

Developing network monopoly price controls – Update Document February 2003

Response by United Utilities

Annex 1

This annex contains the detailed thoughts of United Utilities about the issues raised in Ofgem's February update document and the two reports developed by Frontier Economics. The annex follows the structure of the main body of the update document for easy of reference.

Chapter 3 - Consistency of Price Controls

Applying aspects of the electricity transmission framework to electricity distribution

SO incentives

There are significant differences in both the design and the operation of distribution and transmission networks. This leads to a significant variance in the access issues faced by the two types of electricity network. It does not seem appropriate to apply a common approach to either access rights or system operator costs and incentives at this time. However, there may be important lessons that can be learnt from the experience of developing the transmission framework for potential application to distribution once the nature of network operation has changed following a significant growth in Distributed Generation.

NGC shared assets

At present, our experience is that DNO-NGC shared assets are being replaced at the same time in a co-ordinated manner. Decisions are made as to whether the efficiency savings available through joint work outweigh the costs of completing work ahead of a condition-based assessment of useful asset life. Information on NGC's age-based replacement programme is available to DNOs and United Utilities have been successful in negotiating with NGC to agree the timely replacement of assets in the North West. We ask that Ofgem confirm that this approach would be viewed as efficient when reviewing DNO investment behaviour.

Chapter 4 - Assessing costs and incentives for efficiency and Frontier Economics Workstream B Report

There seemed to be wide-spread and significant levels of confusion and controversy surrounding Ofgem's approach to assessing efficiency at the last distribution price control review, particularly whether the confidence attached to cost projections was consistent with the accuracy of efficiency analysis and company comparison. Therefore we welcome the proposal to use a range of methods for assessing efficiency and projecting costs. Techniques will need to be developed that enable Ofgem to take account of a number of key factors that did not appear to be considered in previous opex analysis. Two of these factors are highlighted as issues for consideration in the update document – these are the capital expenditure associated with opex and the quality or outputs that are delivered from opex. It is not credible to develop a methodology for projecting the costs of an averagely efficient company if the methodology does not include a consideration of all the costs and does not consider what is being delivered for the expenditure.

Issues for the DNO price control review

Adjustments to individual companies reported costs.

United Utilities has some specific concerns related to the consistency of the accounting policies applied by companies when reporting information to Ofgem. We will write to Ofgem separately to expand upon issues that have recently come to our attention. We agree that more precision and clarity of information provided to regulators is required. This can best be achieved by companies and Ofgem working together to understand how the data required will be used, agreeing the underlying assumptions that should be made when gathering the data and clearly specifying accounting rules to be followed by all companies.

Impact of mergers

United Utilities agree that past mergers between DNOs will have an impact on Ofgem's ability to undertake comparative analysis. Ofgem should try to ensure that all the cost savings made by merged companies are separately identified. Mergers give companies the opportunity to exploit economies of scale and scope, dependent on the contiguity of their boundaries and may also provide an opportunity to share costs across a Group structure. Therefore, Ofgem should develop a mechanism to take this into account when comparing the costs of companies. Our initial thoughts in this area are detailed in Annex 3.

Efficiency assessment on a total cost basis

United Utilities believe that it is essential to consider efficiency from a total cost perspective. Whole life cost modeling is fundamental to our business decision processes, and it is disappointing to find that the long term benefits of this approach have not been picked up in your previous attempts at comparative efficiency analysis. A move towards a total cost analysis can also overcome some of the problems with accounting policies highlighted above and is consistent with the development of balanced opex and capex efficiency incentives.

We are currently developing our own models of how this can best be achieved, as detailed in Annex 3, and would be happy to share our thoughts on such approaches with Ofgem and others in the industry. Within any total cost analysis it is important to incorporate the quality and other outputs that are being delivered for the expenditure. With a total cost approach one is less concerned with which quality factors drive opex or capex, and can be more confident that CIs, CMLs and other outputs are material drivers of cost.

United Utilities also has experience of the cost modeling approach employed by Ofwat. This approach assesses opex and capital maintenance costs together, but split across a range of models reflecting the various activities of the business. This activity-based approach may also help to reduce the difficulties of comparing performance between companies, although we recognise that there may be limitations arising from the lack of consistent disaggregated data for past years. It may therefore be necessary to acknowledge that the weight applied to such work should be less than may be appropriate in the future.

Frontier performance approach

We were pleased to hear at the workshop on 4 April that Ofgem seem to share our reservations over the use of frontiers to set future revenues. We question whether Ofgem's duty to have regard to the need to secure that licence holders are able to finance their activities is consistent with a frontier approach. Given the cyclical nature of expenditure in electricity distribution and the differences between companies, projecting a level of expenditure for all companies based on the notional short-term performance of one or two companies appears to put the sustainability of the industry at too great a risk.

There are a number of alternative models that could be employed to assess historic efficiency, including total cost models. The high level principles associated with some of these are discussed in Annex 3. Given the availability of a number of techniques, United Utilities would encourage Ofgem to evaluate companies using a range of techniques and publish all their findings before deciding upon forecasts of allowed revenue.

Reviewing capex efficiency

We would expect Ofgem to establish clear and simple rules for determining capital expenditure efficiencies. The mechanisms agreed at the last review require companies to pass a test based on performance. It should not be necessary for Ofgem to embark on detailed scrutiny that is inconsistent with the general move towards output based regulation. However, as we have noted above, we do see merit in a broader base for any comparative analysis that is done across companies.

Assessing value-for-money delivered to customers

We have argued for some time that the real measure of comparative performance should be value for money. It was heartening to see the concept raised in the IIP, but we have not seen any recent evidence of further work within Ofgem. United Utilities are currently working on the development of a value-for-money index that could be used as an overall measure for assessing efficiency. This would encompass opex, capex and quality. Such a measure will provide a useful input to the determination of future revenues. This is discussed further in Annex 3.

Efficiency incentives

Periodicity of incentives

United Utilities believe that the periodicity of efficiency incentives can be addressed through the consistent application of a “rolling” retention period to all out- or under-performance, including both opex and capex.

Retention period for efficiency savings

Lengthening retention periods increases the power of incentives and thus the potential efficiency savings that can be realised for the benefit of customers and shareholders. However, longer periods between reviews can also increase risk for investors and may result in an undesirable increase in costs. This issue can be overcome by decoupling the retention period from the price control review cycle.

The five-year review cycle has, with the inclusion of specific mechanisms for dealing with uncertainties, provided an adequate degree of protection from the risks of increasing costs or changing obligations. However, five years may not be the optimum period for encouraging efficiency improvements. Retention periods are selected to give a particular ratio of benefit sharing between customers and shareholders. The initial starting point for consideration of a sharing of benefits should be 50:50. Frontier Economics work in this area indicates that with a depreciation period of 20 years this is almost achieved for one-off capex savings by a retention period of 5 years. However, for opex benefits that are recurring, as the current process assumes all savings to be, the necessary retention period is more like 10 years.

One issue Ofgem should consider when selecting an appropriate retention period is whether the sharing of benefit should be on a net basis. As efficiencies become harder to find, more often an initial investment is likely to be required before a long-term saving can be procured. To ensure that these investments are made companies will require a sufficiently high share of the benefits or an assurance that the costs of the investment will be funded from the benefits before any sharing ratio is applied. We therefore recommend that the 50:50 split be applied to net benefits.

Distortion of incentives between opex and capex

The distortion between opex and capex can be significantly reduced by balancing the benefits received from the saving of £1 of capex with the benefits received from

saving £1 of opex. This is achieved by fixing the retention periods so that the sharing benefit enjoyed by the company is the same for both opex and capex savings.

The treatment of non-operational capex

Where forecast non-op capex is capitalised rather than expensed, the pay-back will be spread over the depreciation period rather than in the year of expenditure. In NPV terms this should make no difference provided that the actual cost of capital is no more than the allowed cost of capital under the price control. However, we believe that cashflow will be one of the main constraints to be handled in the next review and any increase in capitalisation would add to the pressure on financability.

Chapter 5 – Developing the overall incentive and price control framework

Both Ofgem and their advisors from Frontier Economics have done excellent work in developing an approach to incentives. There is now a much better understood framework within which discussions can take place and a common language that has been missing in the past. We would like to feel that we have also helped this process by emphasising the distinction between incentives to perform existing tasks at reduced cost and incentives to behave differently.

At United Utilities we are slightly confused by some of the terminology used 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 has led 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 deliver at reduced cost, and therefore true efficiency.

The four-step process to developing incentives for appropriate behaviour developed in Chapter 5 of the update document is an important development. This process contains a number of key principles that United Utilities endorse, namely:

- Identifying circumstances where incentives to cut cost alone may not be appropriate
- Robust monitoring of boundaries within the price control
- Clearly identifying outputs that companies are required to deliver
- Assessing customers' preferences and willingness to pay
- The separation of overall targets for entire networks and appropriate protections for the individual rights of customers
- Developing a variety of incentive mechanisms, tailored to the appropriate behaviours required

For example, following this process would lead us to conclude that encouraging DNOs to change their behaviour with, and to actively facilitate the development of Distributed Generation, should be incentivised outside the main price control review, as described in our response to Chapter 7 below. However, we would accept that the efficient delivery of those new services could be captured in an extension of the price control, so long as a suitable revenue driver can be found.

Appendix 4 – Assessing customer’s preferences in the DNO price control review

Scope of survey

It is important to decide early how the results of the survey will feed into the price control review process. A clear understanding of the use of the results will assist greatly in understanding what the survey output should look like and hence the survey focus and techniques required. Whilst the areas suggested for inclusion in the survey all appear valid and important areas for exploration, the resulting scope for market research is very wide. It is essential that the results of any survey are robust with significant sample sizes covering a number of different customer groups, geographic regions and DNO areas. Therefore, given the likelihood of cost and time constraints, we suggest that the scope of any market research is narrowed significantly and initially targets a better understanding of the price customers put on quality.

Method for assessing customers’ preferences

The DNOs have previously submitted a useful document on methods for assessing customer preferences, highlighting the strengths of choice experiments. However we agree that it would also be helpful to engage other parties in the debate on process. To ensure that any market research is focussed and robust the use of focus groups to develop and refine the market research approach is likely to be a useful and efficient technique. We are pleased that Ofgem has established a working group of DNO representatives who can assist in the selection of survey techniques, the development of a detailed questionnaire and the interpretation of results. This involvement will be a welcome increase in transparency.

United Utilities believe that the survey should assist in the development of revised incentive rates for the IIP scheme, understanding customers’ views on reducing the number of worst served customers and appropriate compensation levels for service failures. We believe that these areas can be assessed by a survey that explores customers’ perceptions of the value of continuity of supply in different circumstances. Focusing on the outputs required in these areas will give useful insights into designing a robust and useful survey methodology.

Appendix 5 - Developing incentives for quality of service for DNO price controls

We are pleased to see that there will be further efforts devoted to incentives for quality of service. Whilst the IIP has been a valuable beginning, the current scheme should not be considered complete. In particular we welcome the suggestion that Guaranteed and Overall Standards need to be reconsidered in the context of more specific incentive mechanisms. In principle we support the conversion of Overall Standards into measures that are capable of penalty/reward mechanisms akin to the existing IIP. There should also be a review of Guaranteed Standards to confirm that this is the most appropriate means of incentivising companies and compensating customers.

A critical aspect of any review of service standards must be the views of customers. We remain to be convinced that there is any genuine need for a tightening of the targets for CML and CI. The present form of the IIP scheme allows companies to go beyond the targets only if they are confident that further enhancements can be

provided within the revenue allowances available. Such an approach should be maintained; which implies greater certainty of long-term revenue for quality improvements is required. We see greater merit in exploring the value of secondary targets related to service levels that may not otherwise be improved. An example would be the resolution of problems identified by OS5, where a carefully targeted incentive scheme with an appropriate valuation could bring real benefits to some of the 'worst served' customers.

What must accompany any new approach to service targets is a clear means of linking revenue with service levels, whether this comes entirely through assured long-term incentive schemes or additional capital expenditure allowed to pass into the RAV. We can see merit in the use of normalised performance data to help Ofgem to determine the extent to which additional capital allowances are justified in raising service levels.

Chapter 6 – Financial Issues

Obligations and duties with respect to the financing of companies

Ofgem has a duty to secure that licence holders are able to finance their licensed activities. United Utilities believes that to fulfil this duty Ofgem must set prices that ensure that:

- a well-managed company earns a return on its RAV that is at least equal to its experienced cost of capital; and that
- companies must be able to raise finance from the capital markets on reasonable terms.

It is essential 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. Retained profits are typically close to zero, because Ofgem sets the allowed rate of return equal to the experienced cost of capital. Raising equity therefore requires rights issues to succeed. This is particularly relevant given Ofgem's goal to "rewire the UK" to meet renewables targets, which will require increased levels of investment which will be riskier than traditional DNO investment, and therefore suitable for equity funding.

Ofgem therefore needs to have regard not only to credit ratings and the financial indicators used by the debt market but also to the criteria for successful rights issues. This will require dividend growth and dividend cover to be at adequate levels.

Cost of Capital

We agree that the cost of capital should continue to be calculated as a weighted average of the cost of debt and equity.

Cost of Equity

In regard to the cost of equity, a recent report by Smithers & Co for the UK economic regulators has pointed out a useful simplification of CAPM. Traditionally the cost of equity is calculated as follows:

$$\text{Cost of Equity} = \text{risk free rate} + (\text{beta} \times \text{equity risk premium})$$

Unfortunately there is considerable uncertainty about the calculation of all three of these parameters.

Smithers & Co therefore advocate re-casting the equation as follows:

$$\text{Cost of Equity} = (\text{beta} \times \text{market return}) + (1 - \text{beta}) \times \text{risk free rate}$$

On the basis that beta can be expected to be close to one, the calculation of the cost of equity then reduces to the estimation of market returns, about which there is significantly less uncertainty. This seems to us a sensible simplification for Ofgem to employ.

Gearing

We agree with your provisional conclusion that you should calculate the cost of capital using gearing of 50%. This is supported by Oxera's report for Ofwat, and will avoid forcing companies to adopt thin equity structures. In our view the disadvantages of thin equity structures are:

- a weakening of the incentives for efficiency;
- a reduction in the size of the equity buffer, which transfers risk to customers, taxpayers and debt investors; and
- a reduction in funding flexibility, since it would be very difficult for a thin equity company to raise new equity.

Taxation

The future projected effective tax rates of the distribution network operators will vary on a company-by-company basis. Where this is the case, we agree that it is not appropriate to adopt a pre tax basis for calculating tax allowances. We believe that Ofgem should calculate the allowance for tax liabilities by estimating the specific tax liabilities of each company i.e. adopt a post-tax cost of capital.

Ofgem has expressed its concerns about moving to highly geared structures such as that adopted by AWG and Glas Cymru in the water industry. Adopting a pre tax basis for calculating the tax allowance could serve as an incentive for companies to adopt highly geared structures as compared to companies adopting a more conventional equity structure. 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.

We do not believe that moving to a post tax basis will adversely affect the incentive for companies to manage their tax liabilities efficiently and experience within the water industry, where a post tax basis is adopted, supports this view.

The projected tax cash rate will increase further if proposed changes to the capital allowance regime, mooted under the Reform of Corporation Tax consultation process, are implemented. Whilst this change may not eventually occur and should not be built into the calculation of allowed revenue, it can be dealt with simply using an appropriate mechanism for dealing with uncertainty under a post-tax regime.

As noted, Ofwat adopts a post tax basis for calculating the tax allowance. A consistent approach with Ofwat would be in line with the recommendations of the Better Regulation Task Force

Fixed Rate Debt

In our judgement Ofgem should not include an adjustment to the cost of capital to take account of fixed rate long term debt. This is because companies can use the market to hedge movements in interest rates after the future price review.

For example, suppose a company raised long term fixed rate debt in 2000, following the 1999 price review. The interest rate for the period 2000-05 should align with the cost of debt allowed by Ofgem in setting prices. For the period beyond 2005 the company was able to swap the debt from fixed rate into floating rate. This floating rate debt can be swapped back into fixed at future price reviews in order to again align interest rates with the assumptions used for price setting.

It is, of course, necessary for Ofgem to include the cost of such swaps, and all other transaction costs, in calculating the allowed cost of debt.

The Regulatory Asset Value (RAV) and the approach to depreciation

Investment by DNOs falls into two generic categories:

- investment to maintain the network; and
- investment to enhance the network.

Enhancement can take various forms such as increasing security of supply and converting networks from being passive to active in order to facilitate embedded renewable generation.

It is appropriate for current customers to fund investment to maintain the network, so that they pass on to future customers a network which is as good as they inherited. It is appropriate for current and future customers to fund investment to enhance the network, since both will benefit from such enhancements.

This concept of “inter-generational equity” underpins Ofwat’s calculation of RAVs since for water and sewerage:

- maintenance investment is charged to profit and paid for by customers on a “pay as you go” basis; while
- enhancement investment is added to the RAV where it earns a return and is depreciated.

We recommend that Ofgem adopt this approach to the funding of DNO investment in the interests of both equity between current and future customers and regulatory consistency.

Financial Ratios

We agree that Ofgem should “target credit ratings which lie comfortably within the investment grade category”. We presume this means an A grade rating and it would be helpful in terms of sentiment and investor confidence if Ofgem could be more

explicit about this target. We understand that Moody's currently look for the following ratios when assessing a DNO to have a rating at the bottom of the A's:

FFO interest cover	> 3.25x
Net debt/RAV	< 65%
Retained cash flow/Net debt	>9%

(FFO is funds from operations: PBT + depreciation – tax paid)
(FFO interest cover : (FFO + interest)/interest)

These indicators reflect the debt market's focus on cash flows rather than profits. They are consistent with ratios published by Standard and Poor in September 2001:

FFO to total debt	13 – 25%
FFO interest coverage	3 – 5x

This is the most up to date information actually published by a rating agency of which we are aware, however, since its publication the rating agencies have become more conservative in their views. In addition United Utilities' debt covenants with the European Investment Bank (EIB) require:

gross gearing (excluding deferred tax)	< 150%; and
gross interest cover	> 2x.

The EIB provides United Utilities' cheapest source of funds.

We agree that Ofgem should focus on the financial position of the licence holder, rather than its intermediate or ultimate parent. It is, however, necessary for Ofgem to address the ability of companies to access both debt and equity capital. If Ofgem assume all new capital is provided by the debt market then over time companies will inevitably move towards thin equity structures, a move which will be hard, if not impossible, to reverse. Meeting the criteria for successful rights issues is therefore as important as meeting the criteria for a single A credit rating.

Chapter 7 - The next DNO price control review

The issues we have considered here are:

- Dealing with uncertainty
- Distributed Generation
- Treatment of correction factors
- Metering
- Rebates for distribution use of system charges
- Pensions

Dealing with Uncertainty and Frontier Economics Workstream A Report

United Utilities agree that the next price control is likely to be characterised by a greater level of uncertainty than has been experienced before and therefore, welcome Ofgem's focus on this area. These uncertainties are a mixture of industry-wide changes such as potential changes in taxation and firm specific factors such as the penetration and operational impacts of Distributed Generation.

We also support the principles that Ofgem propose must be applied when identifying the most appropriate arrangements for dealing with uncertainty, namely:

- arrangements must be appropriate to the nature and level of uncertainty that is expected
- arrangements must achieve an appropriate balance between the risk that companies are exposed to and the protection that is provided to consumers
- arrangements must provide appropriate incentives towards efficiency

As uncertainty increases, arrangements that follow these principles are required to contain the level of risk companies are exposed to or to ensure that it does not increase without explicit recognition.

There are two different aspects to dealing with uncertainty that must both be addressed at this price control review. Firstly, how the review will deal with known or expected events where the magnitude of their impact is uncertain, such as Lane Rental. Secondly, how we put in place a framework that gives more certainty about the likely regulatory response to unforeseen events.

United Utilities agree that uncertainty can have a negative impact on the ability of a company to operate efficiently. This may increase costs as dealing with a wide variety of external risks may distract managers or lead them to choose more cautious approaches than they might otherwise, in order to limit the total amount of risk they must manage.

However, United Utilities also agree that in many circumstances it is appropriate for companies to be exposed to many forms of uncertainty where they are best placed to manage the associated risks. In developing arrangements to deal with uncertainty United Utilities agree that materiality, separability, controllability and predictability are the key factors. Therefore it is clear that controllability is the first consideration as this will identify which uncertainties should be dealt with by creating incentive mechanisms.

Where an incentive approach is required the type of mechanism will be largely governed by separability and predictability. The incentive mechanism should not be greatly affected by materiality as long as the arrangements are appropriately priced or funded.

For pass-through arrangements the level of predictability and separability will identify where relatively rapid responses to changes in costs can automatically feed through to prices via error correction mechanisms. For those uncertainties that Ofgem and the companies cannot control, predict or easily separate, specific actions will be required to identify what costs should be passed through. The timing of this pass-through will depend upon the materiality. It may be possible to agree that small cost changes can be logged up and dealt with at the next price control review. Where a change is likely to have a material impact on a company's cashflow it may be necessary to provide more immediate pass-through and for very major cost changes some form of interim determination mechanism or price review re-opener is likely to be more appropriate.

In the next few paragraphs we provide more detailed comments on the factors debated in Frontier Economics report.

Materiality

This debate poses the important question – “what constitutes a material impact?” – but makes no attempt to quantify it. Ofwat specify a threshold of 10% of turnover for an Interim Determination and 1% for a Logging Up item. Frontier indicate that the regulator will need to consider this, but give no recommendations. In our experience the thresholds employed in the water regime are broadly appropriate.

Separability

Separability is undoubtedly important, but in practice it will be difficult to draw the line between two identified effects. This may be done on an arbitrary base or may be open to gaming. The allocation of appropriate costs to the activity in question is key and may result in increased audit requirements.

Controllability

The Frontier Economics work on this area appears logical. In the simple process described above we would also separate controllable and non-controllable events into those where incentive mechanisms can be used and others where some form of cost pass through is required.

Predictability

This section of Frontier's report seems overly complex – indeed the answer to the first question implies ‘no uncertainty’ if the answer is yes and is therefore handled at the Price Review.

If the company can predict an outcome, but the regulator cannot, then the suggested outcome is a “Revelation Mechanism”. Unless the company forewarns Ofgem before an event happens it could be difficult to ascertain whether the company could have predicted the outcome, so the ‘Revelation Mechanism’ may become some form of enquiry.

Diversifiability

Whilst it is arguable that certain risks can be diversified, the examples given seem to be somewhat tenuous. Investing in NGC shares and shares in an energy-intensive company to mitigate the risk of changes in TNUoS may be appropriate if TNUoS was the only source of income and cost for each company, but as they represent only a small element it would appear to increase risk rather than reduce it.

We would need to see more appropriate examples to be able to judge whether diversifiability is a valid measure in assessing uncertainty that is applicable given the realities of the structure and ownership of the distribution companies in England Wales and Scotland.

Distributed Generation

We are engaged in separate correspondence with Ofgem on ways to develop the regulatory framework to address the emergence of increased quantities of distributed generation. As in other areas, we see much useful work from Ofgem and Frontier Economics, in particular the recognition that there will be a continuing need to incentivise efficient behaviour whilst encouraging DNOs to support government policy objectives. The Frontier assessment that concluded cost efficiency is best handled within the overall price control requires the identification of appropriate revenue drivers. We hope that the work we will do on the DG-BPQ will help to inform that discussion. As you know we have also proposed incentive schemes intended to encourage both the development of suitable infrastructure to facilitate future connection of distributed generation and a mechanism for sharing more equitably the costs arising from new connections between consumers in different parts of the country. We will continue to work with Ofgem to develop practical proposals in this area.

Treatment of correction factors

United Utilities supports Ofgem's proposal that it would be appropriate to carry forward any under or over recovery for 2004/05 to the first year of the new price control. A long-term objective in developing the price control process should be to minimize the impact on the operation of the business. Companies should be incentivised to undertake their price setting and revenue forecasting work by following best practice, i.e. in the same manner each year irrespective of where they are in the price control cycle.

Metering

The competitive provision of metering services is developing quickly and United Utilities believe that it will be possible to demonstrate that competition is effective well before the next price control is set.

In such circumstances the best protection for customers would be afforded by ensuring that this competitive market is not distorted by the continued obligation on DNOs to provide price controlled Last Resort type services. Additionally, to avoid premature asset replacement, meaningful competition in asset provision should take place at the time of meter replacement.

If the obligations on distributors to provide new meters were not continued into the next price control period any new meters provided by distributors, or other providers, after 2005 would be provided voluntarily at their own commercial risk and would not need to be subject to any price control, other than normal competition law.

Therefore, after the obligation is lifted price control protection would only be needed in relation to distributors' existing meter assets. As these assets have been provided by distributors under obligation it is appropriate that they are protected from stranding.

For these existing meter assets a continuation of the current treatment, where the meters are part of the RAV and an allowance for metering depreciation included in the calculation of allowed revenue, would seem appropriate. This protection against stranded assets could be continued for the reducing cost base that would be depreciated out of the RAV. There would be no need to split the RAV or derive a specific value for the meter assets.

Rebates for distribution use of system charges

Rebates for distribution use of system charges are an inevitable consequence of the constraints within which DNOs must operate when setting prices. The key issues that DNOs must consider are the asymmetry of interest rates for over and under recovery and the five-month notice period for changes in prices. We are also aware that some suppliers desire to have all price changes take place at the same time each year, although this should not preclude price adjustments that help to ensure consistency with price caps. Typically we are required to forecast the impact of the next two winters ahead when setting prices. Prices published in October in Year 1, will come into effect in April Year 2 and continue until the April of Year 3.

Pensions

We were pleased to note that the substantial issue of future pension costs is already on Ofgem's list of issues for the next DPCR. It is important that there is careful consideration of the appropriate future treatment of this area of costs. We must also be aware of the likelihood that Ofgem's approach may have a strong influence on companies' policies. Pension arrangements could be seen as just one element of employees' remuneration package. However the particular nature of the pension schemes inherited at privatisation, and the statutory protection for members is unusual.

One key aspect of the debate is therefore who should stand the risks arising from the pension arrangements that exist within the industry. Over the current price control period we understand that opex allowances have been set with reference to a frontier company whose costs were depressed by the benefit of a strong pension scheme performance. If this is the case customers have enjoyed the benefits of a strongly performing equity based pension scheme and it could, therefore, be argued that they should also be exposed to the downside risk. The argument for this is strengthened if pension scheme performance depends on trustees who act independently of the employer.

United Utilities perceive two options for the future treatment of pension costs:

- a) to continue to expose customers to the risks and benefits associated with changes in pension costs
- b) to balance the historic benefits received with an exposure to the costs of funding required to make up current deficits so that all schemes achieve a stable basis by 2010. From this position of stability it may be possible to fund pension schemes from 2010 onwards as if they were entirely gilt based, limiting the future risk for customers.

It may also be appropriate to consider whether pension costs have been efficiently incurred by comparison with pension performance in other, competitive, sectors of the economy. Any such comparison should, of course, be made with similar engineering-based firms with large workforces and must take into account the constraints placed upon DNOs by the legacy of privatization, such as the protected status of some of the worker force.

ANY COMPARISON OF PENSION COSTS SHOULD BE INCLUDED AS PART OF THE OVERALL ASSESSMENT OF RELATIVE EFFICIENCY THAT Ofgem carries out for operating costs. A COMPANY WITH A DEFINED BENEFIT SCHEME MIGHT APPEAR TO HAVE HIGH PENSION COSTS COMPARED TO A COMPANY THAT HAD SWITCHED TO A DEFINED CONTRIBUTION SCHEME. YET SALARY LEVELS BETWEEN THE TWO COMPANIES MIGHT BE EXPECTED TO REFLECT THE VALUE OF PENSION BENEFITS AND SO PENSION COSTS SHOULD NOT BE VIEWED IN ISOLATION.

OFGEM SHOULD SATISFY ITSELF THAT PROPOSED FUTURE CONTRIBUTION LEVELS ARE SOUNDLY BASED. ANY ISSUES OF COST RELATIVE TO OTHER COMPANIES SHOULD THEN CONTINUE TO BE DEALT WITH THROUGH AN OVERALL ASSESSMENT OF RELATIVE EFFICIENCY. TO DO OTHERWISE MAY INTRODUCE DISTORTIONS IN THE TREATMENT OF COSTS.

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Response by United Utilities

Annex 2

Comments on Ofgem's timetable and the future workplan

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.

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:

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.

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. 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. 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.

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.

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.

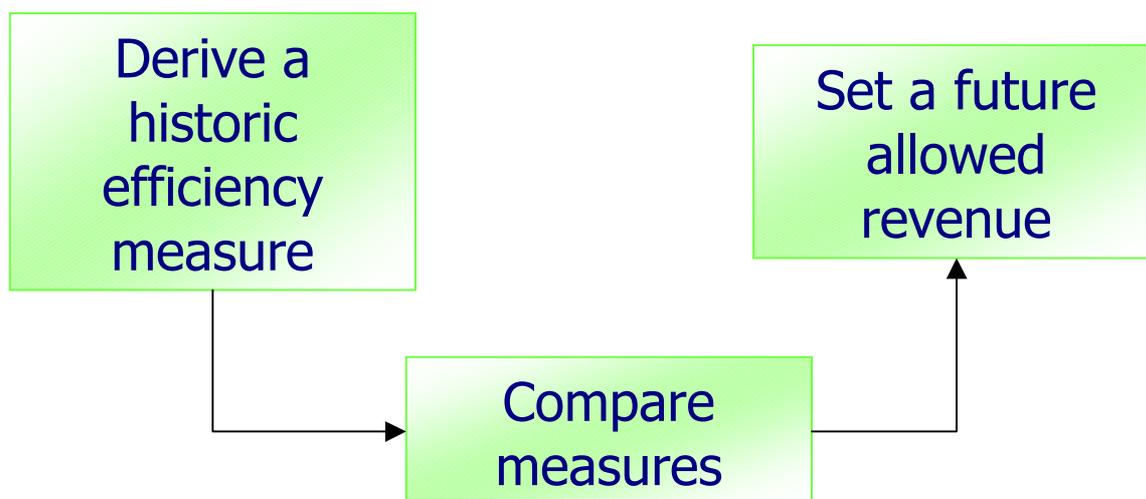
Developing network monopoly price controls – Update Document February 2003

Response by United Utilities

Annex 3

Analysis of possible methods for setting future allowed revenues

The overall regulatory framework for setting allowed revenues for distribution businesses requires a three step process as described by the diagram below.



This document identifies three high-level options for carrying out this process that could all be employed at the next distribution price control review.

These can be summarised as :

1. repeating the approach from last time but adding greater discretion to the interpretation of comparative analysis of opex
2. developing a more mechanistic way of combining the different views on relative efficiency
3. using a measure of total factor productivity to set future trends in allowed revenue and adjust between companies to reflect views on historical performance.

What all of these approaches have in common is a recognition that a simple comparison of operating expenditure (represented as standardised controllable costs) is not an appropriate measure of relative efficiency.

There are three particular adjustments that need to be made, which are discussed in turn below.

1. Number of comparators

As Ofgem's own work on merger policy has demonstrated there are cost savings available to DNOs that merge. This means that any comparison of the 14 licensees will not produce a fair representation of the comparative efficiency of the companies. There are a number of ways that this can be dealt with. The simplest appears to be to use only 8 data points in the analysis, picking up the observation that Ofgem have made that mergers reduce the number of ownership groups which could pursue differing management styles and approaches. However, this may not be so straightforward. Ofgem have also concluded that it is unreasonable to expect companies to instantly secure all the cost reductions available from merging and have allowed 5 years for those benefits to accrue.

We therefore recommend that any analysis of opex should be adjusted so that licence holders that are part of groups owning more than one distribution business should have their costs increased by £2.5m for each of the first five years since the merger (i.e. up to a maximum of £12.5m). Once this adjustment had been made it would be possible to compare opex in a manner consistent with Ofgem's merger policy. There would also be no presumption that mergers were desirable (since the assessment would not consider the national customer detriment of £32m identified by Ofgem).

2. Consideration of Total Cost

What matters to customers is the total cost of the services provided to them. Any comparison of opex alone will risk confusing efficiency with differing policies on whole life costs or accounting methods. We therefore recommend that comparative efficiency analysis considers total costs. There are a number of techniques that can be used to incorporate the consumption of capital. It is not yet clear to us which would be most appropriate. The choice may depend on the accessibility of historical data, but we would prefer a measure that considers all capital employed rather than just looking at one (or even several) recent years' expenditure.

3. Introduction of quality measures

The other glaring omission in previous reviews of efficiency has been the outputs delivered for the money. Now that IIP has secured more robust comparative performance data it should be relatively straightforward to establish a means of adjusting costs to take account of quality of supply. Again there is no one right way to do this, but we suggest that a first approximation can be achieved by taking the marginal IIP incentive rates to produce a financial measure of the difference from a base IIP performance. Other more sophisticated measures can be derived later if necessary.

We have begun to model companies' performance on these lines and will be happy to share the results with you when it is completed. Whilst there are reasons to doubt the precision of the adjustments we recommend, the overall effect should be to improve the comparison from that used in the past.

Armed with this additional information about the respective performance of different companies we can then consider how it should be used to set future allowed revenue.

Option 1 – Building on the approach at the last review

This approach builds upon the methodology Ofgem employed at the last distribution price control review. The SCC calculation would incorporate adjustments to reflect anticipated merger savings. However the process of converting from historic performance analysis to opex allowance for the future would not be a straight mechanical process (such as glidepath to reach a point three quarters of the way to the efficiency frontier). Instead the target cost level would be adjusted to take account of Ofgem's interpretation of both total cost efficiency and quality of service. There would be a separate approach to capital investment, so the 'building block' methodology would be maintained, with the WACC applied to the RAV as the final component.

Option 2 – a more rigorous approach to combining measures

This approach would specify the mechanics by which Ofgem would combine the various assessments of performance to secure an allowance for future revenue. This could either take the form of predetermined weights for the total cost and quality indicators as adjustments to the output of the SCC analysis, or a more explicit shift towards total cost as the primary input to a model for future allowed income. In the first case, the subsequent steps in the methodology would be very similar to those described in Option 1 above. In the second case, a great deal more thought would be needed as the traditional link with the RAV may be lost. A partial move in this direction may be possible, with certain categories of capital expenditure being dealt with alongside opex. This may be particularly appropriate for replacement of existing network assets and is consistent with the views we expressed in Chapter 6 on inter-generational investment. Other elements of capex could still be handled separately (such as load related expenditure or capital needed to support new priorities like distributed generation or other environmental initiatives).

Option 3 – focus on indicators of underlying trends in future costs

Another approach would be to use the various measures of comparative performance only to fine tune calculations of allowed income that have been derived from broader indicators of likely future costs. The concept of Total Factor Productivity as the prime driver of underlying future revenue is commonly promoted. This could be combined with individual adjustments to future income allowances to reflect company specific performance. Such adjustments could be derived from the same comparative analyses described above. Again this technique could be applied either to opex only or to a broader definition of costs depending upon the particular measures of productivity that were available and the consistency of requirements on companies. We doubt that it would be possible to completely ignore the different investment plans arising from external factors such as the potential growth in distributed generation.

Summary

We recognise that the discussion above is quite sketchy and that much work remains to be done to develop a robust approach to setting revenues for 2005-2010. However, we see some common themes running through the options. All require inter-company comparison to take account of ownership structures, total cost and service performance. They differ only in how Ofgem would use the results of the broader

analysis that must be undertaken. At present we have no strong view as to which method will prove most suitable. Indeed the immediate emphasis should be on improving the quality of comparison with the aim of informing Ofgem's views on the value for money received by customers. The more different the conclusions drawn from the separate forms of analysis, the stronger the arguments would become for an approach that weights many possible outcomes, and for the exercise of judgement by Ofgem. Whilst, in principle this is less appealing than a mechanistic process that is more obviously transparent, we may have to accept that the data available to inform this broader view may not be of the quality we would hope.

We are keen to continue working in this area in order to help to develop a superior means of calculating allowed revenues. We hope that Ofgem will give this area focus as the price control project develops.