RIIO-2 Draft Determination Consultation Response

NARMs Annex

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FORWARD SUMMARY

NARMs (formerly NOMs) was developed by network companies under the direction and support of Ofgem to create a common currency that would allow customers to understand what companies' asset health related investment plans were delivering for them. The current models have taken nearly eight years to be developed and validated; monetised risk targets for RIIO-1 were agreed in June 2019. The intention of NOMs was to allow:

- A measurable outcome of the amount of risk being delivered by the interventions to be determined and which performance could be measured against;
- Create the incentive to ensure that companies were focusing on the most efficient way to manage overall asset health risk on the network by allowing a currency to trade interventions to get the optimal mix for customers (as measured by monetised risk and the Totex incentive) and
- Penalties to be in place for unjustified failure to deliver the network level risk targets and rewards for delivering additional risk early that is in the interests of customers.

Northern Gas Networks (NGN) considers that the implementation and measurement of monetised risk through NARMs can provide a robust framework to enable a consistent and transparent basis upon which to measure asset health, criticality and risk.

Over the course of RIIO-1 we have been committed to working with Ofgem and other network companies to ensure that the application of the monetised risk incentive is appropriately and effectively implemented and relevant for RII0-2 planning. We have also actively supported the work that has been undertaken in producing a methodology that can be used by all sectors during RIIO1 and into RIIO2.

Whilst this approach has delivered a good balance across the four sectors, we consider that significant differences remain across the sectors both in the defined licence requirements, investment profiles and the requirements outlined in Final Proposals for RIIO1. It is disappointing that despite clear and consistent feedback from the network companies, that Ofgem has failed to take this into account in its RIIO2 Draft Determination (DD) assessment.

The NARMs model is very much in its infancy in terms of application and reporting; consequently, the following challenges have been observed with the models:

- It is highly data intensive, complicated and is unable to be understood by end consumers;
- The model parameters can never completely replicate the physical requirements for health, criticality, and impact as they are approximations and averages;
- The monetised risk metric is not acknowledged by the HSE as a measure of asset management or safety;
- The model does not represent all investment decisions and the reason to which they have been made and
- Assets are represented at various aggregation levels which does not necessarily reflect how investment decisions are made or the physical asset base, for example, sites are represented by their functional purpose (such as pre-heating, pressure reduction etc)

rather than at a site level, while mains and services are represented at a cohorted level rather than individual pipes.

We have significant concerns regarding what Ofgem consider is achievable from a “theoretical” perspective versus what is practicably achievable from the existing NARMs models and process in RIIO2. The current models have been designed to model a network level risk target and incentivise risk trading between asset classes rather than a project by project level assessment.

Although the current network level risk target would remain, the introduction of the NARMs allowance, efficiency assessment and unit cost of risk into the NARMs mechanism would drive NARMs to be an assessment at project/scheme level which is a significant deviation from the RIIO-1 approach and would require the application of many assumptions to represent data at this level. Through previous discussions with Ofgem regarding the RIIO1 NARMs target rebasing exercise and the NARMs BPDT reconciliation, we have demonstrated the challenges that are present when NARMs data is disaggregated below asset type level; the models have not been designed for this purpose.

The impact of the NARMs mechanism on RIIO 1 investment and out-performance is not fully understood as RIIO 1 targets have only recently been agreed with Ofgem. There is no evidence to support the requirement for a more complicated mechanism that considers efficiencies and allowances and whereby data needs to be assessed at a more granular level.

The SSMD set out the intent to continue with the NARMS methodology and through consultation explored options for the NARM performance measures. Ofgem’s sole focus has been to implement a tool which holds network companies to account for the long-term impacts of their asset management activities, and whilst we agree with the reasons for Ofgem’s focus in this area, it was raised by SRWG that NOMs had not been designed for this purpose and the results of the model against this requirement had not been validated.

Through the RIIO-2 business plan submission process, it was determined that Ofgem’s proposals to implement a lifetime benefit metric for reporting proved unworkable for GDNs. This was due to data on the life of interventions being unavailable. As a result, SRWG’s expectation for Draft Determination was that a mechanism similar to the existing mechanism would be proposed. We consider that what Ofgem has presented in its Draft Determination is a very significant deviation from the current approach and not consistent with what was discussed during consultation stages or indeed within the SSMD. The SSMD stated:

> ‘6.34 We will continue to work with the network companies and other stakeholders to ensure that specific technical aspects of the NARM reflect the modelling approaches applied and the data output from the models. We will also take this into account when using the NARM for setting cost allowances and output targets, as explained in the next section.’

> ‘6.45 As noted in the previous section, we recognise that the current maturity of the modelling and uncertainty around long-term monetised risk make it difficult to estimate accurately the value of consumer benefit associated with asset management work. Whilst it is an appropriate measure to inform our setting of the cost allowances

> and output targets, this will not be used in a deterministic way. Consumer benefit lost due to any under-delivery may not be accurately captured by the numerical value of the shortfall in the reduction of long-term monetised risk. We have therefore decided that adopting a penalty mechanism similar to that used in RIIO-1 – a proportion of the relevant cost allowances clawed back – is a more suitable approach.'
>
> '6.46 Before we decide on the detailed aspects of the mechanism, we will carry out further work to ensure that the mechanism works for all potential delivery scenarios and to ensure that it incentivises appropriate company behaviour and efficient delivery.'

In addition, we recognise that the SSMD included references to justification cases, cost benefit analysis and NARMs informing allowances, the SSMD does not include any indication of Ofgem's intent to include an assessment of efficient costs, unit cost of risk or an adjustment to prevent windfall gains. As these parameters are not an output from the current models, and these concepts were not raised before Draft Determination, this does not align with the intent declared in the SSMD in paragraph 6.34. These concepts have been introduced by Ofgem at Draft Determination which has not allowed sufficient time to evaluate the impact of these proposals.

We are concerned that Ofgem's approach on NARMs has moved overtime from an output measure to an input measure which is not consistent with the eight years of work that has been spent developing the current methodology and supporting models. We reiterate that the purpose of NARMS, preceded by NOMs, is to measure the health and criticality of the network assets following investment. In this respect it is used to demonstrate net risk benefit of an output and not to differentiate inputs. This would require a completely different modelling approach.

We have previously noted Ofgem's intention to use NARMS as an input measure into the investment planning process. We and other network companies have stressed consistently and repeatedly that the current modelling and data sets used in the NARMs process are not fit for purpose to be used explicitly as investment planning tools. However, they can help inform the process.

As asset management companies we rely on data to inform our decision making, however, the outcomes of the models that we employ are used to inform decisions rather than make them. Our qualified engineers and asset managers make these decisions based on practical risk assessment and not theoretical modelling. NARMs is a useful tool to assess the impact of these practical decisions and model the residual risk that a company is theoretically managing at a portfolio level to help inform the next decision.

Relying on NARMs as an input measure can only be considered as an extremely poor approach to asset management, in that it focuses on individual assessment of risk at a process/project level which can lead to short term reactive decisions focussed on cost rather than a holistic assessment of the state of the asset base and the value that can be driven. This is why the concept of risk trading is so important for NARMS in ensuring that a business can balance risk, cost and value in the management of its assets. In the SSMD, Ofgem recognised that NARMs should be part of a toolbox for decision making:

> ‘6.28 We note the broad support for our proposals regarding the definition and use of the NARM. We accept that monetised risk may not necessarily be the suitable primary basis for justifying all the investment choices. We expect it to be part of a toolbox approach to justifying and assessing network companies’ proposed investments and preferences for chosen strategies. The toolbox approach should also include engineering judgement and CBA in accordance with the relevant sectoral guidance note on engineering justification and investment decision pack guidance.’

The current proposals do not align with the above statement from the SSMD and represent a very clear departure from the previously stated policy and the principles of good asset management.

In summary, we are concerned that the current approach that Ofgem has outlined in the Draft Determination in a number of areas:

- It can be regarded as an example of a very poor asset management and represents a gross over-simplification of the complex analysis and decision-making processes that exist in the real world;
- As such presents a significant risk for companies that good asset management decisions made at an operational level using all the relevant information available to our asset managers engineers and network operating colleagues will be overridden by Ofgem deploying the proposed approach;
- It has added further complexity into what was already a complex process and the outputs do not make reasonable sense in the context of value-based asset management;
- We do not consider that Ofgem has appropriately reflected the feedback from all companies in its assessment of RIIO2 business plans, and we do not consider the current option is fit for purpose or applicable in RIIO2, in fact it has deviated from the original purpose to the extent that it is no longer fit for purpose; and
- Ofgem’s proposals do not fully align with what was set out in the SSMD and companies have not been given sufficient time to adequately evaluate the impact of these proposals. Ofgem stated in the SSMD that they would work with companies to develop an appropriate mechanism for NARMs and that the penalty mechanism would be similar to RIIO-1. The proposals for RIIO-2 does not align with these statements.

NARM Annex - Consultation Response

NARMQ1 Do you agree with our proposals on the scope of work within each of the NARM Funding Categories and on the associated funding arrangements?

The SSMD set out the intent to exclude monetised risk delivered through other funding mechanisms in assessing a company's NARM output delivery for RIIO-2. The SSMD explicitly referred to mandatory repex and load-related expenditure. We support Ofgem's decision to remove these expenditure types from NARMs to avoid double funding and we agree that this position is reflected in Draft Determinations. However, we disagree with the following points:

- Ofgem need to continue to ensure that the investment represented within NARMs allowances is sufficient to allow, and promote, effective asset risk trading. The scope and investment associated with the NARMs metric has been reduced so significantly that we have concerns that effective asset risk trading will not be feasible in GD2.
- Removal of some intervention types from the metric such as asset interventions which effectively increase the risk of an asset and decommissioning.
- NARMs allowances being determined at a scheme/project level. Disaggregation of NARMs expenditure should not be lower than asset type to ensure full alignment with the NARMs models. We recognise that further disaggregation to allowances will be required for mandatory repex, but disaggregation should not go further than this.

The above concerns are discussed in detail below.

We have concerns that Ofgem's funding category proposals and the associated funding arrangements issued at Draft Determination significantly reduces a networks ability to use NARMs as a tool to assess total asset risk across asset populations and respond to changing requirements. As the majority of our non-mandatory repex has been disallowed in full, the introduction of the proposed funding categories and the removal of some intervention types reduces NARMs remit to approximately £30m per annum for NGN (which is less than 15% of Totex). Such a significant reduction in the scope of NARMs expenditure effectively removes the ability of the NARMs mechanism to promote asset risk trading across different asset types and is inconsistent with the stated objectives of the NARMs approach as defined in previous discussions with Ofgem.

We disagree with the removal of some of the NARMs interventions from the scope of work such as interventions which could increase the level of risk and asset decommissioning. There are instances where application of an intervention will consequently increase the risk e.g. converting LTS pipelines to piggable pipelines, however, there may be other factors driving this investment beyond risk. Whilst the removal of these interventions from the scope of NARMs simplifies the problem for Ofgem, it not only reduces the scope to risk trade, it moves the content of NARMs so far away from the reality of the asset base as to be almost meaningless.

Ofgem's proposals as they stand do not outline how outperformance against repex will be incorporated into the funding arrangements. It is also not clear whether monetised risk for assets and investments that are outside of the proposed NARMs funding mechanism will need to be reported. These additional layers of detail add further complexity to a methodology that has already been recognised as too complex and difficult to explain to stakeholders.

NGN has already observed through the RIIO-2 business plan submission process that reporting NARMs investments in alignment to the proposed funding categories is a significant piece of work and is at a level of detail that NARMs was not designed to be reported at. If annual reporting for RIIO-2 would consequently need to be at the same level of detail as the NARMs BPDT, whereby funding categories and funding arrangements are reported, this would lead to annual reporting and RIIO-2 close-out being a much more resource intensive exercise as well as being at risk of not being able to meet the required Quality Assurance standards.

At the time of submission to this consultation, Ofgem had not confirmed the resulting NARMs allowance for our business plan. We have been working with Ofgem to address this issue, however as this has not been achieved within the Draft Determination timescales, this illustrates our concern that disaggregating allowances to create a NARMs allowance and subsequent funding categories adds significant complexity to the NARMs mechanism. We do not consider the current option is fit for purpose and has deviated significantly from the original purpose to the extent that it is no longer useful or in the interest of stakeholders.

Our recommendation is for the funding category approach to be simplified so that allowances are calculated and monitored at asset type level with the exception for repex which would also need to include further disaggregation to account for whether investment is mandatory. This would significantly simplify the approach and ensure that monitoring against a NARMs allowance would be feasible.

NARMQ2 Do you agree the funding adjustment principles and our proposals for applying funding adjustments?

There are two parts to the funding adjustment principles:

1. Non-intervention risk changes
2. Funding adjustment

For non-intervention risk changes, we agree with Ofgem's proposals to exclude factors that cause a change to NARMs output delivery but are unrelated to asset intervention actions, from out-turn delivery before considering any funding adjustments. However, we have the following concerns regarding these proposals:

- Ofgem's proposals do not outline how non-intervention risk changes will be considered (if at all) during annual reporting. This could potentially be very complex, lead to spurious results and not a feasible solution for annual reporting.

For the funding adjustment proposals, we agree that companies should not be rewarded for windfall gains, however we disagree with the introduction of this approach for the following reasons:

- This concept has been introduced at Draft Determination without any opportunity for meaningful discussion, engagement. This has not allowed sufficient time to evaluate the impact of the mechanism and does not align with Ofgem's statement of intent to consult with companies as set out in the SSMD;
- Ofgem has not provided any clear evidence that would support the requirement to introduce this adjustment for gas distribution. All evidence that has been provided by Ofgem has been qualitative and based on electricity transmission;
- Ofgem has not provided any analysis which supports the proposed DAF value of 95%. Further evidence is required to evaluate if this value is appropriate for gas distribution and
- The proposed approach is unduly complicated, and a simpler approach could be adopted such as a cap on the level of possible reward that can be claimed through the TIM.

The concerns listed above are discussed in more detail below.

Non-intervention risk changes

Ofgem have consulted with GDNs on the non-intervention adjustment approach through meetings with SRWG regarding the NARMS BPDT. Through these discussions, it has been identified that what has been proposed for non-intervention adjustments is too complex and could lead to spurious results if this is adopted for annual reporting. This is because the ordering of the non-intervention adjustments in the calculation is important. We would propose that Ofgem adopts a simpler mechanism for non-intervention risk changes which groups non-intervention risk changes together but also uses the direct outputs from the NARMs models. In addition, from previous discussions with Ofgem regarding non-intervention risk changes, all examples used an absolute rather than a delta position. The examples provided in the penalty mechanism workbook imply that the data fed into the mechanism would be a delta position; this is significantly more complex than absolute values. We propose that Ofgem changes the proposals to reflect absolute rather than delta values.

In determining the requirements for non-intervention adjustments, we ask that Ofgem continues to consult with companies to determine what would be practical and achievable to deliver within annual reporting timescales.

Funding adjustments

The funding adjustments that Ofgem have proposed have only been introduced at Draft Determination and was not included in the SSMD. The intention and reason for this requirement has not been clear and is a cause for concern due to the lack of consultation with networks on the application. In addition, there is limited visibility of this new mechanism as it does not feature in any of the core documents and is only contained within the NARMs annex. This significantly reduces the likeliness of a range of stakeholders identifying and consequently providing feedback through the Draft Determination consultation process. The proposed funding adjustments are a significant deviation to the agreed NARMs mechanism with the Unit Cost of Risk Benefit being an entirely new concept to NARMs which creates a further level of complexity to the NARMs metric. Ofgem have stated that this requirement is to ensure that companies do not achieve significant gains through choosing cheaper interventions to meet the total Network Risk Output Delivery. However, Ofgem has provided no evidence that supports this statement.

We understand from further discussions with Ofgem in the NARMs specific Draft Determination meetings, that this adjustment was introduced following analysis of electricity transmission data and we are concerned this is not reflective of an equivalent analysis of GDN data. The BPI outcomes for Draft Determination, applied large penalties to electricity transmission which significantly dwarfed the total penalty applied to the gas distribution sector. It is our view that this illustrates that the GDNs have a more robust asset management approach and it would be inappropriate to apply the same mechanism to gas distribution without any demonstratable evidence that the mechanism is suitable. NGN have requested the delivery scenario analysis for gas distribution that has led to this proposal through the SQ process so that we can understand if this statement is true for gas distribution, but we have not received a response to this request. Without this information and without prior discussion, it is difficult to understand whether there is a requirement, or a benefit to customers, of introducing this adjustment for gas distribution.

The adjustments to TIM, from a sharing factor that favours networks to one that is nearer 50:50, is a significant change that ensures networks and consumers equally benefit from networks delivering outcomes and outputs at lower cost. We do not understand the driver for an additional bespoke sharing mechanism for spend associated with NARMs. This removes any stimulus to innovate and restricts our ability to adapt to stakeholder requirements. This also introduces significant data submissions and analysis that are not proportionate to the relatively low levels of spend that are now associated with the asset investment monitored under NARMs.

Our suggestion is that Ofgem remove the DAF and Unit Cost of Risk Assessments from the NARMs mechanism proposals.

NARMQ3 Do you agree with our proposed approaches to calculating funding adjustments and to application of penalties?

We are supportive that networks should be penalised for failure to deliver NARMs commitments and agree with the continuation of a 2.5% penalty for unjustified under-delivery. However, we disagree with the following points:

- Ofgem's intention to remove the deadband mechanism that is currently in place for GD1;
- The introduction of the Unit Cost of Risk. This concept has been introduced at Draft Determination without any prior discussion or consultation. This has not allowed sufficient time to evaluate the impact of the mechanism and does not align with Ofgem's statement of intent to consult with companies as set out in the SSMD;
- Ofgem have not provided any clear evidence that would support the requirement to move away from the mechanism that is currently in place for gas distribution. All evidence that has been provided by Ofgem has been qualitative and based on electricity transmission;
- Ofgem have not provided any analysis which supports the proposed DAF value of 95%. Further evidence is required to evaluate if this value is appropriate for gas distribution;
- We do not feel that it is appropriate to include a further efficiency test within the NARMs mechanism. It is our view that the cost assessment within the business plan submission process is sufficient to evaluate whether out-turn costs are efficient. We are also concerned that this concept has been developed without the required level of understanding regarding how the two separate assessment mechanisms will work alongside and complement each other;
- The proposed penalty/reward mechanism has been introduced at DD without any prior discussion or consultation. This has not allowed

sufficient time to evaluate the impact of the mechanism, especially the sensitivity and interaction of the variables within the mechanism. This does not align with Ofgem's statement of intent to consult with companies as set out in the SSMD and
- The proposed approach is unduly complicated, and a simpler approach could be adopted such as a cap on the level of possible reward that can be claimed through the TIM.

The concerns listed above are discussed in more detail below.

Removal of the deadband will discourage companies from risk-trading as the consequence of not hitting the NARMs target exactly will be an exercise to justify under/over delivery which could be a substantial regulatory burden for both Ofgem and network companies. The removal of the deadband also has the potential to drive the wrong behaviours, with companies likely focussing on volume targets rather than making good asset management decisions that are responsive to changing stakeholder needs and asset information throughout GD2. In effect removal of the deadband removes any element of risk from what should be a risk-based approach; we suggest that a +/-5% deadband for the NARMs delta is kept in place for GD2.

We are concerned that the calculations of funding adjustments are now based on a new concept of Unit Cost of Risk (UCR) that has not been previously mentioned or consulted on. Ofgem have not provided enough information to companies to objectively assess this metric within the Draft Determination consultation period. As such, it has not been possible to thoroughly review the impact of this new metric within the consultation. Therefore, we would encourage Ofgem to spend more time with companies in reviewing the impact of this metric and also sharing with wider stakeholders.

With our limited understanding of the issued NARMs penalty mechanism workbook, we have analysed a range of scenarios and we have provided this data to Ofgem, however further clarification and guidance is required from Ofgem to ensure that required data has been populated correctly. If this metric was to be introduced, we agree with Ofgem's proposal to include a cap for UCR as without this cap, companies could incur counterintuitive rewards/penalties and it could promote undesired asset management behaviours. However, our overall position is that we disagree with the new funding adjustment and penalty mechanism as no guidance or information has been received to undertake appropriate analysis.

A Delivery Adjustment Factor has been set at a seemingly arbitrary level of 95%. We do not understand this requirement or the analysis behind determining a DAF value of 95%. We have not received enough information to make a judgement as to whether this is a suitable factor. Ofgem have requested feedback on this value, however the delivery scenario analysis behind this value has not been published therefore NGN have not been able to undertake appropriate analysis to evaluate the proposed DAF value. NGN has requested the delivery scenario analysis for gas distribution through the SQ process, but we have not received a response to this request. Without this information and without prior discussion, it is difficult to understand whether there is a requirement, or a benefit to customers, of introducing this adjustment for gas distribution. From further discussions with Ofgem in the NARMs specific Draft Determination meetings, it was confirmed that this adjustment was introduced following analysis of electricity transmission data only and without an equivalent analysis of GDN data it cannot be supported as applicable in all sectors.

Ofgem have proposed a mechanism which removes efficient schemes or programmes of work from the Unit Cost of Risk assessment. This provides another example of a mechanism developed in isolation of network companies and where insufficient evidence has been provided for companies to make an objective assessment. From our very simple analysis of the NARMs penalty workbook, the new mechanisms are very sensitive to this parameter, but as no guidance has been issued by Ofgem as to what would constitute a legitimate claim for efficient spend, we cannot explore the implications of this mechanism in significant detail.

In addition, as no evidence has been issued regarding the reason for the introduction of this mechanism, it is difficult to understand the proportion of the programme that could be claimed as efficient spend. If it is possible for the proportion to be the whole NARMs allowance, the current proposal would error as it creates a divide by zero in the model. If it would be possible for companies to claim 100% of NARMS out-turn expenditure, the mechanism needs to be updated to allow for this. Furthermore, we are concerned that costs are being subject to an efficiency test that is outside of the efficiency test that is within the business plan submission process.

A mechanism is already in place which assesses whether companies' costs are efficient within cost assessment, therefore it is not appropriate to introduce a further efficiency test that is specific to NARMs. We consider that any test of efficiency needs to be taken through the cost assessment group and not NARMs. We are concerned that the amount of data that would need to be submitted to make an efficient spend claim could be significant as the template indicates this would need to be on a project/scheme basis. This feels disproportionate when comparing this to the relatively low levels of spend that are now associated with the asset investment monitored under NARMs

Our suggestion is to remove the DAF, UCR and efficiency parameters from the NARMs penalty assessment. This proposal is preferable over the current proposals as the proposed mechanism comprises of several parameters that have not been sufficiently tested against gas distribution data and the implications of the introduction of this mechanism are not fully understood.

NARMQ4 Do you agree with our proposals in regards to requirements for justification cases?

The current NARMs mechanism requires companies to justify at RIIO-1 close-out any under/over delivery against the NARMs target where out-turn is outside of the range of the +/-5% deadband. This close-out is expected to be very much a qualitative approach with supporting analysis performed by the gas distribution companies to support the justification narrative. We agree with Ofgem's proposal to retain the justification case for NARMs performance.

However, we disagree with the following points:

- The justification case to be extended to include a requirement for companies to demonstrate that companies could not, without a significant dis-benefit, have traded risk against other work in order to deliver overall baseline risk outputs. This moves the metric to an assessment based on UCR rather than a network level risk delta and will disincentivise risk trading;
- Companies are unclear regarding what case would need to be made and the data that companies will need to provide as part of this justification case. We have a significant concern that Ofgem is reserving the right to decide investment was either justified or unjustified at the end of GD2 under a criterion that is not clearly defined;
- It is fundamental that this guidance is issued before Final Determinations to allow companies to design systems and processes to collect the sufficient information for justification cases;
- We have concerns that this increased complexity regarding justification of out-turn performance could make RIIO-2 close out of NARMs a tick-box exercise which would not fully consider the qualitative reasons for re-diverting expenditure or not undertaking investment and
- NARMs is one of many parameters that need to be considered when asset management decisions are made. Ofgem's proposal is a gross oversimplification of very complex asset management decisions and there is a danger that this mechanism could lead to poor asset management decisions.

The proposals set out in Draft Determinations for RIIO2 introduce further dimensions to this justification case, some of which could prevent companies from risk trading. For example, the criteria to demonstrate that companies could not, without a significant dis-benefit, have traded risk against other work in order to deliver overall baseline risk outputs. The proposed approach seems to increase the scope of the justification case from being solely regarding Monetised Risk, to including the out-turn of Unit Cost of Risk and expenditure. There is a risk that this significantly increases the data required to support a justification case, which seems disproportional given the level of spend associated with the NARMs allowance, especially given that Ofgem's default position is that any under/over delivery is fully un-justified.

We are supportive of the requirement for networks to provide a commentary of our investment delivery and to provide further justification where NARMs is under/ over delivery. Our concern is there is little visibility or worked examples of the process and the criteria that Ofgem will apply to evaluate the justification cases. Ofgem have stated that they *may* develop guidance in relation to the nature and quality of engineering and other evidence required for any justification case. It is our view that it is fundamental that guidance regarding justification cases is developed before GD2 commences. This is to ensure that all companies are aware of the requirements for justification cases before GD2 investment commences and to ensure that the relevant data is collected. This guidance would need to be confirmed in sufficient time to enable asset management systems to be configured to capture any newly required data, at the latest we would propose this guidance to be confirmed by Final Determinations.

Companies are unclear regarding what case would need to be made and the data that companies will need to provide as part of this justification case. We have significant concerns that Ofgem is reserving the right to decide investment was either justified or unjustified at the end of GD2 under a criterion that is not clearly defined. Without clearly defined criteria, Asset Managers could make decisions throughout GD2 with Ofgem overriding those decision in a close-out process without relevant knowledge or understanding of why the decision was made at the time.

We consider that Ofgem are clearly moving outside of the remit of incentive-based regulation and mirroring exactly the processes that take place under rate of return regulation elsewhere in the world. Ofgem has granted itself powers to intervene directly in the asset management decisions taken by the company but without any relevant, recent experience or accountability for the implications of those decisions.

This approach implies one of the most significant departures from the incentive-based regulation framework employed in the UK since its inception. It increases significantly the potential for regulatory conflict and legal challenge to Ofgem during the process. Most importantly, this introduces significant risk to network companies and introduces Ofgem as the Asset Managers in the investment process which we significantly disagree with and which we consider is outside of the role of Ofgem.

We have concerns that this increased complexity regarding justification of out-turn performance could make RIIO-2 close out of NARMs a tick-box exercise which would not fully consider the qualitative reasons for re-diverting expenditure or not undertaking investment e.g. engineering judgement and changing stakeholder needs. Additionally, NARMs is only one of the quantitative parameters that is an input into the asset investment decision. It is not the sole numerical parameter e.g. numerical values such as customer willingness to pay and cost benefit analysis may influence the ultimate asset investment decision that is made by our asset managers. The process proposed is less flexible than the current process and justification cases seem to focus on the NARMs metric which could prevent good asset management and encourage companies to focus on solely delivering a NARMs output rather than taking a wholistic decision making approach. The depth of analysis and data required to report does not seem to indicate better outcomes, meaning the process that Ofgem propose is at odds with their own CBA principles for RIIO2 investment.

We propose that Ofgem adopt the current justification mechanism that is in place for RIIO 1 with clear, concise criteria regarding the justification case for under/over delivery against the RIIO2 Monetised Risk target. This approach has yet to be tested, however was agreed across sectors and was subject to a full and thorough consultation that NGN supported.