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Cadent
Your Gas Network

Dear Faysal,

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

I am writing in response to Ofgem's consultation on the "Threshold for justifying Clearly Identifiable Over or Under Delivery under the NARM Funding Adjustment and Penalty Mechanism" which was published on the 3rd July 2024.

I have valued the constructive nature of engagement from Ofgem, and their consultants, in the months leading up to the publication of this consultation. Unfortunately, upon detailed review the proposals consulted upon are not workable as they introduce further uncertainty to the framework, regulatory risk to investment decisions made under the existing arrangements and potentially perverse incentives for network companies to make sub-optimal asset health decisions.

Given these issues, further collective industry work will be required to identify whether there is a workable way in which to implement this element of the NARM framework. Or if a wider review of the NARM framework is required looking at how the issues identified by Ofgem's consultants in this process, particularly relating to the lack of correlation between monetised risk and network allowances, can be resolved.

The annex to this letter provides detailed responses to the specific proposals set out within the consultation, however I have summarised our key points of concern below:

1. Delay to and timing of consultation

Whilst we recognise the challenges in identifying a proposal to finalise this element of the NARM framework, to only consult on this in year-four of a five-year price control period, and only five months before the submission of RIIO-3 business plans, is disappointing. As a key area of Ofgem policy, it would be expected that greater focus and priority would have been provided to this work.

2. Cross-sector alignment

A general reflection is that the proposals within the consultation are focused on resolving issues within the electricity transmission sector and do not reflect the different nature of asset health work within the gas distribution sector, for example the high volume of reactive workload. Whilst we recognise that Ofgem has an objective to align the NARM framework for all sectors, it is important that the different nature of asset health work across these sectors is recognised, otherwise the framework developed will be unworkable in some, if not all sectors.

3. Fundamental changes to NARM framework and impacts to risk profile and incentive properties

We understand the need to clarify elements within the NARM handbook to enable quality end assessment at close out.

However, there are elements within the consultation that go significantly beyond incremental improvements at a point within the price control where the proposals could have considerable impact on forecasted allowances.

The volume and nature of changes to the handbook significantly change the risk profile and incentives within the NARM framework compared to the start of the price control period. The application of these changes is likely to create different outcomes for intervention decisions made under the original framework that companies have been working to. For example, the extension of the CIO/UD criteria to include baseline activity within scope, which is a significant change.

4. Increases in regulatory burden

The proposed changes will significantly increase the amount of ex-post regulatory assessment and burden required within the NARM framework. This is in addition to already complex and burdensome setting, reporting and close out processes. For example, it appears, that the changes will impact the use of network risk deadbands, which were designed to enable automatic revenue adjustment for all but exceptional circumstances.

We are committed to working with Ofgem to address the issues above and to seek to identify a workable solution. We would welcome further collective industry discussion on these issues, as well as to obtain further clarification on a number of elements within the proposals, outlined in the annex to this letter. This will enable us, and other stakeholders, to fully quantify the impacts to delivery and provide further constructive engagement on how this element of the NARM framework can be finalised.

In the meantime, please do not hesitate to contact me should you wish to discuss any areas of our response.

Yours sincerely

[By email]

Ross Wilson
Asset Investment Manager – Risk & Modelling

Annex: Cadent responses to specific consultation questions

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

We agree with the approach to assessing a suitable UCR but we do not agree with the application or consequential changes.

We acknowledge that the correlation between risk and cost is not well defined which each sector outlined within working groups, including GDNs. The change in approach through the handbook is a significant deviation from an automatic funding and adjustment penalty mechanism outlined at the start of this price control period. We do not believe that the level of information provided allows GDNs to fully understand the output positions they may arrive at post consultation.

There are several areas that require more clarification which are outlined within the proposals section of this annex.

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

Although we agree that the threshold supports new projects like our proposed CISBOT project, the mechanism does not support baseline works and the ability to directly separate works that can fluctuate within price control e.g. reactive relays.

GDNs have highlighted this issue previously but it has not been outlined as part of this consultation. Having the UCR threshold set low does not support an approach to ensure that any material differences can be individually assessed, reactive works could fall into this area and would not be captured through this proposal.

If reactive workload decreases and is within the 5% threshold then the alternative workload undertaken in its place could then be assessed by the authority as CIOD but the same reduction in reactive workload would not be assessed. The reactive workload could have a marginally lower UCR than the sub-project UCR meaning that the network company would have a sub-project UCR reduction and potentially a reduction in the CIOD element as well that is compensating for the unforeseen under delivery.

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

We do not agree with the positions taken on the other aspects of the NARM handbook.

We understand the need to clarify elements within the NARM handbook to enable quality end assessment at close out.

However, there are elements within the consultation that go significantly beyond incremental improvements at a point within the price control where the proposals could have considerable impact on forecasted allowances.

At Cadent we have maintained an approach to deliver against our targets and land within the GDN deadband (+/- 5%). We have overdelivered in baseline asset class areas to compensate for any reactive workload volume shortfalls or procurement delays to ensure we maintain our position within these defined deadbands.

We are unclear as to how the overall outturn position is to be calculated based on the formula change in page 29 of the NARM handbook with the removal of CIO/UD. As we understand it, If projects are deemed to be CIOD by the authority but not the company they are then removed from the outturn position which could then create an under-delivery position and a penalty. We need more clarity on how thresholds are to be determined for each project-by-project category. In addition if a project is outlined as CIOD, is the allowance then altered to pay at cost of the CIOD or at the previous UCR allowance per project or sub-project. This aspect requires additional clarification by Ofgem.

We do not believe that this consultation takes the specific nature of some GDN works fully into consideration, especially high-volume reactive workload which can be largely out of our control. Undefined justification percentages and worked examples are not provided to allow us to review in significant detail what the proposed changes will do to our different asset class deliveries and understand the overall impact to plan.

The timeliness of this consultation also does not allow us sufficient time to deviate and mitigate the potential impact to our plan against these still undefined delivery requirements.

We are concerned that the changes in rules outlined in the handbook will contribute to a material difference in allowances based on altering the qualifying criteria to CIOD, especially with bringing baseline works into consideration.

As such we are seeking additional clarification to various elements within the proposals outlined so we can fully quantify the impacts to delivery and provide a suitable response.

Proposals:

4.6 - 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.

This proposal contradicts expectation set within other NARM working groups whereby Ofgem are seeking for network companies to report this information in NARM RRP and are still awaiting clarification on expectation. This is something that will increase the reporting burden on sectors alongside an already long reporting process. It is also a duplication of work on top of what is already provided to Ofgem through Cost and Volume RRP.

In addition, at the start of this regulatory period it was clear that if companies landed within the outlined deadbands that they would not be required to produce detailed project-by-project assessment of works. This change and the introduction of considerable ex-post assessment of all projects that may qualify through the proposed changes to the CIOD mechanism creates significant uncertainty on outturn position. Cadent therefore disagrees with this proposal, especially at this late point in the price control period. We also request that further clarity be outlined in respect to how the deadbands and their reporting requirements will now work given this proposal.

4.11 - 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).

The change to this criterion at this point in the price control creates further uncertainty to network companies due to the time at which this proposal is being made. For example, a network company could land within the required deadband and not require further justification on delivery through risk trading. The projects that would not be proposed as CIO/UD could now be seen as CIO/UD and require documentation/evidence in a different structure and/or level of granularity than known at the point of intervention decision making. We request assurances / clarifications from Ofgem on company expectations and penalties as this is not included within the consultation.

4.18 - 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.

We are seeking clarification on what "element" must be separated out in terms of over or under delivery, is this volume or risk benefit or both? For GDNs that have high volume works within their network delivery targets (including reactive works) there will be movement from the baseline volume.

For example, reactive works could deliver a higher or lower risk output than the required volume as we cannot be clear on where the reactive works will occur, this inevitably creates risk trading which will have been undertaken to cover any shortfalls in NARM delivery.

Cadent are also seeking clarification on how the element would be undertaken in a worked example as this is not available in the proposed NARM handbook updates.

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

A. 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

B. 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.

Cadent are seeking additional clarification on how Ofgem would undertake this as there are not specific worked examples in the updated handbook outlining the approach. NARM allows the flexibility to risk trade while having more certainty of funding, this proposed change is a significant deviation from the initial handbook further increasing uncertainty on outturn allowances.

Given the timelines to date, and likely onward timescales, to finalise this element of the NARM framework, there is a significant risk that the proportions and project specific justification percentages outlined within this proposal will not be defined until very late in the price control period or indeed until after it has finished. This will mean that network companies may not know the rules, and incentive properties, of the framework until after the period has finished which introduces significant uncertainty and risk. The risk to the timelines is amplified when considering the competing industry priorities, including the RIIO-3 price control process, through to the end of RIIO-2. As such we disagree with this proposal.

4.24 - 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.

We are seeking clarification on approach. Our understanding of this proposal is that the projects not proposed as CIO/UD could now be highlighted as CIO/UD by the authority. The network companies would then need to provide the same documentation and justification required at a point in the price control where risk trading has already occurred ensuring that they would land within the required deadband and as per the original price control rules.

If this understanding is correct, we would disagree with this proposal. We also request assurances and clarifications from Ofgem on company expectations and penalties as this is not included within the consultation.

4.28 - 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.

We believe that the on-going consultation highlights that there is still uncertainty to the NARM funding and adjustment penalty mechanism and that the cut off date does not allow for dynamic project delivery prompted by the result of external factors. Although GDNs will not have larger scale capitalised projects like ET and GT have, there is still potential to not claim monetised risk benefit on a project where delivery could land the day after the end of the price control period.

General Feedback:

Do you have any comments about the overall process of this consultation?

- The timeliness of the consultation and continual movement in timeline has been particularly disappointing which could ultimately lead to us losing a significant piece of technology from our asset intervention list

- The extension of the timeline was not updated into the webpage or communicated out through a channel that would have meant it was picked up by a central PMO, in future could communications come through specified channels

Was it easy to read and understand? Or could it have been better written?

- There are references to justification percentages and thresholds being determined which are undefined. It would have been useful for Ofgem to have provided worked examples of proposals as we are unable to fully understand the impacts. Specifically, when these percentages are not currently determined it does not allow us to forecast where we could make specific change at this point and mitigate any currently unknown delivery requirements