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*Promoting choice and
value for all customers*

Our Ref: Networks/Electricity Distribution

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Date: 31 October 2008

Dear Paul

Notice of Authority Decision and Reasons

Notice of decision on the applications of Electricity North West Ltd (ENW) to re-open the current price control to accommodate additional costs related to the introduction of and changes to the Electricity Safety Quality and Continuity Regulations 2002.

1. Introduction

1.1. The purpose of this letter is to advise you of the Authority's decision regarding your application to re-open your current price control to accommodate additional costs related to the introduction of and changes to the Electricity Safety Quality and Continuity Regulations 2002 (ESQCR).

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 Traffic Management Act 2004 (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.

2.2. 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 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. The Amendment Regulations to the ESQCR³ amend and extend the scope of standards for, amongst other things, overhead line clearance particularly in relation to

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

² Arrangements for the recovery of uncertain costs

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

trees. The standards now apply to all lines built before 1988 and require tree cutting for continuity of supply as well as to avoid danger to the public.

- 2.4. Following consultation on 1 July 2008 we published a letter setting out the approach we would apply to assessing reopener applications, requesting information from the DNOs for this purpose and committing to provide a final decision by 31 October 2008 for DNOs who made an application during July 2008.
- 2.5. All DNOs responded to our narrative questionnaire and provided Forecast Business Plan Questionnaire (FBPQ) cost and finance data. As a result we have been able to create an industry wide benchmark of costs and management practices associated with the ESQCR related activities.
- 2.6. On 17 July 2008 the Authority granted delegated powers to me to determine re-opener applications.
- 2.7. On 30 September 2008 we wrote to the Applicants advising them of our proposed treatment of their claims as agreed by Ofgem's Executive at their meeting of 29 September 2008. We have discussed our 'minded to' position with the Applicants and with their agreement we published updated 'minded to' letters on 10 October 2008.
- 2.8. In coming to each decision the Authority has taken into account the views of the applicants regarding our 'minded to' position.

3. Summary of ENW claims

- 3.1. Electricity North West Limited has submitted claims in regard to additional costs incurred due to:
 - Increased vegetation management to meet the requirements of ESQCR,
 - ESQCR costs related to overhead line horizontal or vertical clearances, and
 - The consequential impact of this work on the licensees planned interruption performance
- 3.2. The Table below sets out the amount of their claim for each category.

4. Authority Decision and Reasons

- 4.1. The Authority has considered the Licensee's request in accordance with its principal objective and general duties and taking into account responses to the 'minded to' letter and other representations.
- 4.2. Following consultation with the Applicants and interested parties the Authority has decided that it is appropriate to allow the cost adjustments set out in Table 1 below. This results in the total revenue adjustment set out in Table 2. The Authority has decided that the revenue adjustment should be recovered over a single year in 2009-10.
- 4.3. The following tables set out the Authority's decisions regarding the applications made by ENW and the Authority's explanation for those decisions.

Table 1 –ENW cost adjustments

Costs £m (2007-08 prices)	Company	ENW	Difference	Explanation
Tree cutting costs (ENATS 43-8 and ETR 132)	DNO adjustment	6.3		The direct unit costs of the EATS 43-8 and ETR 132 tree cutting fall within our range. However, looking at the 5 yrs in total, costs are only £0.2m above the overall DPCR4 tree cutting allowance. We have benchmarked the total CI and CML relative to the costs of the tree cutting work being undertaken. The total CI and CML impact for ENW was within our range and we have applied no adjustment
	Authority Decision	1.5	4.8	
Horizontal building clearances	DNO adjustment	3.0		We have compared unit costs across the DNOs, taking account of differences in the number of services per pole for each DNO and also looked at costs in our connections database. The unit costs for ENW are slightly higher than our benchmark
	Authority Decision	2.9	0.1	
Vertical clearances	DNO adjustment	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
	Authority Decision	6.3	1.5	
Other (pensions, indirect and non-operational capex)	DNO adjustment	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
	Authority Decision	16.2	0.7	
Total	DNO adjustment	34.1		
	Authority Decision	26.9		
Difference		7.2		
% difference		21%		

Table 2 – Allowed revenue adjustments

The following table sets out the allowed revenue adjustments derived by feeding the cost adjustments above through the Ofgem financial model.

£m (2007-08 prices)	ENW
Allowed revenue 2009-10	266.1
Increase in allowed revenue (Effect of DNO adjustment through Ofgem financial model)	15.3
% increase in allowed revenue	5.7%
Relevant adjustment in revenue (Authority decision)	10.7
% increased in allowed revenue	4.0%

Table 3 – CI and CML Revenue Adjustment for 2010-11 and 2011-12

Due to the two year lag in the Interruption Incentive Scheme only interruption performance for 2005-6 to 2007-8 has an impact in DPCR4. The remaining impact of interruption performance feeds into DPCR5.

Costs £m (2007-08 prices)		2010-11	2011-12
Total CI and CML impact for 2008-09 and 2009-10 - revenue adjustment to incentive scheme for 2010-11 and 2011-12	DNO view	2.4	1.8
	Authority decision	2.4	1.8

Qualitative Assessment

- 4.4. The Authority notes that 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 the Authority considers that they could do more to develop stakeholder relationships and benchmarking of their costs. The Authority notes that ENW are still in the process of developing their approach to ETR132.
- 4.5. The Authority notes that ENW have discussed their programme for addressing vertical and horizontal overhead line clearance issues with HSE and viewed that they have developed a robust and well managed approach. ENW are particularly affected by the need to replace un-insulated overhead services. The Authority notes ENW's differing approaches to unit costing of vertical and horizontal solutions and intention to further refine cost estimating as the programme progresses.

ENATS 43-8 and ETR 132 tree cutting costs

- 4.6. The Authority has found ENW's unit costs for EATS 43-8 tree cutting costs to be efficient but notes their 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 their assessment the Authority has taken a view across the full period.
- 4.7. The Authority viewed ENW to have a relatively large level of indirect costs and pensions given their level of activity and consequently has scaled back these costs as ENW's overall unit costs for 2008-10 are high once these are taken into account.
- 4.8. ENW's 21 October response to the minded to letter states that "ENW was the only DNO not to receive a specific tree cutting allowance". ENW also argued that the allowance in DPCR4 is discrete from any additional requirement to cut trees to ENATS 43-8 or ETR 132, which was imposed under amendments to the ESQCR in 2006. ENW indicates that the opex allowance was considered in the round and it is inappropriate to claw back efficiencies in other areas because of expenditure on new tree cutting obligations.
- 4.9. The approach we adopted at DPCR4 for calculating tree cutting allowances was consistent across all the DNOs. We carried out bottom-up modelling of tree related

costs including a move to a shorter tree cutting cycle generating higher volumes of work. We then examined the level of tree cutting costs that were implied in the opex regression based on the upper quartile performing companies. Companies were allowed the higher of these methods. In ENW's case the opex regression method was higher and therefore there was no need to uplift their allowance or to make a compensatory adjustment for them as the costs in the regression were already sufficient to meet the costs as calculated on a bottom up basis including additional work.

- 4.10. Given that the new obligations to comply with EATS 43-8 and ETR132 relate to tree cutting the Authority considers that it is appropriate to take into account the allowances at DPCR4. To do otherwise would potentially mean that customers pay twice for the same work.

ENATS 43-8 (horizontal and vertical clearances)

- 4.11. ENW highlighted an issue with our benchmarking of vertical clearance costs, namely that we are comparing their average unit costs for a number of different techniques, such as rebuilding the lines and under grounding, with benchmark unit costs based on individual techniques. The Authority has revised its approach which has increased ENW's allowance.

CI and CML impact

- 4.12. The Authority has allowed the full adjustment to income relating to planned interruptions requested by ENW.

- 4.13. The additional revenue associated with the impact of the additional work on the Interruption Incentive Scheme (IIS) for 2008-09 and 2009-10 will be added to the revenue for 2010-11 and 2011-12 in the updated quality of service scheme for DPCR5. The revenue will be rolled forwards from 2008-09 to 2010-11 and 2009-10 to 2011-12 by applying the mechanism set out in the DPCR4 quality of service incentive scheme.

Timing of recovery

- 4.14. The Authority has 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. The Authority considers 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 after adjusting for inflation) when any other adjustments are taken into account (such as any revenue under recovery from the previous period). If the year on year increase in charges when other adjustment 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 principal i.e. that distribution charges do not increase by more than 4 per cent in real terms year on year.
- 4.15. In the case of ENW there is an over-recovery in 2008-09 so the additional revenue allowed through the reopener only has a small impact on distribution charges. As such the Authority has decided to allow the revenue adjustment to be recovered fully in 2009-10.
- 4.16. The additional revenue associated with the impact of the additional work on the Interruption Incentive Scheme (IIS) for 2008-09 and 2009-10 will be added to the revenue for 2010-11 and 2011-12 in the updated quality of service scheme for DPCR5. This revenue will need to be updated for changes in RPI.

Impact on the capex rolling incentive

4.17. The Authority agrees to adjust the capital expenditure allowances for capex roller/sliding scale purposes to reflect the proportion of the additional expenditure relating to the reopener that, under the DPCR4 financial model and the RRP rules, goes to RAV.

Decision pursuant to section 49A(1)(c) of the Electricity Act 1989.

Yours sincerely



Steve Smith

Managing Director - Networks

Signed on behalf of the Authority and authorised for that purpose

Appendices

5. Summary of the Authority's approach to key issues

- 5.1. The purpose of the reopener was to make provision for the uncertain costs resulting from changes to the ESQCR relating to the management of vegetation to improve network reliability by both mandating tree clearances and setting out the requirements to reduce the impact of abnormal weather conditions on overhead lines. Our approach is to allow DNOs to recover the combined efficient overall level of costs associated with these revised obligations over and above the costs that have already been allowed under the current price control for vegetation management.
- 5.2. Our overall adjustment for tree cutting will be calculated using our assessment of the total of the efficient costs for both ENATS 43-8 and ETR 132⁴ summed over the 5 year period minus the sum of DPCR4 vegetation management allowances for the equivalent period. 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.
- 5.3. 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.
- 5.4. 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 2008 letter which was recommended and agreed by the Authority on 17 July 2008. We wrote to licensees on 31 July 2008 detailing the agreed approach, including the statement 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 these 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. 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.

Tree-cutting costs

- 5.5. 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.
- 5.6. 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

⁴ 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

compliance. As part of this approach we consider that well developed stakeholder⁵ 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.

- 5.7. 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.
- 5.8. 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.
- 5.9. 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.
- 5.10. As there are some significant differences in costs between DNOs 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.
- 5.11. We have applied reductions to vertical and horizontal clearance costs for a number of companies where their unit costs are above our benchmark range.
- 5.12. We have reviewed companies' assessments of their costs for carrying out additional ETR132⁶ 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.
- 5.13. 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.
- 5.14. Notwithstanding that all DNOs responded to our narrative questionnaire and provided Forecast Business Plan Questionnaire (FBPQ) cost and finance data 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

- 5.15. 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 room for improvement.

⁵ 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.

⁶ 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

- 5.16. 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 engineering solution at each supply 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.
- 5.17. Where a DNO's costs are above our benchmark we have adjusted 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, under the DPCR4 financial model and the RRP rules, goes to RAV.

6. The Authority's Powers and Duties

- 6.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).
- 6.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.⁷
- 6.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly⁸.
- 6.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.
- 6.5. The Authority must when carrying out those functions have regard to:
- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
 - The need to secure that all reasonable demands for electricity are met;
 - The need to secure that licence holders are able to finance the activities which are the subject of obligations on them⁹; and
 - The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.¹⁰
- 6.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

⁷ Entitled "Gas Supply" and "Electricity Supply" respectively.

⁸ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

⁹ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

¹⁰ The Authority may have regard to other descriptions of consumers.

- Promote efficiency and economy on the part of those licensed¹¹ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

6.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

6.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation¹² and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

¹¹ Or persons authorised by exemptions to carry on any activity.

¹² Council Regulation (EC) 1/2003