



Paul Bircham
Regulation Director
ENW Ltd
Dalton House
104 Dalton Avenue
Birchwood Park
Warrington
WA3 6YF

*Promoting choice and
value for all customers*

Our Ref: Networks/Electricity Distribution

Direct Dial: 020 7901 7209
Email: rachel.fletcher@ofgem.gov.uk

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Dear Paul

Assessment of application(s) from Electricity North West Ltd to re-open their current price control to accommodate additional costs related to the introduction of and changes to the Electricity Safety Quality and Continuity Regulations 2002 (ESQCR).

1. Introduction

- 1.1. The purpose of this letter is to set out our "minded to" position regarding your re-opener application(s) from Electricity North West Ltd (ENW) associated with ESQCR.
- 1.2. As part of the last price control review we recognised that the introduction of the ESQCR and potential further changes to the regulations that BERR were consulting on at the time associated with tree cutting for network resilience would place additional costs on Distribution Network Operators (DNOs). We also recognised that there were uncertain costs associated with the implementation of the TMA and the equivalent legislation in Scotland. 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 assessed¹.
- 1.3. Under Special Condition A3² ("the relevant condition") of the distribution licence each DNO may by notice to the Authority propose a relevant adjustment to the Charge Restriction conditions in regards to changes to the ESQCR and TMA. Ofgem has four months to determine a relevant adjustment to the Charge Restriction or, by default, the DNO's proposed adjustment is made by the licensee giving notice to the Authority that it will take effect.
- 1.4. The effect of the changes to the ESQCR is to deliver increased safety and improved network performance during both normal and severe weather conditions.

2. Background

- 2.1. We have consulted with all relevant parties in advance of inviting the reopener notices to achieve regulatory predictability and consistency.
- 2.2. We published open letters to all stakeholders on 27 February 2008 and 22 May 2008 inviting views regarding the treatment of reopener applications. In addition we wrote to

¹ Electricity Distribution Price Control Review Final Proposals November 2004 ref 265/04

² Arrangements for the recovery of uncertain costs

licensees on 4 June 2008 setting out the data we required to enable us to carry out efficiency assessments. In an attachment to this letter we provided details of the narrative and statistical information we required from DNOs to assess their current distribution price control re-opener applications as a result of amendments³ to the ESQCR.

- 2.3. We wrote to licensees on 1 July 2008 setting out our “minded to” approach to assessing the reopener applications. This approach was recommended and agreed by the Authority on 17 July 2008. We wrote to licensees on 31 July 2008 detailing this agreed approach.
- 2.4. We have formulated our “minded to” position in relation to this application having considered the responses received from stakeholders to our open letters together with the narrative information on companies processes and procedures regarding tree cutting and building clearances received with the application, and data received in response to follow-up requests and following our bilateral meeting.

3. Summary of 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 over and above 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 have assessed the efficiency of additional costs applied for under the re-opener in a two stage process; firstly by an assessment involving quantitative benchmarking, carrying out cost comparisons and secondly a qualitative assessment of management and contract processes to seek evidence of value for money 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. Indirect costs, non-operational capex and pension costs also follow the treatment set out at DPCR4.
- 3.3. We set out our proposed approach to assessing the impact of the additional work under the ESQCR on quality of service incentives in our 1 July letter. We noted that “where a DNO failed to meet the planned element of their Customer Interruption (CI) and Customer Minutes Lost (CML) targets as a result of this work we would make an adjustment to revenue compensating them for this underperformance.” A number of DNOs have suggested that this approach is inappropriate and may penalise a company that has taken steps to improve its planned interruption performance. We have given this further consideration and have adopted a revised methodology. In our assessment we have benchmarked the planned interruption performance across companies relative to the cost of work being carried out and have allowed the full benchmark impact. We have done this for each of the main sources of planned interruptions Energy Networks Association Technical Specification (ENATS) 43-8 work, horizontal and vertical clearances.

4. Our analysis

Tree-cutting costs

- 4.1. We have carried out a qualitative assessment of the written submissions with DNOs which has enabled us to suggest areas where the applicants can improve. We recognise that DNOs have historically operated to different policies resulting in varying work loads to enable them to meet the common standards now enforced under ESQCR.

³ The Electricity Safety, Quality and Continuity (Amendment) Regulations 2006

- 4.2. Our assessment of applications has taken into account the need for DNOs to have in place appropriate contracts and management structures to enable sustainable vegetation management that seeks long term value rather than low cost short term compliance. As part of this sustainable approach we consider that well developed stakeholder⁴ relationships are important to create the credibility that allows for establishing the set clearances, reducing restricted cuts and applying innovative solutions such as replanting schemes.
- 4.3. In general most companies that have applied for reopeners at this stage have relatively robust tree-cutting processes and procedures in place although there is some room for improvement in areas such as bench marking, auditing and managing stakeholder relationships.
- 4.4. We have compared unit costs for the ENATS 43-8 tree cutting work across all DNOs for each voltage level. Our assessment of the reopener applications focused on: (a) historical expenditure already incurred in the current price control and (b) forecast expenditure for the remainder of the current price control.
- 4.5. We have considered the use of information on tree coverage both in terms of overall woodland cover and linear features to normalise this companies' cost data. However as there is no significant correlation between these measures and the companies' costs we have not made such an adjustment at this stage. We are working with ADAS on further analysis assessing the extent of tree cutting based on overlaying tree data with companies' digitised network maps and will consider a further update of our analysis based on this once it has been received.
- 4.6. As there are some significant differences in costs we have developed a range of costs from the lower to the upper quartile (both including and excluding indirect costs and pension costs). We have adjusted companies' tree cutting costs downwards to the top end of our benchmark range where they fall outside of this.
- 4.7. We have applied reductions to vertical and horizontal clearance costs for a number of companies where their unit costs are above our benchmark range.
- 4.8. We have reviewed companies' assessments of their costs for carrying out additional ETR132⁵ tree cutting for network resilience. Most DNOs have made an initial assessment of the volumes of work required either based on the DTI impact assessment which suggested that 20 per cent of the overhead line network should be addressed over 25 years or their own risk assessment and are prioritising the work on a risk basis. However, companies have made clear that they are at a relatively early stage in assessing the costs and most companies have adopted the £9000 per km unit costs set out in the IA, in some cases adjusted for inflation.
- 4.9. We have assessed the costs for this work by multiplying the DNOs forecast volumes by the £9000 per km unit cost adjusted for inflation and have capped our assessment at the DNO forecast.
- 4.10. Our overall adjustment for tree cutting has then been calculated as the sum of our assessment of efficient costs for the 5 year period minus the DPCR4 allowances for the equivalent period.

⁴ Stakeholders include organisations such as Country Landowners Association, Forestry Commission, Local and Parish councils, Woodland Trust. To develop long term strategies such as replanting schemes, efficient clearances and a reduction in "restricted cuts" it is essential for DNOs to establish credibility with these interest groups to enable DNOs to have sustainable and efficient process and costs.

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

4.11. We have excluded the preliminary costs data submitted by SSE from our assessment as their programmes could be subject to change following further discussion with BERR and HSE.

Vertical and horizontal line clearances

4.12. We have carried out a qualitative assessment of the written submissions with DNOs with regard to vertical and horizontal line clearances. In general companies have robust processes in place although there is some for improvement.

4.13. We have also carried out a unit cost comparison for different approaches to dealing with horizontal and vertical clearance issues at different voltages and also looked at cost data for equivalent work in the cost database we have for our connections work. We have adopted a benchmark for each solution and voltage based on this data. We have used our judgement to establish benchmark costs based on the upper quartile of the DNO cost information and from the cost database.

4.14. Where DNOs' costs are above our benchmark we have adjusted them down to be benchmark.

5. Overall claim summary, proposed adjustments to costs and price control revenue

5.1. Table 1 sets out the DNOs' proposed cost adjustments in their reopener applications and our "minded to" position,

Costs £m (2007-08 prices)	Company	ENW	CE NEDL	CE YEDL	WPD SWales	WPD SWest
Tree cutting costs (EATS 43-8 and ETR 132)	DNO costs	6.3	11.8	21.7	0.0	2.8
	Ofgem view	1.5	10.4	21.7	0.0	1.9
Horizontal building clearances (exc survey costs)	DNO costs	3.0	0.0	0.0	1.3	6.7
	Ofgem view	2.9	0.0	0.0	1.1	6.4
Vertical clearances	DNO costs	7.9	0.0	0.0	0.0	0.0
	Ofgem view	5.8	0.0	0.0	0.0	0.0
Other (pensions, indirect and non-operation capex)	DNO costs	16.9	0.0	0.0	0.2	2.9
	Ofgem view	16.2	0.0	0.0	0.2	2.9
Total	DNO costs	34.1	11.8	21.7	1.5	12.5
	Ofgem view	26.4	10.4	21.7	1.3	11.3
Difference		7.7	1.5	0.0	0.2	1.2
% difference		23%	13%	0%	10%	10%

5.2. Table 2 sets out the DNOs' proposed revenue assessment based on their reopener applications and our "minded to" position. We have carried out our calculations on the basis that all adjustments feed in to 2009-10 revenue. We would welcome views on whether the additional revenue should be spread over a number of years.

£m (2007-08 prices)	ENW	CE NEDL	CE YEDL	WPD SWales	WPD SWest	Average
Allowed revenue 2009-10	266.1	189.5	245.7	176.9	216.9	219.0
Increase in allowed revenue (DNO costs through Ofgem model)	21.5	10.7	19.7	0.3	5.3	11.5
% increase in allowed revenue	8.1%	5.7%	8.0%	0.2%	2.4%	5.2%
Increase in allowed revenue (Ofgem view)	16.8	9.3	19.7	0.3	4.7	10.1
% increased in allowed revenue	6.3%	4.9%	8.0%	0.2%	2.1%	4.6%

6. Next Steps

- 6.1. This letter setting out our "minded to" position further to our assessment of the application will be followed by a two week consultation period. We will then make our final decision by 31 October 2008 taking into account any representations that are made.
- 6.2. The proposed adjustments set out in this letter are based on network and cost data held by Ofgem on 26 September 2008. In recognition that either the Licensee or Ofgem may wish to update this data prior to the final decision we propose to allow a two week period of consultation after which the data will be fixed for the purpose of this assessment. The closing date for data submission to Ofgem will be 5pm on 16 October 2008.
- 6.3. This letter and the final decisions for all current applicants will be published on our website by 31 October 2008.
- 6.4. We are developing a model of tree coverage data with the DNO electronic network maps to better understand the relationship between actual costs and the network in each DNO. We will refine our approach based on this additional data when it is received and setting allowances for DPCR5.
- 6.5. Responses and/or requests for bilateral meetings 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

Rachel Fletcher
Director of Distribution

Appendix

7. Assessment of ENW reopener application

7.1. Table 3 sets out our assessment of ENW application and the reasons for the adjustments that we have made

Costs £m (2007-08 prices)	Company	ENW	Difference	Explanation
Tree cutting costs (EATS 43-8 and ETR 132)	DNO costs	6.3		The direct unit costs fall within our range. However, looking at the 5 yrs in total, costs are only £0.2m above the allowance. We have benchmarked CI and CML relative to the costs of the tree cutting work being undertaken. The CI and CML impact for ENW was within our range and we have applied no adjustment
	Ofgem view	1.5	4.8	
Horizontal building clearances	DNO costs	3.0		We have compared unit costs across the DNOs and also looked at costs in our connections database. The unit costs for ENW are slightly higher than our benchmark
	Ofgem view	2.9	0.1	
Vertical clearances	DNO costs	7.9		We have compare unit costs across the DNOs and also looked at costs in our connections database. The unit costs for ENW are higher than our benchmark
	Ofgem view	5.8	2.1	
Other (pensions, indirect and non-operational capex)	DNO costs	16.9		In general ENW had high levels of these costs. When the indirect costs, pensions and non-op capex are included in the benchmarking of tree costs, ENW's unit costs for 2008-10 fall outside our range. We have applied these adjustments to these costs
	Ofgem view	16.2	0.7	
Total	DNO costs	34.1		
	Ofgem view	26.4		
Difference		7.7		
% difference		23%		

7.2. ENW are in the process of establishing a directly employed resource to carry out their vegetation management and will only retain a small number of contractors. As might be expected with this strategy they scored well in the area of training. They also scored well in many other important areas such as their management structure, data management and landowner surveys. They have a high standard of auditing which when combined with their tree related fault investigation demonstrates a sound approach to quality. Going forward we consider that they could do more to develop stakeholder relationships and benchmarking of their costs. They are still in the process of developing their approach to ETR132.

7.3. ENW have discussed their programme for addressing vertical and horizontal overhead line clearance issues with HSE and have developed a robust well managed approach. They are particularly affected by the need to replace un-insulated overhead services. We noted their differing approaches to unit costing of vertical and horizontal solutions and intention to further refine cost estimating as the programme progresses.

7.4. We found ENW's unit costs for EATS 43-8 tree cutting costs to be efficient but the application requested adjustments for tree cutting expenditure in years where the costs had exceeded the tree cutting allowance without taking into account years where costs were lower than the allowance. In making our assessment we have taken a view across the full period.

7.5. ENW also have a relatively large level of indirect costs and pensions given their level of activity. We have scaled back these costs as their overall unit costs for 2008-10 are high once these are taken into account.