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Promoting choice and value for all customers

Our Ref: Networks/Electricity Distribution

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Date: 23 February 2009

Dear Jonathan

Assessment of applications from Central Networks East plc and Central Networks West plc to re-open their current price controls 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 letter is to set out our "minded to" position regarding your re-opener applications for Central Networks East plc and Central Networks West plc associated with the ESQCR and TMA.

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 assessed[1].

1.3. 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 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.

1.5. Due to the delayed implementation of the TMA we are only considering costs incurred by DNOs in readiness for managing work under the permit schemes.

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

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 licensees on 4 June 2008 setting out the data we required to enable us to carry out efficiency assessments.

2.3. We wrote to DNOs on 1 July 2008 setting out our "minded to" approach to assessing all reopener applications. This approach was recommended and agreed by the Authority on 17 July 2008 and reaffirmed by them on 19 February 2009.

2.4. Under delegated authority, Steve Smith determined the appropriate revenue adjustments for the first round of DPCR4 reopener applications on 31 October 2008. These the outcome of these applications from ENW, CE, and WPD were published on our website and are summarised in table 1 of the attached appendix.

2.5. 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 DNOs processes and procedures regarding tree cutting and overhead line clearances and any further 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 overhead line 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 have assessed the impact of the additional work under the ESQCR on quality of service incentives. 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. 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 suggested that this approach could penalise a company that had taken steps to improve its planned interruption performance. This was given further consideration and a revised methodology was adopted. 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, Engineering Technical Report (ETR) 132 work, horizontal and vertical clearances.

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3.4. Further to the responses to the minded to letters sent out 30 September and the responses received 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.

3.4.1. If DNOs seek to recover these costs within 2009-10 through a mid year change in charges, we consider that this is reasonable , subject to it not leading to an overall increase in distribution charges of more than four per cent per annum in real terms (i.e. over and above any inflationary increase) when any other adjustments are taken into account (such as any revenue under recovery from the previous period). If the increase in charges when other adjustments are made is in excess of four per cent per annum in real terms then any remaining amounts due can be recovered in subsequent years within DPCR5 on an NPV neutral basis and will be a subject for discussion under DPCR5.

3.4.2. If DNOs seek to recover all these costs within DPCR5 the timing for recovery will be agreed as part of the DPCR5 discussions.

4. Our analysis

Tree-cutting costs

4.1. We recognise that DNOs have historically operated to different policies resulting in varying workloads to enable them to meet the common standards now enforced under ESQCR.

4.2. We have carried out a qualitative assessment of the of the applications to ascertain that DNOs 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 stakeholder[3] 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 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.

4.4. 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 DNOs' tree cutting costs downwards to the top end of our benchmark range where they fall outside of this.

4.5. We have reviewed DNOs' assessments of their costs for carrying out additional ETR132[4] 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 (IA) 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, most DNOs have made clear that they are at a relatively early stage in assessing the costs and have adopted the £9000 per km unit costs set out in the IA adjusted for inflation.

[3] 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.

[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

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4.6. We have assessed the costs for ETR132 work by multiplying the DNOs forecast volumes by the £9000 per km unit cost adjusted for inflation and have capped our assessment at this level.

4.7. Our overall adjustment for tree cutting has then been calculated as the sum of our assessment of efficient costs for the five year period minus the DPCR4 allowances for the equivalent period.

Vertical and horizontal line clearances

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

4.9. We have compared unit costs across the DNOs , for different approaches to dealing with horizontal and vertical clearance issues at different voltages taking account of differences in the number of services per pole for each DNO and also compared with costs in our connections database. 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. Where DNOs' costs are above our benchmark we have adjusted them down to the benchmark.

5. Next Steps

5.1. The proposed adjustments set out in this letter are based on network and cost data held by Ofgem on 23 February 2009. In recognition that either the DNO or Ofgem may wish to update this data prior to the final decision we have allowed a two week period of consultation after which the data will be fixed for the purpose of this assessment. The closing date for this consultation period will be 5pm on 9 March 2009. The final decision will be made by 31 March 2009 taking into account any representations that are made.

5.2. Please confirm that you agree to this letter and the final decision being published on our website. If you do not agree please identify the information you wish to keep confidential together with an explanation.

5.3. In consultation with DNOs and other interested stake holders we have carried out some initial research by combining national tree coverage information with companies' digitised network maps to better understand the relationship between actual costs and the network in each DNO. We propose to hold a workshop to consult with industry regarding the further development of this concept and possible use of this methodology in setting allowances for DPCR5.

5.4. 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

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Appendix

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

6.1. Table 1 sets out a summary of the previous reopener applications and decisions.

£m (2007-08 prices)	ENW	CE		WPD		Average
		NEDL	YEDL	S Wales	S West	
Increase in allowed revenue. (DNO costs through Ofgem model)	15.3	11.5	20.3	1.1	6.2	10.9
Allowed revenue 2009-10	266.1	189.5	245.7	176.9	216.9	219.0
% 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 2009/10	4.0%	5.6%	8.3%	0.6%	2.5%	4.4%

6.2. Table 2 - As there is a two year lag in the interruption incentive scheme the interruption performance feeds into DPCR5 as set out below:

Total CI and CML impact for 2008-09 and 2009-10 revenue adjustment to incentive scheme for 2010-11 and 2011-12		Costs £m (2007-08 prices)	2010-11	2011-12
CN	CN West	DNO view	0.34	0.73
		Ofgem minded to position	0.26	0.42
	CN East	DNO view	0.20	0.40
		Ofgem minded to position	0.10	0.30
CE	NEDL	DNO view	0.07	0.12
		Ofgem minded to position	0.07	0.12
	YEDL	DNO view	0.03	0.07
		Ofgem minded to position	0.03	0.07
SP	SP Dist	DNO view	0.37	0.40
		Ofgem minded to position	0.37	0.40
	SP Manweb	DNO view	1.10	1.20
		Ofgem minded to position	1.10	1.20
SSE	SHEPD	DNO view	0.13	0.46
		Ofgem minded to position	0.10	0.23
	SEPD	DNO view	0.05	0.54
		Ofgem minded to position	0.03	0.46

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6.3. Tables 3-5 set out the DNOs' proposed revenue assessment based on their reopener applications processed through our financial model and our "minded to" position. We have carried out our calculations on the basis that all adjustments feed in to 2009-10 revenue.

Table 3

DNO submission through Ofgem model	CN		CE		SP		SSE		Average
2007/08 £m	CN West	CN East	NEDL	YEDL	SP Dist.	SP Manweb	SHEPD	SEPD	
Horizontal clearance	1.5	1.2	0.3	1.0	1.5	6.9	0.8	1.7	1.9
Vertical clearance	1.0	0.8	1.8	2.7	20.6	39.5	4.1	0.0	8.8
Tree Cutting	10.9	10.7	0.0	0.0	0.0	14.2	2.6	8.8	5.9
Indirects, TMA	2.4	2.3	0.5	0.6	2.5	2.9	0.0	0.0	1.4
Pensions	0.1	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
QoS	0.4	0.3	0.0	0.0	0.8	2.0	0.1	0.0	0.4
Additional Revenue	11.9	12.2	0.5	0.6	6.5	24.5	2.7	7.0	8.2
Allowed revenue 2009-10	288.7	295.9	189.5	245.7	351.6	209.9	204.3	409.9	274.4
% of 09/10	4.1%	4.1%	0.3%	0.3%	1.8%	11.7%	1.3%	1.7%	3.2%

Table 4

Ofgem minded to position	CN		CE		SP		SSE		Average
2007/08 £m	CN West	CN East	NEDL	YEDL	SP Dist.	SP Manweb	SHEPD	SEPD	
Horizontal clearance	1.5	0.8	0.3	0.7	1.5	6.3	0.8	1.7	1.7
Vertical clearance	1.0	0.8	1.8	2.3	20.5	39.5	4.1	0.0	8.7
Tree Cutting	9.3	7.4	0.0	0.0	0.0	12.6	0.8	7.1	4.6
Indirects, TMA	2.3	1.8	0.5	0.5	2.5	2.9	0.0	0.0	1.3
Pensions	0.1	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
QoS	0.4	0.3	0.0	0.0	0.8	2.0	0.1	0.0	0.4
Additional Revenue	10.4	8.7	0.5	0.4	6.5	23.0	1.1	5.7	7.0
Allowed revenue 2009-10	288.7	295.9	189.5	245.7	351.6	209.9	204.3	409.9	274.4
% of 09/10	3.6%	2.9%	0.3%	0.2%	1.8%	10.9%	0.6%	1.4%	2.7%

Table 5

Difference	CN		CE		SP		SSE		Average
2007/08 £m	CN West	CN East	NEDL	YEDL	SP Dist.	SP Manweb	SHEPD	SEPD	
Horizontal clearance	0.0	0.4	0.0	0.3	0.0	0.6	0.0	0.0	0.2
Vertical clearance	0.0	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.1
Tree Cutting	1.6	3.3	0.0	0.0	0.0	1.6	1.9	1.7	1.2
Indirects, TMA	0.1	0.5	0.0	0.1	0.0	0.0	0.0	0.0	0.1
Pensions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
QoS	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Additional Revenue	1.6	3.6	0.0	0.2	0.0	1.5	1.5	1.4	1.2
Allowed revenue 2009-10	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
% of 09/10	0.5%	1.2%	0.0%	0.1%	0.0%	0.7%	0.7%	0.3%	0.5%

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7. Detailed assessment of CN reopener application

7.1. Table 6 sets out our assessment of Central Networks plc application and the reasons for the adjustments that we are minded to make.

Costs £m (2007-08 prices)	Company	CN West	Difference	Explanation
Tree cutting costs (EATS 43-8 and ETR 132)	DNO costs	10.9		The unit costs for EATS 43-8 are above our benchmark range and we propose an adjustment to bring these costs back to the top of our range. The ETR132 unit costs are within our benchmark range and we propose no adjustment.
	Ofgem view	9.3	1.6	
Horizontal building clearances	DNO costs	1.46		There is approximately £9k of work in 2007-08 not associated with any workload which has been removed through the benchmarking
	Ofgem view	1.45	0.01	
Vertical clearances	DNO costs	1.0		The unit costs are slightly above our benchmark range and we propose a small adjustment to costs.
	Ofgem view	1.0	0.02	
Other (pensions, indirect and non-operational capex	DNO costs	2.8		As a result of our 'minded to' position we propose a minor reduction in indirect costs associated with this work consistent with the reductions that have been applied for the direct activities..
	Ofgem view	2.8	0.1	
CI and CML impact	DNO costs	0.4		We have benchmarked the total CI and CML relative to the costs of the work being undertaken. We propose no adjustment for CI and CML arising in 2005-06 to 2007-08
	Ofgem view	0.4	0.0	
Total	DNO costs	16.6		
	Ofgem view	14.9		
Difference		1.7		
% difference		10%		
Costs £m (2007-08 prices)	**Company**	**CN East**	**Difference**	**Explanation**
Tree cutting costs (EATS 43-8 and ETR 132)	DNO costs	10.7		The unit costs of EATS 43-8 are significantly above our benchmark range and we propose an adjustment to bring these costs back to the top of our range. The ETR132 unit costs are within our benchmark range and we propose no adjustment.
	Ofgem view	7.4	3.3	
Horizontal building clearances	DNO costs	1.2		There is approximately £400k of work in 2007-08 not associated with any workload which has been removed through the benchmarking
	Ofgem view	0.8	0.4	
Vertical clearances	DNO costs	0.8		The unit costs are either within or very close to our benchmark range and we propose a very small adjustment.
	Ofgem view	0.8	0.0	
Other (pensions, indirect and non-operational capex	DNO costs	2.8		As a result of our 'minded to' position we propose a minor reduction in indirect costs associated with this work consistent with the reductions that have been applied for the direct activities.
	Ofgem view	2.3	0.5	
CI and CML impact	DNO costs	0.3		We have benchmarked the total CI and CML relative to the costs of the work being undertaken. We propose no adjustment for CI and CML arising in 2005-06 to 2007-08
	Ofgem view	0.3	0.0	
Total	DNO costs	15.8		
	Ofgem view	11.5		
Difference		4.3		
% difference		27%		

7.2. In our qualitative assessment of CN's vegetation management we identified a number of areas of good practice. In particular CN have developed good contract management and organisational practices with regular performance reviews and clear

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management accountability. In addition they have adopted good arboricultural practices and are members of the Utility Arboricultural Core Group.

7.3. CN are introducing new leafleting to make customers aware of the reasons for the work they are doing to manage vegetation in their locality. However, we believe there is still scope for further improvements in managing stakeholder contact.

7.4. We noted that CN's LV networks will not be ESQCR compliant by January 2009. CN will be carrying out a combination of LV ABC re-conductoring and LV under grounding to achieve ESQCR compliance during DPCR5.

7.5. We noted that CN are still developing their approach to ETR132 and intend to commence work in January 2009. CN has submitted a claim for forecasted costs related to ETR 132 which we assessed as representing efficient expenditure.

7.6. CN scored highly in their approach to addressing the resolution of horizontal and vertical overhead line clearances issues. We considered that their consultation with HSE, intention to achieve full compliance by 2013, and attention to seeking optimum site specific solutions to all be good practice. We found their costs to be within or close to our benchmark range with the exception that in CN East we found the horizontal clearance costs to be high in relation to the work load and are 'minded to' make the reduction indicated, with a corresponding reduction to the associated indirect costs.

7.7. We found CN's unit costs for ENATS 43-8 tree cutting to be high and are minded to reduce the claim to the level of the upper quartile, with a corresponding reduction to the associated indirect costs.

7.8. CN has submitted a claim for set up costs arising from the TMA. We are minded to accept its set up costs of £0.33m.

7.9. CN has submitted a claim for costs incurred under Regulation 19 'Precautions against access and warnings of dangers' and Regulation 20 'fitting of insulators to stay wires' of the ESQCR. We are minded to reject these claims as these particular Regulations are not relevant enactments within the terms of SLC A3 and therefore the recovery of these costs is not part of the DPCR4 re-opener.

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