory burden, and that once the incentive applies, it should apply to the full deviation from targets, i.e., it is not a deadband. One respondent considered that given how late it is in the price control period, there would not be scope for Licensees to take advantage of their positions relative to the threshold level, so Ofgem's concerns of potential perverse behaviour by Licensees was unfounded. A further respondent noted that in the DPCR5 close-out, a similar mechanism stated an intent to expose Licensees to the full extent of the deviation from targets. That respondent also noted that irrespective of whether the incentive applies from the target or from the materiality threshold, Ofgem needs to assess the full extent of any under/over delivery. Respondents also made the point that exposure from the materiality threshold would mean that Licensees were exposed to a lot of work for potentially very little reward. One ED respondent noted that the ED licence does not explicitly provide that the incentive only applies to "material deviation" from the target, and so believed that exposure from the target level is more appropriate.

Ofgem view

Having considered the responses, we maintain our view that it is appropriate for exposure to the NOMs incentive to be measured from the upper/lower materiality thresholds. The degree of exposure to the incentive needs to be considered in conjunction with the use of those materiality thresholds. The thresholds give relief to Licensees from the application of the incentive mechanism over those threshold intervals; to then apply the incentive to Licensees over those intervals if they just fall outside the threshold would produce a disproportionate change in outcome for marginal differences in inputs. We think that such an outcome would be inappropriate and would not be in the interests of consumers.

We acknowledge the point that the Transmission and GD sectors are in year 6 of an 8-year control period, and so have limited opportunity to "game" the system. However, as noted above, we believe the principle of the NOMs incentive being measured from the upper/lower materiality threshold is appropriate, irrespective of the likelihood of Licensees trying to gain

advantage, and therefore consider this is what should be applied. We also note that the ED sector is still in a position to change its work programme to respond to the incentive, and so it is important that the framework is robust to such considerations.

In response to the DPCR5 example quoted by respondents, we believe that due to the various uncertainties and assumptions around the calculation of monetised risks as explained in response to Question 2, exposing Licensees to a cliff-edge effect for marginal deviations from the threshold would not be appropriate. We also agree that in the event of under/over delivery, the assessment should apply scrutiny to the entirety of the over/under delivery.

During the NCSWG meetings, it was noted that the ED licence does not make explicit reference to the incentive applying in the event of material deviation from targets. It was also noted that due to the high volumes of work in that sector, ED would be most likely to face significant regulatory burden justifying low values of work in the absence of a threshold. However, the ED Strategy Decision makes clear reference[4] to the intention that the mechanism would only apply in the event of a material deviation from target: "*The mechanism will only come into effect if the under or over delivery is of a level considered material*". We therefore consider that applying a threshold to the ED sector in implementing the NOMs incentives mechanism is not only justifiable but also in line with the policy intent.

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.

Consultation responses

Respondents addressed this question in three parts: first, in respect of the proposal that non-intervention risk gains and losses should be valued at zero for the purpose of the incentive; secondly, whether under-delivery should be valued at the unit cost rate; and thirdly, whether over-delivery should be subject to an ex-post efficiency review.

On the first point, respondents from the distribution sectors largely agreed that risk movements arising from non-interventions should not expose Licensees to windfall gains or losses, and noted that this is the case for those with a relative risk reduction target. Electricity Transmission (ET) respondents were unclear on how such a mechanism would work, and proposed deferring this aspect until the sector-specific discussions. One ET respondent questioned whether this constituted a re-opening of Final Proposals and another presented its interpretation of how the mechanism might work.

On the second point, respondents were in agreement that the associated cost of under-delivery should be based on the allowed unit cost for that work, where such a rate exists.

On the third point, the majority of responses were against the idea of over-delivery being subject to an ex-post efficiency review. The common basis for this agreement was that due to uncertainty of cost recovery, Licensees would not over-deliver, even where it is in consumers' interests to do so. Some respondents stated that the incentive arrangements should be symmetrical, i.e., based on the allowed unit cost, so that over-delivery can also gain the benefit of the totex incentive mechanism (TIM). A few respondents proposed a compromise position of using revealed incurred costs, so long as these were less than the allowed unit costs. They noted that this would still preserve the 2.5% incentive to justifiably over-deliver while providing some degree of certainty on cost recovery.

Some GD respondents also stated that any ex-post efficiency of their on-target delivery was, in their view, contradictory to statements made by Ofgem in their Final Proposals.

A common view across responses was that whatever the outcome, the Ofgem review of over/under-delivery should be proportionate and should not impose burden on other

[4] "Strategy decision for the RIIO-ED1 electricity distribution price control: Reliability and safety", Ofgem 26f/13, 4 March 2013, p. 41- https://www.ofgem.gov.uk/sites/default/files/docs/2013/02/riioed1decreliabilitysafety.pdf

licensees who have delivered on target (e.g. through a significant data collation/benchmarking exercise).

Ofgem view

With respect to the first point, we consider that risk movements arising from non-interventions should not expose Licensees to windfall gains just because the information on asset health provided by them to set the allowances proved to be incorrect. The intention of the NOMs incentive is to reward Licensees for appropriate stewardship of their assets, and to enable them to conduct necessary actions on their networks without being constrained by the allowance allocation at the start of the RIIO-1 control period.

As the ED and GD sectors deliver against a risk delta target, they do not benefit from any non-intervention reductions in risk. If the risk increases, they need to address this as part of the delivery of their risk targets.

For the Transmission sectors, we note that the price control package specified that Transmission Owners (TOs) would bear the risk of any improvement/deterioration of asset risk during the price control[5]. Therefore, TOs would have been aware that they are responsible for any non-intervention risk movements, both reductions and increases.

However, we consider that it would not be in the interests of consumers for companies to make windfall gains due to non-intervention risk reductions. For this reason, we consider that over-delivery due to non-intervention risk reductions should be valued at zero, as this is reflective of the true cost to consumers.

In respect of under-delivery due to non-intervention risk increases, the draft methodology incorrectly stated that '*all risk changes 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*'. If this were left unchanged, the application of the NOMs incentive mechanism for under-delivery due to non-intervention risk increases would not be in line with the policy intent in RIIO-T1 Final Proposals. Consequently, we have made changes to the final methodology to reflect that only over-delivery due to non-intervention risk reductions will be valued at zero. We believe that in doing so, we are acting in the best interests of consumers.

With regards to the second point, respondents were in agreement that under-delivery should be valued at the unit cost rate, where such a rate exists. We consider that this is the most logical and appropriate approach; consumers should be able to claw back unused/over-estimated revenues at the same rate as they were allowed. Licensees are still incentivised to act in the best long-term interests of consumers as they would will bear the risks of under-delivery and will not be double-funded for the same work in the next price control.

With respect to the final point, the NCSWG discussed the range of options available for funding over-delivery, and the associated advantages and disadvantages of each. Ofgem's preferred option of using efficient costs was based on consideration of a range of examples where this gave the best outcome for the most efficient Licensee. However, we acknowledge the argument that in practice, establishing the efficient cost could be a complicated and lengthy process, and the risk around cost recovery may deter Licensees from investing even when it is the correct thing to do for consumers. We maintain our view that to use the unit cost rate to recompense Licensees for over-delivery could over-estimate what consumers need to pay. Therefore, we have decided to adopt the compromise proposal from the ED sector; namely, that we will use the lower of the revealed incurred cost and allowed unit cost. Where a unit cost does not exist, the incurred cost will be subject to a high-level efficiency

[5] "*The difference between forecast and actual degradation is a risk borne by the TO*": RIIO-T1: Final Proposals for National Grid Electricity Transmission and National Grid Gas: Outputs, incentives and innovation Supporting Document, Appendix 1, Para 1.15 - https://www.ofgem.gov.uk/sites/default/files/docs/2012/12/2_riiot1_fp_outputsincentives_dec12.pdf

review to ensure that consumers are obtaining value for money; we expect Licensees to provide suitable evidence as part of their submission of the efficiency of both the costs incurred and the decision to over-deliver. Using the lower of the revealed incurred cost and allowed unit cost will preserve the incentive of the 2.5% reward and recovery of financing costs where the over-delivery was proven to be justified.

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.

Consultation responses

The majority of respondents noted that it is difficult to identify which specific elements of a delivery programme had constituted the over/under delivery element. Accordingly, they considered that using the incurred NOMs spend profile as a proxy for the timing of over/under delivery was a relatively simple and proportionate way of identifying the associated costs' financing cost under the incentive mechanism. Several respondents highlighted that whatever method is implemented, it should be done through the Price Control Financial Model (PCFM) to ensure compatibility with all other incentives.

One respondent considered that Ofgem should use the NOMs allowance profile (rather than spend profile) to calculate the financing cost. It claimed that precedent had been set through the approach used when gas mains replacement work was deferred until RIIO-2, where it was assumed that the later allowances were the ones deferred. This respondent also noted that Gas Distribution Network operators' allowances have a mostly flat profile through the RIIO-1 period and so an equal proportioning across the period would be a proportionate way of dealing with the issue. Another respondent outlined many of the plausible mechanisms that could be employed, and proposed that since justified over-delivery would indicate that the original allowance should have been greater, the associated costs should be profiled in line with allowance rather than expenditure.

Ofgem view

Once the associated costs of delivery are identified, the NOMs incentive mechanism requires the estimation of the associated financing costs. The difference between the financing allowance and actual financing costs constitutes part of the incentive mechanism adjustment. The NCSWG discussed a number of options for implementing this calculation and the pros and cons of each. Our proposal represented a comparatively simple means of estimating the associated costs when they could not be explicitly identified, and the majority of respondents have agreed with this approach. We also agree with respondents that the mechanism should be implemented through the PCFM so that it is consistent with all other incentive mechanisms.

We disagree that the deferral of expenditure in the gas mains replacement scheme sets a precedent for profiling against allowances. The gas mains replacement case related to the deferral of specific and identifiable allowances and it was reasonable in those circumstances to assume deferral from the back end of the work programme for work not yet delivered. In the case of the NOMs incentive mechanism, identifying specific over- or under-delivery within a work programme could give rise to distortion and/or unnecessary regulatory burden. Also, where the Licensees' spend profile has departed from the allowance profile, calculating the cost of over- or under-delivery on the basis of the allowance profile could also distort the overall financing impact. Therefore, we consider that profiling in line with the total NOMs-related actual spend profile is more appropriate in this case.

In respect of whether the associated cost should be profiled equally across the period, we consider that while this may be a suitably equitable outcome for some sectors, others have "lumpy" investment profiles and therefore such an allocation would not be appropriate. A comprehensive range of options was considered during the NCSWG discussions, and while it was noted that there is no obvious solution that addresses the issues of simplicity, equity and transparency, adopting the profile of actual spend met with the approval of a significant

majority; this is further reflected in the responses. Therefore, we consider that the total NOMs-related actual spend profile should be used for allocating the associated costs of a justified over-delivery or unjustified under-delivery.

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.

Consultation responses

All respondents who answered this question considered that the proposed timeline was tight but achievable. They noted that the timeline had been based on the experience of the DPCR5 close-out process and had been fully discussed within the NCSWG and so had benefitted from relevant expertise across the sectors. One respondent proposed the inclusion of a discretionary 12-month extension if Licensees are not able to provide justification information in the format required by Ofgem within the specified timeframe(s). A few other respondents proposed some minor changes that they considered would clarify the responsibilities of each participant and increase the flexibility of individual stage timings, while maintaining the overall process timeline.

Ofgem view

We agree with respondents that the timeline is tight but achievable. Close-out and legacy issues should be dealt with at the earliest opportunity after the end of the price control, and both the regulator and Licensees should be clear about the stages and responsibilities associated with the NOMs incentive mechanism. We have incorporated some of the suggested amendments into the presentation of the flow diagram[6] to make it easier to understand and to clarify responsibilities and timings. We consider that the inclusion of further discretionary extensions should be avoided where possible, as this could slow down close-out and the resolution of legacy issues, which in turn could make unintended outcomes more likely. We will consider the requirement for extensions after the sector-specific discussions conclude, but our default position is to exclude them unless strong justification is presented.

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.

Consultation responses

About two-thirds of respondents considered that an impact assessment (IA) was not required as the policy had been agreed as part of the RIIO-1 package, and the methodology was the means to implementing this part of the package. The methodology as proposed was largely set out in the various Final Proposals documents and has benefitted from the NCSWG expertise to both highlight the issues of greatest impact and propose mitigations.

Those who thought that an IA should be conducted/would be helpful did so on the basis that there are still some elements of the common methodology that are not yet agreed upon, so their potential impacts are unknown. They considered that a full or partial IA would help to determine the exposure of Licensees and consumers under the incentive mechanism and would help to identify whether there are unintended interactions with other aspects of the licence. One respondent was specifically concerned about the valuation of asset deterioration and suggested that an IA should be carried out if this element is not deferred to the sector-specific groups. Another noted that an IA might be useful to inform parties who have not been closely involved in the development of the methodology.

Ofgem view

[6]Figure 1 in Section 3.1 of the NOMs Incentive Methodology published alongside this letter.

We agree with the majority of the respondents that an IA on the common NOMs incentive methodology is not needed. The methodology implements the high-level framework policy agreed at Final Proposals across all sectors, which will be further developed at sectoral level by smaller groups. At a conceptual level, the main impact of the methodology for consumers is that justified overspend/underspend will receive a 2.5% reward above what would have been allowed had we had perfect foresight to set NOMs-related capital allowances ex-ante. Conversely, consumers are protected from bearing the financing costs of any spend deemed inefficient. Both of these effects were considered and agreed as part of the incentivisation package when setting RIIO-1 and so we do not consider that any new information would be gained by conducting an IA at this stage.

Other issues

Adjustment of targets & disapplication of the incentive

A respondent who supported the proposed adjustments for non-intervention risk changes considered that Licensee risk targets should also be adjusted to take account of other changes that were not envisaged when the price control settlements were agreed. An example given was that mild winters have been the main driver of underspend on GD networks; the concern was that without such an adjustment, it becomes very difficult to determine whether efficiency or "good luck" are the main drivers of under-delivery. That respondent also considered that, given the late stage of the Transmission and GD price controls, they cannot react to the incentive mechanism, and therefore it was inappropriate to introduce the mechanism for these sectors. That respondent thought that the mechanism should be dis-applied until the next control, citing similarities with the RIIO-T1 stakeholder satisfaction incentive.

Ofgem view

We note the respondent's support for the proposal of non-intervention risk changes, but consider that expanding this to all elements that do not align with the assumptions at the start of the control is inappropriate. Our stance on non-intervention risk changes is driven by the lack of factual information on asset condition being available at the start of RIIO-1; this is different from the wider macro-economic risks that Licensees take on as part of the price control package. We consider that seeking to adjust these now would constitute a re-opening of the price control package, which is beyond the scope of this methodology decision.

With respect to the point that Licensees cannot respond to this incentive: although the Transmission and GD sectors have not yet rebased their targets to a monetised risk measure, that rebased target is derived from being as equally challenging as the volume-based interventions in the Licence. We note that the Transmission and GD sectors have been working towards achieving those NOMs targets for the last 6 years and so we consider that those licensees have been responding to the incentive mechanism.

Drafting points

A small number of drafting changes were recommended under the assumption that the policy remains unchanged.

Ofgem view

We have reviewed these suggestions and implemented them, where appropriate. The methodology will be published without any mark up alongside this letter. We will also publish a tracked-changed version of the methodology, which shows the changes made from the draft methodology.

Next Steps

Now that we have decided on this common methodology, the next step is for each sector to form their own group to work on specific aspects of implementing this methodology. This includes the detail of how it will be realised within the PCFM.

We are currently in the process of reviewing, and where necessary auditing, the quality and robustness of asset data submitted by Licensees. Any data shortcomings will need to be adequately addressed and any residual uncertainties reflected in our eventual implementation of the NOMs incentive mechanism, for example in setting the materiality threshold as mentioned above.

In view of the further ongoing work and recognising that this is the first time the NOMs incentive mechanism is being implemented on the basis of monetised risk, we will need to keep the mechanism and the methodology of its application under review. If there is clear evidence of the mechanism not operating in consumers' interests, we will consider whether we need to take appropriate action and make an adjustment to it.

Yours faithfully,

Min Zhu
Deputy Director, Electricity Transmission