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Our Ref: Networks/Electricity Distribution

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Date: 1 July 2008

Dear Colleague

Assessing applications to re-open the current price control to accommodate additional costs related to vegetation management and overhead line building clearances associated with the changes to the Electricity Safety Quality and Continuity Regulations.

1. Introduction

1.1. The purpose of this letter is to set out our "minded to" position which we will be recommending to the Authority on 17 July 2008 regarding our approach to re-opener applications associated with ESQCR. Subject to approval it is the approach we will take to all applications, unless after detailed scrutiny (and possibly further consultation) we think there is a very good reason for doing something different.

1.2. As part of last price control review we recognised that the introduction of the ESQCR and potential further changes to the regulations that BERR were consulting on associated with tree cutting for network resilience would place additional costs on DNOs. At that time the magnitude of these costs was uncertain and we considered it was preferable to specify fixed allowances once the efficient level of costs could be assessed[1].

1.3. Under Special Condition A3 [2]("the condition") of the distribution licence each DNO may issue Ofgem with notice that they wish to re-open the price control in regard to these changes. Ofgem has four months to determine a relevant adjustment or, by default, the DNO's proposed adjustment is made.

1.4. The effect of these changes will be to deliver increased safety and improved network performance during both normal and severe weather conditions. The likely cost impact per customer per year of these changes for the current price control is estimated to be around 65 pence, which is less than customers on average have indicated that they would be prepared to pay for improved storms resilience.

2. Background

2.1. We have consulted with all relevant parties in advance of the reopener notices to achieve regulatory predictability and consistency, given that DNOs may raise formal

[1] Electricity Distribution Price Control Review Final Proposals November 2004 ref 265/04
[2] Arrangements for the recovery of uncertain costs

notices at different times for each area of the re-opener. We welcome the DNOs' intention to submit applications before October 2008.

2.2. We have formulated our approach having considered the responses received from stakeholders to our open letters of 27 February 2008 and 22 May 2008. In addition we wrote to licensees on the 4 June 2008 setting out the data we propose to collect to enable us to carry out efficiency assessments. In an attachment to this letter we have provided details of the narrative and statistical information we will require from Distribution Network Operators (DNOs) to assess their current distribution price control re-opener applications as a result of amendments[3] to the Electricity Safety, Quality and Continuity Regulations 2002 (ESQCR).

2.3. We anticipate receiving the first re-opener applications from 1 July but request that companies complete the data sheets and respond to the narrative questions to the best of their ability by 1 August, whether or not they are ready to make a re-opener application by that date. This data[4] will allow us to make appropriate comparisons of companies' costs taking into account the effect of the different approaches companies have adopted. Companies that have submitted completed data templates in advance of their formal application can submit updated data with their application.

3. Approach to key issues

3.1. Our approach is to allow DNOs to recover the efficient overall level of costs associated under the revised obligations minus the costs that have already been allowed under the current price control. This will avoid any risk of double counting given that as part of DPCR4 final proposals we made an allowance for increased tree cutting activity.

3.2. We will assess efficiency of additional costs applied for under the re-opener in two ways; firstly by carrying out cost comparisons and secondly by reviewing the DNOs' strategies' procedures and approaches for managing the work. The additional building clearance costs will be capitalised and the additional tree cutting costs part expensed and part capitalised in accordance with the DPCR4 rules.

3.3. Where a DNO is performing worse than the assumptions on planned interruptions (used to set their target under the current price control) then their revenue will be adjusted to take account of their underperformance as a result of the impact of the additional work.

3.4. In general respondents were in agreement with our approach but did identify five key questions which are discussed below together with an outline of the reason for our chosen approach:

Issue 1 – How should we measure efficiency?

3.5. Most respondents agreed with our view that the assessment of efficient costs should take into account company strategies, processes and procedures for meeting the new standards as well as comparing costs incurred by different DNOs. We do not agree that there should be a presumption of efficiency if the work has been let through a competitive tender process.

3.6. We therefore propose a combination of approaches to efficiency assessment including unit cost comparisons, reviewing contracting strategy, tendering process, contract incentives, and contract structure.

[3] The Electricity Safety, Quality and Continuity (Amendment) Regulations 2006
[4] This data requirement is in line with the updated Forecast Business Planning Questionnaire to avoid duplication

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3.7. In line with a number of the responses we consider that the DNOs' proposed unit costs for building clearance remedial work should be supported by detailed costing for a representative sample of ten per cent of affected sites or be based on an equivalent amount of work that has already been completed. We recognise that there are variations between DNOs and intend to use this cost information to create an initial range of costs that DNOs' unit costs can be compared against. We will review DNOs' strategy both for selecting the most cost effective solutions and the approach to planning and managing work programmes.

3.8. DNOs all recognise that building clearance remedial work can potentially impact on other asset replacement programmes but are of the view that this has no material impact during the remainder of DPCR4. There is a possibility that this work could have a greater impact during the next price control review period. We will expect DNOs to demonstrate how they are managing both these issues as part of their forecasts for DPCR5.

Issue 2 – How should we treat of early adopters?

3.9. 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 Energy Networks Association Technical Specification (ENA TS) 43-8 *Overhead Line Clearances* dated 1988".

3.10. Those DNOs that voluntarily adopted ENA TS 43-8 at an early stage may have incurred higher costs relative to allowances in previous price controls and will incur smaller incremental revenue allowances in this period. We have considered whether it is appropriate to take this into account in the reopener. Early adopters claim they will be disadvantaged if they do not get an increased allowance reflecting their additional spend in the previous control period.

3.11. Our view is that those DNOs that voluntarily adopted the requirements of ENA TS 43-8 in price controls prior to DPCR4 made a management decision to do so within the context of existing allowances. They may have incurred additional costs in this area and lower costs in other areas. Such expenditure can be considered to have been accepted by the companies and settled at that time. As such we consider it would be inappropriate to revisit the allowances prior to the current price control period.

Issue 3 – How should we treat the impact on quality of supply performance?

3.12. We consulted on whether DNOs should be allowed to recover any Customer Interruption (CI) and Customer Minute Lost (CML) penalties that they have incurred under the IIS scheme when carrying out additional planned tree cutting and clearance work. DNOs viewed that it would be unfair to recognise the impact of these changes in regard to costs whilst denying there was any impact on performance under IIS. One respondent suggested that it would not be appropriate to allow DNOs to recover any CI and CML penalties associated with tree cutting as over the medium to longer term the additional tree cutting work should reduce the number of tree-related faults and unplanned CI and CML.

3.13. We recognise that the additional work required under ESQCR 2002 as amended has had an impact on planned CIs and CMLs that was not anticipated in setting the interruption targets during DPCR4. It would potentially be unfair if no account was taken of this in assessing the reopener. However, DNOs should have an appropriate incentive to manage the impact of planned work on the network.

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3.14. We will require documented evidence of the impact of this work on CI and CML performance to determine if any CI or CML allowance adjustment is appropriate for DPCR4. Where a DNO is performing worse than the assumptions on planned interruptions (used to set their target under the current price control) then their revenue will be adjusted to take account of their underperformance as a result of the impact of the additional tree cutting and building clearance work. DNOs who are currently outperforming their original targets will not receive any adjustment.

3.15. As a result of increased tree clearance distances there will be a reduction in the number of tree related faults and consequently the associated unplanned CI and CML should be reduced during DPCR5.

Issue 4 – What are the compliance requirements?

3.16. DNOs should provide us with evidence of their discussions with BERR and HSE regarding their building and ground clearance remedial programmes to demonstrate that their re-opener applications enable compliance with legislation.

3.17. There is some debate as to whether DNOs are only required to have compliant policy and procedures in place at January 2009 or whether they must be fully compliant with the clearance distances on all lines by this date. The deferred date of 31 January 2009 in the guidance and Regulatory Impact Assessment to ESQCAR 2006 was to allow duty holders and arboricultural contractors sufficient time to be able to demonstrate an acceptable degree of compliance with the new requirement. Based on discussions with BERR we consider that it would be a reasonable approach for DNOs to undertake tree clearance work to achieve the tree clearance distances set out in ENA TS 43-8 by 31 January 2009. We are prepared to fund an efficient level of costs where DNOs are carrying out the work on this basis. We will assume for the purposes of DPCR5 that compliance has been achieved and only work to maintain clearances will be funded.

3.18. Where DNOs are carrying out this work over a longer period they will need to satisfy themselves in discussion with BERR that they are compliant. We will assess the efficient level of costs associated with their programme.

3.19. Earlier responses suggested that a number of DNOs believed that to comply with the additional requirements ETR132[5] they had to carry out risk-related tree cutting for 0.8% of their network per annum. We have clarified with BERR that this interpretation is incorrect; 0.8% pa is a national benchmark and each DNO's interpretation must take this benchmark as a material consideration. However it is for each company to determine by risk assessment its actual workload in practice and justify this position. The 'circa' 0.8% in the RIA[6] was posited as a figure that would also enable works to be undertaken in a manner to minimise environmental and social impacts. These impacts will be different across the DNOs, thus different percentages will also be applicable from that perspective.

3.20. We will require evidence of the programme and prioritisation of feeders that have been risk assessed for clearance in accordance with ETR132.

How should we treat financial and RAV adjustments?

3.21. We will treat the additional costs allowed through the re-opener in the same way as if they had been known at the time we set the DPCR4 allowances, namely:

[5] ETR132 – Engineering Technical Report – "Improving network performance under abnormal weather conditions by use of a risk based approach to vegetation management near electric overhead lines" March 2006
[6] RIA - Full Regulatory Impact Assessment dated 7th June 2006: (BERR Publication Reference URN 06/1295)

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- 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 will 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.

3.22. This approach will have a much smaller impact on allowed revenue and distribution charges in the first year of recovery than treating all expenditure to date as opex and reimbursing it over a single year. One DNO argued for this latter approach, although they conceded that it would be acceptable to spread the additional revenue over the period to March 2015. The other DNOs, to the extent they commented, were supportive of our preferred approach.

3.23. 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.

3.24. The DPCR4 allowances were stated in 2002 prices. We will need to deflate DNOs' actual costs from 2005-08 and forecasts from 2008-10 back to 2002 prices to determine the allowances. These will then be reflated using the RPI factor set out in Special Condition B1[7] 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.

3.25. 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 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 building clearance and tree cutting costs would not have the same incentive properties, and we do not propose to do so.

3.26. 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. We do not propose to apply this smoothing.

3.27. Even without this smoothing, it is likely that the re-opener will result in additional allowances for costs relating to 2007/08 or earlier. DNOs will be remunerated for the effect of the delay in being able to recover these costs using the relevant cost of capital (5.55% vanilla WACC).

3.28. A final point to note is that we will 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.

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[7] Special condition B1 – Restriction of distribution charges: demand use of system charges

4. Next Steps

4.1. This letter sets out our approach which will shortly be recommended to the Authority. If you have any serious concerns regarding this approach please notify me no later than the 7 July 2008.

4.2. We are now ready to take formal applications. Please could those DNOs that do not plan to make an early submission confirm by the 7 July that they are able to submit responses to the questions in the attached appendix together with a completed statistical data template by 1 August 2008.

4.3. For those DNOs who submit applications in July we will publish final decisions by 31 October 2008, decisions regarding later applicants will be published on determination.

4.4. Applications or responses should be sent by email to simon.polley@ofgem.gov.uk or by post to Simon Polley, The Office of Gas and Electricity Markets, 9 Millbank, London SW1P 3GE.

Yours sincerely

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Appendix – Reopener under Special Condition A3 of the distribution licence – Data requirements

1. Introduction:

These questions constitute part of the data submission requirement for assessing DPCR4 re-opener applications as a result of amendments to the Electricity Safety Quality and Continuity Regulations 2002 (ESQCR).

These questions will require a narrative reply and supporting evidence so we can consider your strategies, processes and procedures for managing these areas of work. We request all DNOs to submit responses to these questions together with the statistical template data by 1 August 2008.

2. Questions – Vegetation Management

2.1. Company Strategy

In this section we are seeking to understand your strategies, policies and the timing of changes and innovation. We expect to see details of the following:

- What is the current company strategy and policy regarding vegetation management? Please explain changes and timing from previous strategies and policies.
- Did you adopt ENATS 43-8 in relation to the management of tree clearances for both new and existing lines for both safety and continuity of supply prior to DPCR4?
- What further changes do you propose to implement, when and why.
- At each voltage do you maintain clearances according to tree types, by regular cyclical cutting (if so over what period) or reactively?
- An outline of your method for forecasting annual work load and budget; e.g. on a historical basis, or using a dynamic asset data base, or other. How have you estimated volumes and unit costs for this work?
- Explain your approach to in sourcing and outsourcing vegetation management.
- An outline of how you have prioritised your feeders in accordance with ETR132 and used this to create your programme.
- How do you review your strategy in relation to ENATS 43-8 and ETR132 compared to actual network performance?

2.2. Contract tendering process

Sections 2.2 to 2.5 apply where all or part of this work is outsourced.

The purpose of this section is to understand your approach to potential vendor selection and the criteria you apply to determine which vendor is awarded the contract(s). We expect your response to address the following:

- Outline the pre-qualifiers used to determine who you invited to tender for vegetation management.
- Did you tender only to established vegetation management companies?
- Did you tender to existing contractors who have not traditionally provided this service on the basis that management experience in contract operation was an essential to your criteria for selection?
- Did you tender for a single company or multiple contracts either by geographical area or voltage? Please give reasons for your choice.

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2.3. Contract Specification

The purpose of this section is to seek out innovation in the way your vegetation management contracts are specified including evidence or commentary in relation to the following;

- What vegetation management contracts do you have in place?
- Please include copies of contracts with schedules, contract value and duration.
- Describe form of contract; traditional client/provider or partnership
- Is the management of the tree cutting programme out sourced with the contract?
- Do you employ arboricultural experts to proactively manage tree cutting work load according to tree types and seasonal growth?
- Do you incentivise your vegetation management contractors by the use of reward and/or penalty payments? If so please explain the incentive structure.
- Do you share ownership of equipment with your contractors?
- Do you share office and depot facilities with your contractors?
- Do you provide or sponsor City & Guilds NPTC certification for contract staff?

2.4. Contract Management

In this section we seek to understand the day to day operation of your contracts.

- Describe your contract management and supervision structure
- What are your business processes/procedures/physical arrangements for managing your tree cutting work both for routine cutting and emergencies?
- Summarise your management information and cost accounting procedures.
- Do you embed supervisory contract staff within your organisation?
- Do your contractors organise their own operational outages including switching and permitting?

2.5. Contract Performance

In this section we wish to identify how you demonstrate value for money, please include the following information:

- How contractor performance is reviewed, audited and reported; (service level agreements, guaranteed standard failures, unplanned outages, HSE compliance).
- Do you benchmark your contracts in terms of price and quality of work?
- How do you know your contracts are delivering value for money? Provide evidence of how this has been assessed.

2.6. Directly employed tree cutting staff

If your tree cutting work is currently carried out in house using directly employed tree cutting staff please describe how it is managed including details of the following:

- Management and supervisory structure
- Do you directly employ full time tree cutting staff?
- Do you employ arboricultural experts in-house to proactively manage tree cutting work load according to tree types and seasonal growth?
- Details of City & Guilds NPTC training provided for direct staff?
- Cost accounting including management and supervisory costs demonstrating segregation from other activities
- Benefits from synergies such as shared use of equipment (e.g. MEWPs[8])
- How performance is reviewed, audited and reported
- Methods of benchmarking cost to demonstrate efficiency and value for money.
- Quality Assurance standards and Audit procedures

[8] MEWPS – Mobile Elevated Working Platforms

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3. Questions – Building and Ground Clearances

3.1. The purpose of this section is to understand how you have used unit costs and prioritisation to create your remedial programme. Your answer should include the following information.

- What has determined the duration of your proposed work programme?
- Please explain how you have prioritising work in regard to your risk assessment and resource availability.
- Please provide details of your unit cost build up.
- Please provide details of how you have determined the volume of each proposed solution.
- Have you awarded new contracts specifically for this work or included this work within existing framework contracts?
- Have you out sourced the management of the remedial programme or retained this in house?
- In the case of sites with ground clearance below ESQCR requirements as a result of previous variations being rescinded as part of the introduction of ESQCR 2002 have you attempted to re-instate these variations on a site by site basis? If so please provide details.

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