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10 September 2019

Dear RIIO-ED1 Team

Response to RIIO-ED1 Reopener Consultation – Specified Street Works costs

We write in response to your consultation paper dated 2 August 2019 setting out Ofgem's proposed allowances in respect of the RIIO-ED1 Specified Street Works Costs (SSWC) reopener submissions under Charge Restriction Condition (CRC) 3F of the Electricity Distribution Licences.

We concur with Ofgem's assessment of the Licence conditions and Price Control Financial Handbook considerations as set out in paragraph 2.2 to 2.6 of the consultation. We also support Ofgem's approach to lane rental costs and logging up as set out in paragraphs 2.18 to 2.20. We do, however, consider that a review of the need for Licence drafting to support this should be undertaken to ensure that the strategy decision intent¹ can be delivered in practice. In particular it needs to be made clear that the materiality threshold will not be reset.

We also suggest some proposed developments to Ofgem's approach and consider that some errors have been made that we request Ofgem reconsiders, including the use of industry benchmarks where DNO specific costs should be used.

Broadly speaking we support using benchmarking to inform checking of costs and where appropriate, and carefully applied, for aspects of future funding. Having said this, we do not consider that benchmarking of our historic costs is applicable when we experienced such a rapid change in the volumes of permitting activity over the first four years of ED1 and consider that the historic costs we have reported should be fully funded as they were efficiently incurred at the time. However, should Ofgem retain the benchmarking approach then we consider that a wider set of data should be used to set the benchmarks, applying statistical techniques to select the relevant data, and have provided a copy of our proposed model.

Additionally we do not support the application of the 3% p.a. compounding efficiency assumption due to its divergence from historical price control assumptions and a lack of evidence for its application.

We set out our proposed developments in more detail below.

¹ https://www.ofgem.gov.uk/sites/default/files/docs/2013/02/riioed1decuncertaintymechanisms_0.pdf

1. Benchmarking

We have a number of concerns over the use of benchmarking, as set out below.

1.1 Permit fees

It is inappropriate to benchmark permit fees as these are set externally by Highway Authorities. Permit fees vary dependent on the category of the road and whether it is deemed traffic sensitive or not. In the majority of cases, due to the nature of the electricity distribution network, DNOs have limited scope to determine where work on the network is undertaken and therefore very limited opportunity to influence the level of the fees. We therefore don't consider that benchmarking should be applied to permit fees.

1.2 Condition costs

We also consider the benchmarking of condition costs to be inappropriate due to differences in the application of permit conditions between individual Highway Authorities. Even within our own licensed area we have evidence of differing behaviours in the application of permit conditions (see our comments in paragraph 2.5 below). In addition, our experience is that certain conditions cause us to incur greater costs than others, and therefore the weighting of the various conditions between licensees in their own local areas will affect the average cost of conditions per permit.

1.3 Administration costs

Benchmarking administration costs is also an inappropriate approach. DNOs that already had an established portfolio of permit schemes at the beginning of RIIO-ED1 would have had time to implement and embed administrative processes and be running them as business as usual. ENWL had only one permit scheme in place at the beginning of RIIO-ED1. Despite the rapid increase in permit coverage over the subsequent three years our administration unit costs reduced each year, as you would expect due to volume efficiencies. These volume efficiencies are now largely exhausted as we have full application of permitting going forward. We therefore used our 2017/18 unit cost for forecasting as this was the lowest achieved to date and we consider this to represent a cost target we should set ourselves going forward. We actively did not propose an average cost benchmark.

1.4 Benchmarking - further considerations

Benchmarking should not result in the average cost being considered efficient for all, especially in areas such as street works where there are different requirements from Highway Authorities in each DNO area.

Notwithstanding the above we appreciate that Ofgem may need to undertake some comparative analysis between DNOs to calculate future unit costs. However, if this is the case, it would seem appropriate to include data from more DNOs, noting the wider range of variability driven by local conditions and only excluding clear outliers. This can be achieved using the inter-quartile range rule to detect outliers.

For condition costs this would result in only WPD WMID's data being excluded and will result in a more accurate benchmark than using the data of only three DNOs (SPMW, EPN and ENWL as set out in Ofgem's consultation).

The data provided for administration costs does seem to contain extremes, specifically for NPgN, NPgY and SSE where unit rates are between £1.79 and £3.76, and so does not lend itself to the inter-quartile range approach. Hence the data for these DNOs, along with the administration costs for WPD EMID and WMID (appearing exceptionally high), should be removed from all calculations.

We have attached as Appendix 1 our calculation of the efficient unit rate for permit fees, administration costs and condition costs on this basis which results in an efficient unit rate for permit fees of £45.41 (from £48.81), of £21.32 (from £20.86) for administration costs and of £76.68 (from £69.04) for condition costs.

2. Proposed efficiency assumption

Ofgem's proposed efficiency assumption of 3% for street works costs represents a significant divergence from other historical price control determinations and we can see no evidence for its use given our already efficient level of costs, as assessed by Ofgem. In the consultation, Ofgem notes that it believes the assumption is reasonable based upon two points.

- The assumed annual 3% reduction is consistent with its RIIO-GD1 SSWC reopeners in 2018.
- Opportunities are available to reduce costs by managing the number of permit variations, innovative solutions, improved efficiency of administrative processes and through working more closely with Highways Authorities.

These points are discussed in detail below.

2.1 The assumed annual 3% reduction is consistent with its RIIO-GD1 SSWC reopeners in 2018.

Ofgem included an efficiency improvement of 3% per year to "account for efficiencies within Cadent's administration as its processes improve and settle (e.g. training impacts and staff becoming more experienced)". The rationale for the efficiency rate was that Ofgem "can see efficiencies made in the submitted year-on-year data, reflecting ongoing improvements in Cadent's systems and processes". No quantitative data or external consultant reports were provided to support the assumption on how or why the perceived rate of efficiency improvement for street works costs would significantly exceed the overarching rate of improvement assumed in the GD1 price controls (set at 1% pa). Within our reopener a number of largely exogenously controlled upwards price pressures (Highway Authorities revising permit fees, market rates for labour) have been identified that we will already have to drive very hard to offset by efficiency gains.

A review of previous price control assumptions on productivity also indicates that the 3% assumption is not consistent with the calculated rate of efficiency improvement (as well as being especially inappropriate in this specific area).

Various regulators (including Ofgem, CMA, ORR and UR) use largely consistent assumed rates of productivity across opex and capex activities. These assumptions are supported by detailed assessments of EU KLEMS data across various relevant activities by the appointed economic consultants. The current working assumption for efficiency in street works is three times higher than the historically established rate of productivity, without an evidenced based explanation as to why it would differ so significantly and indeed in an area where we identify specific upwards cost drivers which we have evidenced in chapter 10 of our submission. We have not been able to establish the relative position of Cadent's efficiency to ours but consider the 3% pa efficiency applied to their reopener is effectively a company specific view taken by Ofgem and so cannot be transposed to another sector and to different company specific circumstances.

2.2 Opportunities are available to reduce costs by managing the number of permit variations, innovative solutions, efficiency of administrative processes and through working more closely with Highways Authorities.

The efficiency rate included in the determination is assumed to be appropriate as Ofgem notes that there are opportunities available to reduce costs. There are two issues with this assumption. Ofgem's analysis does not distinguish between the general rate of productivity available to all efficient networks (frontier shift) and the opportunities available for inefficient companies to move to the efficiency frontier (catch up). Through its comparative analysis, Ofgem will have removed (or at least

minimised) the inefficient costs in the applications and provided allowances based upon those efficient “frontier” costs. With the “catch up” costs removed, the remaining efficiency must be delivered by the general rate of efficiency which, as previously noted, is generally determined to be 1% pa.

Ofgem has further stated, in paragraph 2.17, that permit variations and the associated costs are inefficient, and that it expects all DNOs to “avoid or completely minimise permit variation costs”. As stated in our submission document (section 7.3.1), while Electricity North West aims at all times to minimise permit modifications and variations, there are certain circumstances where it might be necessary to submit a permit variation in the form of a permit modification request (PMR) to ensure works are completed in a manner that minimises disruption to our customers or indeed to meet a customer’s request.

Additionally, if a Highway Authority needs to make a change to an already granted permit it can do so by sending the utility an Authority Imposed Variation (AIV). There is no charge for this form of variation but the AIV will still require the utility responsible for the works (or its contractor) to review, modify and resubmit the permit application within a set timescale and in a prescribed format and to then ensure the works are carried out in accordance with the requirements of the varied permit.

Ofgem has also stated that efficiencies can be achieved by DNOs working more closely with Highway Authorities. As set out in section 9.4 of our submission, we already work closely with all Highway Authorities in our area. We attend regular street works performance meetings which have a set agenda and are supported by jointly agreed performance reports. We also follow the Highway Authority and Utility Committee (HAUC) (England) recommended process for the assessment and recording of permit conditions. This “right first time approach” seeks to ensure that the initial permit application contains all relevant and appropriate permit conditions leading to maximum efficiencies through reduced administration for all parties.

2.3 Permit fee costs

As explained in our submission (section 3.4), permit fees are set by individual Highway Authorities in order to meet the costs of introducing and operating permit schemes. Permit fees can be reviewed by the operating Highway Authority every three years but cannot be set at a level that exceeds the maximum allowable fee as set by the DfT. Permit fee costs are therefore outwith the control of DNOs and additionally, in Electricity North West’s experience, a Highway Authority review of permit fees has never resulted in a reduction in fees.

It is therefore not appropriate to apply a 3% pa efficiency reduction to permit fee costs.

2.4 Administration costs

As stated in our submission (section 3.5.4) we have already used our lowest administrative unit cost achieved to date for the purposes of forecasting our administrative costs because we consider this to be the target that we should achieve going forward. We do not consider that a further 3% pa efficiency saving is realistic. We do however consider that there may be some room for improvement and that a 1% efficiency reduction for future costs, in line with generally accepted rate of efficiency as set out above, is the upper limit of any efficiency target.

2.5 Condition costs

Ofgem states in its assessment of Electricity North West’s permit condition costs that it would expect to see a reduction in unit costs over time. We consider that this is not a reasonable expectation for the following reasons;

- We are seeing a noticeable increase in the volumes of permit conditions required by some Highway Authorities and as a consequence we anticipate that the unit cost of conditions per permit will increase over time.
- The permit condition that contributes the greatest proportion of our permit condition costs is NCT08b – manual control of traffic signals. As the hours of operation for manning the lights are specified on the permit there is extremely limited opportunity to reduce the unit cost of this activity. We do not expect this pattern to change particularly.
- A proportion (72%) of Electricity North West's costs in respect of permit conditions relates to work undertaken by our contractors. As we stated in paragraphs 1.4 and 10.7 of our submission document we are currently in the process of a competitive tender process for our framework contracts for underground cable installation. In our submission we confirmed that we were anticipating a significant increase in the contractor rates that are impacted by street works legislation. We did not however build any of these expected costs into our forecasting model as they were not sufficiently certain. We are heading towards the best and final offer phase of the tender process and while we are not seeking to include these costs into our submission we do consider that they present a strong challenge to Ofgem's view that unit rates for condition costs should reduce over time.
- We also noted (in section 3.6.3.5 of our submission) that, with effect from 1 April 2019, utilities will need to provide a traffic management plan as part of the permit application process for certain works in the Lancashire and GMRAPs areas. It is expected that this will have a significant impact on our costs and this was built into our forecasted condition costs. We do not consider that this element of our submission should have been removed.

Conclusion

We do not consider that the use of benchmarking alone is appropriate to set efficient allowances for ENWL for the following reasons;

- The lack of influence that DNOs have in respect of permit fees
- The differences in Highway Authority behaviours in respect of the application of permit conditions meaning that condition costs are DNO-specific
- The timing differences in respect of the introduction of permit schemes (meaning that DNOs with early adopters of permit schemes within their network areas have had greater opportunity to implement and embed administrative processes)

Should Ofgem continue to use benchmarking directly to set allowances for administrative and condition costs (as opposed to cross checking) then we suggest a methodology enhancement that uses data from all DNOs, using statistical techniques for excluding clear outliers, resulting in a more robust approach.

Additionally, the 3% assumed rate of efficiency improvement used in the assessment is significantly higher than any appropriate rate of efficiency gains used in price control determinations and Ofgem has not provided any support as to why the costs are significantly different.

As stated in our application, Electricity North West has used our lowest administrative cost rate to date and liaises regularly and effectively with the Highways Authorities in our area. We have also not allowed within our forecasted costs for the impact of increased contractor rates effective from 2020/21 onwards, nor for the increasing array of permits per job or any increase in permit fees. These are all things we proposed to manage ourselves rather than expect customers to fund representing our consumer value proposition in this submission.


We therefore propose developments to Ofgem's methodology resulting in the following actions;

- The inclusion of data from all DNOs excluding the clear outliers through applying statistical techniques;

- The removal of the 3% pa efficiency reduction for permit fees and condition costs;
- The removal of the 3% pa efficiency reduction for administration costs. We proposed to use our lowest achieved unit rate for forecasting administration costs meaning that 3% is wholly inappropriate. Should any ongoing efficiency be applied in the case of administration costs it should be no more than 1%.

We trust our submission is constructive and are available to discuss any aspect further with Ofgem. Please contact me or Helen Daly.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Paul Auckland', is centered within a light gray rectangular box.

Paul Auckland
Head of Economic Regulation