

Supplementary Annex 2:  
Draft ED1 Price Control  
Financial Handbook

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## 7. Uncertain costs allowed expenditure – financial adjustment methodology

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### Section 1 - Overview

7.1 At the outset of the Price Control Period, levels of allowed expenditure for the following categories of uncertain costs were set on a provisional basis because of uncertainties about requirements:

- (a) High Value Project Costs;
- (b) Enhanced Physical Site Security Costs;
- (c) Specified Street Works Costs; ~~and~~
- (d) Rail Electrification Costs; ~~and~~
- (e) Shetland Interim Costs; ~~r~~
- (f) Competitive Process and Integrated Plan Costs.

The licensee's Opening Base Revenue Allowances were modelled using the provisional amounts.

7.2 CRC 3F (Arrangements for the recovery of uncertain costs) sets out the basis on which opening levels of allowed expenditure on uncertain cost activities can be revised through 'relevant adjustments'. It also sets out how the PCFM Variable Value associated with each uncertain cost activity should be revised.

7.3 At the start of the Price Control Period on 1 April 2015, the PCFM Variable Value for the licensee for each uncertain cost activity for each Regulatory Year of the Price Control Period was set to equal the level of allowed expenditure referred to in paragraph 7.1. These were the levels that were used to derive the licensee's Opening Base Revenue Allowances and, in respect of High Value Projects Costs, ~~and~~ Enhanced Physical Site Security Costs, Shetland Interim Costs, Competitive Process and Integrated Plan Costs, they are set out against the licensee's name in the tables contained in Appendices 1, ~~and~~ 2, 4 and 5 to CRC 3F. Opening levels of allowed expenditure on Specified Street Works Costs and Rail Electrification Costs are set at zero. The PCFM Variable Values for the uncertain cost categories can be revised so that they continue to match allowed expenditure levels following any relevant adjustments under the provisions of CRC 3F and this chapter.

7.4 The categories of uncertain cost activities together with their associated PCFM Variable Values are shown in Table 7.1. Under the Annual Iteration Process, allowed expenditure levels for uncertain cost activities represented by PCFM Variable Values, as revised, interact with actual expenditure information so that appropriate Totex Incentive Mechanism Adjustments are reflected in the calculation of values for the term MOD.

**Table 7.1 – Uncertain cost activities**

Uncertain cost category	PCFM Variable Value name	Charge Restriction Condition
High Value Project Costs	UCHVP	CRC 3F
Enhanced Physical Site Security Costs	UCEPS	
Specified Street Works Costs	UCSSW	
Rail Electrification Costs	UCRE	
<a href="#">Shetland Interim Costs</a>	<a href="#">UCSIC</a>	
<a href="#">Competitive Process and Integrated Plan Costs</a>	<a href="#">UCCPC</a>	

7.5 PCFM Variable Values relating to uncertain cost activities are stated in 2012/13 prices, consistent with the price base used in the ED1 Price Control Financial Model (PCFM) and the values for the term MOD. The allocation of allowed expenditure for uncertain cost activities into the Totex subdivisions referred to in Table 6.2 in Chapter 6 is handled automatically under the Annual Iteration Process using fixed attribution rates contained in the PCFM.

7.6 CRC 3F provides for:

- the licensee to propose revisions to levels of allowed expenditure (relevant adjustments), but only during an application window specified in CRC 3F (see paragraph 7.8);
- the determination of relevant adjustments by the Authority; and
- the deeming of relevant adjustments in circumstances specified in CRC 3F, in respect of each uncertain cost activity.

7.7 CRC 3F also provides for the Authority to propose relevant adjustments, in relation to High Value Project Costs during a notice window after the end of the Price Control Period, specified in CRC 3F (see paragraph 7.9).

7.8 The application window during which the licensee can propose relevant adjustments runs from 1 May 2019 to 31 May 2019.

[7.9](#) The notice window during which the Authority can give notice of proposed relevant adjustments in respect of High Value Project Costs runs from 1 December 2023 to 31 December 2023. This window is after the end of the Price Control Period whose last day is 31 March 2023.

[7.10](#) CRC 3F also provides for the Authority to propose relevant adjustments, in relation to [Shetland Interim Costs and Competitive Process and Integrated Plan Costs](#) during a notice window during the Price Control Period, specified in CRC 3F (see paragraph 7.12).

7.11 The application window during which the licensee can propose relevant adjustments runs from [1 May 2016 or 2017] to [31 May 2016 or 2017].

7.12 The notice window during which the Authority can give notice of proposed relevant adjustments in respect of Shetland Interim Costs and Competitive Process and Integrated Plan Costs runs from [1 December 2016 or 2017] to [31 December 2016 or 2017]. ~~This window is after the end of the Price Control Period whose last day is 31 March 2017.~~

7.97.13 CRC 3F and this chapter set out the basis on which relevant adjustments can be proposed by the licensee and the Authority. However, this chapter only deals with:

- (a) determinations with respect to relevant adjustments proposed by the licensee; and
- (b) the determination and direction of revised PCFM Variable Values to give effect to determinations made under subparagraph (a).

~~7.107.14~~ Relevant adjustments proposed by the Authority will be addressed through adjustment mechanisms to be included in the RIIO-ED2 price control arrangements for the licensee and are not dealt with further under this chapter.

*Determinations and directions with respect to relevant adjustments proposed by the licensee*

~~7.117.15~~ The Authority will determine the relevant adjustments to the licensee's levels of allowed expenditure with respect to proposals made by the licensee within four months of the close of the application window referred to in paragraph 7.8 – ie by 30 September 2019 unless the timetable is extended by the Authority in the circumstances and to the extent prescribed in CRC 3F. The determination of relevant adjustments will be made in accordance with the methodologies set out in sections 2, ~~3, and 4~~, 5 and 6 as applicable, of this chapter.

~~7.127.16~~ If the Authority has not determined a relevant adjustment in relation to a proposal duly made by the licensee within four months of the close of the application window, and the proposal has not been withdrawn, then the relevant adjustment will be deemed to have been made.

~~7.137.17~~ CRC 3F also provides for the associated PCFM Variable Values to be revised for appropriate Regulatory Years in the Price Control Period so that relevant adjustments are reflected in the recalculation of base revenue figures for the licensee under the Annual Iteration Process for the ED1 Price Control Financial Model. It also sets out the procedures for the direction of revised PCFM Variable Values by the Authority.

### **General principles applicable to uncertain cost adjustment mechanisms**

~~7.147.18~~ CRC 3F states that a proposed relevant adjustment to the level of allowed expenditure on an uncertain cost activity must:

- be based on information about the actual or forecast level of efficient expenditure on the uncertain cost activity that was either unavailable or did not qualify for inclusion when the licensee's Opening Base Revenue Allowance was derived;

- take account of any relevant adjustments previously determined under CRC 3F;
- constitute a material amount as specified for the licensee in Appendix 1, ~~2, 3, 4 or 5~~ 3, 4 or 5 (as the case may be) of CRC 3F;
- relate to costs incurred or expected to be incurred after 1 April 2015; and
- constitute an adjustment to allowed expenditure that (excluding any Time Value of Money Adjustment) cannot be made under the provisions of any other condition of the licence.

7.157.19 The stipulation that proposals must take account of any previously determined relevant adjustments is intended to ensure that relevant costs are not ignored on the one hand, or double counted on the other.

7.167.20 The PCFM Variable Value for any particular Regulatory Year, as revised represents the total amount of allowed Totex expenditure (in 2012/13 prices) for the uncertain cost activity concerned for that Regulatory Year.

## **Section 2 – Methodology for determining relevant adjustments in respect of High Value Project Costs**

### **The uncertainty mechanism for High Value Project Costs**

7.177.21 For the purposes of CRC 3F and this chapter, the term High Value Project Costs means a scheme of works and the associated costs incurred, or expected to be incurred, by the licensee on any investment project with respect to its Distribution System that is reasonably forecast to cost the licensee £25 million or more (in 2012/13 prices) during the Price Control Period, and for which clear outputs, a needs case, and a statement of costs have been provided and in respect of which there is no other mechanism for the adjustment of allowed expenditure levels during the Price Control Period.

7.187.22 Some High Value Project Costs were taken into account in the calculation of the licensee's Opening Base Revenue Allowances. The uncertainty mechanism does not provide for any further adjustment to the licensee's allowed expenditure in respect of these projects, but they remain relevant in two respects:

- (i) Allowed expenditure (included in Opening Base Revenue Allowances) and actual efficient expenditure are taken into account in assessing whether the overall materiality threshold has been reached.
- (ii) The Authority will review the licensee's achievement of outputs associated with High Value Project Costs when determining any relevant adjustment proposed by the licensee under CRC 3F.

#### *Overall materiality threshold*

7.197.23 An overall materiality threshold applies in respect of relevant adjustments for High Value Project Costs. The materiality threshold for the licensee, in 2012/13 prices, is specified in the table entitled 'Opening level of allowed expenditure for High Value Project Costs and the material amount for each licensee' in Appendix 1 to CRC 3F.

~~7.20~~7.24 The amount to be tested against the materiality threshold in respect of a proposed increase in allowed expenditure levels will be determined in 2012/13 prices as:

- (i) the total of the licensee's actual and forecast efficient expenditure on:
  - High Value Project Costs included in the calculation of the licensee's Opening Base Revenue Allowances (if any); and
  - additional High Value Project Costs included in any proposal by the licensee for a relevant adjustment,

for all Regulatory Years in the Price Control Period,

**less**

- (ii) the total amount of allowed expenditure included in the calculation of the licensee's Opening Base Revenue Allowances in respect of High Value Project Costs,

for all Regulatory Years in the Price Control Period.

~~7.21~~7.25 If the materiality threshold is passed, it is not further taken into account in the determination of relevant adjustments to allowed expenditure levels. If the materiality threshold is not passed, then any relevant adjustment proposal will be rejected.

If the materiality threshold is not passed the 'Strategy decision for the RIIO-ED1 electricity distribution price control – Uncertainty mechanisms' specifies how costs will be treated (eg whether they are subject to the TIM and logging up).<sup>1</sup>

**Determination of a relevant adjustment proposed by the licensee**

~~7.22~~7.26 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of High Value Project Costs it will take the steps set out below to determine whether the proposed adjustment should be confirmed, rejected or amended.

*Determination steps*

- (i) The Authority will check whether the Notice has been received during the application window referred to in paragraph 7.8. If the Notice has been received before 1 May 2019 the Authority will notify the licensee that the Notice has been submitted too early and should be resubmitted during May 2019. If the Notice has been received after 31 May 2019 the Authority will notify the licensee that the Notice has been received too late and that a relevant adjustment will not be determined.
- (ii) The Authority will check in respect of each of the projects included in the relevant adjustment proposal whether:

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<sup>1</sup> <https://www.ofgem.gov.uk/ofgem-publications/47070/riioed1decuncertaintymechanisms.pdf>

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- a. costs incurred, or expected to be incurred, are reasonably forecast to cost the licensee £25 million or more;
- b. each of the requirements set out in paragraphs 3F.8 and 3F.9 of CRC 3F have been met (except for the requirement in respect of a material amount – see step (iv));
- c. the proposal by the licensee represents an efficient level of expenditure;
- d. a need for the project to be carried out has been established; and
- e. measurable outputs for the project have been identified.

(iii) The Authority will decide whether it requires any further information from the licensee in order to make a determination and, if it decides that further information is required, it will give Notice of that requirement to the licensee as soon as reasonably practicable and will allow such time for provision of that information as appropriate, taking account of:

- a. the amount of time that the licensee will reasonably require to compile the information;
- b. the four month period for determinations referred to in paragraph 3F.12 of CRC 3F; and
- c. the need to consult the licensee on its proposed determination.

It should be noted that the issuing of a Notice as described above does not preclude the Authority from making further information, analysis and reformatting requests in respect of the proposal.

(iv) The Authority will check whether the overall materiality threshold has been passed in accordance with paragraphs 7.20 and 7.21. If it has not, the proposed relevant adjustment will be rejected.

(v) The Authority will consider whether the outputs associated with the High Value Project Costs included in the calculation of Opening Base Revenue Allowances have been or will be achieved.

(vi) Having carried out steps (i) to (v) above, the Authority will provisionally determine whether to:

- a. reject the relevant adjustment proposed by the licensee;
- b. confirm the relevant adjustment proposed by the licensee; or
- c. amend the relevant adjustment proposed by the licensee.

If the Authority decides to amend or confirm the licensee's proposal it will, in respect of each of the projects included in the relevant adjustment proposal, provisionally determine the adjustments to allowed expenditure that should be made and the Regulatory Years to which those adjustments should be applied.

If the Authority decides to reject the licensee's proposal it will provisionally determine that no adjustments to allowed expenditure should be made.



- (vii) The Authority will consult the licensee on its provisional determination, allowing the licensee at least 28 days in which to respond.
- (viii) The Authority will consider any consultation responses from the licensee and will then make a relevant adjustment determination.

7-237.27 A determination by the Authority that confirms or amends a relevant adjustment proposed by the licensee in respect of High Value Project Costs will specify:

- (a) the Regulatory Years to which the determination applies; and
- (b) the revised total amounts of allowed Totex expenditure (in 2012/13 prices) for each of the Regulatory Years.

7-247.28 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of High Value Project Costs and does not make a relevant adjustment determination within the relevant time limit prescribed in CRC 3F, and the proposal has not been withdrawn, then paragraph 3F.19 of CRC 3F stipulates that the adjustments will be deemed to have been made.

7-257.29 The Authority will apply any relevant adjustment determined or deemed to have been made in the determination of revised UCHVP values under section 6 of this chapter.

### **Section 3 – Methodology for determining relevant adjustments in respect of Enhanced Physical Site Security Costs**

#### **The uncertainty mechanism for Enhanced Physical Site Security Costs**

7-267.30 The term Enhanced Physical Site Security Costs means costs incurred, or expected to be incurred, by the licensee for the purposes of implementing any formal recommendation or requirement of the Secretary of State to enhance the physical security of any of the sites that form part of the licensee's Distribution System as may be further clarified in the Regulatory instructions and Guidance (RIGs). This definition is set out in CRC 3F.

7-277.31 Requirements for Enhanced Physical Site Security related to some sites were taken into account in the calculation of the licensee's Opening Base Revenue Allowances. The uncertainty mechanism only provides for adjustments to the licensee's allowed expenditure in the Price Control Period in respect of sites not included as part of ex ante allowances.

#### *Overall materiality threshold*

7-287.32 An overall materiality threshold applies in respect of relevant adjustments for Enhanced Physical Site Security Costs. The materiality threshold for the licensee, in 2012/13 prices, is specified in the table in Appendix 2 to CRC 3F.

7-297.33 If the materiality threshold is passed, it is not further taken into account in the determination of relevant adjustments to allowed expenditure levels. If the materiality threshold is not passed, then any relevant adjustment proposal will be rejected. However, in that case, costs reported by the licensee in accordance with the RIGs will be deferred up for consideration in respect of the RIIO-ED2 price control arrangements.

~~7.30~~7.34 If the materiality threshold is not passed the 'Strategy decision for the RII0-ED1 electricity distribution price control – Uncertainty mechanisms' specifies how costs will be treated (eg whether they are subject to the TIM and logging up).<sup>2</sup>

### **Determination of a relevant adjustment proposed by the licensee**

~~7.31~~7.35 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Enhanced Physical Site Security Costs it will take the steps set out below to determine whether the proposed adjustment should be confirmed, rejected or amended.

#### *Determination steps*

- (i) The Authority will check whether the Notice has been received during the application window referred to in paragraph 7.8. If the Notice has been received before 1 May 2019 the Authority will notify the licensee that the Notice has been submitted too early and should be resubmitted during May 2019. If the Notice has been received after 31 May 2019 the Authority will notify the licensee that the Notice has been received too late and that a relevant adjustment will not be determined.
- (ii) The Authority will check in respect of each of the sites included in the relevant adjustment proposal whether:
  - a. each of the requirements set out in paragraphs 3F.8 and 3F.9 of CRC 3F has been met (except for the requirement in respect of a material amount – see step (iv));
  - b. works that have been carried out, or that are to be carried out, meet the security requirements specified in the relevant recommendation or requirement of the Secretary of State; and
  - c. works that have been carried out, or that are to be carried out, represent an efficient level of expenditure.

In making the checks at points 'a.', 'b.' and 'c.', the Authority will take into account the results of any audit of the licensee's Enhanced Physical Site Security activity and the results of any benchmarking review that the Authority has carried out.
- (iii) The Authority will decide whether it requires any further information from the licensee in order to make a determination and, if it decides that further information is required it will give Notice of that requirement to the licensee as soon as reasonably practicable and will allow such time for provision of that information as appropriate, taking account of:
  - a. the amount of time that the licensee will reasonably require to compile the information;
  - b. the four month period for determinations referred to in paragraph 3F.12 of CRC 3F; and

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<sup>2</sup> <https://www.ofgem.gov.uk/ofgem-publications/47070/riioed1decuncertaintymechanisms.pdf>

c. the need to consult the licensee on its proposed determination.

It should be noted that the issuing of a Notice as described above does not preclude the Authority from making further information, analysis and reformatting requests in respect of the proposal.

- (iv) The Authority will check whether the overall materiality threshold has been passed in accordance with paragraph 7.30. If it has not, the proposed relevant adjustment will be rejected.
- (v) Having carried out steps (i) to (iv) above, the Authority will provisionally determine whether to:
  - a. reject the relevant adjustment proposed by the licensee;
  - b. confirm the relevant adjustment proposed by the licensee; or
  - c. amend the relevant adjustment proposed by the licensee.

If the Authority decides to amend or confirm the licensee's proposal it will, in respect of each of the sites included in the relevant adjustment proposal, provisionally determine the adjustments to allowed expenditure that should be made and the Regulatory Years to which those adjustments should be applied.

If the Authority decides to reject the licensee's proposal it will provisionally determine that no adjustments to allowed expenditure should be made.

- (vi) The Authority will consult the licensee on its provisional determination, allowing the licensee at least 28 days in which to respond.
- (vii) The Authority will consider any consultation responses from the licensee and will then make a relevant adjustment determination.

7.327.36 A determination by the Authority that confirms or amends a relevant adjustment proposed by the licensee in respect of Enhanced Physical Site Security Costs will specify:

- (a) the Regulatory Years to which the determination applies; and
- (b) the revised total amounts of allowed expenditure (in 2012/13 prices) for each of the Regulatory Years.

7.337.37 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Enhanced Physical Site Security Costs and does not make an relevant adjustment determination within the relevant time limit prescribed in CRC 3F, and the proposal has not been withdrawn, then paragraph 3F.19 of CRC 3F stipulates that the adjustments will be deemed to have been made.

7.347.38 The Authority will apply any relevant adjustment determined or deemed to have been made in the determination of revised UCEPS values under section 6 of this chapter.

## **Section 4 – Methodology for determining relevant adjustments in respect of Specified Street Works Costs**

### **The uncertainty mechanism for Specified Street Works Costs**

7.357.39 The term Specified Street Works Costs means costs incurred, or expected to be incurred, by the licensee in complying with obligations or requirements arising under any order or regulations made under Part 3 of the Traffic Management Act 2004 (or, in Scotland, the Transport (Scotland) Act 2005) that impose a permit scheme and comprise:

- (a) permit fee costs;
- (b) one-off set up costs;
- (c) additional administrative costs arising from the introduction of permit schemes; and
- (d) additional costs arising from the introduction of permit conditions,

as further clarified in the RIGs. This definition is set out in CRC 3F.

7.367.40 The uncertainty mechanism provides for relevant adjustments in respect of efficient costs that were not included in the calculation of the licensee's Opening Base Revenue Allowances.

#### *Overall materiality threshold*

7.377.41 An overall materiality threshold applies in respect of relevant adjustments for Specified Street Works Costs. The materiality threshold for the licensee, in 2012/13 prices, is specified in the table in Appendix 3 to CRC 3F.

7.387.42 If the materiality threshold is passed, it is not taken further into account in the determination of relevant adjustments to allowed expenditure levels. If the materiality threshold is not passed, then any relevant adjustment proposal will be rejected. This is without prejudice to any consideration of costs in respect of arrangements for the RIIO-ED2 price control.

7.397.43 If the materiality threshold is not passed the 'Strategy decision for the RIIO-ED1 electricity distribution price control – Uncertainty mechanisms' specifies how costs will be treated (eg whether they are subject to the TIM and logging up).<sup>3</sup>

#### **Determination of a relevant adjustment proposed by the licensee**

7.407.44 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Specified Street Works Costs it will take the steps set out below to determine whether the proposed adjustment should be confirmed, rejected or amended.

#### *Determination steps*

- (i) The Authority will check whether the Notice has been received during the application window referred to in paragraph 7.8. If the Notice has been received before 1 May 2019 the Authority will notify the licensee

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<sup>3</sup> <https://www.ofgem.gov.uk/ofgem-publications/47070/riioed1decuncertaintymechanisms.pdf>

that the Notice has been submitted too early and should be resubmitted during May 2019. If the Notice has been received after 31 May 2019 the Authority will notify the licensee that the notice has been received too late and that a relevant adjustment will not be determined.

- (ii) The Authority will check whether
  - a. each of the requirements set out in paragraphs 3F.8 and 3F.9 of CRC 3F has been met (except for the requirement in respect of a material amount – see step (iv));
  - b. the licensee has, or will be able to, provide 12 months' worth of costs data to support its proposal; and
  - c. the proposal by the licensee represents an efficient level of expenditure.
- (iii) The Authority will decide whether it requires any further information from the licensee in order to make a determination and, if it decides that further information is required it will give Notice of that requirement to the licensee as soon as reasonably practicable and will allow such time for provision of that information as appropriately takes account of:
  - a. the amount of time that the licensee will reasonably require to compile the information;
  - b. the four month period for determinations referred to in paragraph 3F.12 of CRC 3F; and
  - c. the need to consult the licensee on its proposed determination.

It should be noted that the issuing of a Notice as described above does not preclude the Authority from making further information, analysis and reformatting requests in respect of the proposal.
- (iv) The Authority will check whether the overall materiality threshold has been passed in accordance with paragraph 7.39. If it has not, the proposed relevant adjustment will be rejected.
- (v) In reviewing the level of permit fee costs included in any relevant adjustment proposal the Authority will take into account:
  - a. the number of permits that the licensee has been or will be required to obtain in respect of works schemes; and
  - b. the costs of permits that the licensee has been or will be required to obtain.
- (vi) In reviewing the level of system set up costs and additional administration costs included in any relevant adjustment proposal, the Authority will take into account the results of any benchmarking or other comparative analysis that it has carried out or commissioned.
- (vii) Having carried out steps (i) to (vi) above, the Authority will provisionally determine whether to:
  - a. reject the relevant adjustment proposed by the licensee;
  - b. confirm the relevant adjustment proposed by the licensee; or
  - c. amend the relevant adjustment proposed by the licensee.

If the Authority decides to amend or confirm the licensee's proposal it will provisionally determine the adjustments to the licensee's allowed expenditure that should be made and the Regulatory Years to which those adjustments should be applied.

If the Authority decides to reject the licensee's proposal it will provisionally determine that no adjustments to allowed expenditure should be made.

- (viii) The Authority will consult the licensee on its provisional determination, allowing the licensee at least 28 days in which to respond.
- (ix) The Authority will consider any consultation responses from the licensee and will then make a relevant adjustment determination.

7.417.45 A determination by the Authority that confirms or amends a relevant adjustment proposed by the licensee in respect of Specified Street Works Costs will specify:

- (a) the Regulatory Years to which the determination applies; and
- (b) the revised total amounts of allowed Totex expenditure (in 2012/13 prices) for each of the Regulatory Years.

7.427.46 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Specified Street Works Costs and does not make an relevant adjustment determination within the relevant time limit prescribed in CRC 3F, and the proposal has not been withdrawn, then paragraph 3F.19 of CRC 3F stipulates that the adjustments will be deemed to have been made.

7.437.47 The Authority will apply any relevant adjustment determined or deemed to have been made in the determination of revised UCSSW values under section 6 of this chapter.

## **Section 5 – Methodology for determining relevant adjustments in respect of Rail Electrification Costs**

### **The uncertainty mechanism for Rail Electrification Costs**

7.447.48 The term Rail Electrification Costs means costs incurred, or expected to be incurred, by the licensee in respect of the diversion of electric lines or electrical plant to facilitate rail electrification projects, as further clarified in the RIGs. The definition is set out in CRC 3F.

7.457.49 The uncertainty mechanism provides for relevant adjustments in respect of efficient costs that were not included in the calculation of the licensee's Opening Base Revenue Allowances.

#### *Overall materiality threshold*

7.467.50 An overall materiality threshold applies in respect of relevant adjustments for Rail Electrification Costs. The materiality threshold for the licensee, in 2012/13 prices, is specified in the table in Appendix 4 to CRC 3F.

7.477.51 If the materiality threshold is passed, it is not taken further into account in the determination of relevant adjustments to allowed expenditure levels. If the materiality threshold is not passed, then any relevant adjustment proposal will be rejected. This is without prejudice to any consideration of costs in respect of arrangements for the RIIO-ED2 price control.

7.487.52 If the materiality threshold is not passed the 'Strategy decision for the RIIO-ED1 electricity distribution price control – Uncertainty mechanisms' specifies how costs will be treated (eg whether they are subject to the TIM and logging up).<sup>4</sup>

### **Determination of a relevant adjustment proposed by the licensee**

7.497.53 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Rail Electrification Costs it will take the steps set out below to determine whether the proposed adjustment should be confirmed, rejected or amended.

#### *Determination steps*

- (i) The Authority will check whether the Notice has been received during the application window referred to in paragraph 7.8. If the Notice has been received before 1 May 2019 the Authority will notify the licensee that the Notice has been submitted too early and should be resubmitted during May 2019. If the Notice has been received after 31 May 2019 the Authority will notify the licensee that the notice has been received too late and that a relevant adjustment will not be determined.
- (ii) The Authority will check whether
  - a. each of the requirements set out in paragraphs 3F.8 and 3F.9 of CRC 3F has been met (except for the requirement in respect of a material amount – see step (iv));
  - b. the costs incurred or expected to be incurred fall within the definition of Rail Electrification Costs and have been or will be incurred during the Price Control Period;
  - c. the rail electrification projects to which the costs relate have been approved for funding by the Secretary of State for Transport;
  - d. the costs are not recoverable from a third party; and
  - e. the proposal by the licensee represents an efficient level of expenditure.
- (iii) The Authority will decide whether it requires any further information from the licensee in order to make a determination and, if it decides that further information is required it will give Notice of that requirement to the licensee as soon as reasonably practicable and will allow such time for provision of that information as appropriately takes account of:

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<sup>4</sup> <https://www.ofgem.gov.uk/ofgem-publications/47070/riioed1decuncertaintymechanisms.pdf>

- a. the amount of time that the licensee will reasonably require to compile the information;
- b. the four month period for determinations referred to in paragraph 3F.12 of CRC 3F; and
- c. the need to consult the licensee on its proposed determination.

It should be noted that the issuing of a Notice as described above does not preclude the Authority from making further information, analysis and reformatting requests in respect of the proposal.

- (iv) The Authority will check whether the overall materiality threshold has been passed in accordance with paragraph ~~7.507-48~~. If it has not, the proposed relevant adjustment will be rejected.
- (vi) In reviewing the level of costs costs included in any relevant adjustment proposal, the Authority will take into account the results of any benchmarking or other comparative analysis that it has carried out or commissioned.
- (vii) Having carried out steps (i) to (vi) above, the Authority will provisionally determine whether to:
  - a. reject the relevant adjustment proposed by the licensee;
  - b. confirm the relevant adjustment proposed by the licensee; or
  - c. amend the relevant adjustment proposed by the licensee.

If the Authority decides to amend or confirm the licensee's proposal it will provisionally determine the adjustments to the licensee's allowed expenditure that should be made and the Regulatory Years to which those adjustments should be applied.

If the Authority decides to reject the licensee's proposal it will provisionally determine that no adjustments to allowed expenditure should be made.

- (viii) The Authority will consult the licensee on its provisional determination, allowing the licensee at least 28 days in which to respond.
- (ix) The Authority will consider any consultation responses from the licensee and will then make a relevant adjustment determination.

~~7.507.54~~ A determination by the Authority that confirms or amends a relevant adjustment proposed by the licensee in respect of Rail Electrification Costs will specify:

- (a) the Regulatory Years to which the determination applies; and
- (b) the revised total amounts of allowed Totex expenditure (in 2012/13 prices) for each of the Regulatory Years.

~~7.517.55~~ If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Rail Electrification Costs and does not make an relevant adjustment determination within the relevant time limit prescribed in CRC 3F, and the proposal has not been withdrawn, then paragraph 3F.19 of CRC 3F stipulates that the adjustments will be deemed to have been made.



7.527.56 The Authority will apply any relevant adjustment determined or deemed to have been made in the determination of revised UCRE values under part 6 of this chapter.

## **Section 6 – Methodology for determining relevant adjustments in respect of Shetland Interim Costs**

### **The uncertainty mechanism for Shetland Interim Costs**

7.57 The uncertainty mechanism in respect of Shetland Interim Costs is symmetric and can be opened for either an upward adjustment, as proposed by the licensee, or downward adjustment, as proposed by the authority.

7.58 For the purposes of CRC 3F and this chapter, the term Shetland Interim Costs means the costs incurred, or expected to be incurred by SSEH during the interim period between 1 April 2015 and the new enduring solution for managing supply and demand on Shetland, to the extent that these costs are not recoverable under any other part of this licence.

7.59 Some Shetland Interim Costs were taken into account in the calculation of the licensee's Opening Base Revenue Allowances. These costs are subject to revision through the uncertainty mechanism described in this section. The costs included in Opening Base Revenue Allowances are used in respect of:

- (i) Allowed expenditure (included in Opening Base Revenue Allowances) and actual efficient expenditure are taken into account in assessing whether the overall materiality threshold has been reached.
- (ii) The Authority will review the licensee's achievement of outputs associated with the Shetland Interim Costs when determining any relevant adjustment proposed by the licensee under CRC 3F.

### **Overall materiality threshold**

7.60 An overall materiality threshold applies in respect of relevant adjustments for Shetland Interim Costs. The materiality threshold for the licensee, in 2012/13 prices, is specified in the table entitled 'Opening level of allowed expenditure for Shetland Interim Costs and the material amount for SSEH each licensee' in Appendix 4 to CRC 3F.

7.61 The amount to be tested against the materiality threshold in respect of a proposed increase/change to in-allowed expenditure levels will be determined as the absolute value, in 2012/13 prices as of:

- (i) the total of the licensee's actual and forecast efficient expenditure on:
  - Shetland Fixed Energy Costs included in the calculation of the licensee's Opening Base Revenue Allowances (if any); and

- additional Shetland Interim Costs included in any proposal by the licensee for a relevant adjustment,

for all Regulatory Years from the beginning of the Price Control Period until the enduring energy solution for Shetland is commissioned,

**less**

- (ii) the total amount of allowed expenditure included in the calculation of \_\_\_\_\_the licensee's Opening Base Revenue Allowances in respect of Shetland Interim Costs,

for all Regulatory Years from the beginning of the Price Control Period until the enduring energy solution for Shetland is commissioned.

7.62 If the materiality threshold is passed, it is not further taken into account in the determination of relevant adjustments to allowed expenditure levels. If the materiality threshold is not passed, then any relevant adjustment proposal will be rejected.

7.63 If the materiality threshold is not passed the 'Strategy decision for the RIIO-ED1 electricity distribution price control – Uncertainty mechanisms' specifies how costs will be treated (eg whether they are subject to the TIM and logging up).<sup>5</sup>

**Determination of a relevant adjustment proposed by the licensee or by the Authority**

7.64 An adjustment to Shetland Interim Cost can be triggered by:

(a) a review by the Authority of the licensee's reported and forecast efficient expenditure levels for Shetland Interim Costs; or

(b) an application lodged by the licensee during a window that runs from 1 May [2016 or 2017] to 31 May [2016 or 2017]

7.65 If the Notice has been received before 1 May [2016 or 2017] the Authority will notify the licensee that the Notice has been submitted too early and should be resubmitted during May [2016 or 2017]. If the Notice has been received after 31 May [2016 or 2017] the Authority will notify the licensee that the Notice has been received too late and that a relevant adjustment will not be determined.

7.66 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Shetland Interim Costs it will takeThe following the steps set out below will be used to determine whether the proposed adjustment should be confirmed, rejected or amended.

Determination steps

<sup>5</sup> <https://www.ofgem.gov.uk/ofgem-publications/47070/riioed1decuncertaintymechanisms.pdf>

~~(i) If the proposed adjustment is triggered by the licensee, the Authority will check whether the Notice has been received during the application window referred to in paragraph 7.11. If the Notice has been received before 1 May [2016 or 2017] the Authority will notify the licensee that the Notice has been submitted too early and should be resubmitted during May [2016 or 2017]. If the Notice has been received after 31 May [2016 or 2017] the Authority will notify the licensee that the Notice has been received too late and that a relevant adjustment will not be determined.~~

~~(ii) The Authority will check in respect of each of the projects included in the relevant adjustment proposal whether:~~

- ~~a. costs incurred, or expected to be incurred, are reasonably forecast to deviate significantly from the Shetland-Shetland Interim Costs ex-ante allowance cost the licensee £25 million or more;~~
- ~~b. each of the requirements set out in paragraphs 3F.8 and 3F.9 of CRC 3F have been met (except for the requirement in respect of a material amount – see step (iv));~~
- ~~c. the proposal by the licensee represents an efficient level of expenditure;~~
- ~~d. a need for the project to be carried out has been established; and~~
- ~~e. measurable outputs for the project have been identified.~~

~~(iii) The Authority will decide whether it requires any further information from the licensee in order to make a determination and, if it decides that further information is required, it will give Notice of that requirement to the licensee as soon as reasonably practicable and will allow such time for provision of that information as appropriate, taking account of:~~

- ~~a. the amount of time that the licensee will reasonably require to compile the information;~~
- ~~b. the four month period for determinations referred to in paragraph 3F.143 of CRC 3F; and~~
- ~~c. the need to consult the licensee on its proposed determination.~~

~~It should be noted that the issuing of a Notice as described above does not preclude the Authority from making further information, analysis and reformatting requests in respect of the proposal.~~

~~(iv) The Authority will check whether the overall materiality threshold has been passed in accordance with paragraphs 7.61 and 7.62. If it has not, the proposed relevant adjustment will be rejected.~~

~~(v) The Authority will consider whether the outputs associated with the Shetland Interim Costs included in the calculation of Opening Base Revenue Allowances have been or will be achieved.~~

(vi) Having carried out steps (i) to (v) above, the Authority will provisionally determine whether to:

- a. reject the relevant adjustment ~~proposed by the licensee;~~
- b. confirm the relevant adjustment ~~proposed by the licensee;~~ or
- c. amend the relevant adjustment ~~proposed by the licensee.~~

If the Authority decides to amend or confirm the ~~licensee's proposal~~ ~~proposed adjustment~~ it will, in respect of ~~each of the projects~~ included in the relevant adjustment proposal, provisionally determine the adjustments to allowed expenditure that should be made and the Regulatory Years to which those adjustments should be applied.

If the Authority decides to reject the ~~licensee's proposal~~ ~~proposed adjustment~~ it will provisionally determine that no adjustments to allowed expenditure should be made.

(vii) The Authority will consult the licensee on its provisional determination, allowing the licensee at least 28 days in which to respond.

(viii) The Authority will consider any consultation responses from the licensee and will then make a relevant adjustment determination.

7.67 A determination by the Authority that confirms or amends a relevant adjustment ~~proposed by the licensee~~ in respect of Shetland Interim Costs will specify:

- (a) the Regulatory Years to which the determination applies; and
- (b) the revised total amounts of allowed Totex expenditure (in 2012/13 prices) for each of the Regulatory Years.

7.68 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Shetland Interim Costs and does not make a relevant adjustment determination within the relevant time limit prescribed in CRC 3F, and the proposal has not been withdrawn, then paragraph 3F.21~~18~~ of CRC 3F stipulates that the adjustments will be deemed to have been made.

7.69 The Authority will apply any relevant adjustment determined or deemed to have been made in the determination of revised UCSIC values under section 68 of this chapter.

## **Section 7 – Methodology for determining relevant adjustments in respect of Competitive Process and Integrated Plan Costs**

### **The uncertainty mechanism for the Competitive Process and Integrated Plan Costs**

The uncertainty mechanism in respect of the Competitive Process and Integrated Plan Costs is symmetric and can be opened for either an upward adjustment, as proposed by the licensee, or downward adjustment, as proposed by the authority.

7.70 Some Competitive Process and Integrated Plan Costs in relation to Shetland were taken into account in the calculation of the licensee's Opening Base Revenue Allowances. These costs are subject to revision through the uncertainty mechanism described in this section. The costs included in Opening Base Revenue Allowances are used in respect of:

- (i) Allowed expenditure (included in Opening Base Revenue Allowances) and actual efficient expenditure are taken into account in assessing whether the overall materiality threshold has been reached.
- (ii) The Authority will review the licensee's achievement of outputs associated with the Competitive Process and Integrated Plan Costs when determining any relevant adjustment proposed by the licensee under CRC 3F.

Overall materiality threshold

An overall materiality threshold applies in respect of relevant adjustments for the Competitive Process and Integrated Plan Costs. The materiality threshold for the licensee, in 2012/13 prices, is specified in the table entitled 'Opening level of allowed expenditure for Competitive Process and Integrated Plan Costs and the material amount for SSEH in Appendix 5 to CRC 3F.

7.71

7.72

The amount to be tested against the materiality threshold in respect of a proposed increase in allowed expenditure levels will be determined as the absolute value, in 2012/13 prices of in 2012/13 prices as:

- (i) the total of the licensee's actual and forecast efficient expenditure on:
  - Competitive Process and Integrated Plan Costs (excluding internal and Related Party staff) included in the calculation of the licensee's Opening Base Revenue Allowances (if any); and
  - additional Competitive Process and Integrated Plan Costs (internal and Related Party staff) included in any proposal by the licensee for a relevant adjustment,

for all Regulatory Years from the beginning of the Price Control Period until the enduring energy solution for Shetland is commissioned.

**less**

- (ii) the total amount of allowed expenditure included in the calculation of the licensee's Opening Base Revenue Allowances in respect of the Competitive Process and Integrated Plan Costs,

for all Regulatory Years from the beginning of the Price Control Period until the enduring energy solution for Shetland is commissioned.

7.73 If the materiality threshold is passed, it is not further taken into account in the determination of relevant adjustments to allowed expenditure levels. If the materiality threshold is not passed, then any relevant adjustment proposal will be rejected.

7.74 If the materiality threshold is not passed the 'Strategy decision for the RIIO-ED1 electricity distribution price control – Uncertainty mechanisms' specifies how costs will be treated (eg whether they are subject to the TIM and logging up).<sup>6</sup>

**Determination of a relevant adjustment proposed by the licensee or by the Authority**

7.75 An adjustment to Competitive Process and Integrated Plan Costs can be triggered by:

- (a) a review by the Authority of the licensee's reported and forecast efficient expenditure levels for Competitive Process and Integrated Plan Costs; or
- (b) an application lodged by the licensee during a window that runs from 1 May [2016 or 2017] to 31 May [2016 or 2017]

7.76 If the Notice has been received before 1 May [2016 or 2017] the Authority will notify the licensee that the Notice has been submitted too early and should be resubmitted during May [2016 or 2017]. If the Notice has been received after 31 May [2016 or 2017] the Authority will notify the licensee that the Notice has been received too late and that a relevant adjustment will not be determined.

7.77 The following steps set out below will be used to determine whether the proposed adjustment should be confirmed, rejected or amended.

*Determination steps*

- (i) If the proposed adjustment is triggered by the licensee, the Authority will check whether the Notice has been received during the application window referred to in paragraph 7.11.
- (ii) The Authority will check in respect of each of the projects included in the relevant adjustment proposal whether:
  - a. costs incurred, or expected to be incurred, are reasonably forecast to deviate significantly from the Competitive Process and Integrated Plan Costs ex-ante allowance;
  - b. each of the requirements set out in paragraphs 3F.8 and 3F.9 of CRC 3F have been met (except for the requirement in respect of a material amount – see step (iv));
  - c. the proposal by the licensee represents an efficient level of expenditure;
- (iii) The Authority will decide whether it requires any further information from the licensee in order to make a determination and, if it decides that further information is required, it will give Notice of that requirement to the licensee as soon as reasonably practicable and will

<sup>6</sup> <https://www.ofgem.gov.uk/ofgem-publications/47070/riioed1decuncertaintymechanisms.pdf>

allow such time for provision of that information as appropriate, taking account of:

- a. the amount of time that the licensee will reasonably require to compile the information;
- b. the four month period for determinations referred to in paragraph 3F.14 of CRC 3F; and
- c. the need to consult the licensee on its proposed determination.

It should be noted that the issuing of a Notice as described above does not preclude the Authority from making further information, analysis and reformatting requests in respect of the proposal.

(iv) The Authority will check whether the overall materiality threshold has been passed in accordance with paragraphs 7.70 and 7.71. If it has not, the proposed relevant adjustment will be rejected.

(v) The Authority will consider whether the outputs associated with the Competitive Process and Integrated Plan Costs ~~Shetland Interim Costs~~ included in the calculation of Opening Base Revenue Allowances have been or will be achieved.

(vi) Having carried out steps (i) to (v) above, the Authority will provisionally determine whether to:

- a. reject the relevant adjustment ~~proposed by the licensee;~~
- b. confirm the relevant adjustment ~~proposed by the licensee; or~~
- c. amend the relevant adjustment ~~proposed by the licensee.~~

If the Authority decides to amend or confirm the licensee's ~~proposal~~ proposed adjustment it will, in respect of the project included in the relevant adjustment proposal, provisionally determine the adjustments to allowed expenditure that should be made and the Regulatory Years to which those adjustments should be applied.

If the Authority decides to reject the licensee's ~~proposal~~ proposed adjustment it will provisionally determine that no adjustments to allowed expenditure should be made.

(vii) The Authority will consult the licensee on its provisional determination, allowing the licensee at least 28 days in which to respond.

(viii) The Authority will consider any consultation responses from the licensee and will then make a relevant adjustment determination.

7.78 A determination by the Authority that confirms or amends a relevant adjustment ~~proposed by the licensee~~ in respect of Competitive Process and Integrated Plan Costs will specify:

- (a) the Regulatory Years to which the determination applies; and
- (b) the revised total amounts of allowed Totex expenditure (in 2012/13 prices) for each of the Regulatory Years.

7.79 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Competitive Process and Integrated Plan Costs and does not make a relevant adjustment determination within the relevant time limit prescribed in CRC 3F, and the proposal has not been withdrawn, then paragraph 3F.21 of CRC 3F stipulates that the adjustments will be deemed to have been made.

7.80 The Authority will apply any relevant adjustment determined or deemed to have been made in the determination of revised UCCPC values under section 7 of this chapter.

## **Section 6-87 – Determination, notification and direction of revised PCFM Variable Values for uncertain cost activities**

7.537.81 CRC 3F specifies that the PCFM Variable Value for the licensee for each uncertain cost activity as at 1 April 2015 (ie before any revisions to PCFM Variable Values have been made) for each Regulatory Year of the Price Control Period will be equal to the level of allowed Totex expenditure that was used in the calculation of the licensee's Opening Base Revenue Allowances. It also specifies that revised PCFM Variable Values relating to uncertain cost activities will be directed by the Authority by 30 November in Regulatory Year 2019/20 (ie by 30 November 2019).

### **Determination of revised PCFM Variable Values**

7.547.82 On or before 31 October 2019, Ofgem will check to see whether any determinations of relevant adjustments have been made or have been deemed to have been made in respect of

- (a) High Value Project Costs;
- (b) Enhanced Physical Site Security Costs;
- (c) Specified Street Works Costs; ~~and~~
- (d) Rail Electrification Costs;~~;~~
- (e) Shetland Interim Costs; and
- (f) Competitive Process and Integrated Plan Costs.

that change the level of allowed expenditure for the licensee and that have not previously been taken fully into account in the determination of revisions to the associated PCFM Variable Value for the Regulatory Year or Years concerned.

7.557.83 If any determination of a relevant adjustment has not previously been taken into account, the Authority will determine that the associated PCFM Variable Value (as set out in the next paragraph) for the Regulatory Year or Years concerned is to be revised so that it equals the revised total amount of allowed Totex expenditure (in 2012/13 prices) specified in the relevant adjustment determination.

7.567.84 The PCFM Variable Values referred to in paragraph 7.48-1 are:

- (a) UCHVP values in respect of High Value Project Costs;
- (b) UCEPS values in respect of Enhanced Physical Site Security Costs;
- (c) UCSSW values in respect of Specified Street Works Costs; ~~and~~
- (d) UCRE values in respect of Rail Electrification Works Costs;
- (e) UCSIC values in respect of Shetland Interim Costs; and
- (f) UCCPC values in respect of Competitive Process and Integrated Plan Costs.



### **Notification and direction of revised PCFM Variable Values**

~~7.577.85~~ The Authority will give Notice of any revisions to UCHVP, UCEPS, UCSSW, ~~and UCRE, UCSIC and UCCPC~~ values that it proposes to direct by 15 November in Regulatory Year 2019/20, being at least 14 days before the deadline date of 30 November for the direction of revised PCFM Variable Values. The Notice will confirm that:

- any revised PCFM Variable Value determinations have been made in accordance with Part B of CRC 3F, which cross refers to this chapter of this handbook; and
- the licensee has 14 days from the date of the Notice in which to make any representations concerning the proposed PCFM Variable Value revisions.

~~7.587.86~~ The Authority is required to have due regard to any representations or objections made by the licensee and to give its reasons for any decisions in relation to them.

~~7.597.87~~ The Authority will only direct PCFM Variable Value revisions for uncertain cost activities in accordance with the provisions of CRC 3F. However, the overall direction of PCFM Variable Value revisions in each Regulatory Year t-1 will include a copy of the PCFM Variable Values Table for the licensee showing the state of all PCFM Variable Values including those relating to uncertain cost activities.

### **Delay in direction of revised PCFM Variable Values**

~~7.607.88~~ If the procedures set out in CRC 3F and this chapter call for the Authority to direct revised PCFM Variable Values for one or more uncertain cost categories by 30 November 2019, and the Authority does not make such a direction, then CRC 3F requires that the values concerned should be directed by the Authority as soon as is reasonably practicable, to facilitate the notification and direction of the value of the term  $MOD_t$  for the licensee under CRC 4B (Annual Iteration Process for the ED1 Price Control Financial Model).