

Network Output Measures (NOMs) Incentive Methodology

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1 NOMs Incentive Methodology

1.1 Introduction

In October 2010, Ofgem announced a change in the way it regulates the GB onshore network companies and introduced the RIIO (Revenue = Incentives + Innovation + Outputs) framework¹. The overriding objective of the RIIO framework is to drive real benefits for consumers by providing energy network companies with strong incentives to meet the challenges of delivering a low carbon economy and a sustainable energy sector at a lower cost than would have been the case under the previous RPI-X approach to setting price controls.

RIIO is an outputs-led framework. It is important that throughout the RIIO-1 period the network companies understand what they are expected to deliver, and are held to account for delivery. One of the key areas in this respect are the Network Output Measures² (NOMs).

This document sets out the common methodology for implementing the RIIO-1 incentive arrangements relating to NOMs (referred to in this document here onwards as 'the NOMs incentive methodology') for all the four network sectors.

1.2 What are Network Output Measures?

NOMs are mechanisms that provide a means to monitor and assess the network management outcomes that network companies deliver. They represent the service delivery resulting from companies' asset interventions, and can be considered as a forward-looking indicator of network performance. In RIIO-1, these cover specified asset replacement/refurbishment activities; for some sectors, they also cover network capacity related activities. This document focuses on the aspects related to asset management activities only.

We have set out the arrangements related to NOMs in the licences for all gas and electricity networks. As part of this, Licensees have been set delivery targets. Licensees are obliged to deliver these targets (or an equivalent) taking into account risk trade-offs. Material deviation from these targets is subject to financial adjustments under a NOMs incentive mechanism. 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.

1.3 How have NOMs been set out in licences?

NOMs policy and its implementation has been in development between Ofgem and the Licensees for a number of years and has evolved and matured during this time. Due to

¹ RIIO: A new way to regulate energy networks: Final decision – October 2010
<http://www.ofgem.gov.uk/Networks/rpix20/ConsultDocs/Documents1/Decision%20doc.pdf>

² These are referred to as Network Asset Secondary Deliverables in the Electricity Distribution licences. For the sake of simplicity, we will use the terminology NOMs throughout the document.

the differing stages of industry practice and timings of the price controls for the network sectors, NOMs has been set out in different ways in the sectoral licences³.

- For the Electricity Transmission sector, the licence specifies **Network Replacement Outputs** relating to the position at the end of the price control period. This constitutes a matrix specifying the target number of units, per asset category, that fall within a replacement priority⁴ group remaining on the system at the end of the price control, taking account of load-related asset changes by excluding them.
- For the Gas Transmission sector, the licence specifies **Network Replacement Outputs** relating to the position at the end of the price control period. This constitutes a matrix specifying the target number of units, per asset category, that fall within a replacement priority group remaining on the system at the end of the price control.
- For the Gas Distribution sector, the licence specifies **Network Outputs** relating to the position at the end of the price control period with and without interventions. These are specified in a Workbook and are related to achieving a target level of risk mitigation. This change in total risk, or risk delta, is confined to investment in certain asset categories. Mechanisms outside of NOMs will set minimum investment levels for some assets, such as for the gas mains replacement programme.
- For the Electricity Distribution sector, the licence specifies **Network Asset Secondary Deliverables** relating to the position at the end of the price control period with and without relevant interventions. These are specified in separate Network Asset Workbooks. They were also translated into levels of monetised risk reduction by the Licensees based on their individual methodologies. This change in total risk, or risk delta, is limited to investment in specified asset replacement or refurbishment activity or relevant High Value Projects.

However, despite the different framing of NOMs in the licences, the common expectation is that all Licensees will be assessed against a monetised risk target⁵ at the end of the price control.

The transmission sectors will be assessed against an absolute level of network monetised risk, while the distribution sectors will be assessed against a defined level of monetised risk reduction. For transmission, the NOMs incentive mechanism will reward justified delivery of a lower absolute risk compared to target, and penalise unjustified delivery of a higher absolute risk compared to target. For distribution, the NOMs incentive mechanism will remunerate justified over-delivery of risk reduction and penalise unjustified under-delivery of risk reduction.

The NOMs targets are derived from a range of activities. It is recognised that circumstances can change, and to reflect this Licensees can trade off monetised risk between types of intervention and asset categories in order to deliver an equivalent or

³ The NOMs requirements are defined within the following license conditions for each sector:

- Electricity Distribution (ED): SLC 51 & CRC 5D
- Gas Distribution (GD): SpC 4G & 4H
- Electricity Transmission (ET): SpC 2L & 2M
- Gas Transmission (GT): SpC 7D & 7E

⁴ Replacement Priority is the lists of assets, grouped by equipment type and voltage/pressure, that prioritise replacement based on the Asset Health Index and Criticality

⁵ Monetised risk is an utility function that creates a 'common currency' across different asset classes so that comparisons can be made using monetary values for asset risk.

better outcome to the NOMs target. If the overall outcome results in a material variation from the monetised risk target, it is for Licensees to justify why they have deviated from the target, and how the overall delivery equates to an equivalent or better deal for consumers.

1.4 Methodology scope

This document of the NOMs incentive methodology sets out the basis on which Ofgem will consider performance under the NOMs incentive mechanism and quantify any associated incentive adjustments to RIIO-2 revenues⁶. This methodology is limited to the risk reduction through asset replacement and refurbishment interventions. The overall common methodology set out here applies to all the four network sectors. More sector-specific details will be further developed in line with this methodology.

1.5 Issues to be resolved later

Although this version of the NOMs incentive methodology aims to be as comprehensive as possible, there are a number of elements that remain outstanding and will require revisiting at a later date. We aim to agree on principles around these issues now, so that the methodology can be readily revised in reflection of the development. These issues are discussed below.

1.5.1 Rebasing licence targets

As explained in section 1.3 earlier, when RIIO-1 price controls were set, NOMs targets were specified in different ways across the sectoral licences. The implementation of this NOMs incentive methodology is based on the expectation of the existence of appropriate monetised risk targets across all sectors by the end of the RIIO1 control period(s). Therefore, the current position of each sector should be noted:

- *Electricity distribution* (ED) had NOMs targets originally translated from the Network Asset Workbook network-specific monetised risk reduction targets based on Licensee' individual NOMs methodologies. After the common NOMs methodology for ED sector was approved by Ofgem⁷, the original network-specific monetised risk reduction targets have been translated to this common methodology⁸ (this exercise is known as "rebasing" their targets).
- *Gas distribution* (GD) has completed the development of a common methodology for assessment of risk, which has been approved by Ofgem⁹. This methodology will be used by Licensees to rebase their price control targets into a network-specific monetised risk reduction measure. GD Licensees have also jointly proposed an approach for Ofgem to review the results of this rebasing exercise to ensure their targets remain equally challenging. They have supplied their

⁶ The NOMs incentive mechanism will adjust RIIO-2 allowed revenues (as necessary) to account for performance against delivery of NOMs monetised risk targets during the RIIO-1 price control period

⁷ <https://www.ofgem.gov.uk/publications-and-updates/decision-dno-common-network-asset-indices-methodology>

⁸ <https://www.ofgem.gov.uk/publications-and-updates/network-asset-secondary-deliverables-rebasing-consultation>

⁹ <https://www.ofgem.gov.uk/publications-and-updates/notice-intention-not-reject-modified-gas-distribution-network-output-measures-noms-methodology>

individual rebased data as part of the annual reporting cycle in 2017¹⁰. Currently discussion between Ofgem and GD Licensees is ongoing regarding the assessment of these data. The expectation is that this assessment process will be completed with agreed targets rebased in monetised risks by October 2018.

- *Electricity transmission* (ET) is working on further development of a common methodology for the sector¹¹. Once this development concludes, the sector will need to translate its current targets (specified in their licences as replacement priority profiles for individual asset categories) into network-specific monetised risk measures using the common methodology for the sector. The expectation is that this process will be completed by March 2019.
- *Gas transmission* (GT) is working on the development of a methodology for the sector. Once the methodology is in place, it will need to translate its current targets (specified in its license as replacement priority profiles) into a network-specific monetised risk measure. The expectation is that this process will be completed by February 2019.

Given that at the time of writing three of the four sectors do not yet have monetised risk targets agreed with Ofgem, there is uncertainty about the practical application of the methodology set out in this document to those sectors. Ofgem will undertake a review of the applicability of this methodology with each of these sectors once their monetised risk targets are finalised, and will subsequently consult on any resultant sector-specific amendments.

1.5.2 Use of a materiality threshold (deadband) around target performance

The ET, GT and GD licences make reference to the financial adjustments being made for a “material” deviation from targets. This methodology therefore specifies that upper and lower materiality thresholds should be used when assessing compliance with the overall network target.

The materiality thresholds will be applied to the different types of target that each network sector has (i.e. absolute or relative), and will be applied at the network level to facilitate monetised risk trading across asset categories/types of intervention. As a consequence, the materiality thresholds will apply to the total target, not to individual asset categories.

If a Licensee’s performance falls outside the thresholds, then the quantum under consideration in respect to the application of the NOMs incentive mechanism will be the deviation from the threshold level rather than the deviation from the target level. This is to avoid perverse behavioural incentives that could exist when Licensee performance is close to the extremities of a threshold. This approach is consistent with that developed for the DPCR5¹² close-out mechanism for ED.

Further detail on materiality thresholds and their magnitudes is given in the sector-specific section 4.1.

¹⁰ As required by Gas Distribution (GD) SpC 4H.13.

¹¹ <https://www.ofgem.gov.uk/publications-and-updates/further-instructions-electricity-transmission-licensees-modifications-their-network-output-measures-methodology>

¹² Distribution Price Control (DPCR) 5 was the price control that preceded RII0-ED1 for electricity distribution and covered the 2010-2015 period.

2 General principles for the NOMs incentive methodology

The proposed common governing principles for the NOMs incentive methodology are:

1. A licensee's asset management decisions should be in the interest of consumers.
2. A licensee should be appropriately incentivised to deliver the agreed NOMs risk target, including:
 - a. A reward when it justifies material over-delivery against agreed targets.
 - b. A penalty when it fails to justify material under-delivery against agreed targets.
3. A licensee should not be constrained to adhere to its initial RIIO-1 business plan, and should have discretion to revise its intervention plan to appropriately reflect most up-to-date information.
4. The assessment of companies' delivery shall be measured with reference to agreed rebased monetised risk targets.

These principles have been reflected in the process that is set out in the next chapter.

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3 The NOMs incentive assessment process

3.1 Background

The assessment process for the NOMs incentive follows the same common process across all four sectors. At a high level, it comprises:

- A submission by a Licensee indicating its performance against its delivery target and any supporting information
- A review of this submission by Ofgem.
 - (a) If Ofgem finds that the Licensee has met the delivery target within the defined materiality threshold (i.e. it is within the deadband), then there is no incentive adjustment and the assessment process terminates.
 - (b) If Ofgem determines that the Licensee has either materially over- or under-delivered against target (i.e. it sits outside the deadband), then it will consider to what extent the deviation is justified or unjustified. The incentive adjustment will be calculated accordingly.

A flow diagram for the process is shown below. The remainder of this document details the practicalities of how each stage should work and how it will result in a valuation of the RIIO-1 NOMs incentive mechanism for each of the Licensees.

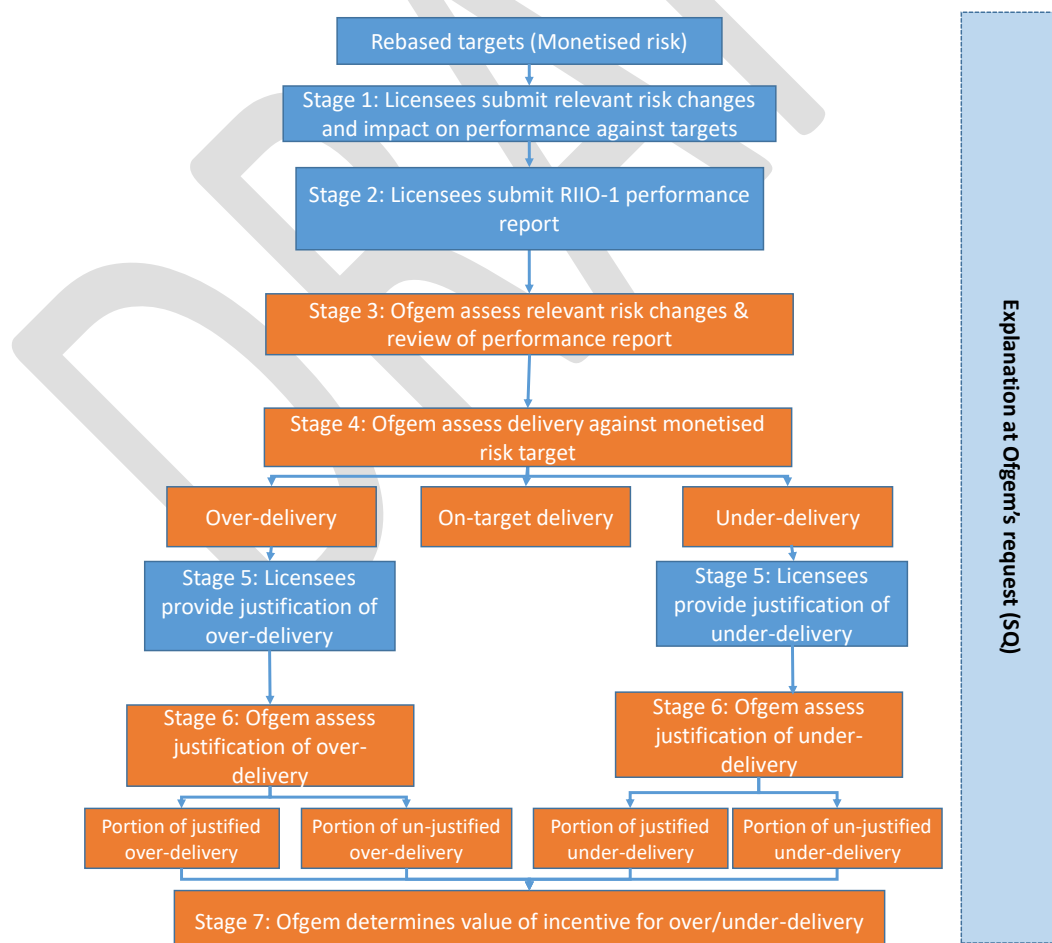


Figure 1: Process flow diagram for the NOMs incentive mechanism

In respect of all submissions as part this assessment process, Ofgem expects data assurance processes to be followed and is likely to perform checks to ensure that data integrity has not been affected during the reporting process and template formulae are working as expected.

3.2 Stage 1: Licensees submit relevant risk changes and impact on performance against targets

The original licence targets were set and quantified on the basis of the asset risk data available at that time and reflected only the expected impact of Licensees' asset intervention. Subsequently, there may be changes to data or other works outside NOMs-related asset intervention that would have impacted the quantitative value of risks¹³.

Relevant risk changes include non-intervention movements in risk value and can be positive or negative with respect to the current and/or forecast levels of asset risk. In addition, relevant risk changes include changes to risk caused by non NOMs-related interventions.

These relevant risk changes may lead to a Licensee altering its work plan. They could impact which NOMs-related interventions are carried out or affect delivery against an absolute or relative target.

The Licensee should submit notice to Ofgem of any such changes the Licensee considers are likely to impact on the nature of the work required to achieve its monetised risk target, along with evidence of how these risk changes have arisen. For non-intervention risk changes we would expect this to include material changes in items such as:

- Data cleansing
- Differences in asset risk data (as compared with assumptions in the rebased targets)
- Differences in asset degradation profiles (as compared with forecast degradation in the rebased targets)

Licensees are required to identify relevant risk changes through annual Regulatory Instructions and Guidance (RIGs) submissions, thereby enabling Ofgem to respond to the data ahead of the end of the price control period.

Ofgem will consider the impact of any such changes on the ability of the Licensee to deliver its targets as part of stage 3 and decide whether any adjustments are needed to the Licensee's NOMs performance. Where appropriate, it will also be part of the assessment of justification in stage 6 and the valuation of the over/under-delivery in stage 7.

Ofgem will give reasonable consideration to other related information or data when considering relevant risk changes, e.g. the use of system operator demand forecasts to support changes to asset criticality assessments.

¹³ Note that these changes to asset risk data are different to those that happen due to the application of relevant sector common methodologies which could lead to different views of risks and would be reflected during the process to rebase risk targets.

3.3 Stage 2: Licensees submit RIIO-1 performance report

The different licence conditions across the sectors require varying levels of information provision for the NOMs incentive mechanism. However, all sectors have the requirement to submit a performance report at the end of the price control period. The report should cover performance against targets and the impact of relevant risk changes; we would also expect the Licensee to provide a narrative to explain the rationale and justification for the actions it has taken during the RIIO-1 price control. In support of its performance, a Licensee may also provide additional analysis in order to demonstrate the benefit of the actions taken by the Licensee. The extent of additional material provided should be proportionate to the magnitude and complexity of changes implemented within the period. Further information could be provided at later stages, as necessary. Where a Licensee's performance is outside of the threshold levels, the report will inform Ofgem's assessment of delivery and justification (see Stage 6).

Appendix 1 sets out the requirements for the performance report; Licensees may augment these as they see fit.

3.4 Stage 3: Ofgem assess relevant risk changes & review of performance report

Ofgem will:

- (a) Review any relevant risk changes.
- (b) Review the performance reports.

Ofgem will engage with the Licensee through the Supplementary Question (SQ) process if there are ambiguities in the information provided or areas where further clarification is required. Where the SQs lead to a revised view of the impact of relevant risk changes or performance, this may result in the Licensee having to make resubmissions under stages 1 & 2. For example, if the outcome of Ofgem's questioning changes a Licensee's view of whether or not it has delivered on target, then it should have the opportunity to present further information to facilitate any subsequent process stages.

At this stage, Ofgem will adjust Licensee performance to strip out any non-intervention risk changes that were not explicitly identified as being at the Licensee's risk. Where such adjustments are not being made, non-intervention risk changes will be taken into account in the valuation of over/under-delivery at stage 7. The outcome from this stage should be a dataset that clearly identifies the Licensee's targets, the impact of relevant risk changes, and performance against targets to allow Ofgem to undertake a definitive assessment of the Licensee's delivery performance against its monetised risk target.

3.5 Stage 4: Ofgem assess delivery against monetised risk target

Once Ofgem, through Stage 3, has accepted any necessary resubmissions and made adjustments for non-intervention risk changes, a comparison will be made between the Licensee's performance and the monetised risk target. If the Licensee's performance on a network-wide basis is assessed as being within the thresholds around the target, then

Ofgem will conclude that the Licensee has achieved its NOMs target and there will be no NOMs incentive mechanism revenue adjustment.

If the Licensee's performance is outside of the materiality thresholds around the target, then the assessment will proceed to the next stage.

Stage 4 will be a definitive process, basing the assessment of delivery on the performance report supplemented by data submitted through the annual regulatory reporting process and in response to SQs. Where necessary, Ofgem may request licensees to provide supplementary data in an agreed template format.

3.6 Stage 5: Licensees provide justification of over/under-delivery

If the Licensee's performance is judged by Ofgem to sit outside a materiality threshold, then it must provide its rationale and evidence to justify why it is in consumers' interests to do so.

If a Licensee considers that it has materially over/under-delivered against its target and the justification details required under stage 5 are readily available at the time of submitting the performance report, they should provide this as part of the performance report supplied at Stage 2, but they will be given the opportunity to supplement the original submission with further justification once stage 4 is concluded.

The extent and nature of the justification and evidence is not prescribed. However, Ofgem expects licensees to justify the delivered level of NOMs compared to the NOMs targets, supported with an appropriate level of detail relating to where the material over/under delivery has occurred, namely:

- Rationale for the high-level strategic asset management decision to materially over/under-deliver including a high-level CBA/lifetime costing, where appropriate, to justify that this is an efficient outcome/delivers better value to consumers;
- Appropriate and proportionate supporting evidence and justification that explains the principal changes that have made up the material over/under-delivery including changes within asset categories, schemes or types of intervention.

Ofgem expects that Licensees would consider the following types of justification:

- Cost Benefit Analysis (CBA) on an intervention lifetime basis including relevant TOTEX changes and benefits as captured by the NOMs methodologies and relevant benefits beyond this;
- Changes driven by other requirements. E.g. HSE repex, ESQCR etc.;
- Qualitative information on type faults, obsolescence, major safety concerns etc.;
- and
- Ensuring work is carried out in a coordinated/efficient manner.

To ensure that CBAs are conducted in a consistent manner, Ofgem has included initial guidance on how key parameters should be treated in Appendix 2. This uses parts of the RIIO-ED1 CBA guidance¹⁴ that are relevant to this assessment process.

¹⁴ RIIO-ED1 CBA guidance note 17 Jan 2014

3.7 Stage 6: Ofgem assess justification of over/under-delivery

In the event that the Licensee is assessed as having over/under-delivered, Ofgem will conduct an assessment of the justification. The assessment can be either qualitative and/or quantitative. It will determine the proportion of any over/under-delivery outwith the threshold level that is deemed to be justified or unjustified. The form of the review will depend on the nature and extent of the evidence provided, but one of Ofgem's primary considerations will be the extent to which the Licensee is able to demonstrate that the over or under-delivery was in the interest of consumers.

(a) qualitative assessment

The qualitative assessment relates to the review of the licensee's narrative justification of its material over/under-delivery including both evidence at a network level and supporting explanation and justification of the principal changes that make up the over/under delivery. The assessment will include whether the work is shown to be equally or more beneficial than the original plan, and whether there are other factors that deliver benefits for consumers (current and future) that drive the differing delivery of NOMs. It will also consider consequential impacts that affect the opportunity to deliver the target performance.

(b) quantitative assessment

The quantitative assessment will be based on a combination of Ofgem-led analysis of data returns and review of data provided by Licensees as part of the justification.

As part of the qualitative and quantitative assessments of justification Ofgem will determine:

1. Whether the licensee has provided adequate cost-benefit analysis (CBA) or equivalent analysis which justifies that the delivery outcome was a better outcome for consumers than:
 - a) delivering the NOMs target; and
 - b) lower levels of over/under-delivery.

Ofgem will review and test the validity and internal consistency of any CBAs or equivalent analysis.

2. Whether the Licensee has provided appropriate supporting evidence and justification at a more disaggregated level that that explains the principal changes that have made up the material under/over delivery including changes in asset categories, schemes and types of intervention.
3. Whether the Licensee has provided alternative evidence supporting changes in delivery (such as new legislative requirements), where it is not possible to justify these based on CBAs or equivalent analysis.
4. Whether the Licensee has provided evidence that appropriate sense checks have been taken to ensure there is a balance between asset risks at an overall network level and risks that arise at a more disaggregated level such as within a particular asset class.
5. Taking points 1-4 into account how much of the material over/under-delivery is justified.

It should be noted that Ofgem may determine that only part of an over delivery is unjustified or that only part of an under-delivery is justified. In these cases, the valuation of the relevant incentive will be treated accordingly.

3.8 Stage 7: Ofgem determines value of incentive for over/under-delivery

In the event that Ofgem decides that a Licensee has materially over/under-delivered against their NOMs targets and the extent to which the over/under-delivery is justified or not, the Licensee's revenue will be subject to adjustment under the NOMs incentive mechanism.

The sectoral licence conditions specify the intent of how the incentive mechanism will reward or penalise Licensees depending on whether they have over/under-delivered, and whether this is deemed as justified or unjustified. The following graphic outlines the differing outcomes arising from these scenarios for GD, GT and ET:¹⁵

Incentives	Justified	Unjustified
Material over-delivery	<p>Cost of over-delivery shall be included in the second price control period allowances.</p> <p>The financing cost incurred by the licensee in advancing the investment shall be reimbursed</p> <p>Reward of 2.5 percent of the additional costs associated with the material over-delivery</p>	<p>Cost of over-delivery shall be included in the second price control period allowances</p> <p>The licensee shall incur the financing cost of earlier investment.</p>
Material Under-delivery	<p>Cost of under-delivery shall be excluded from the second price control period allowances</p> <p>The licensee shall benefit from the financing cost of delayed investment</p>	<p>Cost of under-delivery shall be excluded from the second price control period allowances</p> <p>The benefit arising to the licensee from the financing cost of delayed investment shall be clawed back.</p> <p>Penalty of 2.5 percent of the additional costs associated with the material under-delivery</p>

¹⁵The tables here are an outline of the mechanisms in the respective sector licences, but the licence text takes precedence where there are any differences.

The following table outlines the adjustments for ED (as specified in licence condition CRC 5D).

	Justified	Unjustified
Over-delivery	<p>The cost of that over-delivery will be provided for through the Licensee's revenue allowance for the Next Price Control Period;</p> <p>The Licensee will receive, by means of a positive adjustment of its revenue allowance for the Next Price Control Period, a reward of 2.5 per cent (post tax) of the incremental costs associated with the over-delivery</p> <p>In making any adjustments the Authority will make an adjustment equivalent to the cost of the over-delivery, less any proportion of that cost that has already been provided for via adjustments to revenue included in MOD_t</p>	No adjustment
Under-delivery	No adjustment	<p>The incremental cost of delivering to the Network Asset Secondary Deliverables will not be provided for in the Licensee's revenue allowance for the Next Price Control Period</p> <p>A negative adjustment of 2.5 per cent (post tax) of the avoided costs associated with the under-delivery will be made to the Licensee's revenue allowance for the Next Price Control Period</p> <p>In making any adjustments the Authority will make an adjustment to revenues in the Next Price Control Period to reverse any proportion of revenues included in MOD_t associated with outperformance of allowances included in Opening Base Revenues for the Network Asset Secondary Deliverables</p>

The incentive revenue adjustment comprises three elements:

1. The **associated costs** of the over/under delivery – to be provided/excluded from RIIO-2 allowance;
2. The **financing costs** of the associated costs of the over/under delivery – where 1 takes place there may be a related adjustment to compensate for the later/earlier timing of the allowances; and
3. A **reward or penalty** of 2.5% of the associated costs of the over/under delivery.

For all licensees, adjustments for justified over-deliveries and unjustified under-deliveries will include elements 1,2 and 3 above. However, adjustments for unjustified over-deliveries and justified under-deliveries for GD, ET and GD licensees will only include element 1. There will be no NOMs incentive adjustments for ED in the event of either unjustified over-delivery/justified under-delivery.

When considering the associated costs for justified over/under delivery, Ofgem will undertake the following two-stage process:

- a. 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;
- b. if the remaining delivered risk is outside of the threshold range, then:
 - i. The associated cost of over-delivery will be based on Ofgem's view of efficient costs for the over-delivery element. This may be different to allowed efficient costs used when RIIO-1 allowances were set ex-ante, and may be informed by an ex-post efficiency review. Such a review would use similar techniques to those used at the RIIO-1 price control reviews, for each of the sectors including but not limited to assessment of asset unit costs and scheme costs. These costs will be set at values that balance an updated view of efficient costs with maintaining (albeit at a reduced level) efficiency incentives for Licensees.
 - ii. The associated cost of under-delivery will be based on the RIIO-1 allowed efficient costs. Where under-delivery includes activities which were not assessed when setting the RIIO-1 price controls, the associated costs will be determined in line with the over-delivery process as described above.

In the case of a justified over-delivery or unjustified under-delivery, once the associated costs of over/under delivery of NOMs are valued, Ofgem will profile the total across the price control period using the following method:

1. Where the exact timing of specific over/under delivery of NOMs can be identified, in line with the actual timing of the expenditure/avoided expenditure; and
2. Where the exact timing cannot be identified, in line with the Licensee's NOMs-related expenditure profile.

These profiled adjustments will be added to the original NOMs-related capex allowances for the purpose of calculating the amount of revenue adjustment that will be required for RIIO-2. This will consider the revenues that have already been obtained during the RIIO-1 price control using the original allowances and the application of the totex mechanism and compare these against the revenue that would have been obtained had the additional costs of the over/under-delivery had been added/removed.

In the case of a unjustified over-delivery or justified under-delivery for GD, ET or GT it will also be necessary to make an assumption on the timing with which costs will be or would have been incurred in RIIO-2.

A stylised version of how the calculation would work in the ED sector for a range of scenarios is given in Appendix 2 - "Worked Examples" section of this methodology. It is anticipated that a similar exercises would be undertaken by the other sectors once they have gone through the rebasing process.

This approach will consider the revenues associated with fast pot money, slow pot money, including depreciation of the RAV and return on the RAV. It will also consider the impact on tax. Note that the valuation for the associated costs of the material over/under delivery of NOMs is independent of any associated totex incentive mechanism amounts arising from over/under spend against allowances. However, as indicated above, the impact on revenues has to consider the interaction with the totex incentive mechanism and other financial calculations such as tax calculations used to determine revenues.

Note that any adjustment of the revenue in RIIO-2 to achieve the intended effect of elements 1 and/or 2 above needs to take into account the operation of the totex incentive mechanism across both price controls to ensure that there is no double-counting of cost adjustments associated with over/under-deliveries. The calculation of such adjustments will either be carried out in the price control financial model (PCFM) or in a separate workbook accompanying the financial handbooks for each sector that ultimately feed into the PCFM.

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4 Interaction with other licence mechanisms

Price control output requirements and incentive mechanisms may interact with each other. For example, in the RIIO-GD1 control, there are Health and Safety Executive, repex requirements and NOMs incentives all applying to the gas mains replacement programme, so there is potential for interaction between obligations and associated incentives to cause unintended outcomes, for example, doubly rewarding or penalising Licensees.

Accordingly, if we determine that there are any such interactions (through either our own workings or those of a Licensee/third party), we reserve the right to make correcting adjustments such that the policy intent of the relevant Licence condition and final proposal/determinations is maintained. In particular, we note that a number of licence reopeners across all sectors have yet to be determined, and the outcome of these may affect the ability or necessity of Licensees to undertake NOMs-related interventions.

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5 Sector-specific issues

5.1 Materiality threshold

Ofgem has agreed in principle with the use of a threshold around the target performance. Because of the different stages of methodology development amongst the different sectors, the level at which it will apply may differ by sector.

(a) Electricity and Gas Distribution

We propose to use a +/-5% materiality threshold around the target, so that non-material variations around the target do not trigger a revenue adjustment. This typically results in a threshold of similar magnitude to the materiality threshold used in other reopeners. (For example, in ED the DNOs estimate that a 5% threshold for monetised risk equated to approximately 1% of allowed revenue).

(b) Electricity and Gas Transmission

Because the NOMs methodology for each of these sectors is still under development, it is not currently possible to evaluate the materiality of any proposed threshold. We also need to consider the magnitude of the threshold relative to the absolute network risk targets. The value of this element will be considered following their rebasing exercises.

DRAFT

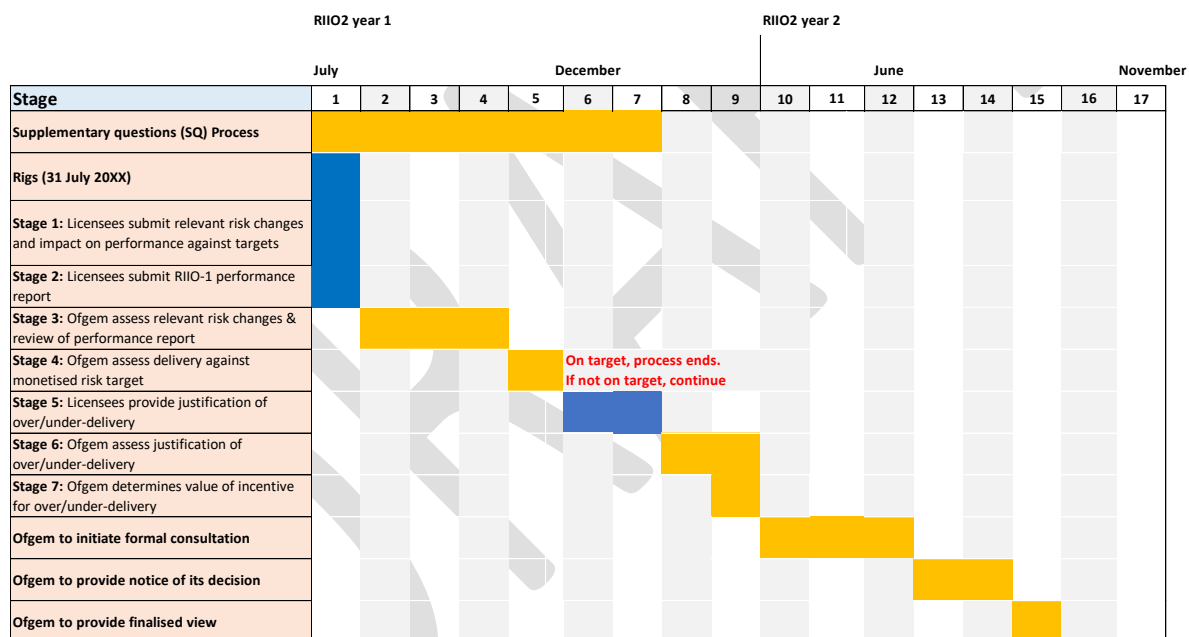
6 Timeline for evaluation exercise

All sectors' licence conditions require that performance reports are submitted at the end of July following the end of the RIIO-1 price controls. As a consequence, there is insufficient time to process the analysis and allow licensees to submit further justification to implement the results within the first year of the RIIO-2 price controls.

It is therefore proposed that the timeline for the implementation of the NOMs incentive mechanism will feed into the second year's Annual Iteration Process in the RIIO-2 price controls.

The following generic timeline sets out the proposed maximum durations for each of the process stages described in the main text of the methodology. Ofgem and Licensees will work to these, on a reasonable endeavours basis, to facilitate a resolution of incentive mechanism outcome in time for the second annual iteration process in RIIO-2.

Timeline - NOMs incentive mechanism process



Appendix 1 - Performance Report – further detail of requirement for each stage of licensees’ submission

Each licensee is required under their licence obligations to provide a performance report at the end of the RIIIO-1 price control. This report should cover off the requirements of stage 1 and stage 2 of the NOMs incentive methodology as set out in this document. If a Licensee considers that it has materially over/under-delivered against its target and the justification details required under stage 5 are readily available at the time of submitting the report, these must also be included. This appendix gives more detail as to the extent and type of information we expect to see in this report in relation to each of these three parts.

It is expected that the length and detail of the performance report and the quantity of data to support the performance report shall be proportionate to the magnitude of difference between actual delivery and targets.

Stage 1 - Relevant Risk Changes and Impact on Performance against Targets

The original licence targets were set and quantified on the basis of the asset risk data available at that time and reflected only the expected impact of licensees’ asset intervention. Subsequently, there may be changes to data or processes outside NOMs-related asset intervention that would have impacted the quantitative value of risks

Relevant risk changes relate to non-intervention risk changes subdivided into three categories:

- Data cleansing
- Differences in asset risk data (as compared with assumptions at target setting)
- Differences in asset degradation profiles (as compared with assumptions at target setting)

Ofgem will adjust Licensee performance to strip out any non-intervention risk changes that were not explicitly identified as being at the Licensee’s risk

It is therefore expected that where relevant risk changes have a material impact on the ability of a licensee to deliver its targets, the type of risk change is identified and its impact described.

For example degradation being higher than expected has different impacts depending on whether the licensee has an absolute or a relative target. For a licensee with an absolute target, higher degradation will lead to an overall higher network risk, which may not be possible to be addressed within the scope of the NOMs allowances, leading to an under-delivery. However higher degradation for a licensee with a relative target, means that there are more higher risk assets to address, potentially making it more appropriate for the licensee to carry out risk trading and address more of the asset type with the higher degradation.

Stage 2 - Performance against targets

The licensee should (where relevant) submit information that includes but is not be limited to:

- (i) a completed template setting out actual NOMs performance;
- (ii) a narrative describing the licensee's overall asset risk performance during RIIO-1, explaining whether the licensee has delivered its target of monetised network risk;
- (iii) a narrative explaining how trade-offs between different asset categories/schemes have impacted the overall asset risk performance;
- (iv) a narrative explaining how trade-offs between different types of intervention have impacted the overall asset risk performance (for example: how the licensee has traded off between asset replacement and refurbishment work);
- (v) a narrative of the specific schemes that have either not been delivered or have been delivered in addition to the original programme to show how they have impacted the overall asset risk performance; and
- (vi) a narrative of activities on other non-NOMs intervention activities (such as Legal and Safety in ED or HSE-driven gas mains replacement in GD) that have impacted the overall asset risk performance.

Stage 5 -Justification of over/under-delivery

Where available at the time of submitting the performance report, the licensee should provide (where relevant) the following:

- (i) if the licensee has under-delivered against the monetised risk target, the licensee should provide a justification of why this was appropriate;
- (ii) if the licensee has over delivered against the monetised risk target that was agreed at RIIO-1, the licensee should provide a justification of why this was appropriate.

This should incorporate:

- an explanation of the drivers of the licensee's interventions and the supporting rationale for those interventions undertaken during the RIIO-1 Price Control;
- Rationale for the high-level strategic asset management decisions to materially over/under-deliver;
- Appropriate and proportionate supporting evidence and justification that explains the principal changes that have made up the material over/under-delivery including changes within asset categories, schemes or types of intervention.

Ofgem expects that the justification would be supported by the following types of data:

- Cost Benefit Analysis (CBA) on an intervention lifetime basis including relevant TOTEX changes and benefits as captured by the NOMs methodologies and relevant benefits beyond this;
- Changes driven by other requirements, e.g. HSE repex, ESQCR etc;
- Qualitative information on type faults, obsolescence, major safety concerns etc; and,
- Evidence that the work was carried out in a coordinated/efficient manner.

Appendix 2 – Worked Examples

The following examples demonstrate how associated costs for over- /under-delivery could be valued for the purposes of the NOMs incentive. These are based on an example where an ED Licensee has a target to deliver a 10m risk point reduction. The following pages show details of how the calculations are set out.

In this example, we have used risk points as a proxy for monetised risk to simplify the explanation, avoiding confusion between monetised risk and the cost of over/under-delivery.

In the first example, the Licensee delivers a 12m risk point reduction (a 2m excess over the 10m target), at a total cost of £200m. The amount spent is the same as allowed values, so the delivery represents a more efficient £16.7 per risk point compared to the allowed £20 per risk point. The Ofgem assessment considers that 500k of the excess delivery was unjustified, but the remainder is justified and so the amount above the materiality threshold will attract an incentive payment. The materiality threshold is 5% of 10m (i.e. 500k). The amount attracting the incentive payment is (delivered value above target – unjustified quantity – materiality threshold), which equates to $(2m - 500k - 500k) = 1m$. This will be rewarded at the lower of the delivered £16.7 per risk point (where this is deemed to be an ex-post efficient value) or the allowed £20 per risk point. Valuing 1m extra points at the £16.7 per risk point rate means that the Licensee would be deemed to have merited a notional additional £16.7m in allowances at the start of the control period. This additional amount would be input to the Price Control Financial Model (PCFM), profiled across the RIIO-1 period in line with actual spend, to derive a revenue and Regulatory Asset Value adjustment that would apply to RIIO-2 allowances. The example also shows the calculation of the 2.5% reward in respect of the associated cost of delivery.

In the second example, the Licensee under-delivers against its target by 2m points. The Ofgem assessment considers that 600k of this under-delivery is justified, but the remainder is unjustified so the amount outside the lower materiality threshold attracts a penalty payment. This amount is (under-delivery – justified quantity – materiality threshold), which equates to $(2m - 600k - 500k) = 900k$. This will be penalised at the allowed £20 per risk point. Valuing 900k points at the allowed £20 per risk point rate means that the Licensee would be deemed to have a deduction of £18m from its RIIO-1 allowance. Again, this additional amount would be input to the Price Control Financial Model (PCFM), profiled across the RIIO-1 period in line with actual spend, to derive a revenue and regulated asset value adjustment that would apply to RIIO-2 allowances. The example also shows the calculation of the 2.5% penalty in respect of the associated cost of delivery.

OVER-DELIVERY							Select Sector	ED
							Select Model	Over/(Under)-delivery
<i>All financial values are £m unless otherwise stated</i>								
NOMS OVER/UNDER DELIVERY VALUATION								
			Valuation Rate	NOMs Adjustment Value	Reward/ Penalty Value			
NOMs Target (Relative Delta)	10,000,000							
Materiality Threshold (%age)	5%							
Materiality Threshold (+/- risk points)	500,000							
Delivered Risk Points (as per stage 4)	12,000,000							
Justified over delivery (as per stage 6)	1,000,000							
Justified under delivery (as per stage 6)								
Unjustified risks points above upper materiality threshold	500,000		-	-	0%	-		
Justified risks points above upper materiality threshold	1,000,000		16.7	16.7	2.5%	0.4		
Risk points above target but within upper materiality threshold	500,000		-	-	0%	-		
Risk points below target but within lower materiality threshold	-		-	-	0%	-		
Unjustified Risk points below lower materiality threshold	-		20.0	-	2.5%	-		
Justified Risk points below lower materiality threshold	-		-	-	0%	-		
			Total	16.7		0.4		
							Derivation of Incentive Rates (£/risk point)	
							<i>Over Delivery (based upon incurred costs)</i>	
							Total Actual Expenditure	200
							Total Risk Points Delivered	12,000,000
							Incentive rate	16.7
							<i>Under Delivery (based upon allowed costs)</i>	
							Total Allowed Expenditure	200
							Total Risk Points Target	10,000,000
							Incentive rate	20.0

UNDER-DELIVERY						Select Sector	ED
						Select Model	Over/(Under)-delivery
<i>All financial values are £m unless otherwise stated</i>							
NOMS OVER/UNDER DELIVERY VALUATION							
			Valuation Rate	NOMS Adjustment Value	Reward/ Penalty Value		
NOMs Target (Relative Delta)	10,000,000						
Materiality Threshold (%age)	5%						
Materiality Threshold (+/- risk points)	500,000						
Delivered Risk Points (as per stage 4)	8,000,000						
Justified over delivery (as per stage 6)							
Justified under delivery (as per stage 6)	600,000						
Unjustified risks points above upper materiality threshold	-		-	-	0%	-	
Justified risks points above upper materiality threshold	-		20.0	-	2.5%	-	
Risk points above target but within upper materiality threshold	-		-	-	0%	-	
Risk points below target but within lower materiality threshold	(500,000)		-	-	0%	-	
Unjustified Risk points below lower materiality threshold	(900,000)		20.0	(18.0)	2.5%	(0.5)	
Justified Risk points below lower materiality threshold	(600,000)		-	-	0%	-	
			Total	(18.0)		(0.5)	
						Derivation of Incentive Rates (£/risk point)	
						<i>Over Delivery (based upon incurred costs)</i>	
						Total Actual Expenditure	200
						Total Risk Points Delivered	8,000,000
						Incentive rate	20.0
						<i>Under Delivery (based upon allowed costs)</i>	
						Total Allowed Expenditure	200
						Total Risk Points Target	10,000,000
						Incentive rate	20.0

Appendix 3 - Summary of key parameters for cost-benefit analysis submissions

This guidance is only for the purposes of justifying material over/under-delivery in the NOMs and therefore draws on parts of the RIIO-ED1 CBA guidance that are relevant in this context.

Ofgem expects Licensees to use CBAs or similar methodologies in most cases as decision-support tools for the wider justification of material over/under delivery. Their use should be proportionate to the level of over/under delivery requiring explanation.

Ofgem would expect the analysis to be at one or more of the following levels:

- Network level
- Asset category/class
- Project level

We have included guidance on key aspects to be considered in any such submissions.

Identification of options

Consistent with the HM Treasury Green Book¹⁶, Licensees should clearly identify the range of options that were considered to meet the stated aim.

The counterfactual should be based on the target outputs with variations to demonstrate that the Licensee's actual delivery position is appropriate.

Costs and benefits

The financial costs and benefits should be in the price base used in RIIO-1 licences (e.g. in ED this is 2012/13 prices). Costs and benefits to be considered in the analysis are those that would occur over and above or below the counterfactual. These additional or reduced costs and benefits represent the marginal or incremental costs or benefits of the option being considered.

Ofgem would expect the quantitative analysis to take account of all relevant costs and benefits associated with the NOMs and, where appropriate, relevant benefits beyond this (for example, wider network benefits). It should be well evidenced with explanations supporting any assumptions and clear linkages to relevant RIGs or NOMs reporting tables. The underlying sources of cost information used should transparent, where possible cross-referring to the annual RIGs reporting tables. Benefits should be quantified consistently with the sector NOMs methodologies.

Licensees should classify all negative impacts of an option as costs and all positive impacts as benefits. The financial costs and benefits should correspond to the view, at the time of the costs and benefits of the interventions in future years.

¹⁶

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220541/green_book_complete.pdf

Licensees should also include additional costs for asset interventions which may need to occur during the assumed lifespan of the main intervention.

Applying the Spackman approach to network investment

The Joint Regulators group (the predecessor of the UKRN) carried out joint work on best practice for carrying out CBAs in a regulated context involving private investment but public benefit. This resulted in the recommendation of the Spackman approach to discounting which was adopted as part of the RIIO-GD1 and RIIO-ED1 price control review CBA guidance.

The Spackman approach involves the following two-step approach¹⁷:

- Convert capital costs into annual costs using the company's cost of capital (use a pre-tax weighted average cost of capital (WACC)). This gives a stream of financing costs which are used as part of the of the cost side of the cost-benefit analysis.
- Use the social time preference rate (STPR) of 3.5% to discount all costs and benefits¹⁸, except safety where the pure time preference rate (PTRP)¹⁹ of 1.5% should be used.

Costs and benefits should be extended to cover the period, from the start of investment, which represents the useful economic lives of the interventions and is consistent with asset life assumptions. Licensees should also set out any non-marketed impacts or factors that cannot be monetised within the wider investment appraisal.

Uncertainty and sensitivity analysis

We expect Licensees to undertake sensitivity analysis consistent with the HM Treasury Green Book guidance²⁰. Appropriate variations around actual delivery should be included in the CBA analysis to demonstrate that the Licensee's actual delivery position is appropriate.

Links to RIGs

Licensees should clearly show the links between their CBAs and their RIGs tables. For example, the Licensees should show how the workload and cost reductions underpinning a CBA relate to the data reported in its RIGs tables.

¹⁷ <https://www.ofgem.gov.uk/sites/default/files/docs/2011/10/discounting-for-cost-benefit-analysis-involving-private-investment-but-public-benefit.pdf>,
https://www.ofcom.org.uk/__data/assets/pdf_file/0029/37856/jrg_statement.pdf

¹⁸ Social time preference rate (STPR) of 3.5% to discount all costs and benefits

¹⁹ http://orr.gov.uk/__data/assets/pdf_file/0003/3828/cnsltrep-NERA_disc_rates.pdf

²⁰ <https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-government>