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Dear Faysal,

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

Thank you for providing the opportunity to provide comment on Ofgem's proposals to update the Funding Adjustment and Penalty Mechanism. We welcome Ofgem proposing the upper and lower threshold values for the Unit Cost of Risk (UCR) which provides some much-needed clarity on how the qualification criteria for the Clearly Identifiable mechanism. We have been anticipating this clarification since the publication of Ofgem's NARM handbook v3.1 which referenced that it would be consulting on these thresholds in Q3 of 2022-23¹.

The starting point for NARM has been the assumption that the methodology provides a close correlation between network risk and funding. We welcome that Ofgem have now provided some acceptance that this is not as strong as assumed². We look forward to Ofgem undertaking the required work to correct this for RIIO-T3 and will continue to support the work to find the required changes. While the proposals of this consultation offer a more short-term fix for the current T2 period, we are pleased to see that this decision has been informed by the analysis shared by licensees that was then used to understand the expectation about the consequences of projects being reviewed at close out.

However, we are disappointed in Ofgem's proposal regarding NARM funding across regulatory periods. During the RIIO-T2 period, we have witnessed customer needs and network drivers changing since our 2019 T2 Business Plans. As a result of supply chain long lead times, consenting timeframes and outages, some of our T2 NARM projects will be fully delivered outside of the arbitrary T2 deadline of the 31 March 2026. As large and complex activities, Transmission projects will not consistently fit into designated 5-year price control periods. This can often differ from other sectors where the assets intended for replacement or refurbishment have other points of dependency and, as has been described before, interact with other projects and delivery mechanisms. Projects of this scale incurring any delays, especially if scheduled for latter part of the price control period, would then need to crossover to the next price control period. We are seeking a pragmatic approach from Ofgem to simply reprofile these allowances across T2 and T3. Ofgem's current proposals as outlined in this consultation document to treat these as under-deliveries will use up time and resource, from both the TOs and Ofgem, through both the T2 close out process and the T3 Business Plan assessment for no benefit of the consumer. We offer potential scenarios in this response where licensees could be forced to resubmit projects that have incurred minor delays as part of their T3 baseline. Alternatively, a T3 re-opener would be required to accommodate those projects not completed within T2. Either of

¹ See paragraph 10.10 of the NARM Handbook v3.1

² 3.6 of the consultation document.

these approaches will create the type of administrative burden that should be avoided since it would offer no benefit for consumers and can be expected to be time and resource intensive for both Licensees and Ofgem.

Ofgem have signalled the intent of finding a pragmatic approach for these crossover projects, but this is not matched with the proposal of them being considered as part of the Clearly identifiable mechanism. This is the most significant shortcoming of the proposals and directly opposes the appeal that we have made in terms of how such projects should be treated. We continue to elaborate on this in responding to the consultation questions in the annex provided below. At present, the intended approach is a notable absence in what is an opportunity to ensure that projects are assessed on the basis of the actual circumstances they have been subject to. Our proposals also follow from the positions set out in our recently submitted 'State of the Nation' report giving an overview progress through the RIIO-T2 period. These include:

- A pragmatic approach that allows responding to changes in project needs and allowing the hand-back of partial or full allowances.
- For projects being deferred to the T3 period we propose the clean and transparent option of handing-back full project allowances with the ability to then request new, and equivalent allowances in T3.
- T2 projects fully delivered by the end of 2026/27 should be treated as 'delivered' with spend re-profiled across T2 and T3 during close out.
- Further overhaul about the appropriateness of how monetised risk is used in T3.
- Consideration of the gap between the expected submission of T3 business plans and the end of the current T2 period.

The proposals also include the intention of having flexibility in applying the Clearly identifiable mechanism as well. In principle this is a way to ensure it is used appropriately but we would also like to ensure that licensees are not disadvantaged by not fully knowing the evidence that would be considered through any justification review.

We will continue to work with Ofgem in developing NARM and build upon the engagement with licensees. Please get in touch if there are any details in our consultation response that you would like to discuss further.

Yours sincerely

Josh Henderson
Senior Regulation Analyst

Annex – SSEN Transmission responses to the Consultation Questions

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

Overall, we agree with the approach taken to establish a suitable UCR threshold since as it reaches a UCR position that is consistent with the analysis provide from SSEN Transmission and the other Transmission Owners. While this is going to offer an opportunity to practically assess project delivery at close out, this should also be noted as being implemented differently from how the Clearly Identifiable mechanism was intended. Whereas, the intent was for it to be considered as an exception process, this is now expected to be widely applied across a substantial number of NARM projects.

The need for this approach strongly highlights that the proposed automatic funding mechanism fundamentally does not work as intended and is reliant on significant intervention to avoid the potential for either windfall gains or losses for licensees and producing undesirable outcomes for consumers. It also highlights that aspects of NARM require substantial overhaul as has been raised by licensees throughout the RIIO-T2 period and captured before as part of our SSMC response³. The now expected wider use of the Clearly Identifiable process will help overcome some of these issues but it should also be acknowledged as being layered on top of a function where this type of ex post assessment was intended to be minimised. We anticipate that there will be further activity required from Ofgem in order to have a more automated adjustment that is fit for purpose or otherwise abandon that approach and instead settle on the certainty of an approach that, while creating more manual intervention, will more likely result in acceptable outcomes. SSEN Transmission made the appeal ahead of the T2 period that Monetised risk outputs is not a real valuation and that a monetised risk function is a utility function to allow trading between asset categories in a common currency. This disconnect from real value and its monetary value has been a contributor to occurrence for windfall gains and losses and so continues to be an issue that should be addressed in T3.

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

As noted above, while being layered on top of a flawed approach (i.e. the funding adjustment principle), we are settled that this will address the previously raised issue of potential windfall gains/losses.

Updates have been made to the NARM handbook to include licensees being required to justify project inclusion as part of the Clearly Identifiable mechanism. Based on current drafting, we do not believe this adequately prescribes what will be required to evidence a projects inclusion as part of the Clearly Identifiable category.

There are two specific reasons why this is necessary as part of having a transparent and predictable assessment:

- 1) Licensees should be able to gather the required information to best ensure a fair and properly informed review.
- 2) It will help avoid Ofgem and Licensees having to debate relevance of provided evidence when going through the assessment process.

The potential for uncertainty is also reinforced with noting that Ofgem will make the assessment with the context of the wider project position and not just the qualifying criteria as has otherwise been the expectation⁴. The potential burden of a widely used Clearly Identifiable mechanism also needs to be considered in the wider context of both closing out of T2 settlement and the moving into the T3 price control period. If there is clearly going to be a

³ Addendum 1: Additional detail on NARM

⁴ Paragraph 4.4 of the consultation document.

substantial number of assessments that will be undertaken during the start of a new price control period, this should be used as strong encouragement to find a more pragmatic approach to those projects not strictly delivered before April 2026 but because of circumstances outside of the licensees' control.

The preferred option of assessing T2 projects as delivered in the first year of T3 also overcomes the gap between the timing of when T3 business plans being submitted to Ofgem in December 2024 but the T2 delivery period concluding in March 2026 and with the close-out report being submitted by 31 October 2026. Alternatively, a NARM re-opener would be required in T3 to add T2 projects not strictly, or entirely, delivered by March 2026. However, this could be expected to introduce its own time consuming and costly process. In terms of introducing the potential for administrative burden, Ofgem should also be mindful of the steps that TOs could take of introducing projects into the T3 baseline plans only for them to be removed if delivered before. Licensees could be in a position of projects being presented in both T2 and T3 periods to anticipate them being completed in either period and as a way to overcome this uncertainty. This could be undertaken to overcome the regulatory risk on funding that would then be resolved during the T3 close-out. Approaching this either way, the potential for projects fully delivered by the end of 2026/27 and then being treated as 'delivered' with spend re-profiled across T2 and T3 during close out, should be taken as the preferred approach.

Having the expected criteria established will also be part of licensees being enabled to understand the allowance that will be settled. It would also provide comfort that any assessment from Ofgem does not conclude on an allowance after licensees have made the required expenditure.

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

We welcome the updated requirements that will inform what is needed for a successful close out. In particular, we appreciate where Ofgem has been responsive to licensee feedback in deciding that projects that have experienced a reduced technical specification. This will be directly applicable to scenarios where load related work has overlapped with NARM interventions and this approach provides a pragmatic view in how it will be assessed. However, it also highlights the disappointment that a similarly pragmatic approach has not been taken for T2/T3 crossover projects as well.

We welcome the inclusion of the justification process that will be used for the assessment of over/under delivery but believe that more needs to be established as part of ensuring that proportionate justification is required as part of Ofgem's decision making process. This is consistent with the feedback provided in response to Question 2 above where licensees should understand what is required for a successful review of the project eligibility and for minimising the burden that the interventions from the Ofgem assessment will require.

NARM funding across regulatory periods

As set out in our recently provided State of the Nation report, we propose the following:

- 1. For NARM projects which have been materially delayed and will be delivered in a future price control period:** As set out in our recently provided State of the Nation report, we propose that where project delivery has been deferred into a future price control period (i.e. T3 or T4 periods), then we are proposing to hand back our T2 allowances in full and request new allowances in our future price control plans (i.e. T3 or T4 plans). Compared with the assessment as required by the Clearly Identifiable process, this is a far cleaner and transparent option. This is also proposed in the context of set price control periods that can often lend themselves to project energisation later in that period. Resultingly, delivery milestones are then more likely to be affected by supply chain issues or having the required outage windows.

2. **For NARM projects which are experiencing minor delays into the T3 period due to issues outside of our control (crossover projects):** We strongly disagree with the intention of reviewing projects through the Clearly Identifiable mechanism where they crossover between the T2 and T3 periods. Disappointingly, this is not consistent with the interest of having a pragmatic view that would remove the burdensome approach of removing allowances from one price control period and then re-applying them in the following period. There are also potential scenarios where a T2 project is delivered late and after the time of T3 business plans being submitted. Without introducing a more pragmatic approach for T2 close out as we have proposed before, licensees will return allowances while having missed the chance to include those projects as part of the T3 plan. We would therefore need to have a NARM reopener mechanism in RIIO-T3 to allow us to request additional allowances for the completion of T2 NARM projects early in the T3 period. Otherwise, we will have to manage the impact of slightly delayed T2 projects during the T3 close out while are then in the T4 price control period, which is simply not an acceptable position.

Our proposed solution, which we believe will be consistent with the previous interest in having a pragmatic approach, is for projects delivered in the first year of T3, the end of 2026/27, to be treated as delivered for T2 close out purposes. The associated spend would then be re-profiled across T2 and T3 during close out. This allows a more sympathetic approach to the timelines of how projects are delivered rather than having an artificial cliff-edge at the end of T2.

As much as this approach would be valued as part of taking a more practical assessment process, it should also be considered the best outcome for consumers where justification for change is also done in conjunction with making proportionate adjustments to project allowances and the handing back of those as well.

The intentions for crossover projects to be considered on these terms has only been revealed with publication of this consultation. During the recent Ofgem-led working groups, there was no opportunity taken to raise this as the proposed approach and for licensees to continue making the case for an alternative and more pragmatic approach.

As well as removing the administrative burden, a specific approach for crossover projects is also best equipped to consider external factors that are outside of licensees' control. These conditions include project lead times being challenged by global supply constraints, timeframes in receiving planning and consents, and required outages being denied or cancelled. Where these circumstances are incurred, resulting in delivery during T3, delivery should still be counted as having incurred during T2 where the delay has been incurred because of circumstances beyond our control.

Clearly Identifiable Criteria

As much as the proposed changes are intended to offer greater certainty as to how the clearly identifiable mechanism is going to be applied, there are still potential uncertainties over the full extent to its application. In some ways, this could be a consequence over the intention of having greater flexibility but there is apparently also the opportunity that projects avoid the assessment even when all relevant criteria apply⁵. The application of all criteria would otherwise be a clear indication of how it would be assessed. While we appreciate that Ofgem will intend to provide themselves with suitable flexibility in considerations beyond the four qualifying criteria, this should avoid putting licensees at a material disadvantage in understanding what else would be assessed. The only immediate reference as to what this might entail is the expectation on providing Network Risk Output and costs on a project-by-project basis at close out.

⁵ Paragraph 3.23 of the consultation document.

The details contained in the handbook are expected to specifically inform the assessment process and the sequence of events that it will consist of. Alongside this, it would be valuable to understand the intentions and sequencing of the events that are proposed in Figure 1 of the consultation document. First, how Ofgem will discern the projects that are intended to be subject to the full Clearly Identifiable assessment (please see the answer above regarding paragraphs 3.23 and 4.4 of the consultation) beyond the four criteria being applied. Second, on whether this indicates the requirement for parallel assessment undertaken by both licensees and Ofgem rather than licensees initially proposing a Clearly Identifiable designation that Ofgem then review and requesting any supplementary input from licensees when required.

Clearly Identifiable Assessment

Even with the proposed handbook updates, we believe that there is still an absence of detail in the methodology of how either partial over/under-delivery and over-delivery allowances will be decided. The criticality of this is added to given the expected number of projects that we can reasonably expect to be reviewed in this way. With the uncertainty in this area, it will be too late to have this revealed after money has already been spent and when we have missed the opportunity to have produced the required supporting evidence had this been known upfront.