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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 from SP Transmission (SPT) which holds the electricity transmission licence for south and central Scotland. SPT is part of SP Energy Networks (SPEN) and the wider Iberdrola Group. Thank you for 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 (“the NARM mechanism”).

We support the setting of the UCR threshold for the determination of clearly identifiable under delivery or over delivery (CIUD/OD) at $\pm 5\%$ to protect consumers interests and ensure appropriate allowances for companies to deliver work under the NARM Mechanism. We remain concerned at the lack of certainty around how allowance adjustment associated with these schemes will be undertaken given that almost all our delivery variance will be handled under this mechanism. We make comment on this matter at the end of this response.

While we welcome the update under this consultation, we are of the view that the NARM Mechanism should be comprehensively reviewed, and its suitability assessed, before any application in the RIIO-3 period. Our rationale for this is set out in response to Question 2. SPT looks forward to further discussion on this topic ahead of final determination and licence drafting for RIIO-3.

SPT make comment on a proposed approach to allowance adjustment as part of the RIIO-T2 close out process to support the NARM mechanism at the end of this response.

We note for clarity that the NARM mechanism as set out in the NARM Handbook does not apply to the SP Distribution and SP Manweb licences within the SPEN group given the different approach to regulating higher volume asset interventions, with fewer defined projects, in the electricity distribution sector.

We look forward to working constructively with Ofgem and other companies in continuing to ensure that NARM remains an effective means by which the need for work is identified and justified and outputs reported against an appropriate mechanism, providing suitable allowances for companies while considering the needs of consumers.

Yours sincerely,

Craig McTaggart
Head of Transmission Network

Annex 1 – Responses 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 welcome the work undertaken by Ofgem to assess the current operation of the NARM mechanism, and in particular in understanding the issues which are being felt acutely in the ET sector. The outcomes presented by Ofgem are in line with our own analysis of our NARM portfolio. Understanding the potential for windfall gain and loss as a result of variance in NARM output delivery relative to the baseline value is an important step to determine the significance placed on the UCR threshold value. We are satisfied that the approach taken is robust and has taken account of the relevant factors in determining a suitable UCR threshold.

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

SPT agrees with the setting of the UCR threshold at a low value given that this reduces the potential for disproportionate allowance adjustment in the event of an under or over delivery. While there is no empirical evidence for $\pm 5\%$ being more appropriate than any other value, in practice it strikes a balance between appropriateness of outcomes and the level of regulatory scrutiny required. A value of $\pm 5\%$ is consistent with the SPT view that it should be limited to a small value, not higher than 10%, which we set out in our original NARW and NARM Handbook Consultation response of 18th March 2021.

In selecting a low value for the UCR threshold to protect consumers, and to ensure fair outcomes for companies delivering sound asset management decisions, does highlight a significant weakness in the NARM mechanism. This weakness is acknowledged in paragraph 3.7 of the consultation document. While there is a requirement to set a UCR threshold for use within the RIIO-T2 period, a high proportion of schemes having the potential to fall under the CIUD/OD element of the NARM Mechanism results in the potential for significant proportions of the NARM delivery programme to have their allowances set or adjusted ex-post. This ex-post assessment, against a set of criteria which is not defined, is not conducive to supporting companies to make timely asset management decisions in consumers' interest given the level of uncertainty which surrounds the calculation of associated allowances. SPT believes that revision to the wider mechanism should be considered ahead of the RIIO-T3 period.

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

Our response on the position taken with regards other aspects of the NARM handbook is set out below in relation to each specific area of proposal.

Selection of projects for clearly identifiable mechanism

SPT is concerned by the apparent introduction of an additional layer of assessment for schemes to be considered as CIUD/OD. These concerns stem from paragraph 3.23 of the consultation document which states that “[the Authority] propose take a pragmatic approach in determining which projects that meet the four criteria should be managed through the clearly identifiable mechanism to appropriately manage the risk of non-cost-reflective expenditure allowances.”.

While we accept that the setting of a low UCR threshold for the determination of projects meeting the CIUD/OD criteria will lead to an increase in projects which may potentially be covered under the mechanism, the use of a “pragmatic” approach to the application of the methodology renders these criteria partially redundant. We believe the use of any additional qualification criteria which are not

clearly set out in the NARM Mechanism has the potential to cause uncertainty and a lack of transparency.

The use of the term “the determined Network Risk Outputs”, the NARM Mechanism para 7.14 b), already serves to identify that the final determination of a scheme’s inclusion as CIUD/OD for the purposes of the NARM Mechanism reside with the Authority. However, it is our understanding that this determination is with regard to a project’s compliance with paragraphs 10.5 and 10.7 of the NARM Mechanism which set out the qualifying criteria for consideration as CIUD/OD.

We do not oppose the proposal in paragraph 4.6 of the consultation to require licensees to report end of period performance at a project level, given that this is already a requirement within the NARM RRP. However, we are firmly of the belief that this should only be for the purposes of assessing the performance of a project against the criteria set out in the NARM Mechanism and not in support of any further “pragmatic” assessment or cost efficiency calculation.

We therefore do not agree with the proposal to insert the wording “... and the Authority deems should be classed as,…” in paragraphs 7.14 b) and 7.15 d) of the NARM Mechanism relating to classification of CIUD/OD for the reasons set out above.

[Clarification to qualifying criteria for clearly identifiable mechanism](#)

The intention to clarify the quantification criteria of CIUD/OD candidates for a subset of project scenarios is supported by SPT. We agree that for schemes where the technical solution remains the same, but delivery of a reduced number of intervention volumes with regards to the baseline scheme results in a higher value of Long Term Risk Benefit (LTRB), then this should not be considered over delivery under the UCR element of the NARM Mechanism and bespoke treatment should be applied.

We are supportive of the intent of the proposed update to paragraph 10.5.2 of the NARM mechanism however for the specific scenario which is envisaged we believe that reference to a lower volume of asset intervention may be easier to transparently and unambiguously identify and quantify than the “reduction in the scope of a baseline project” which is currently proposed.

In order for the Authority to determine where such situations have arisen, an assessment of project scope and/or intervention volumes would be required. Given that the proposed update to paragraph 7.12 of the NARM mechanism specifies neither of these we believe that the Authority may be better served by including a requirement to specify volumes of asset intervention as part of the close out requirements to aid identification of these works, particularly in cases where the justification threshold is not breached.

[Clarification on the ClO_{op} term](#)

We are supportive of the move to reference a CIUD/OD element instead of a project for the reasons set out in the consultation. This distinction arises from the need to adjust the NRO for the amount that the CIUD/OD varies from its baseline value when separating the delivery of network risk output from that which is to be considered CIUD/OD. We do however believe that in relation to the justification and calculation of suitable allowance adjustment that it is important to reference any CIUD/OD element with regard to the whole project to understand the context of the change. A review of the consistency of application of terms related to the reporting of work done vs the baseline and the application of the NARM Methodology would help to improve clarity. Calculating an allowance adjustment on only the risk and cost of a CIUD/OD element risks losing sight of the context of the wider scheme.

SPT look forward to a revision of the Appendix 3 which sets out clearly how the calculation relating to CIUD/OD elements will operate in practice.

Clarification on determining the justification percentage, JUS

The proposal to clarify the calculation of the justification percentage is welcomed and we are agreed on the intention behind the clarification. However, we have reservations about the inclusion of the term “efficient incurred costs”. While SPT strives towards execution of projects in an efficient and coordinated manner we do not believe there is any scope within the NARM mechanism to test the efficiency of that delivery.

We would seek confirmation of our understanding that the need to justify any over/under delivery is only required in cases where the risk work outturn is more than $\pm 2\%$ of the baseline network risk output for any given risk sub-category, after CIUD/OD is excluded.

Given that a justification percentage acts on an allowance value which has been determined through either a UCR assessment or by specific cost assessment, if deemed to be CIUD/UD, then the allowance adjustment should be appropriate for the value of outturn network risk output associated with that project. We believe there is a place in the case of CIUD/OD to ensure allowances are set at an appropriate value, considering work done and actual expenditure. As such it is our view that the term JUS(%) should be weighted by project allowance, either baseline or final depending on the delivery case, and that reference to “efficient incurred costs” should be removed.

We would welcome an update to the Appendix 3 workbook which clarifies how these values will be determined and combined in practice.

Justification for clearly identifiable delivery elements

SPT are supportive of the move to clarify the justification process for those projects determined to be CIUD/OD. We however have the same reservations as set out in the section above regarding the weighting of that justification.

NARM funding across regulatory periods

Using the NARM mechanism to adjust allowances downwards in the RIIO-2 period as a result of under delivery because of a project completing a short time after the end of the period, assume 6 months, introduces a significant administrative burden to assess the justification and determine suitable allowance adjustment. We are of the view that a period following the end of the RIIO-T3 price control where works could be completed, ahead of the submission of the close out report, would simplify this process for companies and Ofgem, without acting against the interests of consumers.

By not setting a mechanistic approach for the rollover of schemes between RIIO-2 and RIIO-3 this creates uncertainty in the recovery of allowance for fully justified works. Where a scheme does not complete in RIIO-2 an allowance adjustment appropriate to the amount of under delivery will be made. Given that this would have been justified as part of the setting of that allowance the completion of the work should be considered necessary and justified. The funding of work which completes in a future price control period is reliant on a future funding adjustment mechanism which makes provision for justified over delivery. It is expected that even with such a mechanism in place that over delivery would not be funded until the end of the next regulatory period, creating a period where the company carries the uncertainty of the investment which has been determined to be justified. This may lead to companies being incentivised to undertake certain actions, taking account of justification and funding timelines rather than in a timeline which prioritised consumer need.

SPT proposals on funding adjustment under the NARM Mechanism

Under the NARM Mechanism, where the works undertaken result in an over or under delivery with a UCR within $\pm 5\%$ of the baseline UCR then allowance adjustment is prorated based on the network risk output.

Where a delivery element is CIUD/OD there is at present no guidance on how the “efficient additionally incurred costs or unspent allowances” will be determined. We would propose that consideration be given to a prorating of scheme costs based on network risk output for each given project which falls under the CIUD/OD mechanism in the case of under delivery. For those costs not aligned with NARM reportable assets they may be assigned a similar fashion, based on the relative percentages of the NARM asset costs within each scheme.