

Email: RIIO.ED1@ofgem.gov.uk

Date: 1 June 2018

To interested parties,

Statutory consultation on proposed changes to Western Power Distribution's licences for the recovery of diversions costs associated with rail electrification.

Western Power Distribution (WPD) is the electricity distribution network operator (DNO) for the Midlands, South West and Wales. Following the UK Government's cancellation in July 2017 of a number of rail electrification schemes within WPD's network areas, WPD confirmed their intention to voluntarily return £77m of unspent capital costs to customers.

In returning this money to their customers, WPD requested that it be covered for any further policy changes that require increased spend on diversions due to rail electrification. This would take the form of an uncertainty mechanism similar to that which applies to slow-tracked DNOs¹, and would require changes to WPD's four licences, as well as the corresponding Price Control Financial Handbook.

This letter explains the background to WPD's voluntary return of unspent capital costs, and the details of its request. We are minded to modify WPD's licences to enable them to recover their costs should a future change in Government policy require diversions work due to rail electrification in their licence areas. We are inviting views from stakeholders on our minded-to position.

Background

WPD is the holder of four electricity distribution licences granted under section 6(1)(c) of the Electricity Act 1989. These are:

- Western Power Distribution (West Midlands) plc
- Western Power Distribution (East Midlands) plc
- Western Power Distribution (South Wales) plc
- Western Power Distribution (South West) plc

As part of WPD's RIIO Electricity Distribution price control settlement (RIIO-ED1), their four licensees received ~£96m to cover the costs of diverting power lines to enable the electrification of rail lines. In July 2017, the UK Government announced that some projects, including within the WPD network in the midlands and South Wales, would not progress as previously planned. The cancellation of these projects resulted in a reduction of WPD's forecast spend in RIIO-ED1 on diversionary works associated with rail electrification from £96.5m to £19.5m.

¹ WPD's four licensees were fast-tracked through the RIIO-ED1 process.

In December 2017, we published our consultation on a potential RIIO-ED1 Mid Period Review (MPR).² In the consultation, we identified a number of external factors that could potentially affect DNOs' outputs, as well as a number of issues that fell outside the scope of an MPR as defined in our strategy decision; one of these issues was the changes to rail electrification schemes.

On 18 April 2018, WPD announced that they would voluntarily return £77m of monies that is no longer required for rail electrification projects.³ In returning this money, WPD requested that it be covered for any further change in policy resulting in increased spend on diversions, in the form of an uncertainty mechanism similar to that of the slow-tracked DNOs.

Ofgem's minded-to position

We believe that WPD's request is in the best interests of consumers and are minded to modify WPD's licences to allow it.

The return of £77m requires us to modify WPD's allowed revenues, which will take effect through this year's Annual Iteration Process (AIP). In addition, providing WPD with an uncertainty mechanism for Rail Electrification Costs requires changes to Special Licence Condition CRC 3F: Arrangements for the recovery of uncertain costs (CRC 3F) and also requires changes to be made to the Price Control Financial Handbook (fast track licensees), applicable only to WPD.

As noted above, as part of their fast-track settlement, WPD had ex-ante funding for Rail Electrification Costs, the full unspent elements of which it is now voluntarily returning. Accordingly, we are proposing that the uncertainty mechanism for WPD take the form of a reopener for Rail Electrification Costs in May 2022, which would enable WPD to recover any costs borne since its voluntary return and those forecast up until the end of RIIO-ED1 on 31 March 2023. In addition, we are proposing that WPD should not have a materiality threshold, which otherwise would expose it to bearing up to a further c£18m in diversion costs (which is the total of the materiality thresholds in WPD's four licence areas). This approach is consistent with the terms of the voluntary return of £77m to consumers.

We welcome views on our minded-to position and the draft licence and Handbook modifications and will take them into account in our decision.

Structure of this letter

There are three annexes to this letter:

- Annex 1 to this letter sets out our Notice of a statutory consultation on a proposal to modify Special Licence Condition CRC 3F and the Price Control Financial Handbook (fast track licensees).
- Annex 2 to this letter sets out the proposed changes to CRC 3F.
- Annex 3 sets out the proposed changes to the Price Control Financial Handbook (fast track licensees).

Views invited

We welcome views from interested parties on our minded-to position and the draft modifications. If we decide to modify WPD's licences, the modifications will take effect from 1 April 2019.

² <https://www.ofgem.gov.uk/publications-and-updates/consultation-potential-riio-ed1-mid-period-review>

³ <https://www.westernpower.co.uk/Financial-Information-Announcement-April.aspx>

Interested parties are requested to submit their views on or before **29 June 2018** to Grant McEachran at Ofgem, 10 South Colonnade, Canary Wharf, London, E14 4PU, or by email to RIIO.ED1@ofgem.gov.uk.

We normally publish all responses on our website. However, if you do not wish your response to be made public then please clearly mark it as confidential. We prefer to receive responses in an electronic form so that they can be placed easily on our website.

If you have any queries in relation to the issues raised in this letter, please feel free to contact Grant McEachran at RIIO.ED1@ofgem.gov.uk.

Yours sincerely,

Steve McMahon
Deputy Director, Electricity Distribution and Cross Sector Policy, Systems and Networks

Annex 1 – Notice of statutory consultation

To: **Western Power Distribution (West Midlands) plc (WMID)**
Western Power Distribution (East Midlands) plc (EMID)
Western Power Distribution (South Wales) plc (SWALES)
Western Power Distribution (South West) plc (SWEST)

Electricity Act 1989 Section 11A(2)

Notice of statutory consultation on a proposal to modify Special Licence Condition CRC 3F and to modify the ED1 Price Control Financial Handbook held by the above licensees

1. The Gas and Electricity Markets Authority ('the Authority')¹ proposes to modify:
 - (a) the electricity distribution licences granted or treated as granted under section 6(1)(c) of the Electricity Act 1989 ('the Act') to the above licensees by amending Special Licence Condition CRC 3F: Arrangements for the recovery of uncertain costs (CRC 3F) in the manner set out in Annex 2; and
 - (b) the ED1 Price Control Financial Handbook ('the Handbook') held by the above specified licensees by amending the Handbook in the manner set out in Annex 3.
2. The Authority considers that it is necessary to modify Special Licence Condition CRC 3F and the Handbook in the manner indicated in response to WPD's voluntary return to customers of £77m of unspent capital costs following the UK Government's cancellation of rail electrification schemes and to ensure WPD has an uncertainty mechanism to enable recovery of future rail electrification costs.
3. The effect of these proposed modifications is to enable WPD to recover any costs should a future change in Government policy require diversions work due to rail electrification in their licence areas.
4. A copy of the proposed modifications and other documents referred to in this Notice have been published on our website (www.ofgem.gov.uk). Alternatively they are available from our Research and Information Centre, (foi@ofgem.gov.uk)
5. Any representations with respect to the proposed licence modifications must be made on or before **29 June 2018** to Grant McEachran at Ofgem, 10 South Colonnade, Canary Wharf, London, E14 4PU, or by email to RIIO.ED1@ofgem.gov.uk.
6. We normally publish all responses on our website. However, if you do not wish your response to be made public then please clearly mark it as not for publication. We prefer to receive responses in an electronic form so they can be placed easily on our website.
7. If we decide to make the proposed modifications, they will take effect from 1 April 2019.

.....
Steve McMahon
Deputy Director, Systems & Networks
Duly Authorised on behalf of the Gas and Electricity Markets Authority
1 June 2018

Annex 2 – Proposed modifications to Special Licence Condition CRC 3F. Arrangements for the recovery of uncertain costs

Deletions are shown in strike through and new text is double underlined>.

CRC 3F. Arrangements for the recovery of uncertain costs

Introduction

3F.1 This condition establishes a mechanism:

- (a) to specify the basis on which the licensee’s opening levels of allowed expenditure on uncertain cost activities, as specified in Table 1, can be revised; and
- (a) to determine any appropriate revisions to PCFM Variable Values for the licensee relating to uncertain cost activities and the Regulatory Years to which they relate, for the purposes of the Annual Iteration Process for the ED1 Price Control Financial Model as described in CRC 4B (Annual Iteration Process for the ED1 Price Control Financial Model).

3F.2 The categories of cost related to uncertain cost activities referred to in this condition and the associated PCFM Variable Values are set out in Table 1 below:

Table 1: Categories of cost related to uncertain cost activities and associated PCFM Variable Values

Category of cost	PCFM Variable Value name
High Value Project Costs	UCHVP values
Enhanced Physical Site Security Costs	UCEPS values
Specified Street Works Costs	UCSSW values
<u>Rail Electrification Costs</u>	<u>UCRE values</u>

3F.3 The PCFM Variable Value for the licensee, for each uncertain cost activity, for a particular Regulatory Year, revised in accordance with this condition as applicable, represents the total amount of allowed Totex expenditure (in 2012/13 prices) for that uncertain cost activity for that Regulatory Year.

3F.4 The opening levels of allowed expenditure for the licensee, for High Value Project Costs and Enhanced Physical Site Security for each Regulatory Year, as at 1 April 2015 (that is, before any relevant adjustments have been made under the provisions of this condition), are set out in Appendix 1 and 2 to this condition and were used in the calculation of the Opening Base Revenue Allowance for the licensee.

3F.5 The opening PCFM Variable Value for the licensee for Specified Street Works Costs (being the opening value for UCSSW) for each Regulatory Year, as at 1 April 2015 (that is, before any relevant adjustments have been made under the provisions of this condition) is zero. The opening PCFM Variable Value for the licensee for Rail Electrification Costs (being the opening value for UCRE) for each Regulatory Year, as at 1 April 2019, is zero⁴, although the licensee's Opening Base Revenue Allowance does include expenditure for Rail Electrification Costs.

3F.6 This condition should be read and construed in conjunction with CRC 4A (Governance of ED1 Price Control Financial Instruments) and CRC 4B.

Part A: Proposal and determination of relevant adjustments to allowed levels of expenditure on uncertain cost activities

3F.7 This Part provides for:

- (a) the proposal of relevant adjustments by the licensee or by the Authority;
- (b) the determination of relevant adjustments by the Authority; and
- (c) the deeming of relevant adjustments in certain circumstances.

(a) Proposal of relevant adjustments

3F.8 The licensee (subject to paragraphs 3F.9 and 3F.10) may, by Notice to the Authority, and the Authority (subject to paragraphs 3F.9 and 3F.11) may, by Notice to the licensee, propose a relevant adjustment to the allowed level of expenditure on any uncertain cost activity listed in Table 1 for any Regulatory Year during the Price Control Period, provided that the proposed change to the level of allowed expenditure:

- (a) is 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;
- (b) takes account of any relevant adjustments previously determined under this condition;
- (c) constitutes a material amount as specified for the licensee in Appendix 1, 2 or 3 (as the case may be) to this condition;
- (d) relates to costs incurred or expected to be incurred after 1 April 2015 for High Value Project Costs, Enhanced Physical Site Security Costs and Specified Street Works Costs, and after 1 April 2018 for Rail Electrification Costs; and
- (e) constitutes an adjustment to allowed expenditure that (excluding any Time Value of Money Adjustment) cannot be made under the provisions of any other condition of this licence.

⁴ Any Rail Electrification Costs incurred in the Regulatory Year 2018/19 will be recorded in the PCFM under the Regulatory Year of 2019/20.

3F.9 A proposal made under paragraph 3F.8 must include statements setting out:

- (a) the uncertain cost activities to which the proposal relates;
- (b) the changes to the licensee's allowed level of expenditure that is proposed and the Regulatory Years to which those changes relate; and
- (c) the basis of calculation for the changes to the licensee's allowed level of expenditure.

(b) Application windows for relevant adjustment proposals

3F.10 Subject to 3F.10(a), the licensee may only give Notice of a proposed relevant adjustment during the application window that opens on 1 May 2019 and closes on 31 May 2019.

- (a) In respect of Rail Electrification Costs, the licensee may only give Notice of a proposed relevant adjustment during the application window that opens on 1 May 2022 and closes on 31 May 2022.

3F.11 The Authority may only give Notice of its intention to make a relevant adjustment in respect of High Value Project Costs at the end of the Price Control Period during the Notice window that opens on 1 December 2023 and closes on 31 December 2023.

(c) Authority's power to determine relevant adjustments

3F.12 Where a proposal has been duly made by the licensee under paragraph 3F.8, the Authority will, within four months of the close of the application window, determine any revisions that are to be made to the licensee's allowed level of expenditure for the uncertain cost activities concerned and the Regulatory Years to which those revisions relate, in accordance with the methodologies set out in the following parts of chapter 7 of the ED1 Price Control Financial Handbook:

- (a) Part 2 – in respect of High Value Project Costs;
- (b) Part 3 – in respect of Enhanced Physical Site Security Costs; ~~and~~
- (c) Part 4 – in respect of Specified Street Works Costs; and
- (d) Part 4A – in respect of Rail Electrification Costs.

3F.13 If, within 10 working days of receipt of a proposal under paragraph 3F.8, the Authority gives Notice to the licensee:

- (a) specifying any further information or analysis, or reformatting of the information or analysis already provided, that it reasonably considers is required in order to assess the proposal; and
- (b) requesting the licensee to provide that further or reformatted information or analysis,

the application window will be treated as remaining open for the purposes of this Part A until the later of the closing date referred to in paragraph 3F.10 and the date on which such further or reformatted information or analysis is provided.

- 3F.14 The giving of Notice under paragraph 3F.13 shall not preclude the Authority from making such further requests for information or analysis, or for the reformatting of information or analysis already provided, as it may consider it requires to assess the proposal.
- 3F.15 In determining any revision under paragraph 3F.12, the Authority will:
- (a) consult with the licensee and other interested parties;
 - (b) have regard to the basis on which the opening level of allowed expenditure for the relevant uncertain cost activities were set for the licensee;
 - (c) have regard to comments duly received in response to the consultation conducted under paragraph 3F.15(a); and
 - (d) take no account of the general financial performance of the licensee under the price control arrangements set out in the Charge Restriction Conditions of this licence.
- 3F.16 A determination under paragraph 3F.12 may confirm, reject, or amend the proposed relevant adjustment.
- 3F.17 Without limiting the general effect of paragraph 3F.16, a determination by the Authority of a relevant adjustment may specify revisions to the allowed level of expenditure for the relevant uncertain cost activities for the licensee for any Regulatory Year within the period 2015/16 to 2022/23.
- 3F.18 A determination under paragraph 3F.12 will specify:
- (a) the uncertain cost activities that are the subject of the determination;
 - (b) the Regulatory Years to which the determination applies; and
 - (c) the revised total level of allowed expenditure (in 2012/13 prices) for the relevant uncertain cost activities specified under 3F.18(a) for each of the Regulatory Years specified under 3F.18(b).⁵
- 3F.19 If the Authority has not determined a relevant adjustment in relation to a proposal duly made by the licensee under paragraph 3F.8 within four months of the close of the application window, and the proposal has not been withdrawn, then the relevant adjustment, insofar as it relates to a revision to the allowed level of expenditure on the relevant uncertain cost activities for the licensee for the Regulatory Years specified in the proposal, will be deemed to have been made.

Part B: Procedure to be followed for the determination and direction of revised PCFM Variable Values

- 3F.20 This Part provides for the determination and direction of revisions to the following PCFM Variable Values for the licensee:
- (a) High Value Project Costs (UCHVP values)
 - (b) Enhanced Physical Site Security Costs (UCEPS values); ~~and~~
 - (c) Specified Street Works Costs (UCSSW values); and

⁵ In the case of Rail Electrification Costs, a determination under paragraph 3F.12 will specify the revised UCRE adjustment (in 2012/13 prices) for each of the Regulatory Years specified under 3F.18(b).

- (d) Rail Electrification Costs (UCRE values).
- 3F.21 Determinations under paragraph 3F.20 are to be made in accordance with the provisions of chapter 7 of the ED1 Price Control Financial Handbook.
- 3F.22 Subject to 3F.22(a), Revised PCFM Variable Values for the licensee, as determined under paragraph 3F.20 will be directed by the Authority by 30 November in Regulatory Year 2019/20.
- (a) In respect of Rail Electrification Costs, revised PCFM Variable Values for the licensee, as determined under paragraph 3F.20 will be directed by the Authority by 30 November in Regulatory Year 2022/2023.
- 3F.23 A direction under paragraph 3F.22 will be of no effect unless, before issuing it, the Authority has:
- (a) by Notice to the licensee set out all of the revised PCFM Variable Values that it proposes to direct;
- (b) stated in that Notice that those values have been determined in accordance with Part B of this condition;
- (c) specified in the Notice the period (which may not be less than 14 days from the date of the Notice) within which the licensee may make representations to the Authority; and
- (d) considered any representations duly received in response to the Notice.
- 3F.24 Where the Authority directs any revised PCFM Variable Values for Regulatory Years earlier than Regulatory Year t, the effect of using those revised values in the Annual Iteration Process for the ED1 Price Control Financial Model will, subject to a Time Value of Money Adjustment, be reflected in the calculation of the term MOD for the licensee for Regulatory Year t, and will not have any retroactive effect on a previously directed value of the term MOD.

Part C: Interpretation

3F.25 For the purposes of this condition:

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 within the licensee's Distribution System as may be further clarified in the RIGs.
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**Specified Street
Works Costs**

means the 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,
- all as further clarified in the RIGs.

**Rail Electrification
Costs**

means costs incurred, or expected to be incurred, other than those recoverable from a third party, associated with the diversion of electric lines or electrical plant to facilitate rail electrification projects approved for funding by the Secretary of State for Transport, as may be further clarified in the RIGs.

APPENDIX 1:

Opening level of allowed expenditure for High Value Project Costs and the material amount for each licensee

(£m, in 2012/13 prices)

(see paragraphs 3F.4 and 3F.8)

	Opening level of allowed expenditure								Material amount
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	
ENWL									
NPgN									
NPgY									
WMID	-	-	-	-	-	-	-	-	5.7
EMID	-	-	-	-	-	-	-	-	5.7
SWALES	-	-	-	-	-	-	-	-	2.9
SWEST	-	-	-	-	-	-	-	-	4.2
LPN									
SPN									
EPN									
SPD									
SPMW									
SSEH									
SSES									

Named High Value Projects and the opening levels of allowed expenditure for each project (£m, in 2012/13 prices)

		Opening level of allowed expenditure							
	Named projects	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
ENWL									
NPgN									
NPgY									
WMID	-	-	-	-	-	-	-	-	-
EMID	-	-	-	-	-	-	-	-	-
SWALES	-	-	-	-	-	-	-	-	-
SWEST	-	-	-	-	-	-	-	-	-
LPN									
SPN									
EPN									
SPD									
SPMW									
SSEH									
SSES									

APPENDIX 2:

Opening level of allowed expenditure for Enhanced Physical Site Security Costs and the material amount for each licensee

(£m, in 2012/13 prices)

(see paragraphs 3F.4 and 3F.8)

	Opening level of allowed expenditure								Material amount
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	
ENWL									
NPgN									
NPgY									
WMID	-	-	-	-	-	-	-	-	5.7
EMID	-	-	-	-	-	-	-	-	5.7
SWALES	-	-	-	-	-	-	-	-	2.9
SWEST	-	-	-	-	-	-	-	-	4.2
LPN									
SPN									
EPN									
SPD									
SPMW									
SSEH									
SSES									

APPENDIX 3:

The material amount for Specified Street Works Costs for each licensee

(£m, in 2012/13 prices)

(see paragraphs 3F.8)

	Material amount
ENWL	
NPgN	
NPgY	
WMID	5.7
EMID	5.7
SWALES	2.9
SWEST	4.2
LPN	
SPN	
EPN	
SPD	
SPMW	
SSEH	
SSES	

Annex 3 – Proposed modifications to the ED1 Price Control Financial Handbook (fast-track licensees)

Changes are proposed to the following sections:

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Chapter 2. The ED1 Price Control Financial Methodologies

- a. Table 2.1 – PCFM Variable Values that can be revised under CRCs and the methodologies in this handbook

Chapter 6. Totex Incentive Mechanism – financial adjustment methodology

- a. Table 6.1 – Charge Restriction Conditions with provisions to revise PCFM Variable Values relating to allowed Totex expenditure levels

Chapter 7. Uncertain costs allowed expenditure – financial adjustment methodology

- a. Section 1 – Overview
- b. Section 4A – Methodology for determining relevant adjustments in respect of Rail Electrification Costs

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Chapter 2. The ED1 Price Control Financial Methodologies

- a. Table 2.1 – PCFM Variable Values that can be revised under CRCs and the methodologies in this handbook

PCFM Variable Value	Charge Restriction Condition	Description	Type of variable value	Values at 1 April 2015	Revised values (where directed)
<u>Specified financial adjustments</u>					
EDE (chapter 3)	CRC 3C	Pension Scheme Established Deficit	revenue adjustment	Allowances for Pension Scheme Established Deficit repair used in the calculation of Opening Base Revenue Allowances.	Revised allowances for Pension Scheme Established Deficit repair.
TTE (chapter 4)		Tax liability – tax trigger events	revenue adjustment	Zero.	Incremental change to tax liability allowances.
TGIE (chapter 4)		Tax liability – Gearing/interest costs	revenue adjustment	Zero.	Incremental change to tax liability allowances (nominal prices) ⁶ .
CDE (chapter 5)		Allowed percentage cost of corporate debt	percentage	Opening allowed percentage cost of corporate debt.	Revised allowed percentage cost of corporate debt.
<u>Totex Incentive Mechanism</u>					
ALC (chapter 6)	CRC 3B	Actual load-related capex expenditure	actual expenditure	Equal to allowed expenditure level for load-related capex.	Actual load-related capex expenditure reported by licensee.

⁶ Subject to iterative modelling effect - see paragraph 4.6 in chapter 4.

PCFM Variable Value	Charge Restriction Condition	Description	Type of variable value	Values at 1 April 2015	Revised values (where directed)
ANLR (chapter 6)		Actual non-load-related capex expenditure - asset replacement	actual expenditure	Equal to allowed expenditure level for non-load-related capex – asset replacement.	Actual non-load-related capex – asset replacement expenditure reported by licensee.
ANLO (chapter 6)		Actual non-load-related capex - other	actual expenditure	Equal to allowed expenditure level for non-load-related capex - other.	Actual non-load-related capex - other expenditure reported by licensee.
AFE (chapter 6)		Actual faults expenditure	actual expenditure	Equal to allowed expenditure level for faults.	Actual faults expenditure reported by licensee.
ARP (chapter 6)		Actual 100% 'revenue pool' expenditure	actual expenditure	Equal to allowed 100% 'revenue pool' expenditure level.	Actual 100% 'revenue pool' expenditure reported by licensee.
ACO (chapter 6)		Actual controllable opex expenditure	actual expenditure	Equal to allowed expenditure level for controllable opex.	<u>Actual controllable opex</u> expenditure reported by licensee.
TRE (chapter 6)		Actual tree cutting expenditure	actual expenditure	Equal to allowed expenditure level for tree cutting.	Actual tree cutting expenditure reported by licensee.
Allowed Totex expenditure adjustments					

PCFM Variable Value	Charge Restriction Condition	Description	Type of variable value	Values at 1 April 2015	Revised values (where directed)
UCHVP (chapter 7)	CRC 3F	Uncertain costs – High Value Projects	allowed expenditure	Allowed expenditure level on high value projects used in the calculation of Opening Base Revenue Allowances.	Revised (total) allowed expenditure level on high value projects.
UCEPS (chapter 7)		Uncertain costs – Enhanced Physical Site Security	allowed expenditure	Allowed expenditure level on enhanced physical site security used in the calculation of Opening Base Revenue Allowances.	Revised (total) allowed expenditure level on enhanced physical site security.
UCSSW (chapter 7)		Uncertain costs – Specified Street Works	allowed expenditure	Zero.	Total additional allowed expenditure level on specified street works.
<u>UCRE</u> (chapter 7)	<u>CRC 3F</u>	<u>Uncertain costs – Rail Electrification</u>	<u>allowed expenditure</u>	<u>Zero (As of 1 April 2019)</u>	<u>Total additional allowed expenditure level on rail electrification works.</u>
SMAE (chapter 8)	CRC 3E	Smart Meter Roll-out costs	allowed expenditure	Baseline level of allowed expenditure on Smart Meter Roll-out costs used in the calculation of Opening Base Revenue Allowances.	Revised (total) allowed expenditure level on Smart Meter Roll-out costs.

PCFM Variable Value	Charge Restriction Condition	Description	Type of variable value	Values at 1 April 2015	Revised values (where directed)
LRRC (chapter 9)	CRC 3G	Load Related Expenditure	allowed expenditure	Allowed expenditure level on Load Related Expenditure used in the calculation of Opening Base Revenue Allowances.	Revised (total) allowed level of Load Related Expenditure.
VAA (chapter 10)	CRC 3J	Visual Amenity Projects	allowed expenditure	Zero.	Revised (total) allowed expenditure level on Visual Amenity Projects.
WSCC (chapter 11)	CRC 3H	Worst Served Customer Projects	allowed expenditure	Zero.	Revised (total) allowed expenditure level on Worst Served Customer Projects.
IRM (chapter 12)	CRC 3D	Innovation Roll-out mechanism	allowed expenditure	Zero.	Revised (total) allowed expenditure level on Innovation Roll-out.
RE (chapter 12A)	CRC3K	Rail electrification ⁷	allowed expenditure	Allowed expenditure level on rail electrification used in the calculation of Opening Base Revenue Allowances.	Revised (reduced total) allowed expenditure level on rail electrification.
Legacy price control adjustments					
LTPG LTPS	CRC 3A	Legacy adjustments to opening tax pool balances	balance adjustment	Zero.	Incremental change to tax pool balances.

PCFM Variable Value	Charge Restriction Condition	Description	Type of variable value	Values at 1 April 2015	Revised values (where directed)
LTPD LTPC (chapter 14)					
OLREV		Legacy adjustments to revenue allowances other than those associated with the DPCR5 RAV Rolling Incentive mechanism	revenue adjustment	Zero.	Legacy revenue adjustment.
OLRAV (chapter 15)		Legacy adjustments to RAV additions	RAV balance adjustment	Zero.	Incremental change to 2013/14 and 2014/15 RAV additions
RIREV (chapter 16)		Legacy adjustments associated with the DPCR5 RAV Rolling Incentive mechanism	revenue adjustment	Zero.	Legacy revenue adjustment.

⁷ Applicable to WPD licensees only – see chapter 12A

Chapter 6. Totex Incentive Mechanism – financial adjustment methodology

- a. Table 6.1 – Charge Restriction Conditions with provisions to revise PCFM Variable Values relating to allowed Totex expenditure levels

Table 6.1 – Charge Restriction Conditions with provisions to revise PCFM Variable Values relating to allowed Totex expenditure levels

Charge Restriction Condition	PCFM Variable Value	Relating to	Handbook chapter
CRC 3F	UCHVP UCEPS UCSSW <u>UCRE</u>	Uncertain Costs High Value Projects Uncertain Costs Enhanced Physical Site Security Uncertain Costs Specified Street Works <u>Uncertain Costs Rail Electrification</u>	7
CRC 3E	SMAE	Smart Meter Roll-out Costs	8
CRC 3G	LRRC	Load Related Expenditure	9
CRC 3J	VAA	Visual Amenity (undergrounding)	10
CRC 3H	WSCC	Worst Served Customers	11
CRC 3D	IRM	Innovation Roll-out	12
CRC3K ⁸	RE	Rail electrification	12A

⁸ Applicable to WPD group licensees only – see paragraph 12A.1 of chapter 12A.

Chapter 7. Uncertain costs allowed expenditure – financial adjustment methodology

- a. Section 1 – Overview
- b. Section 4A – Methodology for determining relevant adjustments in respect of Rail Electrification Costs

Section 1 - Overview

7.1 At the outset of the Price Control Period for High Value Projects, Enhanced Physical Site Security Costs and Specified Street Works Costs, and allowances as at 1 April 2019 for Rail Electrification Costs, 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; ~~and~~
- (c) Specified Street Works Costs; and
- (d) Rail Electrification Costs.⁹

The licensee's Opening Base Revenue Allowances for High Value Projects, Enhanced Physical Site Security Costs and Specified Street Works Costs, and allowances as at 1 April 2019 for Rail Electrification Costs, 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 Values 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, they are set out against the licensee's name in the tables contained in Appendices 1 and 2 to CRC 3F. Opening levels of allowed expenditure on Specified Street Works Costs are set at zero. As of 1 April 2019, the UCRE variable value is set at zero, although the licensees' Totex does include allowed expenditure for Rail Electrification Costs. The PCFM Variable Values for the uncertain cost categories can be revised so that, when combined with amounts included in Totex allowances for Rail Electrification Costs, they continue to match allowed expenditure levels following any relevant adjustments under the provisions of CRC 3F and this chapter.

⁹ As part of WPD's RIIO-ED1 price control settlement, the distribution network operator's four licensees received ~£96m to cover the costs of diverting power lines to enable the electrification of rail lines. In July 2017, the UK Government announced that some projects, including within WPD's networks in the midlands and Wales, would not progress as previously planned. Following this, WPD volunteered to return to customers the unspent capital costs that are no longer required (£77m), on the condition that it is covered for any further change in policy resulting in increased spend on diversions. This takes the form of a change to WPD's licences to give it an uncertainty mechanism similar to that which applies to the other DNOs. Rail Electrification Costs has been added as an uncertain cost category, allowing WPD to recover costs should any future work be required in response to a change in UK Government plans.

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 categories

Uncertain cost category	PCFM Variable Value name	Licence Condition
High Value Project Costs	UCHVP	3F
Enhanced Physical Site Security Costs	UCEPS	3F
Specified Street Works Costs	UCSSW	3F
<u>Rail Electrification Costs</u>	<u>UCRE</u>	<u>3F</u>

7.5 PCFM Variable Values relating to uncertain cost categories 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 sub-divisions 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 to High Value Project Costs (UCHVP), Enhanced Physical Site Security Costs (UCEPS) and Specified Street Works Costs (UCSSW) runs from 1 May 2019 to 31 May

2019. The application window during which the licensee can propose relevant adjustments to Rail Electrification Costs (UCRE) runs from 1 May 2022 to 31 May 2022.

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 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).

7.11 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

7.12 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 paragraphs 7.8 – ie by 30 September 2019 for High Value Project Costs (UCHVP), Enhanced Physical Site Security Costs (UCEPS) and Specified Street Works Costs (UCSSW), and by 30 September 2022 for Rail Electrification Costs 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~~ and 4A, as applicable, of this chapter.

7.13 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.

7.14 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

7.15 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, or 3 (as the case may be) of CRC 3F;
- relate to costs incurred or expected to be incurred after 1 April 2015¹⁰; 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.

7.16 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.

7.17 The PCFM Variable Value for any particular Regulatory Year as revised, when combined with amounts included in Totex allowances for Rail Electrification Costs, represents the total amount of allowed Totex expenditure (in 2012/13 prices) for the uncertain cost activity concerned for that Regulatory Year.

¹⁰ For Rail Electrification Costs for WPD licensees, a proposed relevant adjustment to the level of allowed expenditure relates to costs incurred or expected to be incurred after 1 April 2018

Section 4A – Methodology for determining relevant adjustments in respect of Rail Electrification Costs

The uncertainty mechanism for additional Rail Electrification Costs

- 7.46 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.

As mentioned in the footnote to paragraph 7.1, WPD voluntarily returned £77 million of its allowed expenditure after the UK Government announced that it was scaling back on rail electrification projects in 2017. Due to uncertainty around future projects, an uncertainty mechanism has been added for Rail Electrification Costs applicable as of 1 April 2019.

- 7.47 The uncertainty mechanism provides for relevant adjustments in respect of efficient costs that were either not included in the calculation of the licensee's Opening Base Revenue Allowances, or which were included but have since been reduced.

Determination of a relevant adjustment proposed by the licensee

- 7.48 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 2022, the Authority will notify the licensee that the Notice has been submitted too early and should be resubmitted during May 2022. If the Notice has been received after 31 May 2022, 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;
 - 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 as specified in paragraph 3F.14 of CRC 3F within 10 working days of receipt of a proposal under paragraph 3F.8 of CRC 3F.

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) Not used.

(v) In reviewing the level of 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.

(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 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.

(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.

7.49 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 and in the case of Rail Electrification Costs, the revised UCRE adjustment for each of the Regulatory Years.

7.50 If the Authority receives Notice of a proposed relevant adjustment from the licensee in respect of Rail Electrification 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.

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