Jonathan Ashcroft
Regulation Manager
Central Networks
Pegasus Business Park
Castle Donington
Derbyshire
DE74 2TU

Promoting choice and
value for all customers

Our Ref: Networks/Electricity Distribution

Direct Dial: 020 7901 7430
Email: steve.smith@ofgem.gov.uk

Date: 26 March 2009

Dear Jonathan

Notice of Authority Decision and Reasons

Notice of decision on the applications from Central Networks East plc (CNE) and Central Networks West plc (CNW) 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 (ESQCR) and the Traffic Management Act 2004 (TMA).

1. Introduction

1.1. The purpose of this letter is to advise you of the Authority's decision regarding your applications 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 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. The 2006 Amendment Regulations to the ESQCR[3] 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 and requesting information from the DNOs for this purpose.

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 authority to me to determine re-opener applications made by DNOs in July 2008. This delegated authority was reaffirmed on 19 February 2009 in relation to the current applications.

2.7. We have published the final decisions made on 31 October 2008 for DNOs who made an application during July 2008.

2.8. On 23 February 2009 we wrote to the current Applicants advising them of our proposed treatment of their claims. We subsequently discussed our 'minded to' position with the Applicants and with their agreement we published 'minded to' letters on 13 March 2009.

2.9. In coming to each decision the Authority has taken into account the views of the applicants regarding our 'minded to' position.

3. Summary of Central Networks (CN) claims

3.1. CN has submitted claims in respect of CNE and CNW 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.
- The consequential impact of this work on the licensees' planned interruption performance
- TMA set up costs as a result of changes under TMA.

3.2. The tables below set 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.

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 Tables 1 and 2 below. This results in the total revenue adjustment set out in Table 3. The Authority has decided that the revenue adjustment should be recovered over a single year in 2009-10.

4.3. The Authority has noted that 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. The Authority has rejected these

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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.

4.4. The following tables set out the Authority's decisions regarding the applications made by CN and the Authority's explanation for those decisions.

Table 1 –CNE cost adjustments

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 tree cutting are significantly greater than our benchmark range and we have applied an adjustment to bring these costs back to the top of our range. The ETR 132 costs are consistent with our benchmark.
	Ofgem view	7.4	3.3	
Horizontal building clearances	DNO costs	1.2		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. 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		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 CN East are either within or very close to our benchmarks and we have therefore only applied a very small adjustment to these costs.
	Ofgem view	0.8	0.0	
Other (pensions, indirect and non-operational capex	DNO costs	2.8		There is a 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. There is 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%		

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Table 2 –CNW cost adjustments

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 of the EATS 43-8 fall outside of our benchmark range and we have adjusted the unit costs down to the top end of the range. The unit costs of the ETR 132 work are within our benchmark value.
	Ofgem view	9.3	1.6	
Horizontal building clearances	DNO costs	1.46		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. 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		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
	Ofgem view	1.0	0.02	
Other (pensions, indirect and non-operational capex	DNO costs	2.8		There is a small 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. There is 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%		

Table 3 – 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)	CNW	CNE
Allowed revenue 2009-10	288.7	295.9
Increase in allowed revenue (Effect of DNO adjustment through Ofgem financial model)	11.9	12.2
% increase in allowed revenue	4.1%	4.1%
Allowed increase in revenue (Authority decision)	10.4	8.7
% increased in allowed revenue	3.6%	2.9%

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Table 4 – 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.

CNE

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	0.20	0.51
	Authority decision	0.17	0.38

CNW

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	0.40	0.86
	Authority decision	0.31	0.49

Qualitative Assessment

ENATS 43-8 and ETR 132 tree cutting costs

4.5. The Authority has noted that CN scored highly in the qualitative assessment of their vegetation management with good contract management and organisational practices together with regular performance reviews and clear management accountability. In addition it was noted that CN have adopted good arboricultural practices and are members of the Utility Arboricultural Core Group.

4.6. The Authority has noted that CN is introducing new leafleting to make customers aware of the reasons for the work they are doing to manage vegetation in their locality. However, the Authority still believes there is still scope for further improvements in managing stakeholder contact.

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

4.8. The Authority has noted that CN are still developing their approach to ETR132 and intend to commence work in January 2009. The Authority has decided to allow in full CN's claim for forecasted costs related to ETR 132.

4.9. The Authority found CN's unit costs for ENATS 43-8 tree cutting to be high and have adjusted the claim to the level of the upper quartile, with a corresponding reduction to the associated indirect costs.

TMA set-up costs

4.10. The Authority has decided that it is appropriate to accept CN's claim for TMA set up costs of £0.33m.

ENATS 43-8 (horizontal and vertical clearances)

4.11. The Authority has noted CN scored highly in their approach to addressing the resolution of horizontal and vertical overhead line clearance issues. The Authority considered that their consultation with Health and Safety Executive, intention to achieve full compliance by 2013, and attention to seeking optimum site specific solutions to all be good practice.

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4.12. The Authority found CN's costs to be within or close to the benchmark range with the exception that in CN East the horizontal clearance costs were found to be high in relation to the work load and the Authority has decided to make the adjustments indicated, with a corresponding reduction to the associated indirect costs.

CI and CML impact

4.13. The Authority has benchmarked the CI and CML impact for CN and has found there to be an inefficient level of CI and CML in 2008-09 and 2009-10. The claim has been adjusted back to the benchmark and fed through to the 2010-11 and 2011-12 financial years.

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 principle 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 CN 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 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

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Appendix

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 132[4] 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 stakeholder[5] 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 benchmarking, 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 the 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 ETR132[6] 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.

Vertical and horizontal line clearances

5.14. 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.

5.15. 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.

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[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. Where a DNO's costs are above our benchmark we have adjusted them down to the benchmark. 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.

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 accordingly[8].

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 existing and future consumers, 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 them[9];
- the need to contribute to the achievement of sustainable development; 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:

- Promote efficiency and economy on the part of those licensed[11] 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; and

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

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- 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 Regulation[12] 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.

[12] Council Regulation (EC) 1/2003

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