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16 August 2024

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Dear Faysal

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

This letter is National Gas Transmission (NGT)'s response to the Ofgem consultation of 3 July 2024 on Threshold for justifying Clearly Identifiable Over Delivery (CIOD) or Under Delivery (CIUD) under the Network Asset Risk Metric (NARM) Funding Adjustment and Penalty Mechanism (the NARM mechanism).

We welcome the opportunity to respond to Ofgem's consultation on what is a key component of the Price Control framework. We firmly believe it is of vital importance to the overall network capability and resilience, that the NARM mechanism supports and incentivises the licence holder to deliver the right investments on the network to maintain security of supply whilst providing value to end consumers.

Since the start of RIIO-T2, we have been working to deliver our Asset Health capital programmes to meet the NARM framework and principles. We have been focused on providing consumer benefits across our programmes by determining the needed interventions across the network. For example, we have been ensuring we undertake interventions that are essential for the integrity of the network, ensuring our customers can enjoy continuous supply of energy when they need it. We have also been focused on interventions that provide a meaningful reduction in network risk across the NTS assets, delivering against the NARM Long Term Risk Benefit (LTRB) target¹. Whilst we are still within the current price control period and continue to enact our Asset Health (AH) programmes to achieve our total outputs, we are confident that we will deliver significant consumer benefits by the end of the RIIO-T2 period.

¹ The NGT LTRB target is set at R£200.8m inside +/-5% dead-band based on the cumulative total from the Low, Medium and High sub-risk categories.

We understand and agree with Ofgem that there is a need to evolve the NARM framework and that there is a need to determine an appropriate approach to CIOD and CIUD. The intention of CIOD/CIUD mechanism is the avoidance of ex-post project-by-project assessment, except in rare cases where a small number of projects are clearly identifiable as driving an over delivery or under delivery. NGT is in full agreement with this principle which should safeguard consumer value by not over rewarding network companies with unjustifiable performance, whilst at the same time reducing administrative burden associated with reviewing all relevant NARM projects. Lastly, it should ensure that network companies following the NARM principles are not exposed to significant financial uncertainties due to additional review processes.

For NGT, it is key to recognise how our NARM target was set and how it differs to other networks. Our NARM plan is broken down into circa 140 different asset interventions each with a unique identifier (UID), rather than projects as applicable for some other networks. For RIIO-T2 the NGT Asset Health 2019 business plan took a “volume x cost” approach based on determined ‘run rate’ of AH interventions as the exact interventions were not known ahead of additional inspection and survey work, to be implemented within RIIO-T2. Specifically, our RIIO-T2 plan was built bottom up, using legislative, policy, defect data and historic trends. Furthermore, given the exact interventions were not known ahead of setting the NARM LTRB target it was agreed that NGT would target the 75th percentile of LTRB for each asset type. This approach was presented and agreed with Ofgem² before the targets were set and became the founding principle for the NGT NARM methodology noting there was an equal risk of both under or over performance of the target.

Accounting for how the NGT NARM target was built, NGT is strongly opposed to the proposed thresholds for justifying CIOD and CIUD. As previously mentioned, we agree with the principle and intent. However, the proposals constitute both a change to the principles agreed³ upon for the NGT RIIO-T2 Asset Health business plan and introduces significant and disproportionate financial uncertainty around the NARMs treatment, which risks penalising NGT.

To assess the impact to NGT, we have applied the proposed thresholds to our AH programme and determined that 98% of NGT’s NARM interventions (using latest forecasts on cost and Long Term Risk Benefit (LTRB)) would be subject to the CIOD/CIUD mechanism. This clearly changes the intention from a ‘small number of projects/schemes/programmes of work’ to nearly the entire portfolio and effectively results in a full UID by UID assessment for NGT. The consequence of this is being that NGT would be subject to uncertainty of financial outcome until post RIIO-T2 close out, for the near entirety of the AH interventions spend.

² NGT received a £21.7m penalty for failing to meet the minimum requirements of the Business Plan Guidance in relation to AH volumes.

³ The proposed changes fail to meet the principles set out by Ofgem in 2022. In particular, the principles of ‘no surprises and transparency’, ‘proportionate, cost reflective and avoiding regulatory burden’. In addition, these changes move further away from the principle of a simple and clear NARM framework.

We are also concerned around how the assessment for interventions that fall into the CIOD and CIUD mechanism, will be applied to volume-based NARM target. For many legitimate reasons⁴, there can be significant variation in both the LTRB and the cost for specific interventions within the same UID category. This is the core reason why using the Unit Cost of Risk (UCR) with a 5% threshold change, results in 98% of the NGT AH programme falling into the CIOD/CIUD mechanism. In such a circumstance where most of the AH programmes becomes subject to ex-post review it is unclear to us how this can practically work with the NARM LTRB target and incentive mechanism and would effectively void the framework.

In addition to our concerns articulated in this letter, we have previously highlighted issues with the way the Low, Medium and High risk sub-categories for NGT are expected to function. The existing mechanism at present would overly favour NGT within the Medium and High risk sub-categories. Recalibrating these sub-categories would help ensure the right incentives are applied to NGT in delivering consumer value.

We request further dialogue with Ofgem on an appropriate approach to CIOD/CIUD specifically for NGT to ensure the NARM Funding Adjustment and Penalty Mechanism is equitable to the principles agreed at the start of RIIO-T2 and any subsequent proposals do not undermine the incentive mechanism intended. Currently, we do not agree with the changes proposed and have strong concerns around the potential impact on the principle of NARM for NGT. Further to our request for further dialogue, we would be happy to discuss our response in more detail with you should you seek any points of clarification or further information.

NGT's designated point of contact for this submission is Neil Rowley, Head of Regulatory Performance (neil.rowley@nationalgas.com, 07785 381424).

Yours sincerely

Tony Nixon – By Email
Regulation Director, Commercial - On behalf of NGT

⁴ UID interventions take place across a vast network from entry points and exit points all with differing consequences of failure and costs to remediate.

Appendix 1 – NGT response to 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 Ofgem that it's been the intention to set thresholds for CIOD/CIUD to be considered outside the 'automatic' NARM funding adjustment. However, given the potential impact on NGT of the approach taken, we disagree with the timing of this approach given we are in delivery of year four of our asset health investments of a five-year price control.

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

Ofgem propose to set the UCR threshold at +/-5% of the baseline UCR of the given risk sub-category. Ofgem recognise that this lower UCR threshold to qualify as CIOD/CIUD element will increase the number of projects that can qualify, and ultimately place a greater emphasis on close-out. For Ofgem this is outweighed by the reduced reliance on the 'automatic' funding mechanism. Ofgem consider this approach to be necessary on the balance of evidence available.

We have described our views in our response above and we do not agree that a 5% UCR threshold is prudent or rational for NGT given we have a volume driven NARM target based on UIDs.

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

Ofgem Proposal:

Ofgem 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.

NGT view:

We agree with this proposal given this has already been proposed through the annual reporting for NARMs. For avoidance of doubt, for NGT this reporting will be done on a Unique Identifier level (UID – individual assets), given our NARM target is built upon targets on UID, as opposed to at a project level.

Ofgem Proposal:

Ofgem 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 because 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).

NGT view:

It is unclear to NGT how the proposal will impact the NGT NARM target which is based at the UID rather than project level. In most cases UID will not be subject to reduced technical specifications. We seek further clarifications on this point. Furthermore, in general we disagree with the proposal to include any Baseline UIDs in the CIOD mechanism.

Ofgem Proposal:

Ofgem 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.

NGT view:

We do not agree with this due to our concern around the CIOD/CIUD process.

Ofgem Proposal:

Ofgem 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.

NGT view:

NGT disagrees with the CIOD/CIUD process being proposed, specifically applying +/-5% threshold to the UCR drives 98% of the NGT NARM portfolio into closeout assessment. We believe there is an urgent need to discuss and define an alternative way to determine CIOD/CIUD for NGT. As such we disagree with the proposal for justification percentage above.

Ofgem Proposal:

Ofgem 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. 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.

NGT view:

Whilst we agree with the principle outlined, this proposal highlights the concern we have with the CIOD/CIUD process and the likelihood of NGT having to justify the near entire portfolio. This is not our understanding of the NARMs principles agreed at the start of RIIO-T2 and puts significant

uncertainty on the outcome of the NGT AH programme. We also have no understanding of how the justification process will work for NGT increasing our uncertainty.

Ofgem Proposal:

Ofgem have considered the issue raised by licensees regarding delays to NARM projects in RIIO-T2 and how this could result in NARM projects defined in the RIIO-T2 baseline over-running into the next regulatory period, 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.

NGT view:

We agree with Ofgem's proposal.