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all gas and electricity customers*

Our Ref: SG&G/Cost & Outputs 144/12
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Date: 6 November 2012

Dear Colleague

Consultation on our minded-to position for the determination of a re-opener application in respect of additional income associated with the Traffic Management Act (and Transport for Scotland Act) under the fifth electricity distribution price control review (DPCR5)

Introduction

Ofgem introduced a number of uncertainty mechanisms, including re-opener mechanisms, for costs that were uncertain at the time of establishing the fifth electricity distribution price control for 2010-2015 (DPCR5). The re-opener mechanisms enable the electricity distribution network operators (DNOs) to apply to Ofgem to adjust their revenues to accommodate costs associated with specific uncertain cost categories. The costs associated with permitting under the Traffic Management Act 2004 (TMA) and the Transport (Scotland) Act 2005 (T(S)A)¹ was one such cost category. DNOs can apply to Ofgem if the costs associated with the implementation of this legislation are in excess of one per cent of their base revenues.

In 2011, we made a decision to adjust the revenues of three gas distribution networks (GDNs) who gave notice to us that they were incurring significant costs due to the TMA.² Now one of the fourteen DNOs, London Power Network (LPN), owned and operated by UK Power Networks (UKPN), has given notice to Ofgem confirming that they have started to incur significant costs following the implementation of the TMA. The total gross³ claim for those TMA schemes that have been, and are expected to be, in operation during DPCR5 amounts to an additional £9.08 million (in 2010/11 prices).

Based on our analysis of LPN's submission, subject to consideration of the consultation responses, our view of the efficient additional costs for TMA for LPN is £7.81 million (in 2010/11 prices). This will result in an average increase in customer bills for 2012/13 of £1.60.⁴

We are consulting on our minded-to position regarding the application received. This letter sets out our proposed adjustment to LPN's revenue.

¹ Traffic Management Act 2004 and the Transport (Scotland) Act 2005 referred to throughout this document collectively as "TMA" unless the context requires otherwise.

² <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=545&refer=Networks/GasDistr/GDPCR7-13>

³ Costs prior to any DPCR5 adjustments for IQI or replacement incentive mechanism.

⁴ Based on the average electricity bill for a standard direct debit account across Great Britain of £470 (see <http://www.ofgem.gov.uk/Media/FactSheets/Documents1/household-bills.pdf>).

Responses and consent to share information

We would like to hear the views of interested parties in relation to our minded-to position for adjusting the revenues associated with TMA set out in this open letter. We would especially welcome responses to the specific questions which have been set out below.

Question 1: Do you agree with the proposed adjustments to the revenues associated with TMA for the LPN?

Question 2: Do you agree with the proposed principles that have been set and should there be any changes to the mechanism for RIIO-ED1?

Responses should be received by **26 November 2012** and sent to:

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Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response, or part of response, is kept confidential. Ofgem shall respect this request, subject to any obligation to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and/or in writing.

Background

Streetwork costs are incurred by DNOs when they have to carry out excavations in the roads and public footways in order to maintain the safety, security and reliability of the electricity network, connect new customers to electricity, extend and upgrade the network to meet changing requirements, and to reroute the network to assist infrastructure projects.

In order for local authorities and the Highway Agency to grant permission to the DNO for the time requested to undertake the work, under the TMA the DNOs have always had to submit notifications to them, outlining the requirements of the work.

In addition to the requirement to provide notifications, local authorities and the Highway Agency also introduced 'permits to work' schemes under the TMA. As the schemes were new and there was significant uncertainty over the level and timing of these costs, when setting the current DPCR5 price control we put in place a re-opener mechanism for TMA costs arising from the introduction of these schemes. We provided ex ante allowances for costs associated with complying with other known elements of the legislation to manage congestion and disruption on the road network.

The specific price control re-opener mechanism was established so that any further TMA costs could be considered in isolation from the DNOs' financial performance within the price control period.

Special Condition CRC 18⁵ of the Electricity Distribution Licence sets out the mechanism under which DNOs can apply for their allowed revenues to be adjusted, together with a notice of costs or expenses incurred or likely to be incurred. Following consultation, the Authority then determines whether the threshold has been reached to trigger the re-opener, whether any or all of the costs or expenses were or are likely to be efficiently incurred and any adjustment that should be made to their allowed revenue.

Summary of approaches to key issues

We have approached our assessment in the following way:

- Adhering to the approach as set out in the DPCR5 final proposals and supporting documents.⁶
- Assessing efficient overall level of costs associated with the TMA implementation by benchmarking with other DNOs that have reported TMA costs and volumes, but have not triggered the re-opener mechanism.
- Taking account of the work we have carried out for the re-opener applications under the first gas distribution price control review (GDPCR1).⁷

We have looked at four areas of costs as follows:

- Permit fee costs;
- Additional administrative costs arising from the introduction of permit schemes;
- Additional costs arising from the introduction of permit conditions; and
- One-off set up costs.

Our detailed analysis of the application from LPN is set out in Appendix 1.

Proposed principles

We expect that the principles used within this minded-to position should be taken into consideration in any future TMA re-opener and when setting the price control for RIIO-ED1. It is our current position that DNOs should demonstrate continued efficiencies in delivering streetworks, which include the following:

- Improved working with local authorities.
- A more efficient ongoing administrative support as the permit schemes becomes 'business as usual'.
- An innovative approach to increasing productivity for streetworks where a permit scheme is in place.

Recovery of additional revenue

In relation to the recovery of additional revenue by LPN, we believe that full recovery of the additional revenue should be within DPCR5.

Our minded-to position

⁵ Special conditions of the Electricity Distribution Licence: Charge Restriction Condition 18: Arrangements for the recovery of uncertain costs.

⁶ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=346&refer=Networks/ElecDist/PriceCtrls/DPCR5>, <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=372&refer=Networks/ElecDist/PriceCtrls/DPCR5> and

<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=370&refer=Networks/ElecDist/PriceCtrls/DPCR5>

⁷ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=545&refer=Networks/GasDistr/GDPCR7-13>

Based on the analysis that we have carried out of the LPN application and information provided following the gas distribution TMA re-openers (including information provided by Department for Transport (DfT)) we have set out in Table 1 the proposed additional costs for TMA which we are minded-to allow for DPCR5.

Table 1: Proposed allowed costs for TMA (2010/11 prices)

Actual costs		Projected costs			Total costs over DPCR5
2010/11	2011/12	2012/13	2013/14	1014/15	2010/11-2014/5
£m	£m	£m	£m	£m	£m
1.72	1.39	1.54	1.56	1.59	7.81

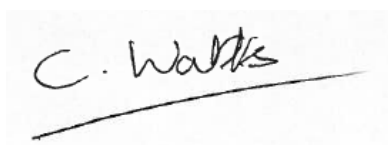
Table 2 shows the proposed adjustment to the LPN's allowed revenue for the current price control period.

Table 2: Proposed adjustment to allowed revenue (2010/11 prices)

LPN Submission	Ofgem Minded-to position	Difference
£m	£m	£m
9.08	7.81	-1.27

Our methodology is detailed in the Appendix below and we welcome views on this and the questions set out above.

Yours sincerely,



Chris Watts
Associate Partner, Costs and Outputs

Appendix 1: Detailed analysis of LPN's proposed adjustments

This appendix sets out our analysis of the proposed adjustments to LPN's allowance for TMA activity related to permit schemes, and the rationale supporting it. It shows the adjustments we have made to volumes, our proposed unit costs and the adjustments made to costs.

Using the information received from LPN, from other DNOs and from the three GDNs that submitted re-opener applications in GDPCR1, we have analysed the costs by benchmarking with other DNOs, where possible. As set out in the final proposals for DPCR5, we recognise the concerns that different local authorities may implement and interpret the application of the permit schemes in different ways. Differences include how penalties are applied, processing of permit applications, the number of inspections and whether the schemes includes all roads or targeted roads.

DNOs were required to report costs against four categories as follows:

- **Permits:** a variable cost based on number of permits.
- **Streetworks Incremental Admin associated with Permitting:** a variable administrative cost based on number of permit projects.
- **Permitting Condition Costs:** the costs associated with the conditions imposed by local authorities, which vary based on number of permits.
- **Streetworks set up costs:** one off fixed set up costs to manage the permit projects (ie IT set up costs). These costs can only be incurred in the first two years of DPCR5).

Each cost category was split by the following sub-categories:

- Connection projects which have an element subject to the apportionment rules
- Network Investment
- Network Operating Costs associated with planned and capital work
- Network Operating Costs associated with unplanned fault work

For the fixed cost category (streetworks set up costs) we benchmarked LPN's expenditure to that of other DNOs and have concluded that we propose to allow the £0.15 million requested.

For each of the variable costs, we calculated the volumes and unit costs as detailed below.

Volumes (of permits)

The final proposals for DPCR5 set out the methodology that we should adopt to assess the volume of permits and it is this that we have followed.⁸

In submitting their baseline volumes⁹ regarding streetworks to Ofgem for DPCR5, DNOs were required to submit their expected volumes of notifications for streetworks over the DPCR5 period. In determining the volume of permits, we took the following approach:

- calculated the percentage of notifications that has involved permit work for the first two years of DPCR5
- applied that percentage to the number of notifications in the original baseline for the three years from 2012/13-2014/15.

This is detailed in Table A1 below, with the proposed adjustments to volumes in Table A2.

⁸ <http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=370&refer=Networks/ElecDist/PriceCtrls/DPCR5>, page 96.

⁹ This is the volume of activity (ie notifications) that DNO expected to undertake for the DPCR5 period on which we would base DPCR5 allowances.

Table A1: Proposed volumes of permits (DPCR5)

	2010/ 11	2011/ 12	DPCR5 to date total	% of permits to notifications	2012/ 13	2013/ 14	2014/ 15	DPCR5 Total
Number of notifications in DPCR5 baselines	85,100	89,468	174,568	7.8%	90,861	92,053	93,743	451,226
Number of permits	7,231	6,373	13,604		7,081	7,174	7,305	35,164

Table A2: Proposed adjustment to volumes (DPCR5)

LPN Submission	Ofgem Minded-to position	Difference
40,422	35,164	-5,258

Unit costs

Again, following what is set out in the final proposals, to determine unit costs for the three variable categories, we have taken the following approach:

- **Permits:** accepted LPN's average unit cost per permit across all four sub-categories. This reflects our acceptance that different local authorities implement and interpret the application of the permit schemes in different ways and therefore an industry benchmark would be inappropriate. However, for the next electricity distribution price control (RIIO-ED1), we intend to review this approach and will consider benchmarking permit unit costs.
- **Streetworks Incremental Admin associated with Permitting:** taken the average industry unit cost across all four sub-categories (benchmarking with other DNOs).
- **Permitting Condition Costs:** taken the average industry unit cost across all four sub-categories (benchmarking with other DNOs).

This has resulted in the proposed unit costs across the three categories as detailed in Table A3.

Table A3: Proposed unit cost by category (2010/11 prices)

Permits	Streetworks Incremental Admin associated with Permitting	Permitting Condition Costs
£	£	£
66.39	18.39	133.12

Applying the above unit costs to the volumes in Table A1, the total allowed revenue we propose to allow LPN is £7.81 million, as set out in Table A4. Overall, this results in a reduction to LPN's application of £1.27m, as detailed in Table A5.

Table A4: Proposed total costs (2010/11 prices)

	2010/11	2011/12	2012/13	2013/14	2014/15	DPRC5 Total
	£m	£m	£m	£m	£m	£m
Permits	0.48	0.42	0.47	0.48	0.48	2.33
Streetworks Incremental Admin associated with Permitting	0.13	0.12	0.13	0.13	0.13	0.65
Permitting Condition Costs	0.96	0.85	0.94	0.95	0.97	4.68
Streetworks set up costs	0.15	0.00	0.00	0.00	0.00	0.15
Total	1.72	1.39	1.54	1.56	1.59	7.81

Table A5: Proposed adjustments to total allowance (2010/11 prices)

LPN Submission	Ofgem Minded-to position	<i>Difference</i>
£m	£m	£m
9.08	7.81	-1.27