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Dear Faysal,

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

This response is on behalf of National Grid Electricity Transmission plc (NGET). We welcome the opportunity to respond to the consultation on the threshold for justifying Clearly Identifiable Over or Under Delivery under the NARM Funding Adjustment and Penalty Mechanism issued on 3rd July 2024. This letter summarises our key concerns with some of the proposals in the consultation along with more detailed responses to the specific consultation questions.

General comments

Definition of 'delivery element'

It is not clear from the drafting and consultation document what a 'delivery element' is and this requires clarification from Ofgem. For example, paragraph 2.12 of the consultation document says:

*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**.*

The highlighted terms “projects/schemes/programmes of work”, “initiatives”, “delivery elements” and “specific project” appear to be used as synonyms. However, paragraph 3.4 of the consultation document says:

We considered the nature of the relationship between funding (£s) and risk benefit delivered (REs) 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 statement implies that “individual projects” are separate from “delivery elements”, which is inconsistent with paragraph 2.12.

The consultation document and the proposed amendments to the NARM Handbook drafting use the term ‘delivery element’ extensively, but this term is not defined in the NARM Glossary. Is a ‘delivery element’ an individual row in each Licensee’s NARM Workbook (NARW), i.e. an intervention with an agreed BNRO and associated baseline funding? If so, this should be clarified and the associated definition should be added to the Handbook Glossary. The definition should also be extended (or a new one created) to cover interventions which were not in a Licensee’s baseline at the time of Final Determination. Also, the NARM Handbook drafting should be reviewed to ensure that the correct term is used consistently throughout the document. If a ‘delivery element’ is something else then please can Ofgem clarify what this is.

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

It is ambiguous from the consultation document, but from separate correspondence with Ofgem we understand that the qualifying criteria listed in the NARM Handbook and the consultation document need clarification. There needs to be a fifth criterion in each case to make it clear that the definitions in Appendix 1 ‘NARM Glossary’ of the NARM Handbook v3.1 apply at the delivery element level as well as the asset sub-category level. Specifically:

Over-Delivery is defined as “Delivery of a higher level of Network Risk Output than a Baseline Network Risk Output or other benchmark measure.” This needs to be added to the four criteria in paragraph 10.5 of the NARM Handbook. Does the definition of over-delivery also need to be extended to include the delivery of new delivery elements, i.e. ones which do not have a BNRO at the time of Final Determination? (These could be considered as delivery elements with a zero BNRO.)

Under-Delivery is defined as “Delivery of a lower level of Network Risk Output than a Baseline Network Risk Output or other benchmark measure.” This needs to be added to the four criteria in paragraph 10.7 of the NARM Handbook.

All criteria need to be linked with ‘and’ conjunctions, i.e. all criteria need to be true for a delivery element to be considered as Clearly Identifiable.

Ofgem's Assessment Process

It is not clear from the consultation document whether there is a first step for considering whether a delivery element should be considered as being Clearly Identifiable which would be:

- (i) For under-delivery, whether the delivery element has delivered a Network Risk Output (NRO) that is less than the Baseline Network Risk Output (BNRO);
- (ii) For over-delivery, as well as being a delivery element that has delivered an NRO that is greater than the BNRO, it would also presumably have to be every intervention added to a Licensee's plan because it would effectively have a zero BNRO and therefore any new intervention would deliver an NRO in excess of zero.

From correspondence with Ofgem, it is understood that the Clearly Identifiable process is only intended to deal with over- and under-delivery elements, i.e. delivery elements that have not delivered their anticipated BNRO. If delivery is consistent with BNRO, the Clearly Identifiable process would not apply regardless of what has happened to the Unit Cost Ratio (UCR) and no further assessment or baseline allowance adjustment is required.

Other networks

It is noted that the consultation document relates to changes to the NARM Handbook that applies to ET, GT and GD. The mechanism for the ED sector is not part of the NARM Handbook and is, instead, described in the ED licence in Special Condition 3.1 in RIIO-2. Whilst not explicitly stated in the consultation, the proposed mechanism changes and amendments to the NARM Handbook are therefore not applicable to ED. NGET agrees that this is correct because, given the high volume of asset replacements undertaken by ED during a price control period, it is inappropriate for project-by-project assessment to be included within the ED NARM mechanism. We understand that it is for this reason that the concepts such as Clearly Identifiable Over-Delivery and Under-Delivery, which require such project-by-project examination, have not been included in the mechanism described in Special Condition 3.1 for ED and should not be extended to ED in future price controls.

RIIO-T3

Looking forward to RIIO-T3, this approach to NARM funding needs to be revised and updated for the future price control periods due to its excessive complexity for the value of investment covered. There is an opportunity to streamline and simplify funding, but still retain appropriate protection for consumers. In its RIIO-3 SSMD, Ofgem has signalled that both Evaluative and Mechanistic PCDs are likely to remain in the regulatory toolkit for RIIO-T3, but that Evaluative PCDs should be used sparingly; a threshold cost of £15m per Evaluative PCD has been mentioned. Looking at NGET's RIIO-T2 NARW, less than 3% of baseline delivery elements exceed that threshold. It may be possible to either group delivery elements to provide more 'material' Outputs, and/or set a mechanistic PCD for those delivery elements with a relatively consistent unit cost, e.g. as was done for NGET's Overhead Line Reconductoring¹ programme in RIIO-T2. For RIIO-T3, there is the opportunity to make such

¹ NB. This works because the unit cost (cost per circuit km in this case) is relatively consistent. It does not work on a Unit Cost Ratio as used in the NARM methodology.

PCDs symmetric, i.e. to allow relatively simple allowance adjustments for over-delivery or new delivery elements. We look forward to discussing this with Ofgem as part of the RIIO-T3 price control review process.

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

Whilst NGET agrees with the need to determine clearly identifiable over and under-deliveries, we do not agree with the principle of using a UCR threshold.

As noted by Ofgem in the section of the consultation document titled 'Investigating the risk between funding and risk output', there is a poor correlation between BNRO and baseline funding. This was evident at the time of RIIO-T2 Final Determinations. As would be expected, this poor correlation also exists between the delivered/forecast NRO and actual costs for both baseline delivery elements and new delivery elements. Transmission projects in particular tend to be bespoke and variable; such capital investments rarely² lend themselves to a simple 'volume x unit cost' approach. There is no evidential linear relationship between the cost of an intervention and its NRO.

Another issue is the manner in which risk sub-categories are assigned to a delivery element to reflect the asset type with the largest Network Risk Output contribution. This means that, if an asset is removed from the scope of a delivery element and consequently the delivery element gets assigned to a new risk sub-category, then one is comparing a similar outturn cost and Network Risk Output to an average UCR for a different risk sub-category.

Given the above, assessing a suitable UCR threshold is not useful.

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

Whilst NGET agrees with the need to determine clearly identifiable over and under-deliveries, we do not agree with the proposed UCR threshold.

Ofgem's own analysis demonstrates that UCR is not a useful metric. For the rest of the RIIO framework, the Outputs are defined in various ways to reflect what is being delivered (an outcome or a volume of work). For NARM, the Output is the Network Risk Output (NRO). The agreed baseline Output is therefore the BNRO. When assessing over- or under-delivery, it therefore seems more logical to compare the NRO to the BNRO.

In order to move to assessing the NRO vs the BNRO, a practical route would be to treat all the baseline delivery elements in a similar way to Evaluative PCDs. Ofgem then already has an agreed

² There are a handful of higher-volume, repeated works where this is not the case, e.g. a national programme of *in situ* instrument transformer replacement, but this is the exception rather than the norm.

process (Special Condition 9.3 in the electricity transmission licence (PCD assessment principles and reporting requirements)) and guidance to support close-out at the end of the RIIO-T2 period:

[Price Control Deliverable Reporting Requirements and Methodology Document | Ofgem](#)

In order to demonstrate how this would work, we have drafted a flowchart which is attached in Appendix A.

Whilst this approach could increase the regulatory burden considerably compared to that envisaged at the start of the RIIO-T2 period (as does Ofgem's proposed approach as set out in the consultation document), it has the following advantages:

1. There is no discretion on the part of either the Licensees or Ofgem as to which assessment mechanism should be used on a delivery element ('automatic' or 'Clearly Identifiable');
2. The evidence requirements are set out in existing guidance (e.g. paragraph 6.5 of the 'PCD Reporting Requirements and Methodology Document' sets out what is to be included in a Basic PCD Report); and
3. There would be a mechanism for dealing with delivery elements whose final completion is delayed beyond 31 March 2026, e.g. if system constraints prevented final commissioning of an otherwise complete asset. At the moment, Licensees are concerned that RIIO-T2 allowances for such delivery elements would be removed (and possibly more than the associated baseline funding if the sub-category UCR is used to make the adjustment). The project could in principle be funded as part of the RIIO-T3 baseline (if the delay is known as of today) but it is not clear how funding for costs incurred in RIIO-T2 would be recovered. Alternatively, projects would 'fall into the gap' between price controls if the delay is not known as of today, the project is consequently not assessed as part of RIIO-T3 baseline, and there being no clear route to funding via RIIO-T2 close-out. If the Outputs were treated as Evaluative PCDs, the delivery element would be identified as 'Delayed' and Ofgem could reprofile the associated baseline allowances to reflect the revised delivery date.

The disadvantage of this approach is that the existing Evaluative PCD assessment process does not provide a route for funding new delivery elements or elements of over-delivery, but then neither does Ofgem's proposed approach as set out in the consultation document. To enable such funding we assume that Ofgem will want to see an Engineering Justification Report (EJR) and, to be consistent with the RIIO-T3 submission, this would be of the Lead Asset Portfolio³ variety that has been recently developed by Ofgem. If this assumption is correct, it would be helpful if Ofgem could explain how this would then be assessed to adjust allowances appropriately? We see no reason why these submissions and subsequent assessment should wait for the T2 close-out process, and Licensees would welcome the increased certainty of funding provided by an earlier submission and determination of allowance adjustments by Ofgem.

³ T3_EJP_Portfolio_Lead template in the *BPG Annexes > Annex 7 BPG Templates > EJP Templates* subfolder published here: [RIIO-3 Business Plan Guidance | Ofgem](#)

The administrative burden could be reduced by enacting a simplified process (as we have illustrated in Appendix A) to set out that:

- If NRO = BNRO, no further submission of evidence (beyond annual Regulatory Reporting at delivery element level) or funding adjustment is required.
- If a delivery element has under-delivered, been delayed or is no longer required, a spreadsheet that captures the elements of a Basic PCD report can be provided as part of the RIIO-T2 close-out process.
- If a new or additional delivery element has been introduced, the Lead Asset Portfolio EJR can be used to justify the intervention and agree funding.

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

Selection of projects for clearly identifiable mechanism

NGET does not agree with paragraphs 3.23 and 4.4 of the consultation document. For the same reason that the Authority sees risk in Licensees self-identifying Clearly Identifiable delivery elements, Licensees see risk in the Authority being able to decide which delivery elements are Clearly Identifiable, and hence which assessment mechanism is to be used.

As a point of principle, in order to provide a fair and transparent process, there should be no discretion for either Licensees or Ofgem to take a view on what is Clearly Identifiable and hence how delivery should be assessed. Considering all the baseline delivery elements as though they were Evaluative PCDs with Outputs equal to their respective BNROs and following the established Evaluative PCD process for assessing delivery solves this potential problem.

We agree with paragraph 4.6. Tab N1.5 of NARM RRP already shows the outturn NRO and actual costs incurred on a project-by-project basis. A column with a drop-down could then be used to identify which projects are 'Fully Delivered', 'Delayed', 'Not Delivered', etc, in line with the existing guidance on Evaluative PCDs; this could replace column R which is currently used for 'Network proposed Clearly Identifiable? (CIOD, CIUD)'. This spreadsheet could be further developed at the end of the RIIO-T2 period to capture the required metrics as set out in the Basic PCD reporting guidance (paragraph 6.5 of the 'PCD Reporting Requirements and Methodology Document') to provide the necessary information for the RIIO-T2 close-out process.

Clarification to qualifying criteria for clearly identifiable mechanism

NGET agrees with the proposal to clarify that, where over-delivery is achieved as a result of a reduced technical specification (i.e. a decreased scope) for a delivery element, this delivery element should not qualify as clearly identifiable over-delivery. However, the wording is confusing. Given that it is intended to address a situation where a lower volume of asset interventions is delivered, it would be clearer to state that.

Clarification on the CIO_{OD} term

NGET agrees with Ofgem's intent as set out in this section and summarised in paragraph 4.18 of the consultation document:

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.*

However, we disagree with the way in which this is proposed to be implemented. Instead:

- Where the NRO is greater than the BNRO, we agree that the 'baseline part' of a delivery element should be treated as a baseline delivery element and that the 'additional' part (the additional scope, additional cost and associated NRO) should be considered as a new delivery element. However, we do not agree that such additional delivery elements can necessarily be funded via the 'automatic' funding adjustment mechanism. If the UCR of the additional delivery element is different to the asset sub-category (e.g. outside the +/-5% range), then presumably Ofgem would not want to use the 'automatic' funding adjustment mechanism. Please can Ofgem clarify what would be done in such circumstances?
- Where the NRO is less than the BNRO, Ofgem should consider the Output as 'Partially Delivered' (as defined in the existing Evaluative PCD guidance) and adjust allowances to reflect the revised Output. This may be a simple pro-rating exercise, e.g. if 2km of a 20km OHL Fittings replacement intervention were no longer required because a line diversion had resulted in a rebuild of that section, then a simple 10% reduction in baseline allowances for that delivery element might be appropriate. As per the Evaluative PCD process (paragraph 6.5), the Basic PCD Report allows Licensees to propose "the indicative value of any potential adjustments to allowances associated with delivery of the PCD output that may be required. The licensee may wish to indicate which methodology of adjustment set out in the licence it believes would be appropriate."

Clarification on determining the justification percentage, JUS, and Justification for clearly identifiable delivery elements

The proposal provided in the consultation document is not clear. The rest of the document moves away from assessing performance at a sub-category level, so it is unclear why this part of the process is being retained at a sub-category level. Under both Ofgem's and our proposal, Ofgem will have the opportunity to carry out an ex-post assessment of the outturn NRO vs BNRO, the delivered scope and actual cost for each delivery element where the Output has deviated from the agreed baseline. If Ofgem is not satisfied that under-delivery is justified, it has the opportunity to adjust allowances accordingly. Over-delivery will be assessed as 'new' Outputs and efficient allowances set (albeit, as mentioned above, the process for this is not currently set out). The concept of 'Justified' and 'Not Justified' becomes redundant.

NARM funding across regulatory periods

NGET does not agree with Ofgem's position.

Specifically, it is incorrect to say that 'project delays should be treated in the same manner as other types of over- and under-delivery through the existing mechanisms available'. Delays to completion of projects started during the RIIO-T2 period will normally result in under-delivery, and probably appear as non-delivery (an NRO of zero) because it will be the final completion that is delayed beyond the end of the RIIO-T2 period. As currently drafted, under-delivery will result in removal of RIIO-T2 allowances under the NARM mechanism. We are not aware of a NARM mechanism to provide the missing funding in RIIO-T3 when the Output is delivered *unless* the delay is already known today AND the project has been included in a Licensee's RIIO-T3 baseline submission AND Ofgem determines to allow RIIO-T3 funding AND a currently unknown process provides funding for costs efficiently incurred in RIIO-T2.

Please can Ofgem clarify how it believes this will work in practice, preferably via a worked example?

Please can Ofgem also provide an example of how this will work for a project that is not currently known to be delayed and therefore will not be included in a Licensee's RIIO-T3 baseline submission in December 2024?

Without clarity regarding a route to funding for such RIIO-T2/T3 cross-over projects, it is possible that delivery will fall off in the final year of the price control period because of the increased risk and uncertainty around funding when even a small delay to commissioning could result in the associated funding (which was previously determined as being efficient for a necessary intervention) being removed. This is not in customers' and consumers' best interests.

Treating each 'Delayed' delivery element in the same way as an Evaluative PCD as per our proposal provides a practical mechanism to deal with this issue.

We look forward to working collaboratively to develop the mechanism for Clearly Identifiable Over- or Under-Delivery and the RIIO-T2 NARM close-out process. If you would like to discuss or clarify anything in this letter, please do not hesitate to contact either myself, Julie Hooper (julie.hooper@nationalgrid.com) or Aisling Rapier (aisling.rapier@nationalgrid.com).

We hope that you find this response useful and constructive.

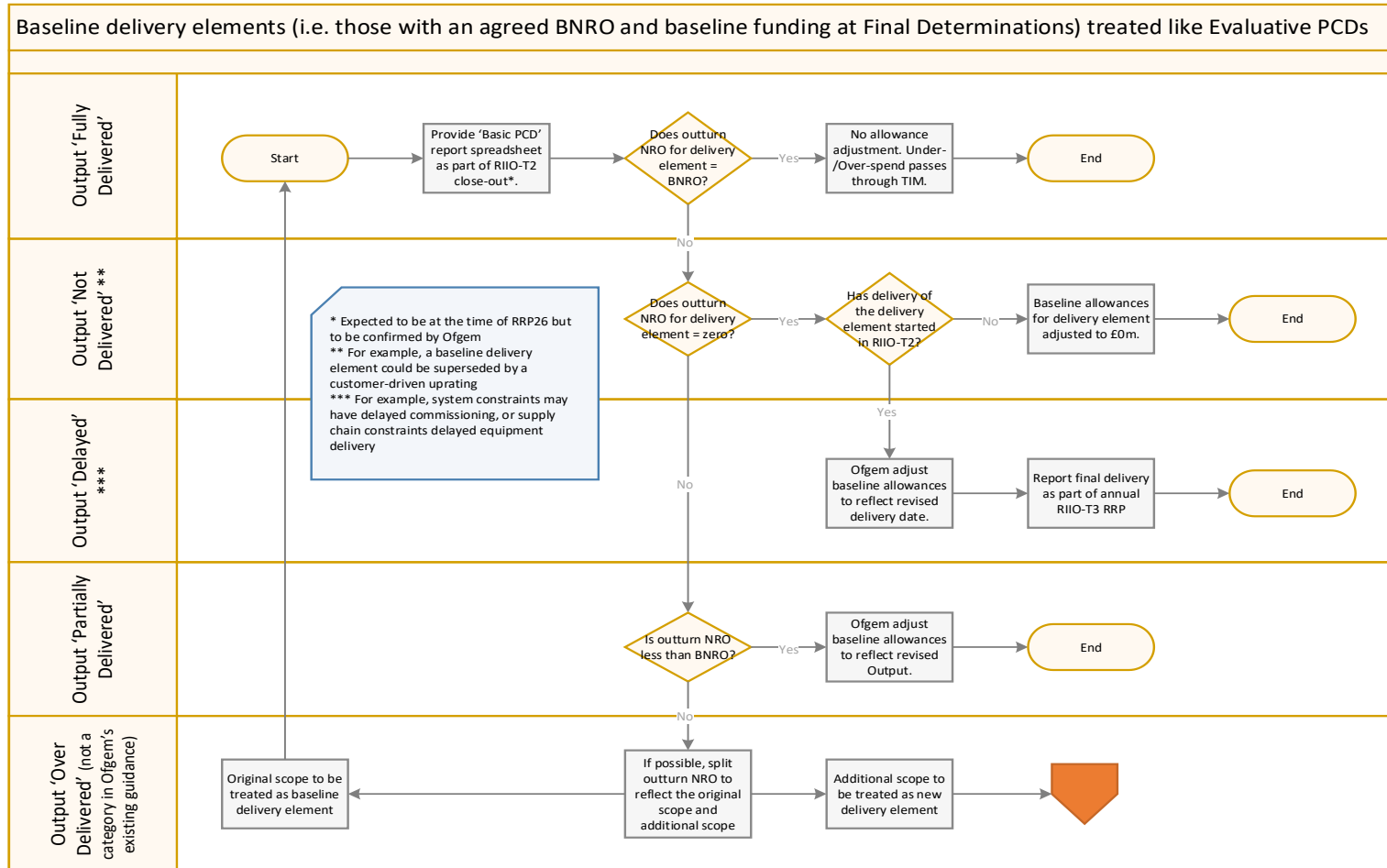
Yours sincerely,

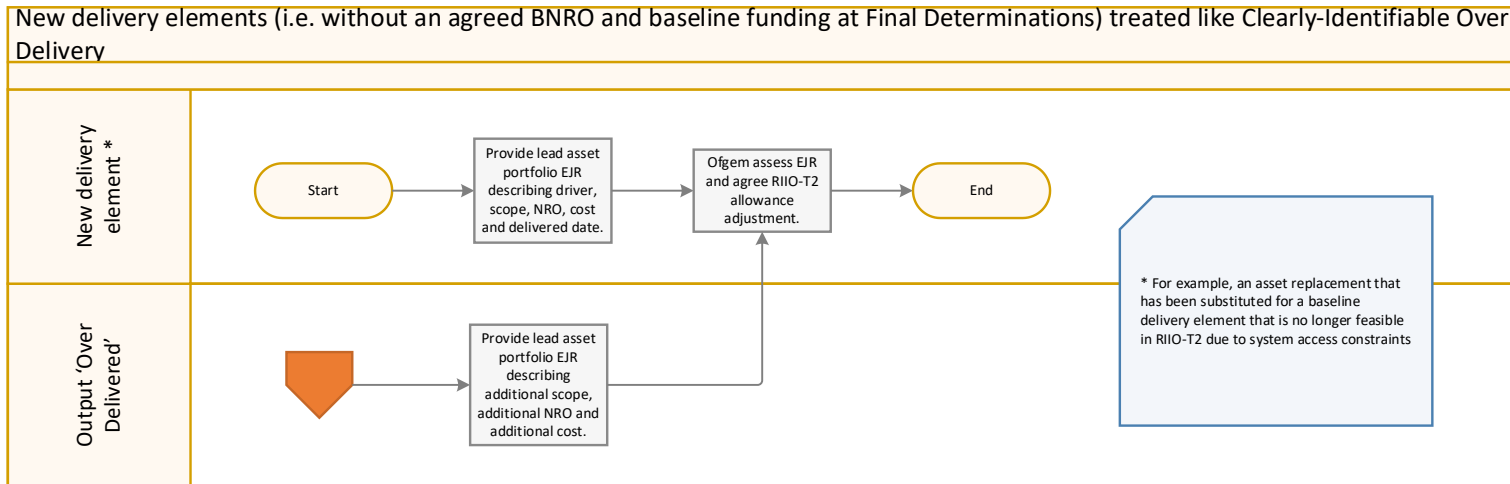
AM Clark

Michelle Clark

RIIO-2 Policy and Performance Manager, NGET
(by email)

APPENDIX A: Flowchart illustrating application of Evaluative PCD process to NARM delivery during RIIO-T2 close-out





https://www.ofgem.gov.uk/sites/default/files/2023-08/Price%20Control%20Deliverable_Reporting_Requirements_and_Methodology_Document_v4.pdf