

To: Electricity Distribution  
Network Operators and other  
interested parties

Date: 18 September 2019

To whom it may concern,

**Notice of decision to revise allowed expenditure for Subsea Cable Costs under special licence condition CRC 3F**

Ofgem<sup>1</sup> introduced a number of uncertainty mechanisms for costs that were uncertain at the time of establishing the first RIIO electricity distribution price control (RIIO-ED1), which runs from 1 April 2015 to 31 March 2023. This includes re-opener mechanisms, which enable adjustments to electricity distribution network operators' allowances to accommodate costs associated with specific uncertain cost categories. These mechanisms are set out in Special Condition CRC 3F<sup>2</sup> of the Electricity Distribution Licence

Subsea Cable Costs was one such uncertain cost category. The mechanism was introduced to allow Scottish Hydro Electric Power Distribution (SHEPD)<sup>3</sup> to recover efficient costs of protecting subsea cables should they be required to do so. In 2015, Marine Scotland published the National Marine Plan<sup>4</sup>, which provides a framework for all marine activities in Scottish waters, including how subsea electricity cables are laid and protected on the seabed. The National Marine Plan states that subsea cables should be buried to maximise protection, unless it can be demonstrated that burial is not a feasible option. In these cases, cables should be suitably protected "where practicable and cost-effective and as risk assessment directs".

Since 2015, SHEPD has been developing a risk assessment tool (based on Cost Benefit Analysis (CBA) techniques) to understand if it needs to change its engineering practices to meet the requirements of Scotland's National Marine Plan, in terms of how subsea electricity cables are installed on the seabed.

SHEPD, which is part of Scottish and Southern Energy Networks (SSEN), gave notice to Ofgem of a proposed relevant adjustment of £58.9m (in 12/13 prices) for the period 2018/19 to 2022/23. The level of additional funding requested exceeds the required materiality threshold in order to trigger an adjustment for Subsea Cable Costs (£4.54m).<sup>5</sup>

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<sup>1</sup> References to the "Authority", "Ofgem" "we" and "our" are used interchangeably in this document to refer to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work.

<sup>2</sup> Charge Restriction Condition 3F: Arrangements for the recovery of uncertain costs.

<sup>3</sup> This mechanism was only made available to SHEPD.

<sup>4</sup> <https://www.gov.scot/publications/scotlands-national-marine-plan/>

<sup>5</sup> As specified in Appendix 8 to CRC 3F of the special licence conditions.

We recently consulted on our minded-to position with regard to the proposed adjustments,<sup>6</sup> which was to adjust SHEPD’s allowances by £42.5m. SHEPD were the only respondent to the consultation. We have decided to allow SHEPD £45.2m for Subsea Cable Costs, which is an increase of £2.8m from our minded to position. In making our decision we have considered SHEPD’s response to our consultation, and taken account of our principal objectives under the Electricity Act 1989 as well as our powers and duties under the Acts and under the licences. This letter sets out our decision on the adjustment to SHEPD’s revenues.

We have decided to allow:

- £0m of the £6.2m requested by SHEPD for subsea cable inspection costs. We make no adjustment from our initial view.
- £33.7m of the £37.7m requested by SHEPD for subsea proactive replacement costs. We make no adjustment from our initial view.
- £5.9m of the £9.4m requested by SHEPD for subsea cable fault costs. This is an increase of £2.8m from our initial view.
- £5m of indirect costs and £0.6m of costs associated with SHEPD’s marine licence cost benefit analysis (CBA). We make no adjustment from our initial view as requested by SHEPD in its reopener submission.

Our final decision for SHEPD’s allowances are set out below. Additional information explaining our decision is provided in Appendix A.

**SHEPD adjustment profiled over RIIO-ED1 (12/13 prices) (£m)**

2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	RIIO-ED1 total
1.4	5.4	3.8	8.2	3.2	3.5	9.4	10.4	45.2

Our decision will be implemented through the 2019 Annual Iteration Process, which will mean that any adjustments to SHEPD’s allowed revenues will take effect from 2020/21.

Yours faithfully,

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

<sup>6</sup> <https://www.ofgem.gov.uk/publications-and-updates/consultation-our-minded-position-revise-allowed-expenditure-subsea-cable-costs>

## Appendix A: Responses to consultation

In our consultation, we sought views on the question set out below. A summary of the response and our view is provided. We received one response to our consultation which was from SHEPD.

### **1. Do you agree with Ofgem's assessment and the proposed adjustment of £42.5m to SHEPD's allowed expenditure for Subsea Cable costs?**

#### Subsea Cable Inspections

As part of its submission, SHEPD requested £6.2m for inspection costs. We proposed to allow no additional allowance for this programme of work in our initial view. Through its consultation response and in answer to supplementary questions, SHEPD provided Ofgem with further evidence to justify its request and we have taken this into account when making our decision.

This included further evidence to justify that its inspections are an important part of a risk-based approach to asset management, which supports its determination of which subsea cables are at risk of failure and, therefore, need to be repaired or replaced. As in its original submission, in its consultation response SHEPD set out that, under the National Marine Plan and marine licence regime, the inspections required in order to discharge its obligations are more onerous than its previous subsea inspection programme. SHEPD argues that if it had continued with its previous inspection methods, the incremental costs to customers would have been far higher.

As set out in our consultation, we believe the inspection process set out in its RIIO-ED1 business plan, if undertaken to a sufficient level to meet the requirements of the Common Network Asset Indices Methodology (CNAIM), should have also met the standards of the National Marine Plan. In such a circumstance, SHEPD would be able to prioritise its existing programme of work to meet the requirements of the National Marine Plan. Therefore, we make no adjustment from our minded to position.

In SHEPD's consultation response it proposed that subsea cable costs incurred in relation to inspections in RIIO-ED2 should be considered as part of the RIIO-ED1 closeout process. We reject this proposal as we believe SHEPD's inspection process, as above, should be of a sufficient standard to inform its RIIO-ED2 programme of work.

#### Proactive cable replacement protection costs

As part of the RIIO-ED1 business plan, SHEPD requested an allowance of £44.6m to proactively replace<sup>7</sup> 112km of subsea cables. In its final determination<sup>8</sup>, Ofgem gave an allowance of £36.9m to replace 85.1km.

As part of its application under this mechanism, SHEPD requested additional allowances to protect 95.2km of subsea cable under its proactive subsea cable programme. In SHEPD's consultation response it argued that our assessment was crude and lacks any basis given SHEPD has provided a work plan for RIIO-ED1, with specific protection requirements. SHEPD provided further evidence to justify its request of 95.2km which we have considered in reaching our decision. While we considered that SHEPD's reopener submission met the criteria that "*the costs submitted are based on auditable evidence and justification...*"<sup>9</sup> we

<sup>7</sup> This does not include protection of cables.

<sup>8</sup> <https://www.ofgem.gov.uk/publications-and-updates/riio-ed1-final-determinations-slow-track-electricity-distribution-companies>

<sup>9</sup> Paragraph 3F.31 of CRC 3F – Arrangements for the recovery of uncertain costs, available here: <https://epr.ofgem.gov.uk/Content/Documents/Scottish%20Hydro%20Electric%20Power%20Distribution%20Plc%20-%20Special%20Conditions%20Consolidated%20-%202018-12-2018%20-%20Current%20Version.pdf>

do not believe sufficient evidence was provided to give us certainty of its replacement plans for the remainder of RIIO-ED1. This was primarily because a significant proportion of its subsea cable asset base is yet to be inspected, and only three of its sixteen cable works are underway. This uncertainty does not provide us with the confidence to allow the volumes requested by SHEPD.

We make no adjustment to our minded to position and reject the volumes that SHEPD has submitted to us, and accept the protection costs for the efficient view of volumes decided in Ofgem's final determination: 85.1km. We have applied a reduction to SHEPD's request based on our efficient view of volumes set in RIIO-ED1. Any additional volumes that SHEPD believe should be protected will be subject to the Totex Incentive Mechanism.

We have decided to maintain our minded to position, and adjust SHEPD's allowance for its proactive protection of cables by £33.7m. This is £4m lower than the £37.7m proposed by SHEPD.

### Subsea Cable Faults

As part of its application under this mechanism, SHEPD requested £9.4m additional allowances to protect cables that have been replaced due to a fault. In our initial view we were minded to allow £3.1m for this programme of work. Following our review of SHEPD's consultation response and further conversations with SHEPD, we have revised our minded-to position to now allow SHEPD £5.9m.

In our initial assessment, we reviewed the fault data provided to us by the DNOs in their annual submissions. In our consultation, we used SHEPD's historical fault rates across DPCR5 and RIIO-ED1 to date (8 years) and applied these to SHEPD's application. In SHEPD's response to our consultation it raised concerns with our calculation of fault rates and argued that applying an average annual fault rate was incorrect. We acknowledge SHEPD's proposal and accept SHEPD's methodology, but we do not agree with its use of a fault rate of 3.6 faults per annum. Based on this further evidence provided to us by SHEPD, we accept SHEPD's request of £3.66m in relation to the three faults that it has incurred to date. We outline our assessment of its forecast costs below.

In SHEPD's slow track RIIO-ED1 business plan submission, it forecast an average fault rate of 2.2 faults per annum. We believe that the increase in SHEPD's fault rate from its RIIO-ED1 business plan and its request under this reopener was a result of SHEPD's approach to monitoring and managing these assets, and reject the use of a fault rate of 3.6 faults per annum. We have used SHEPD's RIIO-ED1 business plan fault rate in our decision. Within SHEPD's submission, it applied a forecast reduction to 0.5 faults per annum. We apply this forecast reduction in our analysis and allow SHEPD £2.26m for its forecast fault costs.

We adjust SHEPD's RIIO-ED1 allowances by £5.9m for their subsea fault programme. This is £3.5m lower than the £9.4m proposed by SHEPD.