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value for all customers*

Our Ref: Networks/Electricity Distribution

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Dear Colleague

Special Condition A3 of the distribution licence – price control re-opener applications

Introduction

The purpose of this open letter is to consult with all relevant parties regarding our approach for managing DPCR4 re-opener applications as a result of amendments to the Electricity Safety Quality and Continuity Regulations 2002 (ESQCR), the Traffic Management Act 2004 (TMA) and the equivalent in Scotland.

In it we outline our views on key policy issues such as how we should assess the efficiency of any additional costs incurred, the impact of these changes on the Interruption Incentive Scheme (IIS), the process for the recovery of costs and the data we will require from Distribution Network Operators (DNOs) to assess their applications. We also set out our understanding of the new legal requirements on DNOs following the introduction of the ESQCR and subsequent amendments.

Reopener under DPCR4

While consulting on DPCR4 we recognised that DNOs would be exposed to unpredictable costs in several the areas associated with:

- the application of regulations 17 and 18 of the ESQCR (“ESQCR costs”);
- any amendments to the ESQCR (“new ESQCR costs”);
- secondary legislation on road occupation under the New Roads and Street Works Act (NRSWA) 1991 (“road occupation costs”); and
- permit schemes introduced through secondary legislation under the TMA (“permit scheme costs”).

We considered at the time of the DPCR4 that it was preferable to specify fixed allowances once the magnitude of the cost impacts became known or could be more readily assessed, so that DNOs would be incentivised to manage costs efficiently.

Under Special Licence Condition A3 (“the condition”) DNOs may issue Ofgem with a notice that they wish to re-open DPCR4 in regard to these changes. Their notice gives Ofgem four

months to determine an appropriate adjustment or, by default, their proposed adjustment is made.

Process

We wrote to all DNOs on the 27 February 2008 requesting information relating to the effects of the ESQCR, NRSWA and the TMA. The information provided in the responses to that letter has enabled us to begin to quantify the impact of these changes across the industry and identify a number of areas where we will require further detailed information to assess re-opener notices.

This consultation with all relevant parties including BERR and HSE provides an opportunity to discuss a number of implementation issues (such as the use of benchmarking in our efficiency assessment and how additional costs will be treated in the price control), to discuss our interpretation of law and what new costs it does/does not trigger and to provide clarity on points of process such as the data we will require from DNOs to assess their applications. The consultation will assist us in taking a consistent approach across DNOs, even though DNOs may raise formal notices at different times. Publication of our conclusions from the consultation in early July should also provide DNOs with a predictable and transparent framework within which to submit their notices.

For these reasons we would prefer DNOs to withhold their re-opener notices until the 2 July to allow us to conclude this consultation and set the framework in place before assessing applications.

Proposed timetable

Task	Date
Issue this open letter to relevant parties for three week consultation*	23 May
Consultation closes	13 June
Publish minded to letter to all DNOs including data template	1 July
DNOs notify us of adjustment proposals from this date forwards	2 July
Publish minded to letters to adjustment proposals submitted in early July	Mid Sept
Invite representations to minded to letter	Late Sept
Publish final decision regarding proposals submitted in early July	31 October

*We are adopting a three week consultation period recognising that this is part of an ongoing consultation that was initiated in February 2008 and to enable any necessary adjustments to be included DNOs 2009-10 Use of System charges.

NRSWA and TMA

As there remains uncertainty regarding when the Local Authorities will implement road occupation charges and permit schemes under the NRSWA and TMA the costs associated with these will be considered at a later stage.

Consent to share information:

Regarding work undertaken to achieve compliance with ESQCR 2002 and ESQCAR 2006 we intend to work closely with BERR and the HSE. To that end as a matter of good administrative practice, we seek the consent of each DNO to share with BERR and the HSE any information provided to us regarding this matter¹. Please clearly mark your response

¹ Under section 105(4) Utilities Act 2000, Ofgem can generally disclose information to BERR and the HSE without a DNO's consent

confidential if you do not wish us to publish it on our website or share it with other relevant parties and state the reasons associated with this.

Responses to this letter should be sent by e-mail to simon.polley@ofgem.gov.uk or by post to the address set out in this letter by 5pm on Friday 13 June 2008.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Rachel Fletcher', is placed over a light grey rectangular background.

Rachel Fletcher

Director of Distribution

Appendix – Reopener under Special Condition A3 of the distribution licence

Introduction

We recognise the additional requirements under ESQCR 2002 and ESQCAR 2006 are giving rise to or will give rise to additional costs. Our current thinking is that the appropriate way of addressing this is by giving DNOs the difference between the efficient costs of complying less associated DPCR4 allowances (where relevant). This gives rise to a number of issues that we are consulting on in this document including: the impact of the changes in the requirements on the DNOs' activities, how we should assess the efficient level of costs, how we address companies that adopted the requirement at an earlier rather than a later stage and the associated data requirements. The following section sets out the structure of the rest of this document in more detail.

Issues for consultation

We have identified the following issues for consultation from the responses to our letter of 27 February 2008 and following discussion with HSE and BERR. These issues are discussed in detail in the following appendixes:

1. ESQCR - Safety clearances:

Background – Safety clearances

Consultation Issues

- Impact of the introduction of ESQCR 2002
- Approach to cost/efficiency assessment
- Data requirements (safety clearance)
- Time table

2. ESQCR - Tree cutting requirements:

Background – Tree cutting requirements

Consultation Issues

- Impact of the introduction of ESQCR 2002 and the 2006 amendment
- Approach to cost/efficiency assessment
- Treatment of early adopters of ENA TS 43-8
- Appropriate levels of work under ETR 132²
- Data requirements (tree Clearance)
- Impact on the interruption incentive scheme (IIS)

3. Treatment and timing of recovery of any additional allowed costs

- Tax
- Recalculating the RAV
- Inflation and compensation for delayed revenue
- Profiling
- Impact on RRP

² ETR 132 – Energy Networks Association Engineering Technical Report 132; Improving network performance under abnormal weather conditions by use of a risk based approach to vegetation management near electric overhead lines – March 2006

Appendix 1: ESQCR – Safety clearances

Background – ESQCR - Safety clearances

- 1.1. This section outlines Ofgem’s understanding regarding the required safety clearances for OHL lines both under the revoked Electricity Supply Regulations 1988 (ESR) and under the Electricity Safety, Quality and Continuity Regulations as originally made (ESQCR 2002). Our view is based on discussions with the DNOs, BERR and HSE.
- 1.2. There has always been a need to maintain clearances between overhead lines and buildings, trees and the ground to safeguard members of the public from accidental contact with conductors.
- 1.3. Prior to ESQCR 2002 DNOs had a duty under ESR³ that required that “Every overhead line shall be so placed that it shall not, so far as is reasonably practicable, come so close to any building, tree or structure as to cause danger”.
- 1.4. Companies developed their own practices and policies to comply with the law. The voluntary technical standard later known as Energy Networks Association Technical Specification 43-8 “Overhead line clearances” (ENATS 43-8) was first issued in 1988. This specification detailed both horizontal and vertical clearances for all new lines in all circumstances including clearances in relation to buildings, trees, and the ground.
- 1.5. ESQCR 2002 regulation 18(5) introduced the requirement that “no overhead line shall, so far as is reasonably practicable, come so close to any building, tree or structure as to cause danger”. The main difference between this duty as expressed in ESQCR 2002 and the duty as previously expressed in ESR is that the obligation under ESR applied at the moment the line was placed, whereas under ESQCR 2002 the duty became continuous.
- 1.6. The associated DTI guidance published alongside the ESQCR 2002 states that regulation 18(5) “places a continuous duty on generators and distributors to maintain a safe distance between any overhead line and any tree, building or other structure where persons may be present” and the guidance goes on to say that, “in general, duty holders may demonstrate compliance with this requirement by complying with the Electricity Association’s Standard 43-8 *Overhead Line Clearances* dated 1988”.
- 1.7. Regulation 18(5) in effect requires DNOs to continuously maintain the appropriate safety clearances having regard to the risks that are present. The guidance indicates that where a person may be present, this duty may be met by achieving the clearances specified in ENATS 43-8. As a result DNOs will have to carry out some remedial work where safety clearances are insufficient.
- 1.8. No fixed allowance was made for this remedial work under DPCR4 as the cost impact could not be properly assessed. At that time there was uncertainty regarding the volume, cost and timing of the work required to meet ESQCR. The provision for costs of this work would be subject to the price control adjustment process under Special Condition A3 once clarity about the volume, materiality and timing of the work following agreement of each DNOs programme with the HSE.
- 1.9. It was agreed that each DNO would complete a survey by the end of January 2008 to identify all sites which did not comply with the minimum safety clearances under ENATS 43-8. Work on higher risk sites would start as they were identified and a programme of work to address the lower risk sites would be agreed with the HSE once the survey was completed.

³ Electricity Supply Regulations 1988 Part IV 13 (5)

Consultation Issues

Impact of the introduction of ESQCR

1.10. Ofgem accepts that for some electric lines the introduction of ESQCR will require DNOs to undertake remedial work to meet the required safety clearances.

Question: Is our understanding of the impact of ESQCR correct?

Approach to cost/efficiency assessment

1.11. Our principal objective is to protect the interest of consumers, so it is important that we carry out appropriate analysis to ensure that any costs, that are allowed to be funded through the re-opener, are efficient. In order to do this we wish to seek the views of relevant parties about the best way to measure efficiency recognising that lowest cost is not the only determining factor. Our current thinking is that a combination of approaches such as benchmarking, reviewing the DNOs processes and procedures and contracting strategies is likely to be appropriate.

1.12. We recognise that some of the clearance issues identified by DNOs would in due course be resolved by routine asset replacement and given this overlap we wish to understand how DNOs propose to account for this work in relation to normal asset replacement programmes.

1.13. The responses received to our earlier open letter indicate that some DNOs are more affected by issues related to certain voltages and vertical or horizontal clearance for historical reasons. The number of affected sites per DNO varies from 2345 to 41539 though the latter does include over 30,000 sites of low ground clearance. It is worth noting that historically some DNOs had agreed variations regarding certain statutory clearances; these variations were rescinded as part of the introduction of ESQCR 2002 but we understand that DNOs may apply to reinstate these variations on a site specific basis.

Question: What are your views regarding the appropriate methodology for assessing the efficiency of any remedial work?

Question: How should DNOs account for this work in relation to normal asset replacement programmes?

Data requirements (safety clearance)

Special Condition A3 requires that in order to serve notice DNOs must:

- a) State the obligations or requirements to which the notice relates;
- b) Set out by reference to each such obligation or requirement the basis on which the licensee has calculated the relevant adjustment; and
- c) State the date from which the DNO wishes the Authority to agree that the relevant adjustment shall have effect ("the adjustment date") which in the case of ESQCR costs may not be earlier than 1 April 2008.

1.14. These conditions set out high level requirements for serving a notice. However, we need to gather much more detailed information relating to the efficient associated level of costs to be able assess whether there is a case for adjustment to the price control and the associated efficient level of costs.

1.15. Some DNOs have provided greater detail than others but overall the suggested unit costs per site for compliance with ENA TS 43-8 vary from £516 to £12,570. There are

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differences in the techniques DNOs propose to use in resolving building clearance issues. One proposed approach is to replace whole sections of overhead line conductor (10 spans) with ABC insulated conductor to resolve a clearance issue rather than just replace a single span. Another difference is in the use of shrouding which can resolve some clearance issues cheaply but does not appear as an option for all DNOs.

1.16. Given the variances highlighted above and the need for regulatory consistency we recognise that there is a need to gather further information on a uniform basis regarding details of the methods of resolution and basis of calculation of unit costs.

1.17. In our proposed minded to letter on 1 July 2008 we will provide a template including the following data requirements:

- Number of sites affected at each voltage.
- Method of resolution. (Negotiate removal of obstacle/ shrouding/ insulated conductor/ pole height increased (new pole or extension bracket)/ overhead diversion/ underground diversion).
- Unit cost for each method.
- Details of the programme of work agreed with BERR/HSE on a year by year basis showing the number of sites and their priority, unit and total cost.

1.18. Our intention is that this template will be completed by all DNOs so that we can carry out an assessment of efficiency by comparative analysis using data from all DNOs.

Question: Is there any further information you consider we require to carry out our assessment?

Timing of the work

1.19. All DNOs have confirmed that they have completed their surveys and are now in various stages of creating a programme of works to address the lower risk sites. Although that they have yet to agree their programmes with the HSE most DNOs have indicated a wish to operate a ten year programme in order of priority to address the lower risk sites.

1.20. Some companies are well advanced with cost estimates and propose to commence this year, 2008/09.

1.21. We would expect DNOs to have agreed a programme of work in this area with the HSE before submitting a reopener application.

Question: Where there is a large volume of work is the indicated 10 year programme appropriate?

Question: Do you agree it is appropriate for DNOs to wait for HSE agreement before submitting their reopener applications?

Appendix 2: ESQCR - Tree cutting requirements

Background - Tree cutting requirements

- 1.22. This section outlines Ofgem understanding regarding the changes to the tree cutting requirements as a result of the 2006 amendments to the ESQCR. Our view is based on discussion with the DNOs, BERR and HSE.
- 1.23. ESQCR 2002 introduced requirements for the DNOs to cut trees to avoid danger, i.e. to ensure safety. ESQCR 2002 did not contain any specific requirements to cut trees to ensure continuity of supply.
- 1.24. ESQCR 2002 was amended in 2006 (ESQCAR 2006) with the inclusion of regulation 20A which states that "a generator or distributor shall, so far as reasonably practicable, ensure that there is no interference with or interruption of supply caused by an insufficient clearance between any of his overhead lines and a tree or other vegetation". Compliance with regulation 20A is required by 31 January 2009.
- 1.25. The associated guidance for ESQCAR 2006 states that "...it is expected that all duty holders will operate a progressive vegetation control programme in accordance with...
- ENA TS 43-8... in relation to clearances from lines to trees and other vegetation for all lines and;
 - ENA ETR 132 "*Improving Network Performance under Abnormal Weather Conditions by Use of a Risk-Based Approach to Vegetation Management Near Electric Overhead Lines*".
- 1.26. The guidance notes indicated that the amendment introduced two new requirements:
1. To maintain the minimum clearances specified in ENA TS 43-8 not only for safety reasons where persons may be present but also to ensure continuity of supply for all lines regardless of whether a person may be present.
 2. To implement a further programme to establish risk based tree clearance to secure the network against interruptions caused by trees during abnormal weather events.
- 1.27. Our understanding of ESQCAR 2006 is that by 31 January 2009 every DNO should have achieved, insofar as it is reasonably practicable to do so, in relation to the entire length of each of its overhead electric lines, the maintenance of minimum clearances specified in table 6.2 of ENA TS 43-8. i.e. a ENA TS 43-8 corridor clearance of trees.
- 1.28. As part of DPCR4 final proposals we made allowance for increased tree-cutting activity in light of public concerns over the level of disruption and the amount of time required for supply restoration following major storms.

Consultation issues

Impact of introduction of ESQCR 2002 and the 2006 amendment (ESQCAR 2006)

Question: Is our understanding of the impact of the introduction ESQCR 2002 and ESCQAR 2006 correct?

Approach to cost/efficiency assessment

- 1.29. Our current thinking is that the appropriate method for calculating additional costs under the reopener is to assess the efficient level of costs associated with meeting the revised obligations and then deduct tree-cutting costs that have already been allowed under the DPCR4 settlement.

1.30. Our principal objective is to protect the interest of consumers, so it is important that we carry out appropriate analysis to ensure that any costs, that are allowed to be funded through the re-opener, are efficient. In order to do this we wish to seek relevant party's views about the best way to measure efficiency recognising that lowest cost is not the only determining factor.

1.31. Our current thinking is that a combination of approaches such as benchmarking, reviewing the DNOs contracting strategy, tendering process, contract incentives, contract structure, processes and procedures is likely to be appropriate.

Question: Do you agree that the appropriate method for calculating additional costs under the reopener is to assess the efficient level of costs associated with meeting the revised obligations minus tree-cutting costs that have already been allowed under the DPCR4 settlement?

Question: What are your views regarding the appropriate methodology for assessing the efficiency of tree cutting?

Treatment of early adopters of ENA TS 43-8 compared to those who have adopted the standard more recently

1.32. As ENA TS 43-8 was a voluntary industry standard introduced in 1988 DNOs policies to tree cutting have varied significantly in practice. Those DNOs that adopted ENA TS 43-8 or similar at an early stage may have incurred higher costs relative to allowances in previous price controls and therefore incur smaller incremental costs in this period.

Question: How should we treat DNOs who chose to be early adopters of ENA TS 43-8 compared to those who have adopted this standard more recently?

Appropriate levels of work under ETR 132

1.33. In accordance with ETR 132, DNO's are required to undertake a risk based assessment to determine whether additional tree cutting work should be carried out to improve network resilience. In response to our open letter a number of DNOs suggested that they would carry out additional tree cutting work on 20 per cent of their overhead line network over 25 years or approximately 0.8 per cent per annum in accordance with the DTI impact assessment for ESQCAR 2006. We do not consider this approach appropriate and believe DNOs should be establishing their own programme of work specific to their networks based on their own risk assessment.

Question: Is it appropriate for DNOs be carrying out their own risk assessment to determine appropriate volumes of work?

Data requirements (tree clearance)

1.34. Special Condition A3 sets out high level requirements for serving a notice. However, we need to gather much more detailed information relating to the efficient associated level of costs to be able assess whether there is a case for adjustment to the price control.

1.35. In our proposed minded to letter on 1 July 2008 we will provide a template including the following data requirements:

- Number of spans cleared and projected to be cleared per annum at high and low density, unit costs and total cost incurred by voltage for DPCR4.
- If the work is carried by contractors request contract schedule details to indicate impact of ESQCR 2002 and ESQCAR 2006.
- Details of ETR 132 programme year by year indicating which feeders have been prioritised for clearing to this standard and basis of forecasted costs.

- Details of CI and CML variation attributable to ESQCAR 2006 tree cutting.

Question: Is there any further information you believe we require to carry out our assessment?

Impact on the IIS incentive scheme

- 1.36. Some DNOs have raised concerns about the impact of the additional tree-cutting work on pre-arranged interruptions and their performance under the quality of service Interruption Incentive Scheme.
- 1.37. Our current thinking is that the reopener was only intended to cover costs directly associated with carrying out work on the network. It was not intended to reopen the quality of service incentive scheme.

Question: Should DNOs be allowed to recover any CI and CML penalties that they have incurred under the IIS scheme due to additional tree cutting outages?

Appendix 3: Treatment and timing of recovery of any additional allowed costs

Treatment and timing of recovery of any additional costs

- 1.38. There are a number of possible options for how these costs could be recovered by the DNOs, since the Condition is not explicit on the matter. One proposed approach is that a one-off revenue adjustment should be made for 2009-10 to allow DNOs to recover these costs. This is likely to have a significant impact on distribution charges. Our preferred approach is to treat these costs in the same way as if they had been known at the time we set the DPCR4 allowances. All of the costs associated with safety clearances would be capitalised. The majority of costs associated with tree cutting would be expensed and a smaller proportion capitalised. This would have a much smaller impact on allowed revenue and distribution charges, but raises a number of issues as set out in 1.39 to 1.44 below.
- 1.39. All of the costs associated with safety clearances would be treated as capex and added to the RAV. A proportion of the tree cutting costs would be treated as capex and added to the RAV under the rules for opex set out in DPCR4 Final Proposals. We would therefore need to restate the RAV for each year of the price control in which the DNOs had incurred costs allowed in the reopener.
- 1.40. When we modelled the allowances for DPCR4, we had to make adjustments to reflect the difference between the timing and rates of taxation of the income and the timing and rates of tax relief on the underlying expenditure that was assumed in setting the allowances. We will have to do this with the re-opener costs as the timings of the revenue allowances will not match the timing of the tax relief. Further, since the majority of the tax allowances will not be recovered by the DNOs until after 2010, we will need to ensure consistency with the capital allowance pool assumptions used in DPCR5. Even if we made a one-off revenue adjustment for 2009-10, a tax adjustment would be required.
- 1.41. The DPCR4 allowances were stated in 2002/03 prices. We will need to deflate DNOs' actual costs from 2005-08 and forecasts from 2008-10 back to 2002/03 prices to determine the allowances. These will then be inflated using the RPI factor set out in Special Condition B1 of the distribution licence as applied to revenue allowances. This will entail checking any inflation assumptions used in DNOs' forecasts for consistency and reasonableness. It will be important to deflate and reflate using consistent measures of inflation.
- 1.42. In DPCR4 we introduced a sliding scale mechanism as part of our assessment of capex. This mechanism incentivised accurate forecasting by the DNOs and involved an uplift to PB Power's views of the efficient level of capex based on the ratio of this figure to the DNOs' forecast. To recalculate this sliding scale ex post for the adjusted capex in respect of vegetation management and tree cutting costs would not have the same incentive properties, and we do not propose to do so. However, we could use the sliding scale with respect to capex forecast for 2008-10 in respect of costs qualifying for the re-opener. Our current thinking is that we would not do so, taking into account the additional complexities that could result in DNOs having different incentive rates for different types of capex.
- 1.43. Following assessment of the costs required to operate the networks and finance investment in DPCR4, these costs were profiled in an NPV-neutral manner to provide a "smoothed" set of revenue allowances. If we were to replicate this financial modelling approach for revised revenue allowances including the re-opener, this would have the effect of entailing revised revenue allowances for all years of the price control, even if

re-opener costs are only allowed for some of those years. Our current thinking is that there would be no merit in applying this smoothing.

- 1.44. Even without this smoothing, it is likely that the re-opener will result in additional allowances for costs relating to 2007/08 or earlier (indeed the terms of the Condition effectively make this a prerequisite for a re-opener application). We will need to consider how DNOs are remunerated for the effect of the delay in being able to recover these costs. One alternative is to revise each year's revenue allowances and to treat the additional amounts as an under-recovery. This allows the DNOs to increase the amount they recover by the average specified interest rate plus an adjustment factor for the period between the allowances falling due and when they can be collected via an increase in distribution charges, as set out in Special Conditions B1 and E1 of the distribution licence. Given that the revenue allowances were adjusted after the year in which they were collected, we would not expect to apply the provisions relating to under recoveries of more than 2%. Alternatively, we could roll up the earlier adjustments into the first year in which the DNOs can practically collect the revenue (2008/09). This may be regarded as analogous to an ex-post adjustment as made in a subsequent price control, for which we typically increase allowances using the relevant cost of capital. The DPCR4 cost of capital is 5.55% vanilla WACC, whilst the specified interest rate has varied from 4.5% to 5.5% during the price control period.
- 1.45. A final point to note is that we will have to ensure that we collect cost data relating to ESQCR in the annual RRP in a manner that ensures we can compare DNOs' actual costs with revised allowances. This matter will be taken forward with the DNOs as part of the annual cost reporting cycle. For 2007/08 a table to collect these costs has already been added to the RRP.

Question: Are you in agreement with our preferred approach? If not what are the alternatives? Are there any other factors we have not considered in determining how the allowed costs translate into revenue allowances?