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11<sup>th</sup> April 2003

Dear Richard

## **DEVELOPING NETWORK PRICE CONTROLS AND THE NEXT REVIEW OF DNO'S**

I am writing to you on behalf of the Electricity Association Price Review Group. Your letter of 13 March provides welcome detail of your plans for the forthcoming review of Distribution Price Controls. We are pleased to see that you have set out a draft framework for the next two years, which, once finalised, will form a firm foundation for our own internal planning as well. I have identified below a number of high level comments which will, no doubt, be supplemented by companies sending in further comments individually as parts of their responses which are due by 14 April.

There is a great deal to do if we are to achieve the ambitions set out in your Update document. As your work programme demonstrates, there are a number of substantial policy issues to be resolved as well as the data gathering that must accompany the resetting of price controls. Indeed it may be helpful to break down your plans into these three components : policy work, data gathering, and setting the price control. Part of the planning challenge is to ensure that tasks are timed to secure efficient completion of the whole project. In this context we need to understand how the output of each piece of work will be used. For example, many of the policy issues need to be resolved because they will contribute to the planning assumptions in the business planning process. Others relate directly to the eventual construction of price controls and allowed revenue.

We also need to look at the dependencies in the 'setting price controls' area upon the data gathering exercise. As far as possible we should be able to identify the use to which data will be put before it is collected. This may also identify areas in which the timetable may be capable of improvement. From an initial assessment of your draft timetable the following comments arise:

### **1. Policy issues**

We think it is important to distinguish between policy work, which is about identifying expected outputs, and that which will contribute to the development of incentive regimes.



Whilst we may eventually find the attractiveness of the review outcome depends more on the strength and periodicity of incentives, resolution of these issues is less likely to influence our views on the necessary costs of running our businesses. This work, and agreement on the methodology for calculating allowed income, needs to be timed to fit with the third strand of work on setting the control.

In contrast, there are a number of policy areas to resolve which will impact on the development of business plans. The scope of the control is an obvious example, which can help to shape the coverage of the BPQ. In addition there are areas where business plans must be built on specific assumptions. For example our future expenditure, both opex and capex, will be influenced by the nature of outputs or targets in respect of distributed generation, losses and quality of supply. The levels of expenditure on distributed generation could also be considerably altered by any changes in commercial policy driven by your review of structure of charges (especially to the extent that connections become cheaper for developers). Clarity in such areas will generally help to make the forecast BPQ easier to complete and more useful to you because of the greater consistency that will result.

## **2. Data Gathering**

In many ways this section of the plan is the most challenging. We do not yet know how extensive the business plan questionnaires will be, but experience suggests that their completion will be a substantial task. Consequently we are anxious to secure not only clarity of planning assumptions but also carefully specified datasets and the maximum time to complete our work.

Your work on financial modelling can be very helpful here. In an ideal world the model would be completed early so that the BPQ could be designed to provide the necessary inputs. However we note that your model is not scheduled for completion until April 2004, four months after BPQ submission is complete. Whilst we would prefer to see the model developed early, at the least, its specification should be complete before the forecast BPQ is designed. It is also important that the objectives and principles for undertaking the review are finalised before data gathering begins. This will make it easier to understand why questions have been asked and how the results will be used.

Likewise we would hope to see some output from the thinking on total cost modelling (due to be initiated in May 2003) before the historic data in the BPQ has to be submitted. If you intend to pursue this methodology, the information request will need to be designed in a way that ensures sufficient data is collected to allow total costs to be evaluated for each company. If not, it may be possible to reduce the data collection burden.

Moving on to the issue of the time allowed for completion of the BPQ, we appreciate that the plan must allow adequate time for the setting of price controls. It would not be in our interests to compress that activity unreasonably. However, if a fully functioning version of your model cannot be delivered until April 2004, then we have to question the need to submit final forecast BPQ details as early as December 2003.

## **3. Distributed Generation**

We understand your desire to collect some information on distributed generation early, since this is a new area of assessment. However it is less easy to see why the final submission of cost projections should precede the base cost estimates. We would expect the DG-BPQ to

represent sensitivity analysis. The impact of different levels of Distributed Generation need to be seen as variations to our base cost projections for the plan period. Whilst you may wish the central case to be consistent with the government's targets for the development of renewables and CHP by 2010, there may be value in showing explicitly the changes from a world with relatively little embedded generation. We are pleased to see that you have initiated a separate consultation on the DG-BPQ and this will provide an opportunity for more extensive comment and debate.

#### **4. Overall Flow-chart**

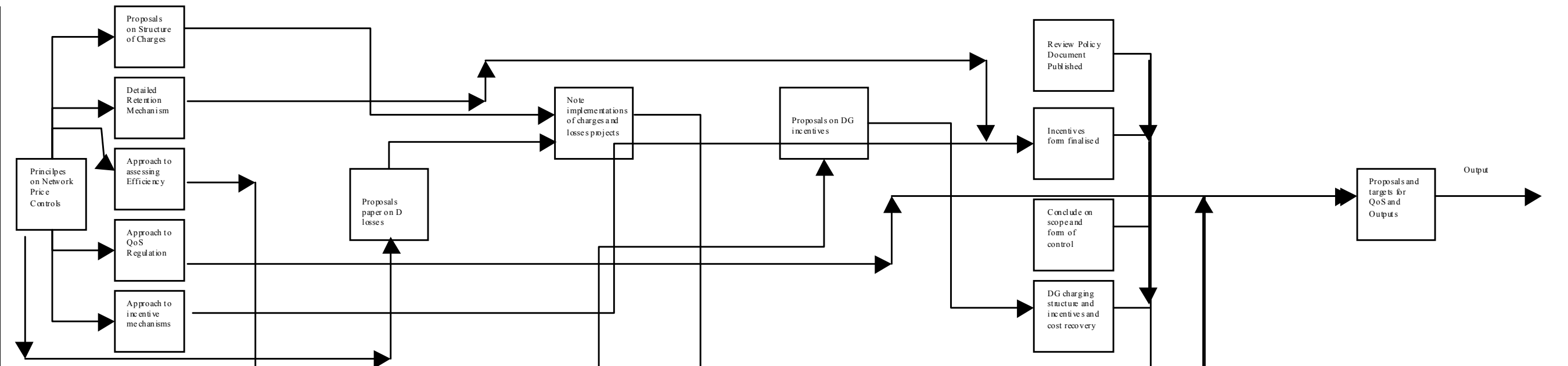
It is difficult to see the linkages envisaged in your timetable and to aid our own interpretation we have constructed the attached diagram. It would be helpful to have your comments on the inter-relationships we have identified between separate work packages and the practicality of the relative timings that are highlighted from this representation.

I hope you find these comments helpful. I would be pleased to discuss them further if you wish.

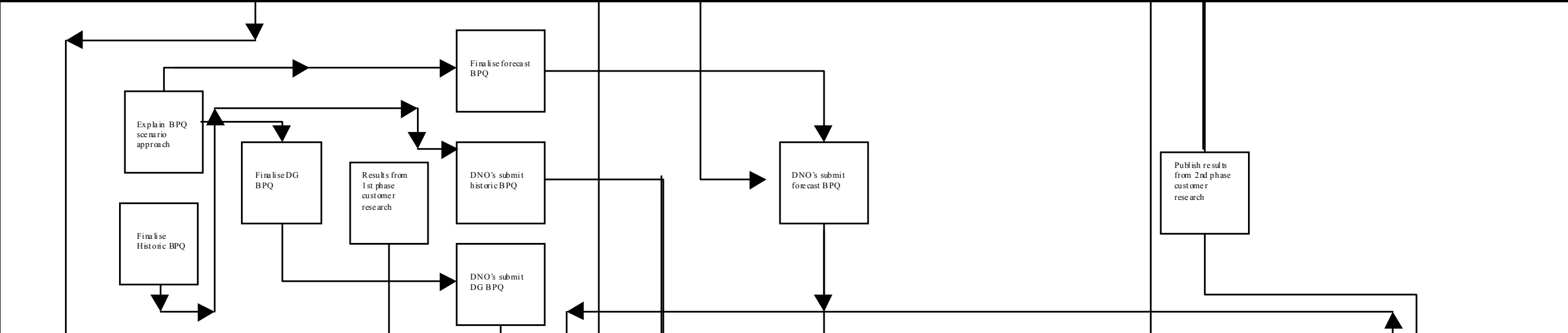
Yours sincerely,

**Mike Boxall**  
**Head of Electricity Regulation**

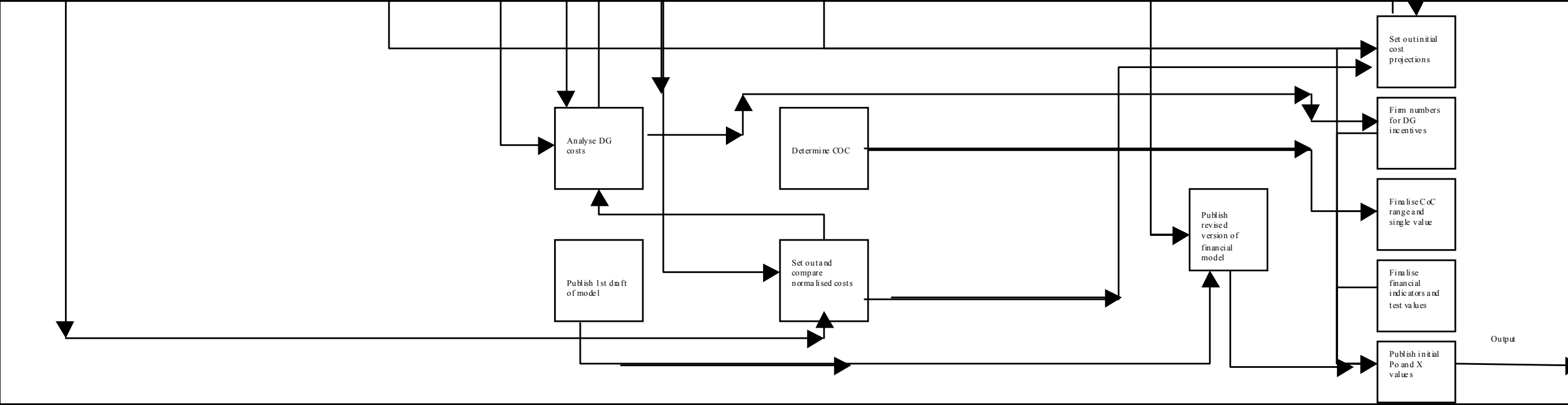
Policy



Data Gathering



Setting the Control



Date

May June July Aug Sep Oct Nov Dec Jan Feb Mar Apr May June

2003

DNO Price Review Plan - Schematic Diagram

2004