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Ofgem
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16th August 2024

Dear Faysal,

[Re: Consultation on the qualifying criteria for Clearly Identifiable Over-Delivery and Clearly Identifiable Under-Delivery, under the NARM Funding Adjustment and Penalty Mechanism](#)

Thank you for the opportunity to provide a response to the above noted consultation. Northern Gas Networks (NGN) has been actively involved in workgroups and discussions relating to NARM and appreciate this opportunity to inform your decisions. We have set out our responses to the specific consultation questions in Appendix 1 and, highlight below the pertinent points we have made in our response.

Overall NGN, support the principle of Clearly Identifiable Over or Under Delivery (CIO/UD) to mitigate the risk of cases where projects/schemes costs would not be reflective of outputs and would result in windfall gains and losses for networks/customers.

For Gas Distribution, a single Unit Cost of Risk (UCR) target is defined for each licensee as a whole, i.e. for their entire network. Therefore, NGN welcome that there is no automatic allocation to CIO/UD for UCRs outside the proposed threshold for individual projects/schemes. For GD, there are large volumes of work and deviations in individual projects / programmes should balance out so that outturn UCR at a network level is not materially different from target, assuming delivery is broadly consistent with RIIO-2 Business Plans.

NGN consider that the use of CIO/UD has the potential to add significant regulatory burden to Ofgem and Networks and should only be reserved for material deviations from UCR targets. There is still a requirement to justify delivery for non-CIO/UD delivery in the NARM RIIO-2 Closeout Report and for Ofgem to determine the proportion justified, which gives customers protection without the need for CIO/UD bespoke assessments.

NGN would like to raise again that the Baseline Network Risk Output figure of 9.67 in Part F, 3.1.24, Appendix 1 of NGN's Special Condition 3.1 Baseline Network Risk Outputs (NARMT) is incorrect and does not reflect the value in the latest Network Asset Risk Workbook (V9.0) of 8.09 submitted to Ofgem on 29/07/2022 (email attached, not for publication).

This updated NARW reflects NGN's closeout position of RIIO-1 and is the basis of our annual NARM RRP reporting, which has been accepted by Ofgem. We request that Ofgem rectify this as part of their next Statutory Consultation as soon as possible so that all NARM associated documentation is aligned for RIIO-2 closeout.

I hope these comments will be of assistance and please contact me on details provided below should you require any further information on this response.

Yours sincerely,



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we are
the network

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Appendix 1 – NGN consultation questions and responses.

Overall

NGN support in principle 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. However, the detail of the normalisations are important and there is a risk that they could cause perverse incentives and outcomes for both networks and customers depending on how the targets and remaining outturn UCR are adjusted to account for CIO/UD.

Ofgem have not shared any proposed calculations or analysis of the updated NARM funding mechanism as part of the consultation and NGN would welcome sight of this to fully assess the implications and provide detailed views on the proposed changes. We would also welcome more detail on the proposed bespoke assessment of the cost and risk output characteristics of specific CIO/UD projects.

The *Appendix 4 Worked Examples: NARM Funding Adjustment and Penalty Calculations* should be updated and reworked based on the formulae updates outlined in the consultation and the underlying files shared with networks so we have the opportunity to undertake a thorough assessment of the implications and provide useful feedback to Ofgem to determine the final NARM mechanism.

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

Overall, NGN broadly agree with the approach subject to the specific suggested changes outlined below. We also request further detail and the underlying analysis to test the formulae updates outlined in the NARM Handbook to ensure there are no unforeseen perverse consequences.

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

NGN do not disagree with the proposed threshold, which aligns with the RIIO-2 deadband for GD, as CIO/UD delivery elements are proposed by networks / determined by Ofgem and those outside the threshold do not automatically become classified as CIO/UD as outlined above.

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

We have made suggested changes outlined below.

NARM Handbook Version 3.1 Specific Comments

NGN suggest the following amendments:

7.12 *“The licensee is also advised to include the breakdown of these values by project, specifically the ONRO attributable to each ~~project~~ delivery elements, its associated costs, and the contribution of identified Non-Intervention Risk Changes. Individual ~~projects~~ delivery elements that the licensee considers qualify for Clearly Identifiable Over-Delivery or Clearly Identifiable Under-Delivery should be specifically indicated.”*

For GDNs, there could be large volumes of individual projects under specific delivery elements that make up our NARM targets (e.g. mains replacement projects) and it would not be practical or useful to provide the breakdown at a project level.

7.14, 7.15 & 7.22 Formulae Updates

NGN request that networks receive the calculation spreadsheets to test the proposed updates for unforeseen consequences and sensitivities that could result in windfall gains and losses for networks / companies.

10.1 *“The NARM Funding Adjustment and Penalty Mechanism approach avoids the need for ex-post ~~project delivery element-by-project delivery element~~ assessment except in cases where ~~projects delivery elements~~ are clearly identifiable as driving an Over-Delivery or Under-Delivery.”*

10.5 *“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). The exception to this is a case where an Over-Delivery is achieved as a result of a reduction in the scope of a baseline ~~project delivery element~~ or the workload and costs of that delivery element have materially changed since the licensee’s RIIO-2 Business Plan due to factors outside of the control of the network (e.g. due to legislation, engineering policy or customer driven work), in which case this criterion will be considered met.”*

NGN consider that CIO/UD could be triggered by unforeseen material workload or costs changes to a delivery element driven by factors outside of the control of a network, such as a change to legislation or local authority requirements. A specific example in GD is <2” Steel which was set as A1 by Ofgem and included in NARM targets. It is mandatory workload that is done as and when it is found as part of Tier 1 Iron work, which is classed as A3 and not part of NARM targets. It is possible that delivered workload could materially deviate from that set at the start of RIIO-2 if the proportion of <2” Steel is different in outturn Tier 1 projects. Therefore, there should be the flexibility for Ofgem to assess this at RIIO-2 closeout.

10.5 *“The Over-Delivery element must have an outturn UCR greater than 105% of the baseline UCR, or less than 95% of the baseline UCR value, for the given risk sub-category where applicable.”*

Setting the CIO/UD threshold equal to the deadband of GD means that, in theory, all UCR outturn outside of the deadband could qualify as CIO/UD. NGN consider that the use of CIO/UD has the potential to add significant regulatory burden to Ofgem and Networks and should only be reserved for material deviations from UCR targets. There is still a requirement to justify delivery for non-CIO/UD, which gives customers protection from windfall costs if Ofgem determine they aren’t fully justified.

As detailed in the Consultation Document, NGN support that the networks propose delivery elements of CIO/UD rather than automatic classification based on the threshold, which would avoid unnecessary regulatory burden and focus scrutiny on material instances rather than high volumes of delivery elements which should balance out overall at a network level. We support the proposal to take a pragmatic approach in determining which delivery elements that meet the four criteria should be managed through the clearly identifiable mechanism to appropriately manage the risk of non-cost-reflective expenditure allowances.

Please note, the publication information needs updating on the NARM Handbook cover and the criteria in 10.5 of the Handbook differs from the criteria in the Consultation Document. NGN have assumed the criteria in the NARM Handbook is the correct one to comment on. We also suggest the final version is retitled to version 3.2 or 4.0.