Consultation

Threshold for justifying Clearly Identifiable Over or Under Delivery under the NARM Funding Adjustment and Penalty Mechanism

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We are consulting on our proposed upper and lower threshold values for the Unit Cost of Risk (UCR) in determining whether a delivery element qualifies as a Clearly Identifiable Over or Under Delivery under the Network Asset Risk Metric (NARM) Funding Adjustment and Penalty Mechanism. We are also consulting on a small number of other proposed amendments to the NARM Handbook, which describes the methodology for the NARM Funding Adjustment and Penalty Mechanism. We would like views from licensees and network customers, particularly those with an interest in NARM. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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1. Introduction

Background

1.1 Gas and electricity network companies are required to provide safe, secure, reliable and efficient energy network services. They are funded to carry out activities such as the replacement or refurbishment of assets in order to ensure that the risks to consumers associated with network failure are maintained within reasonable bounds. We developed the NARM framework to allow us to quantify the benefit to consumers of these asset management activities.

1.2 Each company maintains NARM Methodology which details how they calculate Monetised Risk on their network. Monetised Risk is generally determined through multiplication of the probability of asset failure by the monetised value of the consequences of the failure (e.g. the value of interruption to supply, or cost of damage to the environment, etc.). Monetised Risk is the primary measure for defining the outputs and setting allowances associated with asset management activities.

1.3 The network companies' RIIO-2 business plans contained a range of proposed investments, some of which deliver Monetised Risk benefits (mainly replacement and refurbishment of existing network assets), and others that do not deliver a Monetised Risk benefit (such as installation of new network assets, or investment in non-network assets, or network assets not covered by the NARM Methodology).

What are we consulting on

1.4 We used a range of techniques, including econometric and engineering assessments, in determining which investments should be funded during RIIO-2 (through baseline funding), which investments should be subject to uncertainty mechanisms (such as volume drivers), and which investments should be disallowed completely.

1.5 The mechanism by which network companies are held to account for their Baseline Network Risk Outputs (BNRO) delivery during RIIO-2 is known as the NARM Funding Adjustment and Penalty Mechanism. Under this mechanism, some financial adjustments and penalties are applied automatically depending on the network company's delivery versus their BNRO and the extent to which any over-delivery or under-delivery is deemed to be justified.

1.6 Our decision on how the NARM Funding Adjustment and Penalty Mechanism should be applied is set out in our RIIO-2 Final Determination NARM ANNEX[1]. We explained that companies will be expected to justify deviation in delivery from their output targets. However, we also introduced a deadband around the BNRO within which justification will not be required and we set out the size of the deadband for each of the sectors: ±2% for ET[2] and ±5% for GT and GD.

1.7 Separately, we introduced an additional element to the NARM Funding Adjustment and Penalty Mechanism for cases where an over-delivery and/or an under-delivery is driven by a clearly identifiable projects or schemes i.e. Clearly Identifiable Over or Under Delivery (CIO/UD). These cases being projects/schemes where costs would not be reflective of outputs.

1.8 The NARM handbook sets the guidance and qualifying criteria for CIO/UD; however, there are elements of the CIO/UD guidance which were not fully developed, owing to the need for us to conduct further assessments.

1.9 We have conducted this further assessment and are proposing amendments to the CIO/UD guidance provided in the NARM Handbook. Section 3 of this consultation details the rationale and analysis behind our proposed amendments.

1.10 The RIIO-2 Final Determinations NARM Annex[3] and NARM Handbook[4] are the key publications related to this consultation.

1.11 This consultation seeks views on proposed thresholds and their appropriateness in enabling the CIO/UD element of the NARM Funding Adjustment and Penalty Mechanism to effectively mitigate against the risk of non-cost reflective losses and gains.

1.12 This consultation also sets out a small number of other proposed changes to the NARM Handbook and the rationales behind these additional suggested amendments.

[1] RIIO-2 Final Determinations NARM Annex (REVISED (ofgem.gov.uk)
[2] The lower deadband for ET reflects the relatively higher cost of the individual investments
[3] Ibid
[4] Decision on the proposed modifications to the RIIO-2 Transmission, Gas Distribution and Electricity System Operator licence conditions - 1 April 2022 | Ofgem: NARM Documents 030222, NARM_Handbook_v3.1.pdf

2. Background

Overview of NARM framework and funding mechanisms

2.1 NARM is a central part of the engineering assessment, contributing to articulating consumer benefit within cost benefit analysis (CBAs). NARM allows for different asset intervention options to be assessed on a comparative basis. and allows for assessment of outputs, stating them upfront and monitoring progression throughout the price control

2.2 Network licence conditions tie allowed funding through NARM to the delivery of a certain amount of network risk output (the BNRO). To the extent that network companies under- or over-deliver against this BNRO over the price control period, funding adjustments and penalties can be applied at close out. The NARM Handbook specifies the methodologies by which such funding adjustments and penalties are applied.

NARM Funding Adjustment and Penalty Mechanism

2.3 The NARM Funding Adjustment and Penalty Mechanism is principally designed to work by anchoring ex-post funding adjustments to pre-determined ratios between funding (£m) and the network risk output this funding is expected to deliver (R£m). This is what we will refer to in this document as the '*automatic'* funding adjustment mechanism.

2.4 Elements of over- and under-delivery on network risk output that qualify as 'clearly identifiable' are intended to be separated out of this 'automatic' adjustment mechanism, with appropriate funding adjustments for these delivery elements then applied on a case-by-case basis.

2.5 In effect, there are two channels to determining the final allowed NARM expenditure for a licensee at close out:

- the 'automatic' funding adjustment mechanism which uses the baseline ratio between allowed funding and network risk output to adjust funding in cases where the delivered network risk output deviates from baseline; and
- the 'clearly identifiable' mechanism which enables bespoke funding adjustments for qualifying over- or under-delivery elements.

2.6 Figure 1 depicts these two components of the funding mechanism. It also shows how the justification process and penalty determination fit into the wider NARM Funding Adjustment and Penalty Mechanism.

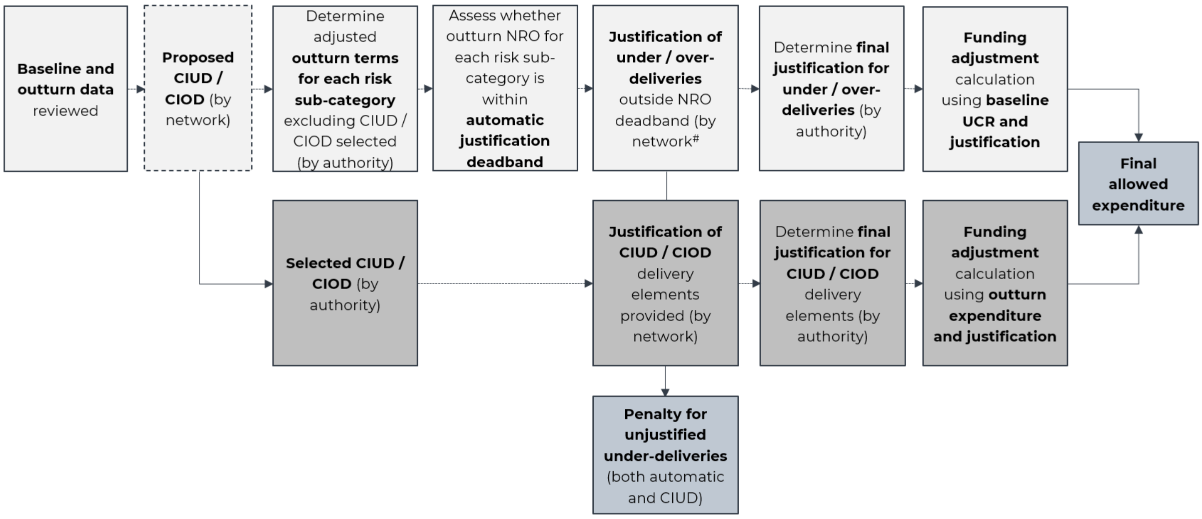

Figure 1: process to determine final allowed expenditure for each network

Unit Cost of Risk (UCR)

2.7 The relationship between funding and risk output is formalised as the Unit Cost of Risk (UCR), defined as the average funding per unit of network risk output delivered (£/R£). This UCR is applied at aggregate levels, rather than on a project-by-project basis, with the specific application for each sector as follows:

- For Electricity Transmission, a unique UCR is defined for each of seven different asset sub-categories.
- For Gas Transmission, a unique UCR is defined for each of three different risk levels (low, medium and high).
- For Gas Distribution, a single UCR is defined for each licensee as a whole

2.8 While there are these differences by sector, going forward we use the phrase 'risk sub-category' to refer to all such scenarios for simplicity.

2.9 For all sectors, the UCR forms the basis for adjusting funding allowances in line with deviations in the delivered network risk output from baseline expectations. As such, UCRs are critical in determining the final funding allowances that licensees receive.

2.10 The application of UCR in the funding adjustment process avoids the need for ex-post project-by-project assessment across all NARM investments.

2.11 However, our assessments have identified that there are certain cases where use of the UCR can result in a problematic basis for an automatic funding adjustment mechanism, and a separate bespoke adjustment should be considered that is more reflective of the project-specific risk outputs and costs. It is in these cases that the 'clearly identifiable' mechanism is applied.

Clearly identifiable over-delivery and under-delivery

2.12 The NARM Handbook states that for projects/schemes/programmes of work which are clearly identifiable as driving an over-delivery or under-delivery, these initiatives will be normalised out of the delivered output and cost out-turn and a separate adjustment will be made to the final NARM allowance. For these projects, the final allowed expenditure for these delivery elements will not be based on the underlying UCR for the risk sub-category in question, but rather a bespoke assessment of the cost and risk output characteristics of that specific project.

2.13 The qualifying criteria for clearly identifiable under and over-delivery elements are specified in Section 10 of the NARM Handbook and replicated below.

Qualifying criteria for clearly identifiable over-delivery or under-delivery

10.5 To qualify as Clearly Identifiable Over-Delivery, an Over Delivery element must meet the following criteria:

1. *Outputs and costs must both be quantifiable and separable from the overall delivery (e.g. a specific project);*
2. *The Over-Delivery element must not have been specified within the licensee's RIIO-2 Business Plan, or if specified, must have been specifically excluded from BNRO at Final Determinations as reflected in the NARM Workbook (NARW);*
3. *The Over-Delivery element must not be specified in NARM Funding Category A3; and*
4. *The Over-Delivery element must have an outturn UCR greater than a specified upper-threshold, or less than a specified lower-threshold value (see paragraph 10.9 for further detail on these values).*

10.7 In order to qualify as Clearly Identifiable Under-Delivery, an Under-Delivery element must meet the following criteria:

1. *Outputs and costs must both be quantifiable and separable from the overall Under-Delivery (e.g. a specific project);*
2. *The Under-Delivery element must be included in the licensee's BNRO and individually specified in its NARM Workbook (NARW);*

3. *The Under-Delivery element must not be specified in NARM Funding Category A2 or A3; and*
4. *The Under-Delivery element must have a UCR greater than a specified upper-threshold, or less than a specified lower-threshold value (see paragraph 10.9 for further detail on these values).*

2.14 In each case, the fourth criteria states that in order to qualify the over- or under-delivery element must have a UCR greater than a specified upper-threshold and less than a specified lower-threshold.

2.15 The setting of this UCR threshold is important insofar as it impacts which NARM projects can be processed through the 'automatic' funding adjustment mechanism, and which cannot (and must instead be treated as 'clearly identifiable'). In doing so, the choice of UCR threshold for 'clearly identifiable' determination will ultimately impact licensees' final allowed expenditures calculated at close out.

2.16 When published in February 2022, the NARM Handbook stated that we would undertake further analysis before consulting on the appropriate level of the upper and lower threshold values.

2.17 We have completed this further assessment and we are issuing this consultation on the proposed amendments to the clearly identifiable guidance provided in the NARM Handbook. The next section focuses specifically on the appropriate UCR threshold values, and the analysis and judgement underpinning that position. The section after that (Section 4) focuses on other associated updates and clarifications to the NARM Handbook that were identified in the process of reviewing the 'clearly identifiable' mechanism. This consultation seeks feedback on both sets of proposed changes.

3. Establishing an appropriate UCR threshold for clearly identifiable over-deliveries and under-deliveries

3.1 An appropriate UCR threshold for CIO/UD has included a broader assessment of the effectiveness of the NARM Funding Adjustment and Penalty Mechanism. In particular, we have considered whether the 'automatic' funding adjustment mechanism in its own right adjusts funding allowances appropriately in light of changes in delivered risk output. We have considered, in this context, whether the mechanism adjusts allowed expenditures closely in line with efficient additionally incurred or foregone costs relative to baseline.[5]

The role of Unit Cost of Risk in 'automatic' funding adjustments

3.2 In our assessment, we considered the effectiveness of the NARM Funding Adjustment and Penalty Mechanism and the suitability of the UCR (unit cost of risk) as a tool for adjusting allowed expenditures in proportion to changes in delivered network risk output.

3.3 As explained in the previous section, the UCR defines a fixed relationship between pounds spent and pounds of risk benefit delivered (£/R£) at a risk sub-category level and then acts as an 'anchor' around which automatic funding adjustments are calculated.[6] For example, if the baseline UCR for a particular risk sub-category is 0.5£/R£, and there was a network risk output under-delivery relative to baseline of R£10m, the 'automatic' funding adjustment mechanism would reduce allowed expenditure for this risk sub-category by £5m (i.e., 0.5£/R£ * R£10m).

Investigating the relationship between funding and risk output

3.4 We considered the nature of the relationship between funding (£s) and risk benefit delivered (R£s) at an overall risk sub-category level, and whether it closely reflects the relationship between funding and risk benefit delivered for individual projects and delivery elements within that risk sub-category. This assessment resulted in the following questions:

- Whether the UCR of a given risk sub-category is closely aligned with UCRs of individual projects and delivery elements within that risk sub-category?

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[5] For the avoidance of doubt, the use of the term 'efficient' is not referring to a mechanism which would adjust expenditure allowances in light of genuine efficiency gains by the licensee. Rather we are referring to a mechanism that adjusts allowed expenditures in line with the physical realities of the work undertaken and the costs this imposes (irrespective of any efficiency gains).

[6] We note for completeness at this stage that, with all Delivery Adjustment Factors set to zero in RIIO-2, it is the *baseline* UCR for each risk sub-category that forms the 'anchor' point for all 'automatic' funding adjustments in RIIO-2.

- Whether there is a consistent relationship (i.e., a strong correlation) between funding and risk output within a given risk sub-category?

3.5 In considering these questions, we analysed NARM data submitted in licensees' RIIO-2 Business Plans and in the latest Regulatory Reporting Packs (RRPs). We found there to be generally poor correlations between baseline network risk output and baseline funding within individual risk sub-categories. The data supports this across all sectors – i.e., ET, GT and GD.

3.6 Evidence of a poor correlation between funding and network risk output suggests that, for a given risk sub-category, the amount of money committed to a project is not a good indicator of the network risk output that project expects to deliver. By consequence, the UCRs of individual projects are not well aligned with the baseline UCR of the overall risk sub-category. This concern was raised by Electricity Transmission Owners (ETOs), and our analysis has found this to be a consistent issue across all sectors (ET, GT and GD).

Implications for 'automatic' funding adjustment

3.7 We consider that the lack of correlation between baseline funding and network risk output evident in RIIO-2 NARM submissions to be problematic from a funding adjustment perspective. This is because 'automatic' funding adjustments are anchored to the single baseline UCR of the overall risk sub-category. This evidence of a poor correlation means that funding adjustments through the 'automatic' mechanism are unlikely in most instances to be cost-reflective in nature.

3.8 The impact on final allowed expenditure relative to actual incurred outturn expenditure will depend on the project specific UCR relative to the baseline UCR for the overall risk sub-category:

- Where the project specific UCR (£/R£) is greater than the baseline UCR, an over-delivery (under-delivery) would see final allowed expenditure fall below (exceed) actual incurred expenditure through the 'automatic' adjustment mechanism.
- Where the project specific UCR (£/R£) is less than the baseline UCR, an over-delivery (under-delivery) would see final allowed expenditure exceed (fall below) actual incurred expenditure through the 'automatic' adjustment mechanism

3.9 The lack of correlation between funding and risk output will in these ways see final allowed expenditure deviate from efficiently incurred outturn expenditure.

It also creates incentives that favour the over-delivery of certain projects (those with a project specific UCR less than the risk sub-category baseline UCR), and the under-delivery of others (those with a project specific UCR greater than the risk sub-category baseline UCR).

3.10 This is because the rewards in terms of final allowed expenditure would exceed the additionally incurred costs. By the same logic, there is a risk that licensees may be dissuaded from over-delivery of other projects, even if that over-delivery is considered necessary and of net benefit to network customers.

3.11 We do not consider it possible to predict ex-ante the accuracy of the final allowed expenditure, nor to assume that the over- and under-adjustments are likely to approximately balance out.

3.12 Use of 2023 RRP data where available, which provides licensees' latest expectations of project cost and network risk output outturns for RIIO-2, has confirmed this issue. By applying the full NARM Funding Adjustment and Penalty Mechanism methodology set out in the NARM Handbook, latest evidence from RRP data clearly illustrates the potential for deviations between final allowed expenditure and efficiently incurred outturn expenditure, if relying solely on the 'automatic' funding adjustment mechanism.

3.13 We consider that this evidence base presents a strong rationale for utilising the 'clearly identifiable' mechanism. It can be used to help limit deviations between allowed expenditure and efficiently incurred outturn expenditure that can arise through the 'automatic' funding adjustment mechanism. Setting an appropriate threshold for this mechanism is the issue to which we next turn.

Setting a UCR threshold for clearly identifiable under- and over-deliveries

3.14 The evidence presented above has persuaded us that predominant reliance on the 'automatic' funding adjustment mechanism will likely be problematic. The 'Clearly Identifiable' mechanism has an important role to play in ensuring final allowed expenditures are more closely aligned with efficiently incurred costs.

3.15 We set out previously the criteria that must be met for an over- or under-delivery element to qualify as 'clearly identifiable'. The fourth criteria – i.e., that the over- or under-delivery element must have an outturn UCR greater than a specified upper-threshold, or less than a specified lower-threshold value – remains undefined. This UCR threshold must be specified in order to provide clarity as to which projects will be considered through the 'clearly identifiable' mechanism.

3.16 Based on the evidence available to date, we propose to set the UCR threshold at +/-5% of the baseline UCR of the given risk sub-category. This means that, in order to meet the fourth criteria for clearly identifiable, the over- or under-delivery element in question would need to have a UCR more than 5% above the baseline UCR of the risk sub-category, or less than 5% below the baseline UCR of the risk sub-category. The reasons for this position are set out below.

3.17 The evidence has shown poor correlations between funding and network risk output, which limits the effectiveness of the 'automatic' funding adjustment mechanism. This is a problem observed consistently across all sectors – ET, GT and GD.

3.18 A further critical observation from our analysis is that there is a poor correlation between: (i) project specific UCR relative to baseline risk sub-category UCR; and (ii) final allowed expenditure and efficiently incurred outturn expenditure if managed through the 'automatic' funding adjustment mechanism.

3.19 The key reason for this poor correlation is that projects and associated under- and over-delivery elements can also vary significantly in terms of their network risk output, and it is this coupled with variations in UCR, that ultimately determine the funding impact. This means that:

- An over- or under-delivery element with a large difference in UCR, relative to the risk sub-category baseline, can result in a small deviation between final allowed expenditure and efficiently incurred outturn expenditure if the network risk output associated with this over- or under-delivery element is sufficiently small.
- An over- or under-delivery element with a small difference in UCR, relative to the risk sub-category baseline, can result in a large deviation between final allowed expenditure and efficiently incurred outturn expenditure if the network risk output associated with this over- or under-delivery element is sufficiently large.

3.20 The implication is that, if the UCR threshold for 'clearly identifiable' is set higher, there is a risk that under- or over-delivery elements with small UCR deviations but large network risk outputs may be excluded from consideration through the 'clearly identifiable' mechanism. Our analysis of available 2023 RRP data has verified this concern, demonstrating that even small differences in UCR can result in large deviations between final allowed expenditure and efficiently incurred outturn expenditure through the automatic adjustment mechanism, if the over- or under-delivery element is sufficiently large in terms of its network risk output.

3.21 This evidence justifies the use of a lower UCR threshold for 'clearly identifiable' qualification, in order to manage the risk of non-cost-reflective funding allowances (either positive or negative). A UCR threshold of +/-5% is considered a suitable threshold to manage this risk within acceptable bounds, on the basis of current evidence available. Moreover, we consider a symmetrical target appropriate to limit the risks consistently in each direction.

3.22 We recognise that a lower UCR threshold to qualify as a 'clearly identifiable' under- or over-delivery element will increase the number of projects that can qualify, and ultimately place a greater emphasis on close-out. In doing so, this will reduce reliance on the 'automatic' funding mechanism. However, we consider this approach to be necessary on the balance of evidence available. A higher threshold would increase the risk of non-cost-reflective expenditure allowances, either to the detriment of licensees or end customers. These would be arbitrary reallocations, fundamentally reflective of the poor correlation between funding and risk output, rather than specific cost and risk characteristics of the projects in question.

3.23 Under this approach, we acknowledge that more NARM projects will meet the four criteria for a clearly identifiable over- or under-delivery. Therefore, rather than requiring that all such projects *must* go through the clearly identifiable mechanism, we propose to take a pragmatic approach in determining which projects that meet the four criteria should be managed through the clearly identifiable mechanism to appropriately manage the risk of non-cost-reflective expenditure allowances. Paragraph 4.4 in the next section sets out our proposed amendments to the NARM Handbook to achieve this.

Question 1: Do you agree with our approach to assessing a suitable UCR threshold for determining clearly identifiable over and under-deliveries?

Question 2: Do you agree with our proposed UCR threshold for determining clearly identifiable over and under-deliveries?

4. Additional considered amendments to the NARM Handbook

4.1 In reaching a position on the appropriate UCR threshold for clearly identifiable over-deliveries and under-deliveries, we have considered whether other amendments to the NARM Handbook are also necessary. In doing so, we have reflected on the views shared by licensees and our own internal review of the NARM Handbook as currently written.

4.2 We set out each considered amendment in turn, describing the issue and setting out whether we propose any associated amendments to the NARM Handbook. A marked-up version of the NARM Handbook incorporating these changes has been published alongside this consultation document.

Selection of projects for clearly identifiable mechanism

4.3 As set out in Table 5 of the NARM Handbook (page 43), the Authority will make a determination of the Network Risk Outputs and efficient additionally incurred costs or unspent allowances associated with projects which meet the specified criteria for Clearly Identifiable Over-Delivery or Clearly Identifiable Under-Delivery. To do this, we will require data on outturn Network Risk Output and costs on a project-by-project basis at close-out. This will allow us to reach our own determination on which projects should be processed through the ‘clearly identifiable’ mechanism.

4.4 For the avoidance of doubt, NARM projects for consideration through the ‘clearly identifiable’ mechanism will not be limited to those initially put forward by each licensee in its NARM Closeout Report. As explained in Paragraph 3.23 of this consultation document, the choice of ‘clearly identifiable’ projects can have a critical bearing on final allowed expenditures. For this reason, the final decision on which projects are processed through the ‘clearly identifiable’ mechanism will be made by the Authority on reviewing the full set of NARM projects (and applying the qualifying criteria set out previously).

4.5 The current reporting requirements for licensees (as set out in Chapter 7, Section D of the NARM Handbook, pages 26-27) are problematic in this respect, as they only require licensees to report data on Network Risk Output and costs on a risk sub-category basis.

4.6 **Proposal:** We are proposing to update the reporting requirements to specify that licensees will be required to report Network Risk Output and costs on a project-by-project basis in the NARM Closeout Report. This is crucial in enabling us to review all projects and determining which should be processed through the 'clearly identifiable' mechanism.

Clarification to qualifying criteria for clearly identifiable mechanism

4.7 Review of latest RRP data from licensees has led to the identification of situations where a reduced technical specification (relative to baseline) results in the expectation of more Network Risk Output being delivered (i.e., an over-delivery), as fewer physical assets are being added back onto the network. This could be, for example, a situation where new load-related expenditure reduces the interventions required from a non-load (asset replacement) perspective.

4.8 For a given amount of risk per asset, if fewer physical assets are being added onto the network, then the amount of risk added back onto the network would fall and so ultimately the overall Network Risk Output would rise. Since 'automatic' funding adjustments are made based on changes in Network Risk Output, such situations could lead to a licensee's final allowed expenditure increasing despite making fewer NARM-related asset interventions. This is not a result that was originally intended as part of the NARM Funding Adjustment and Penalty Mechanism.

4.9 This problem would be addressable if such projects could be considered through the 'clearly identifiable' mechanism, with a bespoke funding adjustment applied. However, projects exhibiting these characteristics would also fail to qualify through the 'clearly identifiable' mechanism as the qualification criteria are currently worded. This is because the second criteria for clearly identifiable over-delivery states that: "The over-delivery element must not have been specified within the licensee's RIIO-2 Business Plan, or if specified, must have been specifically excluded from BNRO at Final Determinations as reflected in the NARM Workbook (NARW)". Since the final technical specification is a subset of that specification defined at baseline, this criterion would not be met and, therefore, the project in question could not currently qualify through the 'clearly identifiable' mechanism.

4.10 This is clearly an unacceptable result that was not intended when designing the NARM Funding Adjustment and Penalty Mechanism. Left unaddressed, it can reward licensees with more allowed expenditure despite undertaking fewer physical asset interventions, ultimately to the detriment of end customers.

4.11 P**roposal**: We are proposing to amend the second criterion for clearly identifiable over-delivery to ensure that such projects can still qualify for the 'clearly identifiable' mechanism. Specifically, we will add text to the second criterion to clarify that this criterion will not apply in cases where the over-delivery in question is achieved as a result of a reduced technical specification for that project (i.e., only a subset of assets being added back to the network relative to what was determined in baseline).

Clarification on the CIO_{OD} term

4.12 There is currently a lack of clarity in the NARM Handbook on the processing of clearly identifiable projects through the NARM Funding Adjustment Mechanism. Specifically, there is uncertainty as to whether to separate out the entire clearly identifiable 'project' Network Risk Output and expenditure or just the over / under-delivery 'element' from the 'automatic' funding adjustment mechanism. In other words, whether to separate out the project in its entirety, or just the component of that project that has been under- or over-delivered. In some cases, these will be the same (i.e., if a project is fully deferred or cancelled, or an entirely new project is undertaken), but in cases of partial under- or over-delivery this will not be the case.

4.13 On reviewing the NARM Handbook, it appears that this uncertainty arises from an inconsistent use of terminology. In paragraph 7.14(b), CIOOD is defined as "the determined Network Risk Outputs from projects that meet specified criteria for Clearly Identifiable Over-Delivery or Clearly Identifiable Under-Delivery projects". However, in paragraphs 10.5 and 10.7, the NARM Handbook specifically refers to "an Over-Delivery element" and "an Under-Delivery element" respectively.

4.14 The normalisation of the full project with 'clearly identifiable' under- over-delivery out of the Network Risk Output is problematic. This can be seen by considering Formula 4 in the NARM Handbook:

$$NRO_{OAD} = NRO_{OR} - CIO_{OD}$$

4.15 In this formula, NRO_{OR} represents the licensee's outturn network risk output and thus is an aggregate figure impacted by all underlying projects with under- or over-deliveries. This term would still include the baseline components of projects that were delivered, e.g. the partial component of a project delivered in the case of a 'clearly identifiable' under-delivery, or the full baseline project in the case of an associated 'clearly identifiable' over-delivery.

4.16 In this context, if the term CIO_{OD} were interpreted as representing the entire 'clearly identifiable' projects, the formula would not result in the exclusion of just the under- or over-delivery element, but the entire project. This is not the desired effect and critically would be to the detriment of the accuracy of the 'automatic' funding adjustment mechanism.

4.17 Formula 4 is intended to adjust the outturn Network Risk Output, NRO_{OR}, as if the 'clearly identifiable' under- or over-delivery elements had not occurred (i.e., as if the projects were delivered exactly as specified in baseline). For this reason, it is only the under- and over-delivery *elements* that should be captured in CIO_{OD} term.

4.18 **Proposal**: We are proposing to update the NARM Handbook to clarify in all relevant places, that it is the over- or under-delivery element that must be separated out from the outturn Network Risk Output, for the purposes of the 'automatic' funding adjustment mechanism, rather than the full project associated with over- or under-delivery.

Clarification on determining the justification percentage, *JUS*

4.19 When the outturn Network Risk Output deviates sufficiently from baseline for a risk sub-category, the NARM Handbook requires that this deviation be assessed to determine the extent to which it is justified. This is a deviation exceeding +/-2% in the case of ET, and +/-5% in the case of GT and GD. The justification percentage matters insofar as it impacts final allowed expenditures (licensees' unjustified over-deliveries are not compensated) and the potential imposition of penalties (for unjustified under-deliveries).

4.20 The NARM handbook currently states that the justification percentage (JUS) "… is the proportion of over- [or under-] delivery (NROOAD – NROBL) the Authority determines to be justified." This means that justification is centred on explaining deviations in Network Risk Output from baseline.

4.21 We want to clarify here that the justification percentage determined for an overall risk sub-category would not simply be based on summing up the amount of under- or over-delivered Network Risk Output justified for each individual project. This would be problematic, as projects have very different risk and cost characteristics, as we have demonstrated in the previous section. As such, if we simply summed up the amount of justified Network Risk Output for each project and used this to adjust allowed expenditures, then it is unlikely that the funding adjustment would be reflective of the underlying projects delivered.

4.22 **Proposal:** We are proposing to make the following clarifications to how the justification percentage is calculated in the NARM Handbook:

- A justification percentage, stated as a proportion of Network Risk Output, will be determined for each project with an under- or over-delivery in a risk sub-category that is required to go through the justification process; then
- Each project-specific justification percentage would be weighted by its relative efficient incurred costs to determine the expenditure-weighted share of Network Risk Output over- or under-delivery that is justified for a given risk sub-category.

Justification for clearly identifiable delivery elements

4.23 The current process of justification for over- or under-deliveries occurs after the clearly identifiable delivery elements have been normalised out of the NRO term (i.e., after Formula 4 set out above). As such, it is not explicitly defined in the NARM Handbook how the justification process is applied in the case of delivery elements deemed clearly identifiable over- or under-deliveries.

4.24 **Proposal:** We are proposing to clarify in the NARM Handbook that projects dealt with separately through the 'clearly identifiable' mechanism would still be subject to the same justification process as those projects processed through the 'automatic' funding adjustment mechanism. This means that we would determine for each clearly identifiable over- or under-delivery element the share (%) of that which is justified. This is critical to ensure equal treatment of unjustified over- or under-deliveries, irrespective of whether the projects in question are processed through the 'automatic' funding adjustment mechanism or the 'clearly identifiable' mechanism.

4.25 As 'clearly identifiable' over- or under-deliveries will be liable to the same justification process, licensees will need to provide the same information for clearly identifiable projects as for those projects within risk sub-categories which sit outside the automatic justification deadband.

4.26 In the case of unjustified under-deliveries for which a penalty is imposed, we will clarify that this includes any unjustified under-deliveries associated with 'clearly identifiable' delivery elements. In other words, 'clearly identifiable' under-deliveries which are deemed to some extent unjustified will be liable to the penalty mechanism. Chapter 7, Section I of the NARM Handbook will be updated to clarify this.

NARM funding across regulatory periods

4.27 Some licensees raised concern about delays to NARM projects in RIIO-2 (e.g., due to supply chain delays), and how this could result in NARM projects defined in the RIIO-2 baseline over-running into the next regulatory period. These licensees proposed extending the cut-off date for NARM projects beyond the end of the RIIO-2 window, if these projects are expected to be completed within a set period (for example, within three months of the RIIO-2 end date).

4.28 **Proposal:** We have considered the issue raised by licensees, but are not minded to make any amendments to the NARM Handbook in this respect. The NARM Handbook already provides sufficient mechanisms to deal with over- or under-deliveries within a regulatory period. In our view, project delays should be treated in the same manner as other types of over- and under-delivery through the existing mechanisms available.

Question 3: Do you agree with our positions taken on other aspects of the NARM Handbook?

5. Your response, data and confidentiality

Consultation stages

5.1 The consultation will be open until 02 August 2024.

How to respond

5.2 We want to hear from anyone interested in this consultation. Please send your response to AssetRiskResilience@ofgem.gov.uk.

5.3 We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

5.4 We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, your data and confidentiality

5.5 You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

5.6 If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

5.7 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

5.8 If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

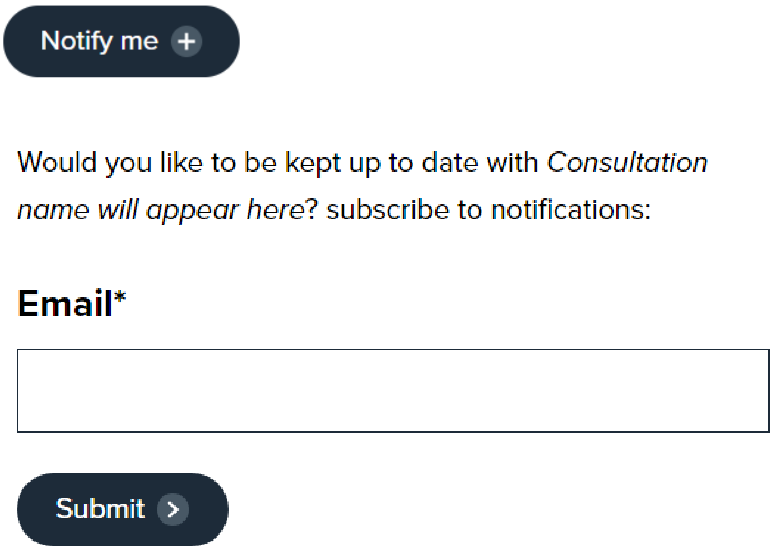
5.9 We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Choose the notify me button and enter your email address into the pop-up window and submit. [ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations)



Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

Appendix 1 – Privacy notice on consultations

Delete this box when producing your document.

Instructions: Please edit the content of the generic privacy notice provided below to take account of the specifics of your consultation.

Contact the Data Protection Officer dpo@ofgem.gov.uk if you are unsure about any of the information to be provided to those responding to your consultation.

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

4. With whom we will be sharing your personal data

(Include here all organisations outside Ofgem who will be given all or some of the data. There is no need to include organisations that will only receive anonymised data. If different organisations see different set of data then make this clear. Be a specific as possible.)

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for (be as clear as possible but allow room for changes to programmes or policy. It is acceptable to give a relative time e.g. 'six months after the project is closed')

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US. In that case use "the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this".

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system. (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

10. More information For more information on how Ofgem processes your data, click on the link to our "ofgem privacy promise".