



*Promoting choice and
value to customers*

Our Ref: JS/mc/05-0136
Direct Dial: 020 7901 7366
Email: john.scott@ofgem.gov.uk

14 July 2005

Dear Colleague

Refocusing Ofgem's Asset Risk Management (ARM) Activity

Ofgem recognises that good asset risk management underpins the ability of network companies to deliver both supply quality and security, and value for consumers. ARM refers to the co-ordinated policies and practices, through which a network operator will acquire, analyse and review information on its assets to enable cost effective management of its network.

Ofgem conducted an ARM survey of the large electricity and gas network operators in 2002. The survey was developed by Ofgem to explore the medium and long term asset risk management practices of these companies and specifically:

- to enable Ofgem to gain assurance that each network operator was employing a systematic and co-ordinated approach to asset stewardship and risk management, and
- to identify and encourage the sharing of good practices

A consolidated report of the findings was published in December 2002. At that time Ofgem indicated its intention to conduct a further ARM survey in due course. There was encouraging feedback following the first survey both from network companies and industry commentators. To assist in identifying good practices Ofgem employed a scoring methodology to assess the practices of each company. However, the anonymity of the results hindered this process and, as such, was widely criticised. We stated our intention that any future survey results should identify each company.

Ofgem has also considered companies' ARM strategies in relation to assessing capital expenditure during the distribution price review and is similarly considering these as part of the current transmission price reviews. The asset investment decision processes of companies are of particular interest here.

Since the completion of the 2002 ARM survey, there has been substantial industry restructuring. Mergers have taken place in the electricity distribution sector resulting in the number of network operators being reduced to seven, a single gas and electricity transmission company has been established, and four separate gas distribution network owners have been created.

In addition, there has been significant development in asset management best practices. In April 2004 Publicly Available Specification (PAS) 55 was published by British Standards. PAS 55, championed by the Institute of Asset Management, sets out a systematic approach to the processes that link company objectives and the assets used to deliver them. In essence, PAS 55 does not prescribe mandatory approaches to asset management, but promotes requirements, which allows operators to demonstrate effective asset management to stakeholders against an independent standard. Significantly, the specification requires ownership and accountability for Asset Management at “Top Management” level to ensure that a company's assets support the delivery of the key corporate objectives in a controlled and visible way.

Ofgem has noted that the concept of risk is a recurring theme when discussing capital expenditure and, as already established by the Ofgem ARM Survey, there are differences in the way each network operator perceives, assesses and manages it. A better appreciation of how the network operators undertake investment decisions, including the treatment of risk, is considered to be of benefit to all parties.

In the light of industry restructuring and the development of the independent PAS 55 asset management specification, Ofgem is reviewing the way forward and considering whether a second Ofgem ARM survey is the preferred option for maintaining regulatory visibility of asset management and encouraging good practice. To assist with the development of our thinking, we would welcome views on a revised approach that would:

- recognise a PAS 55 framework when consulting with network operators on their asset management activities, both at price reviews and when considering specific asset performance issues,
- develop the Ofgem ARM survey scoring methodology to align it with PAS 55; this would retain consistency as far as possible with that used in the original survey. This is envisaged as an extension module to the PAS 55 specification. It would be used when reviewing the companies against PAS 55 (or as part of seeking formal certification to PAS 55),
- as part of the activities, develop in greater detail an understanding of investment decision processes in the companies including how short, medium and long-term network risk is incorporated in capital expenditure decisions.¹

Ofgem is committed to maintaining its interest in the approach of network companies to asset management and will welcome views on it adopting a PAS 55 framework when considering asset related matters.

¹ It is intended that the question of risk-led capital expenditure will also be addressed as part of the capex review visits arranged with the Distributed Network Operators (DNOs) later this year.

This letter seeks views from network operators and other interested parties on the refocusing of Ofgem's ARM activity. A short questionnaire is attached to this letter to assist this process. The questionnaire is intended to encourage responses to those issues on which Ofgem would particularly value feedback, but it is not designed to be exhaustive and should not constrain the scope of any comments that the respondent wishes to make. Ofgem will give careful consideration to the responses it receives.

All responses should be submitted in writing or electronically to arrive at the following address by **31st August 2005**. Please make it clear if you wish your comments to be held in confidence.

Leigh Williams
Ofgem
9 Millbank
London SW1P 3GE.

Email: leigh.williams@ofgem.gov.uk
Tel: 020 7901 7184

Ofgem is also planning an open seminar in October 2005 to promote discussion of the above. If you have any questions about the contents of this letter please do not hesitate to get in touch with me.

Yours sincerely

A handwritten signature in black ink that reads "John Scott". The signature is written in a cursive style with a horizontal line underneath the name.

JOHN SCOTT
Technical Director

Questionnaire on Refocusing Ofgem's Asset Risk Management (ARM) Activity

PAS 55 Framework

1. What is your view of Ofgem adopting a PAS 55 framework as a means of taking forward the aims of Ofgem's Asset Risk Management survey ?
2. To what extent do you regard PAS 55 as representing industry best practice for asset risk management?
3. How might Ofgem best apply the PAS 55 framework in seeking assurance of effective asset stewardship and promoting best asset management practices?
4. What is your view on the benefits and practicalities of developing the Ofgem ARM survey scoring system to align it with PASS 55?
5. What is your view on the value of facilitating comparisons between different companies and indeed sectors?
6. How might Ofgem maintain a suitable degree of visibility of PAS 55 audit results, including non compliances?
7. What is your view of the impact in terms of cost, time and effort, of undertaking an ARM review aligned to a PAS 55 framework?
8. What are your views on the merits of network companies seeking formal PAS 55 certification?
9. What is your view of the timing of a PAS 55 aligned review? Is there any merit in decoupling the timing of reviews of the Transmission and Distribution companies?

Investment Decision processes

10. What is your view of the benefit to be gained, in the regulatory context, of a better understanding network company investment decision processes, including the treatment of risk ?
11. What would be your view on regulating the effective management of short, medium and long term network risk? Is this a realistic prospect and how might it be implemented?
12. What is your view on the assessment and sharing of best practices in deriving short medium and long term risk for steering network investment?
13. What is your view on the benefits and practicalities of sharing best practice in this area? In this regard, is intellectual property or commercial confidence a substantive concern?