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Our Ref: Networks/Electricity Distribution

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Date: 7 November 2008

Dear Colleagues,

Applications from Distribution Network Operators (DNOs) 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) and the Traffic Management Act 2004 (TMA).

1. Introduction

1.1. The purpose of this open letter is to inform DNOs and interested parties that we have published the Authority's decisions for the DNOs that have submitted applications to re-open their current price control. These letters detail the Authority's decisions and reasons. The Authority's decision regarding the timing for the recovery of costs is also detailed in paragraph 3.2 of this letter.

1.2. In addition we seek the views of DNOs on whether the remaining applicants would be in a position to make applications by 1 December 2008 for final decision by 31 March 2009.

2. Background

2.1. 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 assessed[1].

2.2. Under Special Condition A3 [2]("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 any Order or Regulations made pursuant to Part 3 of the TMA. Ofgem has four months to determine a relevant adjustment to the Charge Restriction after which time the licensee may give notice to the Authority that the relevant adjustment will take effect.

2.3. 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 amendments[3] to the ESQCR.

2.4. We wrote to licensees on 1 July 2008 setting out our "minded to" approach to assessing the reopener applications. This approach was agreed by the Authority on 17 July 2008. We wrote to licensees on 31 July 2008 confirming this approach which has been applied to the applications received and will be similarly applied to all future applications.

3. Summary of approach to key issues

3.1. Our approach is to allow DNOs to recover the efficient overall level of costs associated with 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 considered the appropriate timeframe over which the additional revenue should be recovered taking into account the fact that some of these costs have already been incurred and the potential impact on consumers. We consider that, in principle, it is reasonable for these costs to be recovered in a single year, subject to it not leading to an overall increase in distribution charges of more than 4 per cent in real terms (i.e. over and above any inflationary increase) when any other adjustments are taken into account (such as any revenue underrecovery from the previous period). If the year on year increase in charges when other adjustments are made is in excess of 4 per cent in real terms then any remaining amounts due can be recovered in subsequent years on an NPV neutral basis subject to the same principle i.e. that distribution charges do not increase by more than 4 per cent in real terms year on year. We will ensure that this recovery is ring fenced from the setting of allowances under DPCR5.

3.3. We assess the efficiency of additional costs applied for under the re-opener in a two stage process; first by an assessment involving quantitative benchmarking, carrying out cost comparisons and second 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 usual DPCR4 rules. Indirect costs, non-operational capex and pension costs also follow the treatment set out at DPCR4.

3.4. 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 the DNO 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 the comments 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 on this basis. 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.

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

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4. Our analysis

Tree-cutting costs

4.1. We have carried out qualitative assessments of the written submissions from DNOs to enable us to suggest areas for improvement. 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.

4.2. Our assessment of applications takes 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 approach we consider that well developed stakeholder[4] 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. We have sought confirmation that applicants have robust tree-cutting processes and procedures in place with evidence of 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. 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.

4.6. We apply reductions to vertical and horizontal clearance costs for companies where their unit costs are above our benchmark.

4.7. We have reviewed companies' assessments of their costs for carrying out additional ETR132[5] tree cutting for network resilience. We have sought evidence that companies' have discussed their programmes with BERR and have included their own risk assessment and prioritisation of the work on a risk basis.

4.8. Our overall adjustment for ENATS 43-8 and ETR132 tree cutting is calculated as the sum of our assessment of efficient costs for the 5 year period minus the DPCR4 allowances for the equivalent period.

Vertical and horizontal line clearances

4.9. We have carried out a qualitative assessment of the written submissions from DNOs with regard to vertical and horizontal line clearances to confirm that companies have robust management processes in place.

4.10. We have carried out a unit cost comparison for different approaches to dealing with horizontal and vertical clearance issues at different voltages. We have used our judgement to establish benchmark costs for each solution and voltage based on the upper quartile of the DNO cost information and from our own cost database.

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[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

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4.11. Where DNOs' costs are above our benchmark we adjust them down to the benchmark. We will adjust the capital expenditure allowances for capex roller/sliding scale purposes to reflect the proportion of the additional expenditure relating to the reopener that goes to RAV, under the DPCR4 financial model and the RRP rules.

5. Allowed revenue adjustments

This table summarises the allowed revenue adjustments as determined by the Authority for applications to date.

£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 as applied for by DNO through Ofgem financial model	15.3	11.5	20.3	1.1	6.2	10.9
% increase in allowed revenue	5.7%	6.1%	8.3%	0.6%	2.8%	5.0%
Relevant Adjustments (Authority Decision)	10.7	10.5	20.3	1.1	5.5	9.6
% increased in allowed revenue	4.0%	5.6%	8.3%	0.6%	2.5%	4.4%

6. Next Steps

6.1. DNOs that have yet to submit applications have indicated their intention to apply for a reopener during 2008. For the benefit of consistency and fairness during the decision process we would prefer to manage the remaining applications in a single batch. We seek views on whether the remaining applicants would be in a position to make applications by 1 December 2008 for final decision by 31 March 2009.

6.2. This letter and the final decisions for all applicants will be published on our website.

6.3. We are continuing with the development of a model of using Forestry Commission tree coverage data combined with the DNO electronic network maps to better understand the relationship between vegetation management costs and the high voltage networks in each DNO. If during this development we identify any useful correlation we will hold a workshop for interested parties to contribute their views prior to setting allowances for DPCR5.

6.4. Responses to this letter 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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