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Mark Hogan
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16 August 2024

Dear Mark,

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

I write on behalf of SGN with reference to the consultation on the NARM Handbook regarding changes relating to the Threshold for justifying Clearly Identifiable Over or Under Delivery under the NARM Funding Adjustment and Penalty mechanism published by the Authority on 3rd Jul 2024.

We broadly support Ofgem's approach to determining the clearly identifiable UCR threshold. However, the analysis used to establish this threshold has not been included in this consultation, which limits us from commenting on the broader analysis underpinning the UCR threshold. Based on our own analysis of the UCR threshold, we do not have any specific objections to Ofgem's proposed ±5% margin stated in the handbook.

We acknowledge that significant effort has been made to conclude the UCR threshold and refine the Handbook. However, we are disappointed by the timing of its release in the price control process. We believe Ofgem had sufficient information, in the form of the Network Asset Risk Workbook, to establish the UCR threshold earlier in the price control process as stated in the previous version of the NARM Handbook and this would have improved regulatory stability.

We are committed to delivering a program that adheres to good asset management practices, this delay introduces a substantial level of uncertainty regarding the funding of our completed and planned workload.

While some of the amendments to the NARM Handbook offer valuable clarity on the funding mechanisms, we maintain significant concerns that the methodology for the NARMs Funding Adjustment and Penalty Mechanism remains unclear and urgently requires clarification.

We understand the proposed amendments are to mitigate risks associated with any windfall gains/losses and we fully support that principle. However, we believe some these amendments significantly deviate from the original framework as set out at start of the price control. For example:

Exclusion of Clearly Identifiable project for deadband threshold

We do recognise the need to normalise Clearly Identifiable elements from Network Risk Output for funding allocation. However, we are unclear on the rationale for excluding Clearly Identifiable elements from the justification deadband. In our view, the deadband for justification should be applied at the ONRO level, regardless of the funding mechanism, 'automatic' or 'Clearly Identifiable'.

Amendment to second qualifying criteria of Clearly Identifiable and the clarification on CIO_{OD} 'element'

We understand the rationale provided in the consultation where 'fewer physical assets are being added back onto the network' following an intervention can lead to a higher risk benefit and consequently, a higher overall Network Risk Output. We agree that this should be normalised and assessed through the Clearly Identifiable mechanism. However, the wording in the Handbook does not entirely reflect this logic. Instead it suggests that any project that deviates from the Baseline scope can also be normalised through the Clearly Identifiable mechanism. This will include projects that are risk-traded within a specific project or scheme (e.g., 2km smaller diameter mains replaced with 1.5km of larger diameter mains). We believe such activities should be treated under the 'automatic' mechanism; otherwise, it undermines the ability to engage in risk-trading and heavily relies on ex-post assessment on every asset management decision.

Additionally, we have concerns about the selection of Clearly Identifiable 'elements', especially when a project is part of a broader program or scheme of works, as workloads within such programs will change over the price control period compared to the baseline. We remain unclear on how these projects would be distinguished and separated out for the Clearly Identifiable mechanism.

For the avoidance of doubt, it would be useful to clarify that the 'Clearly Identifiable' element is only formed of over-or-under delivery at an aggregated level. In the case of GDNs, that is at network level. Therefore, Clearly Identifiable is the portion of over-or-under delivery element that is above-or-below the Baseline Network Risk Output.

If interpreted as described above, this approach could significantly deviate from NARMs' intended purpose, where risk trading benefits the customer and enables networks to make decisions that are supported by the NARM framework. These proposed changes and the lack of clarity contribute to the funding uncertainty of our asset management decision-making.

Clarification on determining the justification percentage

While we fully support the principles behind determining a justification percentage, the method for calculating this remains unclear. The update to section 7.14.g and the application of the justified proportion (JUS) state that the JUS "*will be calculated by weighting each project's justification percentage by its relative efficient incurred costs*." However, there is no clear guidance on how Ofgem will determine which costs are considered efficient. This lack of clarity continues to create uncertainty in the funding mechanism.

NARMs funding across regulatory periods

We acknowledge that the NARM funding mechanism provides a “sufficient mechanism” to address over- or under-deliveries within a regulatory period. However, it is also important to recognise that asset management decisions and investments are not based on the price-control period. Projects may experience delays due to factors beyond our control, such as supply chain disruptions. Especially for larger projects that extend beyond the planned schedule by a few months, where majority of the work is completed, it is important to consider adjustment in the guidance for these scenarios. This would help mitigate large funding adjustments due to the obligation to an artificial deadline associated with NARMs benefits. Therefore, it is crucial to have a mechanism that accounts for transitions between price-control periods.

To remove this uncertainty, SGN strongly encourage Ofgem to further review the areas highlighted above regarding the criteria of the Clearly Identifiable mechanism. Additionally, it will be crucial that rules of the funding and penalty mechanism are set-out upfront for the coming price control period (RIIO-GD3) to minimise uncertainty around asset management decision making.

Additionally, we have not received an updated Appendix 3 workbook that will help us assess our close-out position. It is crucial that Appendix 3 is released to ensure we have a clear understanding of our outturn position to confirm the benefits of decisions we have made through the RIIO-GD2 period.

The concerns that we have with specific sections of the current handbook are outlined below in our responses to the questions posed by OFGEM in the consultation published on 3rd Jul 2024.

If you have any questions regarding our responses, please do not hesitate to get in touch.

Yours Sincerely

David Handley
Director of Strategy and Regulation, SGN

SGN's response to the consultation questions relating to the NARM Handbook:

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 evidence of poor correlation between funding and network risk outputs is clear and that the potential impacts this could have on funding outcomes are highly variable. However, we would like to note that this is not a revelation found in new information. The information was available during the Final Determination stage in the form of NARW and concerns were highlighted in the initial consultation regarding NARM Handbook. We are disappointed it has taken over 3 years for this to be formally acknowledged as this delay introduces uncertainty into the funding mechanism.

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

We agree with Ofgem's assessment that the evidence clearly indicates that the 'automatic' mechanism has the potential to yield unintended outcomes that are not cost-reflective and therefore, the implementation of a low threshold is reasonable. This will ensure that companies are both fairly funded whilst preventing any windfall gains.

We would like to point out that the original purpose of the NARMs automatic funding and penalty mechanism was to avoid the need for ex-post assessment and to provide companies with flexibility in their asset management decision-making, while providing Ofgem with clarity and confidence in how projects/programs of work were managed. However, we believe the handbook lacks sufficient clarity regarding the funding mechanism and increases the ex-post assessment burden.

During Ofgem's investigation into the UCR threshold it was clear that variation between sectors is a challenge. While reporting monetised risk in a common currency is a goal that SGN agree with, the application of a one size fits all funding methodology approach across all sectors is not in the best interests of consumers. In particular, the variation between the typically high-volume intervention driven distribution sectors and the major project driven transmission sectors does not lend itself to a common automatic funding methodology.

The problem between sectors is demonstrated in the proposed change to qualifying criteria (10.5.2). During consultation this change was generally explained with a specific Electricity Transmission problem as a result the wording put in the handbook is ambiguous as to the treatment of higher volume assets. Our concern is that this change will lead to penalisation of risk trading and, as a result, will hamper Networks' ability to react to changes in their asset base, removing the flexibility required to ensure the correct interventions are undertaken at the correct time. This ability to risk trade is a cornerstone of the NARM methodology.

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

We firstly seek clarity on whether, following this consultation, a license consultation will be initiated. We believe the amendments proposed for the NARM handbook do not meet the criteria defined under Part E of SpC 3.1 and therefore requires a license consultation.

We understand the proposed amendments to the Handbook are intended to mitigate potential risks associated with windfall gains/losses and to provide further clarity to Networks. However, we believe some these amendments significantly deviate from the original framework as set out at start of the price control and create more ambiguity.

The delay in finalising the NARM handbook has added to the funding uncertainty for the price-control. SGN will always prioritise making asset investment decisions in-line with asset management best practices to ensure that we maintain a safe and reliable network and will always intervene in the appropriate manner to deliver best value for of our customers. In making such investment decisions, it is also important to be clear on the funding implications – changes to the funding framework mid period makes understanding these implications highly challenging.

Selection of projects for Clearly Identifiable mechanism – Amendments to section 7.12

We understand the need to provide cost information at project-by-project level to identify schemes/projects that meet the Clearly Identifiable criteria. However, we are concerned that adding finances into the NARM RRP duplicates information that is already provided to Ofgem through the cost and volume RRP and, therefore, increases opportunities for errors. We propose that costs submissions be contained to the cost and volumes RRP and that the NARM-Cost and Volume interfaces be developed for alignment at the level of detail necessary for the assessments.

Further to this point, there are some project misalignments between the NARW workbook and the latest C&V RRP. We propose to aggregate lines/projects provided in the NARM RRP to the level available C&V RRP. We believe this would improve consistency of submissions across the networks and reduce complexity.

For example, the current C&V RRP requires cost to be split into NARM asset type (Preheating, filter, etc.) but the cost information is captured at project level. Therefore, breaking down project management and construction cost is arbitrary and does not reflect reality.

Another example of misalignment is the REPEX cost data under NARW, these were initially developed from the GD2 BPDT however, the C&V RRP has since been revised and certain lines have been aggregated. For example, within the BPDT, Tier 2 Cast and Spun Iron mains were separated into low and medium pressure but are now aggregated in the RRP. The requirement in the new NARM RRP, to provide cost at the more granular level, demands significant changes to embedded procedures. SGN's reporting systems have been developed for the level of aggregation presented in the cost and volumes RRP.

Clarification to qualifying criteria for clearly identifiable– Amendments to section 10.5

We remain unclear on how amendments to the qualifying criteria will be applied to scheme of works. From the consultation document we understand the amendments are designed to avoid scenarios where 'fewer physical assets are being added back onto the network' and we agree this should be normalised and assessed through the Clearly Identifiable mechanism. However, the wording in the Handbook is unclear around how a scheme that deviates from the Baseline scope would be assessed.

Therefore, we would like further clarification around the definition of 'reduction in the scope of a baseline project'. We would like to understand how risk-trading is treated within a scheme listed under NARW workbook. For example, where a scheme that includes various diameter bands and actual delivery includes risk trading from a smaller diameter main to larger diameter within that scheme.

We believe there should be flexibility within the NARM mechanism to risk-trade between schemes as long as overall Network Outturn UCR is in-line with the Baseline UCR and should not be penalised for changes in delivery where the aim is to maximise value for our customer and to maintain a safe and reliable network.

Furthermore, we are unsure how over-or-under delivery 'elements' will be separated out of a scheme. We would like further clarity around the definition of 'quantifiable and separable' and how this is treated for a scheme. We would also like to point out that all of our transmission projects have been individually named, instead of grouping at the asset type level. In the interest of transparency and fairness will Ofgem assess all network at similar level of granularity.

Amendments to the CIO_{OD} definition and Justification percentage, JUS

We welcome the clarification around the CIO_{OD} term and agree only the over-or-under delivery 'elements' should be captured through the Clearly Identifiable mechanism.

We acknowledge the update to the application of the justified proportion (JUS), which states that the JUS "*will be calculated by weighting each project's justification percentage by its relative efficient incurred costs.*". However, there is a lack of guidance on how the funding mechanism will determine what constitutes an efficient cost. The lack of clarity introduces further uncertainty and therefore, we request further guidance on the criteria for determining what is considered an efficient cost.

Appendix 3

The NARM Handbook Appendix 3 has not been reissued as part of this consultation; we therefore request an updated copy of the Appendix 3 which reflects the amendments made by Ofgem to NARM Handbook.

Late delivery of projects

During the consultation period concerns were raised around leniency in the case of late delivery of projects, specifically in the case of delays outside of the control of networks. We acknowledge that to some extent the NARM funding mechanism provides a “sufficient mechanism” to address over- or under-deliveries within a regulatory period. However, it is also important to recognise that asset management decisions and investments are not based on the price-control period. Projects may experience delays due to factors beyond our control, such as supply chain disruptions. Therefore, it is essential to have a mechanism that addresses transition between price-control periods. We request further guidance on how the transition will be managed and how business will be funded for expenditures incurred shortly after the conclusion of the GD2 period.