



Northern Powergrid's response to Ofgem's consultation on the Threshold for justifying Clearly Identifiable Over or Under Delivery under the NARM Funding Adjustment and Penalty Mechanism

KEY POINTS

It is important that Ofgem's approach in this consultation is not seen as precedent-setting for electricity distribution (ED); the ED NARMS framework is more mature, providing Ofgem with unprecedented levels of asset information, and if the proposal for project-by-project reporting were carried across to ED it would represent a substantial and retrograde step.

- Northern Powergrid has always viewed NARMS as a useful decision making and regulatory reporting tool but we continue to oppose their increasing use by Ofgem to micro-manage and remove incentives towards good asset management where this reduces activity volumes.
- If the proposals in this consultation were applied to ED, the high volume of small projects being captured would further cement the micro-management of company decisions and cost allowances, and create a substantial additional administrative burden for Ofgem.
- In our sector, it is critical for cost efficient delivery of a low carbon future that Ofgem avoids any mindset of seeking to avoid differences between "final allowed expenditure and efficiently incurred outturn expenditure". Removing the scope for such differences removes a fundamental cornerstone of incentive regulation on which a low-cost transition rests.
- The consultation highlights the incentive distortions caused by the manner in which Ofgem has increasingly developed the NARMS framework –to provide (or remove) funding on a largely continuous basis. Using NARMS instead as a broader-brush outputs check and backstop would avoid the distortions.
- The distortions help to further illustrate why volume drivers are best suited to cases where the volume of activity is externally or objectively driven and licensees have little or no control over the number or mix of interventions.
- We cannot tell if the proposed thresholds may be appropriate for high value transmission projects, or gas distribution, but think they would not be proportionate where low cost activities are identified as projects individually, such as is the case in ED. For the same reason, project-by-project reporting would not be proportionate in ED.
- We think that full sector specific definitions of the term 'project' would be beneficial, for clarity and to avoid different interpretations.

Overview

- 1) Ofgem is consulting on its 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.
- 2) Ofgem is 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.

General points applicable to all consultation questions

- 3) It is important that Ofgem's approach in this consultation is not seen as precedent-setting for electricity distribution (ED); the ED NARMS framework is more mature, providing Ofgem with unprecedented levels of asset information, and if the proposal for project-by-project reporting were carried across to ED it would represent a substantial and retrograde step.
- 4) Northern Powergrid has always viewed NARMS as a useful decision making and regulatory reporting tool but we continue to oppose their increasing use by Ofgem to micro-manage and remove incentives towards good asset management where this reduces activity volumes.
- 5) If the proposals in this consultation were applied to ED, the high volume of small projects being captured would further cement the micro-management of company decisions and cost allowances, and create a substantial additional administrative burden for Ofgem.
- 6) In our sector, it is critical for cost efficient delivery of a low carbon future that Ofgem avoids any mindset of seeking to avoid differences between "final allowed expenditure and efficiently incurred outturn expenditure". Removing the scope for such differences removes a fundamental cornerstone of incentive regulation on which a low-cost low carbon future rests.
- 7) The consultation highlights the incentive distortions caused by the manner in which Ofgem has increasingly developed the NARMS framework – to provide (or remove) funding on a largely continuous basis. Using NARMS instead as a broader-brush outputs check and backstop would avoid the distortions.
- 8) These distortions help further illustrate why volume drivers are best suited to cases where the volume of activity is externally or objectively driven and licensees have little or no control over the number or mix of interventions.

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

- 9) Although our general comments (above) apply, taking as a given the need to identify a threshold we agree in principle with Ofgem using the latest outturn data, that is already collected, in order to inform the requirement for further detailed assessment.

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

- 10) We cannot tell if the proposed thresholds may be appropriate for high value transmission projects, or gas distribution, but think they would not be proportionate in a sector such as ED where low-cost activities are identified as projects individually.
- 11) We would expect that a significant number of projects would meet the thresholds proposed due to the wide range of costs and risks associated with different activities of work, i.e. the lack of correlation between baseline funding and network risk output is not unexpected.
- 12) The range of work that may be undertaken on an individual asset may vary though the key sensitivity will be in the network companies' assessment of risk in line with the relevant NARM methodologies. That is, a work activity on two discrete assets may be identical but the risk could be orders of magnitude different for factors including network load.

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

- 13) Our comments in response to this question relate to two areas:
- a. Project-by-project reporting
 - b. The definition of a "project"

Potential project-by-project reporting requirements

- 14) Ofgem is 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.
- 15) This may be more appropriate for high value transmission projects, but we do not consider that this is proportionate for high volume projects of relatively low cost. The reporting requirements for NARMs across all sectors is already extensive and the submission of project level information undermines the principles of NARM.

- 16) Rather than imposing blanket requirements for such reporting, Ofgem could instead use its information powers under the licence to request more information in any instances where such data does become necessary.

The definition of a project

- 17) It is not specifically focussed on in the Consultation but we think that full sector-specific definitions of the term 'project' would be beneficial, for clarity and to minimise the risk of different interpretations.
- 18) For example this could include specifying whether they must be at individual sites, or the degree of similarity between activities undertaken at multiple sites before they must be identified as a single project. If multiple licensees are undertaking similar activity, whether it constitutes a project should not be determined by how the licensee has decided to manage or group the activity.