Northern Gas Networks

RIIO-GD3 Draft Determination Consultation Response

SGN Annex

we are the network

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SGN Annex Response

Outputs & Incentives Question

SGNQ1. Do you agree with our proposed design of SGN's Full Site and System Rebuilds PCD?

No Comment

SGNQ2. Do you agree with our inclusion of the Glenmavis and Isle of Grain projects in SGN's Full Site and Systems Rebuild PCD?

No Comment

SGNQ3. Do you agree with our proposed design of SGN's South London Mains PCD?

No Comment

SGNQ4. Do you agree with our proposal to reject SGN's cost to replace its fleet?

No Comment

SGNQ5. Do you agree with our proposal to reject SGN's Local Gas Treatment PCD?

No Comment

BPI Questions

SGNQ6. Do you agree with our view that SGN passed all of the minimum requirements and as such are considered to have passed Stage A of the BPI?

No. Ofgem specified a clear pass-fail metric for compliance with the business plan guidance, notably on Business Plan length, which it notes SGN exceeded submitting 110 pages.

SGNQ7. Do you agree with our assessment results for SGN against Stage B of the BPI?

No.

Stage B of the Business Plan Incentive (BPI) is the most financially significant component, designed to reward gas distribution networks (GDNs) for submitting cost-efficient and deliverable business plans.

We have concerns and have undertaken additional analysis to demonstrate that the assessment places over emphasis on cost ambition and rewards ambitious cost forecasts, even if they lack deliverability or a historic track record. Coupled with this there is no direct penalty for over-optimism or failure to deliver forecasted efficiencies. This creates a misalignment between ex ante ambition and ex post accountability. We also observe a lack of integration with Service Quality, which distorts the value that is delivered and masks poor performance. The assessment of Stage B rewards demonstrates how Ofgem has inadvertently decoupled cost assessment from service quality performance, despite a stated goal of incentivising value for money.

Unlike the RIIO-GD1 IQI mechanism, Stage B does not adjust the TOTEX Incentive Mechanism (TIM) based on business plan ambition. This weakens the incentive for networks to submit realistic and deliverable plans.

Stage B is mechanistic, and the rewards should be commensurate with the value delivered and confidence in delivering following Ofgem's cost assessment process.

Our appended report, prepared by Oxera provides a comprehensive overview of the performance of GDNs on both cost efficiency and services performance, specifically Section 4 of the report and Figures 4.2-4.7 present GDN performance from a cost and service perspective, this must be taken account of to ensure incentives and rewards are in the interest of consumers.

SGNQ8. Do you agree with our assessment results for SGN against Stage C of the BPI?

Overall, we consider the Stage C assessment is subjective and Ofgem must apply it consistently to derive value from the business plans. Stage C of the Business Plan Incentive (BPI) comprises two components:

- Clarity: Evaluates the structure, accessibility, and coherence of the business plan.
- Commitments: Assesses the ambition of service offerings across net zero, resilience, and service quality.

Having reviewed the draft determinations, NGN commissioned Oxera to review the BPI incentives[1] and they found that stage C had:

- Limited Incentive Strength: The maximum reward for outstanding service quality performance is 13 basis points (bps), significantly lower than the 40bps available for cost efficiency under Stage B.
- Balanced Scorecard Dilution: Rewards are further diluted through a scorecard approach, with equal weightings across four criteria (deliverability, consumer value, stretching performance, and new proposals).
- Skewed Incentive Architecture: The current framework heavily favours cost reduction over service quality, both ex ante (during plan submission) and ex post (during delivery).

In relation SGN's plan we note the subjectivity of the assessment in the round and conflict between ratings of outstanding versus poor.

We have no specific comments on SGN's assessment on commitments but reference our appended report, prepared by Oxera provides a comprehensive overview of the performance of GDNs on both cost efficiency and services performance, specifically Section 4 of the report and Figures 4.2-4.7 present GDN performance from a cost and service perspective. Similar to Ofgem's approach to engineering justification analysis we consider significant weight should be placed on delivered past performance when assessing anticipated performance and notably:

1. Ofgem should not be seen to be rewarding companies at RIIO-GD3 FD who have failed significant service standards in RIIO-GD2.
2. Ofgem must be consistent in how they assess commitments at the group and network level to avoid masking or rewarding poor performance.
3. A sufficient incentive for under delivery or poor performance must be explored.

[1] BPI Incentives at the RIIO3 DD

This is particularly important given parallels with shortcomings observed in Ofwat's cost and service assessment practices since PR14, where over-reliance on optimistic forecasts created *perverse incentives* of chasing business plan rewards and left companies unable to invest adequately to maintain and improve service levels. A similar approach here would risk rewarding networks that failed to meet core service standards in RIIO-GD2, such as the 1- and 2-hour gas emergency standard. That outcome would be unfair to consumers and damaging to Ofgem's credibility if it were to reward companies who failed these core service standards or those with significant overspend in RIIO-GD2 but are now benchmarked favourably, noting this issue has significant implications at both the group and network level. Such an approach would be contrary to Ofgem's principal objective to protect the interests of existing and future consumers. Effective regulation requires that incentives and rewards are tied to demonstrable performance against required standards, which in turn ensures trust in the framework and supports desirable outcomes for consumers over the long term.

We note the ambitious plans that were submitted at RIIO-GD2 and suggest Ofgem sense check how companies have performed in delivering against those outcomes and consider the actual delivered evidence on costs and performance commitments before finalising its Stage C assessment.

Managing Uncertainty Question

SGNQ9. Do you agree that SGN's Remote Pressure Management Strategy proposal should not be eligible for NZARD funding, and instead should be funded through baseline allowances?

No Comments

SGNQ10. Do you agree that SGN's Intelligent Gas Grid proposal should not be eligible for NZARD funding?

No Comments

SGNQ11. Do you agree that SGN's Biomethane improved access rollout proposal should not be eligible for NZARD funding, and instead should be funded through baseline allowances?

No Comments

SGNQ12. Do you agree that, in its current form, SGN's SIU decarbonisation (design costs) proposal should not be eligible for NZARD funding?

No Comments

SGNQ13. Do you agree with our proposal to reject SGN's submitted Other Distribution Mains and Services Re-opener?

No Comments

SGNQ14. Do you agree with our proposal to reject SGN's request for a bespoke River and Coastal Erosions - Asset Intervention Strategy re-opener?

No Comments

SGNQ15. Do you agree with our proposal to reject SGN's request for a bespoke South London Medium Pressure Re-opener?

No Comments

Cost of Service Question

SGNQ16. Do you agree with our engineering assessment of SGN's RIIO-3 Business Plan?

We don’t have the full detail or understanding of the risk position of SGN’s asset base to fully answer this question. However, we consider that SGN, must be provided with sufficient allowances to ensure that they meet health and safety, security of supply and customer outcomes at an efficient cost, taking account of their historic delivered performance. We note that customers should not pay twice for work that has already been funded

Innovation Question

SGNQ17. Do you agree with the level of proposed NIA funding for SGN?

We observe that SGN’s allowed innovation funding is significantly lower than other networks. We appreciate Ofgem has undertaken a comprehensive assessment of funding, based on company proposals, however, the current funding would limit SGN’s ability to contribute to collaborative sector wide innovation.

Historically, Innovation funding, consistent with other allowances has been roughly apportioned on a network/revenue basis to account for the customer base but to ensure parity on progressing valuable research and development. SGN has always been a valuable contributor and collaborator to these projects. If they do not have sufficient allowances then their ability to contribute is diminished and this would be to the detriment of consumer interest.

For projects where there is valuable industry learning we suggest a formalised collaborative approach where all networks fund projects on a 4:2:1:1 split for the benefit of consumers. There are several projects SGN propose that would best serve the industry and not networks own ambitions. NIA should facilitate wider learning as Ofgem outlines. This would help bridge the gap between SGN allowance, minimise cost to consumers and deliver wider benefit.

Data & Digitalisation Question

SGNQ18. Do you agree with our proposed level of funding for SGN's data and digitalisation investments?

No Comments