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Dear Adrianne

Developing network monopoly price controls – Update Document February 2003

Thank you for the extended period provided for the development of responses to this important and wide-ranging set of documents. We have given the issues much thought and have sought to develop a comprehensive and constructive response.

We find a great deal to commend in these documents and believe that they represent a significant step forward in the development of a robust and consistent approach to network monopoly regulation in the energy industry. In this letter I will set out the issues that United Utilities considers key to the development of network monopoly price controls. In the first attached annex are more detailed thoughts about the issues raised in your update document and the two reports developed by your consultants, Frontier Economics. The annex follows the structure of the update document for ease of reference. Also attached, as Annex 2, is a specific response to your detailed timetable for the distribution price control review (DPCR). Annex 3 contains further thoughts on possible methods for setting allowed revenues.

As a distribution network operator (DNO) we welcome the proposal to publish a comprehensive statement of regulatory principles at the beginning of the DPCR. We believe that this statement should alleviate uncertainty around the price control methodology and improve the co-operation between the companies and Ofgem by clarifying the approach and the objectives.

The timing of this consultation process is also opportune as it enables Ofgem and the energy network companies to consider the evolution of the price control process set within a wider context. The requirements of a number of key stakeholder groups are changing and monopoly price controls and the DPCR in particular need to be able to respond to a range of new demands. There is growing evidence that the next review must respond to pressures in a number of areas:

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- network security and resilience , especially in extreme circumstances;
- environmental impact, renewable energy and distributed generation; and
- customer service and quality of supply.

We must ensure that the monopoly price controls have sufficient adaptability and flexibility to address such issues in a comprehensive and sustainable manner. Therefore, this statement and the subsequent DPCR kick-off document must address the key issues facing the energy industry by:

- Delivering the incentives required to change companies behaviour to ensure the delivery of the Government's Distributed Generation targets and to increase emphasis on the sustainable stewardship of network assets.
- Ensuring that equity continues to play its essential role in the financing of network monopolies by addressing the needs of tightening capital markets and avoiding an inexorable trend to thin equity structures.
- Improving confidence in efficiency analysis through the equitable treatment of companies regardless of ownership structure and including considerations of total cost, quality and other outputs.
- Improving the way we deal with uncertainty by explicitly allocating risks between customers and shareholders in clear and transparent processes

Each of these themes is discussed in more detail below.

Incentives to change behaviour

Faced with these changing stakeholder requirements the price control process itself must evolve. We must build upon the foundations of RPI-X to develop an incentive framework of sufficient power that, where required, it will change DNO behaviour. The four step process to developing incentives for appropriate behaviour developed in Chapter 5 of the update document is an important development.

However, I must also note that we are somewhat confused by the wording in Ofgem's update document, particularly in Chapter 5. Ofgem talk about a balance between incentives for efficiency and incentives to deliver outputs. We believe that Ofgem are using the word efficiency as a short-hand for reducing cost. We believe that this short-hand is dangerously misleading. A cost cutting company may believe that it can respond to an incentive described in this way, but if it does not deliver the essential output of operating and maintaining its network in a sustainable manner, how can it be deemed to be efficient?

We believe that this short-hand has lead to a confusion about the role of incentives. Ofgem describe a world where powerful incentives for *efficiency* (to reduce cost) are matched by equally powerful incentives to deliver outputs. This 'cross-fire' of incentives will be difficult to control with any precision. What are actually required are powerful incentives for true efficiency – the sustainable delivery of outputs at the lowest long-term cost. A simple example might be the capex efficiency mechanism already proposed in which the delivery of outputs is a pre-requisite to gaining the incentive reward - a simple mechanism that ensures delivery at reduced cost, and therefore true efficiency.

Where efficiency savings are hard to find it is important to consider an increase in the proportion of the benefit from any saving retained by the company. This will increase the power of incentives to ensure that the companies continue to strive to find ever smaller and more difficult efficiencies. An appropriate position from which to begin such considerations may be to ask if there is any justification to move from a position where the net benefits of any opex or capex efficiency savings should be shared between customers and shareholders on a 50:50 basis.

If we are to "Re-wire Britian" in response to Callum McCarthy's inspiring rallying cry, powerful incentives are required to change DNO behaviour with respect to Distributed Generation. Despite the development of Renewable Obligation Certificates (ROCs), insufficient funding appears to be available for Distributed Generators and they are unable to meet deep connection charges. It seems clear that the general body of customers will have to pay some of the costs of delivering the environmental improvements that society as a whole will benefit from and not just the customers in the regions where there are larger renewable resources. The Renewable Energy Distribution certificates (REDs) scheme that United Utilities have started to develop and proposed to Ofgem on 21 February 2003 is a good example of the type of incentive scheme required to meet the needs of the time.

Ensuring equity plays its essential role

A key driver in determining the overall revenue allowed will be to ensure that companies are able to raise finance from both the debt and equity markets, since otherwise there will be a trend away from conventional equity structures. Financial ratios are likely to be a more focal issue in this review than they have been previously. At a level that could be described as meeting Ofgem's target of "comfortably within investment grade" allowed revenue needs to be set so that Funds from Operations (FFO) interest cover is at least 3.25 times. The reference to FFO interest cover reflects the emphasis of rating agencies on cash flows rather than profits.

Ofgem has expressed its concerns about the move towards highly geared structures such as that adopted by AWG and Glas Cymru in the water industry. The current pre tax approach to calculating a tax wedge within the cost of capital potentially serves as an incentive for companies to adopt highly geared structures. However, if Ofgem were to adopt a post-tax approach the tax savings of any company choosing to adopt a highly geared structure would be passed to customers, rather than shareholders. In order to support the continued role of equity, United Utilities propose that Ofgem should calculate the allowance for tax liabilities by estimating the specific tax liabilities of each company i.e. adopt a post-tax basis.

Improving confidence in efficiency analysis

Ofgem's previous methodology for assessing efficiency and projecting operating cost allowances was overly simplistic and inadequate. Its continued use is unlikely to be acceptable to companies that are faced with increasing financial pressures and reduced scope for efficiency savings. Therefore, we welcome Ofgem's proposals to consider a range of approaches, including considerations of total cost and value-for-money schemes. In the next DPCR, United Utilities will insist that more factors that influence costs are taken into account when comparing companies. As Ofgem has highlighted in the update document, the three most important of these appear to be total cost, quality and merger effects. The previous methodology involved a clear contradiction, identifying an estimate of fixed costs for each

company or group while modelling each licence holder as a separate entity. This issue can be solved in a number of ways, as discussed in the attached annexes.

Given our concerns over the approach used in the past, we have devoted considerable effort to a review of techniques for comparing companies' performance and calculating future allowances. It is possible to develop more robust mechanisms for combining cost and quality information and establishing future income. These could either be presented in a traditional 'building block' format or on a more aggregated basis. Our work in these areas continues. Annex 3 summarises our conclusions to date.

Improving the way we deal with uncertainty

The work of both the Ofgem working group in this area and Frontier Economic's report shows that there is a range of regulatory tools available that can be incorporated within the existing framework to deal with uncertainty. It is clear that a set of transparent processes will be developed to ensure that risks are appropriately divided between customers and shareholders. The key objective in developing this work must now be to ensure that the mechanisms implemented are simple and robust. Over-complication is likely to reduce the transparency that this work is aiming to deliver.

Timetable

There is a great deal to do if we are to achieve the ambitions set out in your Update document. As your separate 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. Our comments on the timetable are intended to identify where policy issues need to be resolved earlier because they will contribute to the planning assumptions in the business planning questionnaire process. It is comforting to note that there are only a few areas where change may be necessary and Ofgem has obviously put considerable thought into the development of the detailed plan.

Conclusions

As previously stated we find a great deal to commend in the update document. It is clear that Ofgem are addressing each of the key areas we highlight in this letter. The ideas and responses developed in the enclosed documents build upon this positive start and demonstrate that the price control principles and the DPCR methodology can and will evolve to meet the requirements of our stakeholders. We look forward to continuing to work with Ofgem on these important developments.

Yours sincerely

Paul Bircham
Electricity Regulation Manager