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Our Ref: SG&G/Cost & Outputs 145/12
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Date: 6 November 2012

Dear Colleague

Consultation on our minded-to position for the determination of re-opener applications in respect of additional income associated with Rising and Lateral Mains under the fifth electricity distribution price control review (DPCR5)

Introduction

Ofgem introduced a number of uncertainty mechanisms, including re-opener mechanisms, for costs that were uncertain at the time of establishing the fifth electricity distribution price control for 2010-2015 (DPCR5). The re-opener mechanisms enable the electricity distribution network operators (DNOs) to apply to Ofgem to adjust their revenues to accommodate costs associated with specific uncertain cost categories. The costs associated with Rising and Lateral Mains (RLM) was one such cost category. DNOs can apply to Ofgem if the costs associated with RLM works are in excess of one per cent of their base revenues.

Two of the fourteen DNOs, Scottish Power Distribution (SPD) and Scottish Power Manweb (SPM), operated and owned by Scottish Power Energy Networks (SPEN) have given notice to Ofgem confirming that they have incurred and will continue to incur significant costs during DPCR5 for RLM works. The total gross¹ claim submitted for SPD was £28.7 million and for SPM was £14.9 million (in 2011/12 prices).

Based on our analysis of both submissions, subject to consideration of the consultation responses, our view is that most of the costs presented by SPD and SPM are efficient additional costs for RLM works and we propose to award SPD the full amount applied for (£28.7 million) and award SPM slightly less (£14.1 million and £0.8 million less than they applied for). This will result in an average increase in customer bills for 2012/13 of £4.51 for SPD customers and £3.76 for SPM customers.²

We are consulting on our minded-to position regarding the application received. This letter sets out our view of the adjustment to both DNOs' DPCR5 revenue.

Responses and consent to share information

We would like to hear the views of interested parties in relation to our minded-to position for adjusting the revenues associated with RLM set out in this open letter. We would especially welcome responses to the specific question which has been set out below.

¹ Costs prior to any DPCR5 adjustments for IQI or replacement incentive mechanism.

² Based on the average electricity bill for a standard direct debit account across Great Britain of £470 (see <http://www.ofgem.gov.uk/Media/FactSheets/Documents1/household-bills.pdf>).

Question 1: Do you agree with the proposed adjustments to the revenues associated with RLM for the two DNOs, SPD and SPM?

Responses should be received by **26 November 2012** and sent to:

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Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response, or part of response, is kept confidential. Ofgem shall respect this request, subject to any obligation to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and/or in writing.

Background

When we were setting the current DPCR5 price control, we put in place a re-opener mechanism for RLM costs. This concerns the cost associated with the RLM in large scale housing estates built by local authorities/developers during the 1950s and 1960s which are reaching the end of their lifespan and require regular inspections and maintenance. At the time of the price control review, there was uncertainty regarding the ownership of these assets and as such, it was unclear if DNOs or other parties (eg local authorities, housing associations etc), should be responsible for the maintenance, repair and replacement of these assets.

We provided ex ante allowances for costs associated with RLM works in the first two years of the price control. But given the uncertainty, the price control reopener mechanism was introduced so that any RLM costs expected to be incurred in the remaining three years of DPCR5 could be considered in isolation from the DNOs' financial performance within the price control period. SPEN submitted their expected costs for the 2012/13 to 2014/15 and that is what we have reviewed.

Special Condition CRC 18³ of the Electricity Distribution Licence sets out a mechanism under which DNOs can apply for their allowed revenues to be adjusted, together with a notice of costs or expenses incurred or likely to be incurred. Following consultation, the Authority then determines whether the threshold has been reached to trigger the re-opener, whether any or all of the costs or expenses were or are likely to be efficiently incurred and any adjustment that should be made to their allowed revenue.

Summary of approach to key issues

We have approached our assessment to SPD and SPM's applications by:

³ Special conditions of the Electricity Distribution Licence: Charge Restriction Condition 18: Arrangements for the recovery of uncertain costs.

- Reviewing the legal evidence regarding ownership and the subsequent responsibility for maintaining, repairing and replacing RLM.
- Assessing the evidence submitted regarding the volumes of activity.
- Assessing the efficient overall level of costs associated with the inspection, maintenance, repair and replacement of RLM. It has not been possible to benchmark with other DNOs, but it has been possible to consider efficient costs by three key cost drivers (length of cable, number of customers and number of properties).
- Visiting sites in the SPD area where RLM work was due to start, ongoing or complete.
- Awarding the lower of Ofgem's view of allowances and what the DNO applied for.

It is usual practice in reaching our view of efficient costs to benchmark across the industry. Given the limited activity in other DNO areas this has not been possible. As such, our analysis in this case is based on our scrutiny of the information submitted by SPD and SPM, including their view of efficient volumes and costs.

Nevertheless, it remains our current position that DNOs should continue to demonstrate continued efficiencies in inspecting, maintaining, repairing and replacing RLMs, which include, for example, ensuring any replacement work is conducted in a manner that is suitable for the efficient installation of smart meters.

It is also our position that while accepting the legal argument presented in this case by SPEN that SPD and SPM are responsible for the inspection, repair and maintenance of RLM as they form part of the distribution system (regardless of who owns the RLM), this is an issue that requires further consideration in the remainder of DPCR5 and it is necessary to reach a firm landing on this prior to RIIO-ED1.

Our detailed analysis of the application from both licensees is set out in Appendix 1.

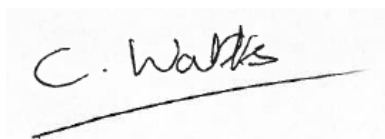
Recovery of additional revenue

In relation to the recovery of additional revenue incurred by SPD and SPM, we believe that full recovery of the additional revenue should be within DPCR5.

Our minded-to position

Based on the analysis that we have carried out of both applications and subsequent information provided by SPD and SPM, we propose to allow the costs applied for from SPD (£28.7 million) and to reduce SPM's application by £0.8 million to £14.1 million. Our methodology is detailed in the Appendix below and we welcome views on this, specifically in answering the question set out above.

Yours sincerely,

A handwritten signature in black ink that reads "C. Watts". The signature is written in a cursive style and is positioned above a horizontal line that serves as a separator.

Chris Watts
Associate Partner, Costs and Outputs

Appendix 1: Detailed analysis of DNOs' proposed adjustments

This appendix sets out our analysis of the proposed allowance for both SPD and SPM for RLM works for the remaining three years of DPCR5, and the rationale supporting it. It presents our views on the volumes, our proposed unit costs and the proposed allowance.

Before doing so, it is important to note that in this case we propose to accept the proposition from SPEN that the key legal point for consideration is not ownership of RLM but whether RLM form part of the distribution system. Following independent legal advice, SPEN argue that as RLM are operated and used by DNOs they form part of the distribution system. As such, the operation and use of RLM by SPD and SPM constitute an activity carried out by the DNOs in order that they meet their obligations under the Electricity Distribution Licence, the Electricity Act 1989 and the Electricity Safety, Quality and Continuity Regulations 2002 (ESQCR).

Volumes

We are minded to accept the volumes that SPEN has submitted to us for both SPD and SPM. This follows a review of their methodology to determine volumes, meetings with them to discuss this methodology and two separate tours in SPD visiting sites where RLM work was due to start, ongoing or complete.

The method SPEN used to calculate the volumes of RLM works adopted the following approach:

- Determining the housing mix in SPD and SPM areas by commissioning an independent audit using census information from the Scotland Census Results Online (SCROL)⁴ and the General Household Survey, Office for National Statistics⁵.
- Undertaking condition-based audits of a sample of properties prior to DPCR5 to establish a Health Index (HI) of RLM assets, and undertaking further random surveys during the first two years of DPCR5 to refine and validate the HI.
- Based on the survey results, the proportion of all properties in the SPD and SPM areas served by RLM was established, as was the HI for those properties.
- It was estimated that 25% of all properties served by RLM in SPD and 24% of all properties served by RLM in SPM fell into the HI4 and HI5 categories (ie the worst asset condition categories on a scale of HI1 to HI5). HI4 is where cable, containment and switchgear is in poor condition and cables have been degraded and HI5 is where cable, containment and switchgear are in poor condition, cables are undersized with degraded insulation and are showing clear signs of distress.
- It is these properties served by RLM with an asset condition of HI4 and HI5 that form the volume of RLM assets that need repaired or replaced.

Further to our meetings with SPEN we requested that the volumes be broken down into the following categories:

- Length of cable installed (km)
- Number of customers
- Number of properties

Each of the above was then broken down by the following sub-categories:

- Houses
- Flats
- Multi-storey

⁴ <http://www.scrol.gov.uk/scrol/common/home.jsp>

⁵ <http://www.ons.gov.uk>

The volumes submitted are detailed in Table A1, A2 and A3 for SPD, SPM and SPEN, respectively.

Table A1: Volumes of RLM activity (SPD)

	2010/11	2011/12	2012/13	2013/1	2014/15	DPCR5 Total
Cable installed (km)						
Houses	10	11	10	12	10	53
Flats	70	137	94	93	85	479
Multi-Storey	148	211	208	169	177	914
Total	228	360	312	274	272	1446
Customer numbers						
Houses	1277	1142	994	898	978	5289
Flats	4266	8300	7156	6042	7510	33274
Multi-Storey	2770	4108	3646	3709	3109	17342
Total	8313	13550	11796	10649	11597	55905
Property numbers						
Houses	678	568	463	443	469	2621
Flats	932	1417	1228	1032	1290	5899
Multi-Storey	45	50	51	45	40	231
Total	1655	2035	1742	1520	1799	8751

Table A2: Volumes of RLM activity (SPM)

	2010/11	2011/12	2012/13	2013/1	2014/15	DPCR5 Total
Cable installed (km)						
Houses	0	0	0	0	0	0
Flats	0	65	128	179	121	493
Multi-Storey	50	70	25	36	24	205
Total	50	134	153	215	145	697
Customer numbers						
Houses	0	0	0	0	0	0
Flats	0	3458	3230	3900	3110	13698
Multi-Storey	1033	1830	1710	1100	1890	7563
Total	1033	5288	4940	5000	5000	21261
Property numbers						
Houses	0	0	0	0	0	0
Flats	0	447	416	505	400	1768
Multi-Storey	14	27	25	15	26	107
Total	14	474	441	520	426	1875

Table A3: Volumes of RLM activity (SPEN)

	2010/11	2011/12	2012/13	2013/1	2014/15	DPCR5 Total
Cable installed (km)						
Houses	10	11	10	12	10	53
Flats	70	202	222	272	206	972
Multi-Storey	198	281	233	205	201	1118
Total	278	494	465	489	417	2143
Customer numbers						
Houses	1277	1142	994	898	978	5289
Flats	4266	11758	10386	9942	10620	46972
Multi-Storey	3803	5938	5356	4809	4999	24905
Total	9346	18838	16736	15649	16597	77166
Property numbers						
Houses	678	568	463	443	469	2621
Flats	932	1864	1644	1537	1690	7667
Multi-Storey	59	77	76	60	66	338
Total	3309	4070	3484	3040	3598	17501

Unit costs

In determining the unit costs, we considered the above three measures for drivers of units costs:

- Length of cable (km)
- Number of customer
- Number of properties.

For each, we then considered three options for selecting an appropriate unit cost:

- **Option 1:** average DPCR5 unit cost to date incurred by SPD and SPM (first two years of DPCR5)
- **Option 2:** average DPCR5 unit cost (actual from first two years and forecast for last three) presented by SPD and SPM
- **Option 3:** minimum unit cost for SPD and SPM for DPCR5 to date (ie first two years of DPCR5).

Our preferred method is to base the unit costs on the number of customers and the average DPCR5 unit cost to date incurred by SPD and SPM (ie Option 1).

The rationale for using number of customers as opposed to number of properties or length of cable is that to our mind the underlying reason for the RLM work is to protect customers from safety risks (notably fire and smoke within high occupancy buildings with constrained exits) and to ensure the same level of security of supply as those customers who do not live in high occupancy buildings.

The rationale for Option 1, as opposed to Option 2 or 3 is that it is based on actual costs to date rather than projected costs (as per Option 2) and is also consistent with the approach we have taken in assessing another re-opener application in DPCR5⁶. This would result in the unit costs as presented in Table A4 and the allowance presented in Table A5.

Table A4: Proposed unit costs (2011/12 prices)

	Houses	Flats	Multi-Storey	Combined
	£	£	£	
SPD	406	611	1,606	901
SPMW	0	751	1,364	1,029
SPEN Average	406	641	1,535	930

Table A5: Comparison of total costs by DNO method and Ofgem method (2011/12 prices)

	DNO Submission	Ofgem Method	Difference
	£	£	£
SPD	28.73	30.63	1.90
SPMW	14.94	14.10	-0.84
Total	43.67	44.73	1.06

As can be seen from the table above, our proposed method gives a slightly higher allowance than that submitted by SPD, but slightly less for SPM. Given that our analysis is based solely on the evidence that the SPD and SPM have presented to us and it is not possible to benchmark with other DNOs, we propose it is appropriate that for each DNO to allow the lower of our analysis or what the DNO has applied for.

⁶ This was used in our proposed approach to assessing unit costs for the Traffic Management Act (TMA) re-opener application submitted by London Power Networks.

Therefore, we propose to award SPD the £28.73 million requested and to award SPM the £14.10 million that emerges from our analysis (as highlighted in green in the table). In total, therefore, we propose to award SPEN £42.83 million as opposed to the £43.67 million requested (an overall difference of £0.84m less than requested). This is detailed in Table A6 below.

Table A6: Proposed adjustments to total allowance (2010/11 prices)

	DNO Submission	Proposed Award	<i>Difference</i>
	£m	£m	£m
SPD	28.73	28.73	0.00
SPMW	14.94	14.10	-0.84
Total	43.67	42.83	-0.84