United Utilities PLC
Dawson House
Great Sankey
Warrington WA5 3LW
Telephone 01925 237000
www.unitedutilities.com

Cemil Altin
The Office of Gas and Electricity Markets
9 Millbank
London
SW1 3GE

Direct Line 01925 237096
mike.boxall@uuplc.co.uk

22nd August 2003

Dear Cemil

Price Control Consultations

I am please to have the opportunity to combine our responses to your initial conclusions on network monopoly price controls and opening document on the distribution price control review. The perspective afforded by reviewing these documents as one allows us to reflect on the application of the principles in the first paper to the issues for distribution companies.

There is evidence of substantial progress in Ofgem's thinking within these documents and we are pleased to see that some of the ideas we have put forward have been taken up. There is a lot of work still to do as it is clear that the DPCR must address a number of new issues as well as the more familiar themes from past reviews.

We agree that there is much within the existing framework that can be retained, particularly for regulating the core distribution service. However, additional features will be needed to address the challenges of the 2005-2010 period. The enhanced model of an (RPI-X)+I+Q format provides that flexibility while allowing a continuing focus on the efficiency of the core business.

In this letter I will focus on the key elements of the review that you have identified :

- Developing a framework to deal with increased levels of DG
- Designing an appropriate incentive framework
- Dealing with uncertainty

An annex provides more detailed comments across the full range of issues raised in your papers.

Developing a framework to deal with increased levels of DG

In developing an investment incentive for DG, thoughts on encouraging innovation and the concept of Renewable Power Zones, Ofgem have taken a number of steps to separate out the funding requirements of Distributed Generation from the base price control revenues. We are

BUSINESS in the COMMUNITY
COMPANY OF THE YEAR 2000
MANCHESTER 2002

very supportive of this approach as it gives much greater clarity and focus to the determination of costs and how they should be recovered in both areas.

Investment projects for distributed generation will involve greater construction cost risk than for more familiar demand related investments. We therefore welcome Ofgem's recognition that a higher return on such projects is appropriate and recognise that this can be delivered by separating Distributed Generation related investment out of the base price control revenue.

Designing an appropriate incentive framework

We identify two elements of an incentive regime. The traditional emphasis has been on efficiency of delivery of broad range of statutory and licence obligations. This has been achieved through an RPI-X approach, where allowed income is specified in advance and companies are encouraged to outperform against known income levels. This has been a highly effective means of encouraging cost efficiency. However, as cost reductions become harder to achieve, the rewards for out-performance need to be enhanced. It is therefore appropriate to extend the period over which the benefits of cost reduction can be retained. Also under this heading, we would put considerable emphasis on the means of calculating allowed income. We are pleased to see that Ofgem intend to review their past methodology and have an open mind to changes of approach.

The second element of the incentive regime concerns performance. The expected behaviour of distribution companies is changing and new incentives should encourage 'good' behaviour and penalise bad. Elements of this regime are being developed (on DG, losses, quality of supply, etc). We support the concept of additional levers, separate from the core RPI-X control for this purpose. These still need development and the output measures also need to be confirmed, often in discussion with Government.

Dealing with uncertainty

We are broadly supportive of the framework for dealing with uncertainty developed by Frontier Economics and have previously commented upon it in detail. We are therefore pleased that Ofgem intend to use this in identifying the most appropriate ways to deal with areas of uncertainty. We see that this framework has two potential applications.

Firstly, for the range of issues facing DNOs, where there is uncertainty about how costs will change in the future or volumes of service might vary, the framework can provide useful guidance on how to reflect this in allowed income. Given the wide range of such issues to be tackled in the DPCR, we urge Ofgem to develop their detailed thoughts on how the framework will be applied as soon as possible.

Secondly, experience suggests that there are likely to be a number of unforeseen events that have an impact on cost before 2010. To provide reassurance that these issues will be dealt with on a consistent basis when they arise the concepts from the Frontier Economic's framework could also be codified into the Electricity Distribution licence. This would reduce the perception of risk in the price control framework and help to limit any potential increases in the cost of capital.

Immediate Issues

Finally I would like to comment on a few issues that are bound to feature heavily in our discussions in the months ahead.

Pensions

In the past pension costs have not been given specific attention in price control reviews. However, it is possible to deduce that the benefits of previous good performance on pensions and other employment costs has been built into price control allowed revenues. It would therefore be appropriate for customers also to face the consequences of recent difficulties for pension funds. Looking forwards we can see the benefits of more explicit pass through arrangements that remove the uncertainty over treatment of a substantial and volatile element of our cost base.

Tax

In determining the relative merits of a pre or post tax approach to the cost of capital, we believe that the overriding principle should be to ensure that the tax allowance provides companies with sufficient cash flow to cover their expected liabilities. However, we also support Ofgem's proposal to continue to incentivise efficient tax management. This can best be achieved by using the company specific ex-ante forecasts associated with a post tax approach to calculating the cost of capital.

Resilience

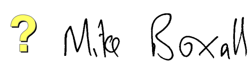
The ongoing dialogue with DTI and Ofgem, following the storms of October 2002, has highlighted the need to specifically address network resilience in this price control review. The Forecast Business Plan Questionnaire will need to address the potential for enhanced investment aimed at reducing the risk of severe loss of supply to customers. To facilitate an informed review of such forecasts, Ofgem must consult on the appropriate level of risk against which network resilience investment plans should be targeted.

Financability

Overarching all price control issues is the fundamental requirement to ensure that DNOs are able to raise the finance necessary to meet customer requirements expressed in the price control proposals. In assessing the financial impact of the price control Ofgem will need to ensure that companies can raise finance from both debt and equity sources. We need to understand the approach to financial modelling that you propose to use, since this is a critical element of the final determination

I hope you find our comments helpful and would welcome the opportunity to discuss them with you.

Yours sincerely



Signature Not Verified

2003.08.22 17:44:46 +01'00'
Document is certified

Mike Boxall
Head of Electricity Regulation

<u>Joint Response to Ofgem Consultation Documents:</u>
<u>'Developing Network Monopoly Price Controls – Initial Conclusions' (D1)</u>
<u>& 'Electricity Distribution Price Control Review – Initial Consultation' (D2)</u>

Annex 1: Response by United Utilities

This document provides more detailed comments from United Utilities on the two price control consultation documents named above. Please note that in the text below D1 refers to the network monopoly initial conclusions paper and D2 to the DPCR initial consultation paper. In order to assist in identifying the sections to which each comment refers, the relevant document and section numbers are indicated at the start of each paragraph.

1. General Principles for Price Control Regulation & Consistency of Regulatory Frameworks

General principles of price regulation & objectives for the Distribution Price Control Review (DPCR)

(D1, s2.2-2.14; D2, s1.8-1.14)

We find much in Chapter 2 of the June document to commend. We welcome the commitment to incentive based regulation and the recognition that Ofgem should seek to work with the normal commercial drivers within a shareholder owned company. One of the key decisions for a regulator is the degree to which it is reasonable to leave companies to respond to incentives. The alternative is to intervene more directly by prescribing standards or details of behaviour. In our view such intervention should be accompanied by a justification that explains why normal commercial incentives would not work. For example the proposed treatment of R&D expenditure in the Distribution Review seems to be an acknowledgement that companies won't otherwise feel that R&D is worthwhile.

The particular principles set out in 2.9 (of D1) are acceptable, but the potential for conflict between them needs to be recognised. Consistency and predictability are both desirable objectives but they do not always sit well with a need for flexibility. In practice Ofgem is trying to address this by providing a framework for dealing with uncertainty that can help to reassure companies of how new circumstances might be treated. However the DPCR paper does not use this to explain the approach to specific issues, nor does it establish the framework as a tool for use between reviews.

Our comments on the objectives for the Distribution Price Control Review (in 1.9 of the July paper) are very similar to those above on general principles. The items listed are appropriate but in cases where they conflict, some indication of the relative importance of each objective would be valuable. In particular we are aware of the tension between providing an efficient and economical network to meet the needs of today's (demand) customers and reflecting social and environmental obligations related to a low carbon future. These conflicts will need to be resolved over the course of the price control review project and the earlier a debate can be initiated the better.

(D1, s2.7) With regard to perceived 'loopholes' in the framework, whilst we fully support Ofgem's view that companies should not expect to keep the benefits of gaming, it may not always be the case that an activity which results in a company benefiting at the expense of its customers was the result of decisions deliberately made to game the system. Ofgem must be clear that the outputs associated with any regulatory contract were defined with sufficient precision. Only if this happens is it possible for inappropriate behaviour to be confidently identified before clawing back any efficiency benefits perceived as inappropriate. Otherwise there is a danger that companies may be deterred from taking innovative steps to improve efficiency and this will be to the detriment of customers in the longer term.

Replacement of Shared GSP Assets

(D1, s2.23) Our approach to replacement of shared DNO/NGC assets was outlined in our response to your February update document. We support Ofgem's view that incentives to invest efficiently should encompass replacement of such assets. These should be supported by clear guidelines defining what constitutes an efficient decision. We believe that decisions to undertake joint work should only be made if assessments indicate that anticipated efficiency savings outweigh the costs of replacing an asset prior to the end of its useful life. DNOs must retain the right to reject a request from NGC to replace shared assets where the DNO believes this will not be efficient - the guidelines should endorse this approach. Development of a complementary incentive scheme will ensure that DNOs are encouraged to accept requests for replacement in other circumstances.

Timetable & Relationship with other Projects & Policy Areas (D2, Chptr8)

The Price Review Programme is a complex combination of tasks and it is important that the significant milestones are now fixed. We are reassured to note that little has changed from your previous timetable plan. However, Ofgem has moved the date for the final determination back to November 2004. This will not give adequate time for the Competition Commission (CC) to complete a review before the end of the current price control. In such circumstances, the most appropriate course of action would be to roll forward the existing price control regime until such time as the CC review has been completed and only then should new price controls be introduced.

On a lesser note, we previously requested additional information regarding the use of outputs from other projects and policy areas. Although Ofgem has outlined how some outputs from their work will be used this is not the case for all workstreams identified. For ease of reference in future documents, such information would be most usefully located within a chapter focussing on the timetable rather than spread throughout the paper.

Harmonisation of Review Dates between Electricity Transmission & Gas Transportation (D1, s2.19-2.22, 2.24-2.31)

We note that Ofgem are not at present considering the harmonisation of the Network Distribution Price Controls with Transmission and take as read that Ofgem would fully consult with industry if this were to change. As such, we have no major concerns regarding either the proposal to roll forward the Scottish Transmission Price

Controls or harmonisation of Gas & Electricity Transmission Review Dates. However, we do believe that some reorganisation of resources within Ofgem will be required and this should be debated and decided at the same time as the consultation on transmission price controls harmonisation.

2. Form & Scope of the price control

Form of Price Controls (D2, s3.8 – 3.10)

As you know we have for some time advocated a development of the RPI-X mechanism to take a form along the lines of (RPI-X) +I+Q. Our understanding of the current control is that it has already moved in that direction and the algebra in 3.9 of (D2) could be better expressed as :

$$BR^* V^* (1+\%RPI-X) + L + Q + Z + CPT - K.$$

The subtle change in brackets makes clear the additive nature of the extra mechanisms. We also had not realised that network rates were a pass-through item, but are grateful for this clarification.

Your proposals for quality of supply and distributed generation do seem consistent with our model for the development of the form of the control, and we support these in principle.

Scope of Price Controls (D2, s 3.17 – 3.19)

In our view, the scope of the existing control should be refined for the next price control period.

There are a small number of policy drivers for change :

- *Development of metering competition* - on which we have commented separately to Maxine Frerk. We believe that obligations on DNOs to provide metering services should be removed and only the existing meter stock be covered by the Distribution Price Control. No separate metering control would then be needed.
- *Losses and reactive power* - which was covered in our response to the Structure of Charges consultation. We believe reactive power charges should be treated as an excluded service. This is consistent with Ofgem's objectives on losses and would recognise that income is not under the control of the DNO.
- *Growth in embedded networks* – as new licensed distributors emerge there is likely to be increasing sales to (or exports from) embedded networks. We believe such transactions should be treated in the same way as wheeling from one DNO to another and the revenues be excluded from price control.
- *Ancillary services* – at some stage over the next decade we can expect DNOs to take a more active role in managing generation connected to their networks. It should be recognised now that this will give rise to a new class of excluded services.

Other than these charges, we believe the existing list of excluded services will continue to be appropriate for the next period. In particular it is important that the special characteristics of EHV supplies are recognised and (as we argued in the Structure of Charges consultation) these should remain outside the price control.

Treatment of the Revenue Driver (D2, s 3.15 – 3.16)

There are three significant changes affecting the operation of the price control to be considered in determining whether changes should be made to the revenue driver.

- <u>Growth of distributed generation</u>

  The costs arising as a result of the anticipated growth in Distributed Generation will not be related to customer numbers or kWh distributed. As such a separate revenue driver will be needed. This is acknowledged in your proposals in D2 5.28. Further consideration of the impact of CHP on units distributed is also needed. We anticipate an explicit mechanism to recover costs associated with Distributed Generation.

- <u>Growth of embedded networks</u>

  We expect that embedded networks will become more common as other parties develop new networks for new housing developments in co-operation with large house builders. This will produce a few large connections to 3rd party distribution systems rather than large numbers of small LV connections to individual domestic customers. It is difficult to predict the extent of market penetration by embedded distributors. However its prospect could suggest increasing the driver towards units distributed rather than customer numbers within the price control.

  We believe a better option would be to change the treatment of units supplied to such networks to bring them into line with units wheeled to other distribution networks outside of the distribution services area.

- <u>Separation of metering activities</u>

  The removal of MAM activities from future Distribution obligations and/or price control will reduce the emphasis on customer numbers in the overall analysis of cost drivers. However we would note that the current 50/50 split on revenue drivers was always arbitrary and approximate.

In our opinion there is no reason to change the treatment of the revenue driver during the next price control period, so long as the proposals above in respect of DG and embedded networks are taken on board.

Duration of the Price Control (D2, S3.21 – 24)

We consider that the duration of the price control is an important element of investor confidence in our business and see five years as the absolute minimum. As regulators become more sophisticated in constructing price control mechanisms to deal with uncertainty, we would hope to see the interval between reviews extending.

Furthermore, we believe that a clear distinction can be drawn between the review period and the duration of specific incentive elements. Hence it is not inconsistent to propose a ten-year period for efficiency benefits to accrue to shareholders, whilst operating within a five-year review process. The way that rolling opex and capex adjustments have been developed allows this to happen.

3. Financial Issues (D1, S4 ; D2, S7)

Financial Ring-fencing (D1, 4.7)

We believe that the financial ring-fence as it currently stands is sufficiently robust. However if Ofgem consider that modifications may be necessary to protect customers of highly leveraged structures, by tightening the definitions and limiting cash flows, these changes must not constrain the financing options of other firms.

We would also be concerned if the adoption of a fallback mechanism by Ofgem, such as requiring capital injections or restrictions to dividend distributions, were to disadvantage UU relative to any firms that have restructured.

Introduction of Special Administration Regime (D1 : 4.7)

In June this year, the EA responded, on behalf of all DNOs, to the DTI's proposals for introducing a special administration regime into the energy sector.

This indicated support for the concept of a special administration regime. However, this should only be used in cases of unequivocal management failure. Where a company has been unable to cope with the effects of circumstances beyond their control, some form of regulator protection is appropriate. The Shipwreck Clause in the water licensing regime provides a possible model. We believe that any statutory change to bring in the potential of special administration to protect customers should be accompanied by licence modifications to ensure that companies are protected from events beyond their control.

Approach to Cost of Capital (D2, s7.8 – 7.9)

We welcome Ofgem's continued use of CAPM to estimate the cost of equity given that, as UK data does not seem to provide robust estimates for the use of arbitrage pricing theory models, there is no clear successor to this model.

With regard to the Smither's report, this has identified that equity returns have been relatively stable over the last ten years or so. We believe that the use of average return on equity may provide a degree of protection to companies if interest rates fall, since, under the traditional model, equity returns would also be assumed to be lower. Further work will be required to address the issue of asymmetry of returns, which is central to the concept of regulatory risk and which means that the normal diversification argument does not hold.

We are also concerned that the use of forward looking estimates could lead to a greater embedded debt problem than would have been generated by an approach based on historical averages.

We have stated in our response to previous consultations that assumed gearing should be around 50% to avoid companies being forced to move towards thin equity structures. The use of the term ‘comfortably within’ to describe the position on investment grade level suggests that Ofgem does not wish to assume a higher level of gearing than was the case at the last review. We interpret this to be consistent with a stable A- credit rating.

Assessment of expected tax positions(D1, 4.10 : D2, 7.8)

In determining the relative merits of a pre or post tax approach, we believe that the overriding principle should be to ensure that the tax allowance provides companies with sufficient cash flow to cover their expected tax liabilities.

Assuming that the deferred revenue rules with Tax Bulletin 53 apply to the DNOs with effect from 1 April 2005, there will be a general trend, in the medium term, towards a tax cash position in excess of 30% mainstream corporation tax rate. Accordingly action must be taken to mitigate the significant risk that for some companies the allowance provided will not satisfy the above overriding principle.

There are two options available to Ofgem:

a) amend the calculation of the tax wedge in conjunction with a pre-tax cost of capital calculation; or,
b) undertake a specific, ex-ante, forecast of tax liabilities for each company in conjunction with a post-tax calculation of the cost of capital.

Whilst we welcome the fact that Ofgem intends to assess the expected tax position of each company as part of the financial modelling at each review, we are concerned that the current “hybrid” approach being proposed may not result in adequate allowance to cover expected tax liabilities. In addition, the proposals may result in unnecessary uncertainty as to the tax allowance for each company that will ultimately be calculated.

Adopting a more company specific approach to tax forecasting and a post-tax approach to calculating the cost of capital would remove the above uncertainties and would also ensure that sufficient cash flow is received in order to cover expected tax liabilities. As we also believe that a post-tax approach offers the best disincentive to companies to adopt high levels of gearing, we still believe that a move to a post-tax regime is to be preferred over the “hybrid” regime currently being proposed by Ofgem.

Approach to RAV & Depreciation (D2, S7.10 – 7.16)

We are pleased to see that Ofgem do not intend to change the method used for assessing the initial value of the RAV.

However, as we make clear in our separate response to the consultation on metering price controls, we do have considerable reservations over any attempt to split the

RAV to remove the value of metering assets. Any assets moved into a separate price control would be exposed to stranding since metering competition is already fierce. These assets were provided under a regulatory regime that assured the recovery of efficient costs and allowed only low rates of return in exchange. It would be quite inappropriate to reverse that understanding, which existed between companies and regulator.

It is also important that Ofgem establishes a clear and consistent approach to regulatory depreciation. The precedent of twenty-year lives for post-vesting assets has been set and must be maintained. This should apply consistently across all companies. We understand that the revised lives were part of the engineering of cash flows for the current period, but do not believe this is a device that can be used further. It would not be appropriate to shorten depreciation lives any more as this would create an unacceptable gap between statutory and regulatory accounting practice. It is essential that other means are found to maintain cash flows. These should include ensuring the cost of capital fully matches investors' expectations and considering the expensing of certain classes of capex, such as maintenance or replacement of network assets.

We recognise the need to ensure that customers share in the benefits of disposals of regulated assets. Therefore we support the proposal that disposals of regulated assets made after 2005 should be removed from the RAB after a 5-year lag. This is not appropriate for disposals of unregulated assets where there should be no regulatory requirement to pass the savings on to customers who have not funded the assets or their maintenance.

4. Treatment of Pension Costs (D1,s4.20-4.35;D2, s7.17 - 7.18)

We have been pleased to see the efforts that Ofgem have already put into the treatment of pension costs. This is clearly one of the critical components of the price control review, since its financial consequences are so substantial. It is also an opportunity to test the potential approach to uncertainty developed by Frontier Economics. We recognise that there are a number of issues to be resolved which make the judgements that must be made particularly complex. Historically pension costs have been subject to incentivisation as a largely unspecified element of employee wage costs. Customers have enjoyed the benefits of reductions in these costs and correspondingly should take on the risk of funding potential increases in such costs.

There are three options for Ofgem to consider in establishing a new policy position on the treatment of pension costs.

- Continue to share the risks and benefits of changes in pension costs from ex-ante forecasts
- Allocate all the risks and benefits to customers through an ex-post pass-through mechanism
- Remove risk from customers by providing companies with sufficient funding to meet their pension liabilities through investment in low risk gilts

United Utilities agree with Ofgem that the negative impact on companies' cost of capital resulting from exposure to the investment risk associated with pension schemes may disadvantage customers. Therefore, it may be appropriate to consider some form of pass-through treatment in relation to pension costs. Ofgem must also recognise the impact that Trustees have on pension decisions and that not all pensions costs are within management control.

Customers of network monopolies should expect to pay the efficient cost of providing a competitive package of pay and other benefits, including pensions, to staff of the regulated business, in line with comparative benchmarks.

We agree with Ofgem's view that, as with any business, DNOs should pay the efficient costs of providing a competitive package of pay and benefits and that it is reasonable for customers of DNOs to meet these costs. Getting the balance right requires careful monitoring of employment data to ensure that grading and pay structures are comparable with external organisations. United Utilities uses Hay job evaluation to assist in this process. However, it is not appropriate to compare distributors with other industries in respect of the pension schemes. As has been pointed out, DNOs still retain legal obligations under section 104 and Schedule 14 of the Electricity Act 1989, which protects pre and post privatisation members of the Electricity Supply Pension Scheme, and provides benefits which cannot legally be withdrawn. Comparisons outside the distribution sector are meaningless unless the implications of these legal obligations can be taken into account in the analysis.

The only significant option for DNOs to consider in respect of the costs of funding pensions schemes is whether to close the pre-privatisation legacy schemes for new employees and put in their place other schemes that remain competitive and attractive to high quality personnel.

In principle, each price control should make allowance for the ex-ante cost of providing pension benefits accruing during the period of the control, and similarly for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex-ante assumptions on which these have been estimated.

United Utilities support this principle as the fundamental approach that should underpin the case-by-case consideration of each DNOs price control.

Pension costs should be assessed using actuarial methods, on the basis of reasonable assumptions in line with current best practice.

United Utilities support this approach.

In principle, we also agree to using the triennial actuarial valuation due to be completed after 31 March 2004 as the basis for the next price control review calculations. However, this valuation has, historically, taken at least six months to complete and it is unlikely it will have been completed by the time Ofgem plan to publish their initial proposals. Therefore, it may be necessary for Ofgem to publish initial proposals that only describe in principle how pension costs would be dealt with.

The financial implications could be confirmed in the final proposals once the valuation has been completed.

Increases or decreases in the future costs of providing accrued benefits resulting from under or over funding in prior periods will need to be considered on a case by case basis.

As all companies are likely to face different circumstances in relation to their pension schemes as detailed, dialogue on a one-to-one basis is welcomed. We believe that this approach should be consistent with the principle of establishing ex-ante forecasts of future costs described above.

Increases or decreases in the future cost of providing accrued benefits resulting from differences between ex-ante and ex-post investment returns in prior periods will also need to be considered on a case-by-case basis.

Again we support the opportunity for detailed discussion of each company's circumstances. However, we do not understand why Ofgem have chosen to highlight ex-ante forecasts of investment returns, from the other ex-ante forecasts considered under the second bullet point above, for special consideration. We can not see any justification for applying any different principle to investment returns other than the current focus on this issue due to its extreme variance from forecasts made at the last price control review. United Utilities restate our support for Ofgem's principle that each price control should make allowance for any increase or decrease in the cost of providing benefits accrued in earlier periods resulting from changes in the ex-ante assumptions. If companies have taken proper advice and acted in a manner consistent with industry norms they should not be rewarded or penalised for any changes in factors, including investment returns, assumed on an ex-ante basis. The only circumstance where any alternative consideration may be appropriate would be where a company had exhibited some extreme form of behaviour at odds to industry norms.

Liabilities in respect of the provision of pension benefits that do not relate to the regulated business should not be taken into account in assessing the efficient level of costs for which allowance is made in the price control.

We are concerned about this guideline for the following reasons:

- Prior to the legal separation of the supply and distribution businesses, the distribution business was purely an accounting and regulatory construct within a single legal entity (the public electricity supplier, or PES) created by statute. Liability for pension costs rested with the PES rather than with the specific regulated 'business'.
- Statutory transfer schemes authorised by the Secretary of State have resulted in the distribution business successor carrying the cost of current pension obligations and of historic redundancy payments associated with employees who left in the past and whose activities would not now be classed as distribution activities.
- The cost of pension obligations caused by these past employees derives from statutory obligations that distributors cannot reduce or avoid, and that are not imposed on other companies. Ofgem should make allowance for recovering the cost of such obligations, since that cost is unavoidable.

- It would not have been appropriate to transfer such obligations to any competitive business unbundled from distribution. The actual size of the obligation would have depended on past levels of efficiency and past efficiency gains, and not on the efficiency with which the new supply business (for instance) was able to carry out its activities. Clearly such businesses are now in competition with other businesses unencumbered with such obligations and so would be unable to recover the costs. More fundamentally, to have knowingly put the payment of such obligations at greater risk would have breached the statutory duties of fund trustees.
- Ofgem's statement is also inconsistent with its stated principle of setting the allowances for pension costs ex-ante with ex-post correction. The scope of the distribution business has changed in response to changes in regulatory and government policy over time. Before April 2000, for example, the business included the activities of meter reading, data processing, and data aggregation. From April 2000, these activities were transferred to supply businesses and are now part of a competitive market. The ex-post correction of pension cost assumptions before that time in respect of such activities must therefore remain within the distribution price control.

Companies will also be expected to absorb any increase (and may retain the benefit of any decrease) in the cost of providing enhanced pension benefits granted under severance arrangements, which have not been fully matched by increased contributions.

United Utilities believe that the use of the word "enhanced" in this statement may be misleading. It is unlikely that companies will have enhanced the benefits for redundant employees who joined pension schemes pre-privatisation, beyond the level of benefit they have been compelled to provide under their statutory obligations. However, using standard terminology these employees would be considered to have received "enhanced" pension benefits. We, therefore, propose that "discretionary benefits" may be a better term.

Companies' decisions about whether to incur the costs of obligatory and discretionary pension benefits in making employees redundant will have been made as part of a consideration of the costs required to achieve certain cost savings. Under an incentive based regulatory regime a company is encouraged to balance the costs of achieving a saving against the benefits accrued from the regulatory incentive mechanism. Where the net benefit is sufficient, companies will take the necessary action to realise the saving.

Customers subsequently enjoy the ongoing net benefit of any saving. In the case of the pension costs associated with cost savings realised through redundancies, companies and customers were initially able to fund these costs from scheme surpluses. As these surpluses have diminished, companies must now fund the ongoing costs. Where the costs have been discretionary it may be appropriate to consider whether efficient decisions were made in providing additional benefits. However, where these costs are obligatory it is appropriate for customers to take on the costs on the same basis as they took the benefits of the savings secured.

5. Improving the Incentive and Price Control Framework

We welcome Ofgem's early work on both incentives and dealing with uncertainty. This has provided an excellent foundation on which to debate the detailed issues for the price control review. In particular we would emphasise the value of the dealing with uncertainty framework to inform conclusions on where incentives should be applied and what form they might take.

Incentive Framework (d2, S3.25 – 3.28)

It was helpful to see the incentive framework set out in Table 3.2 (D2) and to note the areas under review. As we understand this table the basic structure of the efficiency incentives on opex and capex are established, but the incentives on performance and behaviour are generally still out for debate.

Periodicity of Incentives

United Utilities agree that allowing companies to retain efficiency savings for a fixed period of time will benefit both customers and companies by ensuring that companies' decisions about the timing of efficiency savings are not distorted by the regulatory framework. We are pleased to see that Ofgem recognise the need to allow companies to retain the benefits of both the depreciation allowance and the financing costs for capex efficiencies to ensure that the potentially distortive effects of the previous incentive regime are removed.

We also welcome and support the commitment to retain opex efficiency savings achieved from 1 April 2003 for a fixed period of time. Further, Ofgem recognition that the deferment of an investment project can represent an efficient decision is welcomed, as is the decision to allow companies to retain the benefit of all efficiency savings regardless of how they have been achieved.

Distortion of Incentives between Opex and Capex

We have considered further the potential for balancing opex and capex incentives since Ofgem's February consultation. Progress has been made on understanding the need for consistency and Ofgem's proposals represent a step forward. We believe that more work is needed to allow any robust quantification of optimal benefit sharing. This seems likely to be an area of work that could sensibly be left for a subsequent review, so long as pragmatic choices are made now that will ensure that incentives are sharpened and more evenly balanced than in the past. This should be sufficient to achieve a simplicity and directness of incentives, which will influence management behaviour.

Retention period for Efficiency Savings (D1, s3.33 – 3.39)

Having advocated that the retention periods for opex and capex incentives should be the same, we also see a need to extend these periods. As we have discussed earlier, retention periods do not need to match the five-year cycle over which price control reviews are conducted.

The costs of achieving efficiency savings clearly increase over time as easier savings are tackled first. It must be recognised that companies only retain a proportion of the net benefit of any saving. Analysis undertaken by DNOs and shared with Ofgem indicates that when the maximum savings available are three to four times the resource costs of implementing them (i.e. the "low-hanging fruit"), the proportion of savings to be retained by the DNO, if the total benefit going to customers is to be maximised, should be around a half. However, if these savings have all been achieved and more marginal projects need to targeted, customers benefit to the greatest extent if the benefits retained by the DNO are increased to around two thirds to three quarters of the total.

Therefore, if the industry is to continue to move forward at a similar pace the retention period for efficiency savings must be increased to around 10 years.

Non-operational capex (D1, s3.43-3.46)

We cannot disagree in principle with Ofgem's proposal that non-operational capex should be incorporated in the RAB, with a depreciation life that reflects physical reality. However, this will introduce practical complexity into the calculation of the RAB in future and, as we pointed out in the last correspondence on this subject, will add further pressure on financeability over the next price control period. We would therefore prefer to see such costs expensed and dealt with alongside operating costs.

Dealing with Uncertainty, New Obligations and Costs (D1, s3.47-3.51)

We cannot support Ofgem's contention that the existing arrangements for dealing with uncertainty have worked well in the past and we do not believe that they have protected customers' interests. The mechanism of companies "throwing themselves on the Regulator's mercy" on a case-by-case basis has done little to remove concerns about regulatory risk. From a company's perspective it has lead to erratic decision-making and unpredictability. An example would be the decision to only allow companies to recover an (apparently arbitrary) 80% of the bad debts resulting from the failure of Independent Energy as an "incentive".

Having explained how Ofgem and Frontier Economics have developed a decision-making framework for dealing with uncertainty which will be used to aid decision-making it is disappointing that there is no evidence of the application of this framework to the considerations of issues such as Distributed Generation or Pensions.

We believe that Ofgem should develop, at least as outline of principles, a number of the formal arrangements for dealing with costs that the Frontier Economics framework identifies as required, such as pass-through, error correction and incentives arrangements. The decision-making framework should then be applied to issues to give an indication of the relevant set of principles, before detailed price control mechanisms are developed.

Incentives to Invest (D1, s3.52 – 3.57)

The current incentive regime for investment is effected by balancing the need to maintain existing assets (so as to avoid penalties for significant asset failure through licence enforcement, Guaranteed Standards, Overall Standards and Utilities Act fines) against the financial benefits derived by reducing, deferring or avoiding forecast capex. This form of incentive based regulation has been proven as extremely effective in the electricity industry to date, delivering dramatic productivity gains and significant reductions in customer prices.

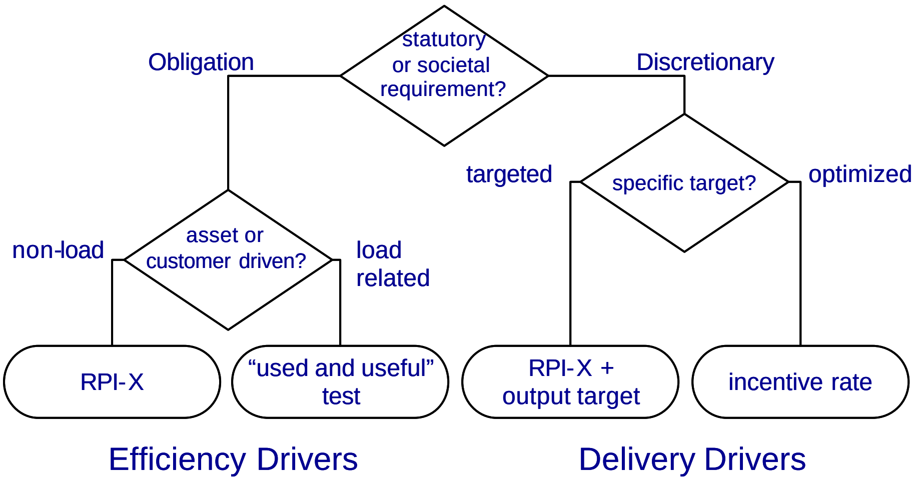
The incentive to satisfy statutory and licence obligations has recently been increased by Ofgem's introduction of a five year fixed retention period for capex savings that is conditional on such obligations being met.

Where there are statutory drivers and obligations on DNOs that require them to deliver investment, the need is for incentives to ensure these investments are delivered efficiently. Where the statutory drivers are not in place the current incentives for efficiency mean that any investment that is at the discretion of the DNO will not be undertaken. The benefits received from the RPI-X incentive and continued regulatory pressure on the cost of capital are such that it is very unlikely that any company will be able to make a strong business case to undertake discretionary capex. In these circumstances additional incentives to ensure delivery, which outweigh the efficiency incentive, are required.

The current incentive regime has been developed to include specific incentive schemes to ensure delivery of incremental improvements in quality of supply and reducing losses. These incremental "incentive rate" schemes encourage companies to undertake investment solutions where the incremental cost is lower than the incentive rate. Effectively, a linear (or possibly a more complicated function) approximation of a demand curve is generated by the incentive rate and companies optimise their position on their own supply curve. This can be applied with or without targets in situations where it is desirable for companies to seek to optimise their performance level rather than meet a specific target.

There may be a range of other areas where incentives to change behaviour are required. In some of these cases, stakeholders will require a particular target to be achieved and this may require a different form of incentive regime. Where desired output targets can be identified, mini regulatory contracts, using the RPI-X form of incentive, can be struck to ensure these targets are met. It may also be possible to move these new incentive regimes into the main body of capex incentivised by the classic RPI-X regime over time as behaviours are successfully changed. Another potential advantage of the approach of identifying separate regulatory contracts for the delivery of key stakeholder requirements is the greater clarity this gives, by exception, to what the main body of the RPI-X price control is expected to fund.

UU have developed a hypothetical decision making process for identifying appropriate capex incentives as illustrated below.



Incentives to change behaviour are separated from incentives to maintain appropriate behaviour. Delivery drivers are required where new outputs must be efficiently provided by DNOs, and efficiency drivers are required where the need to maintain performance at the lowest cost is important. Over time, and following a successful behaviour change, discretionary investments may become obligations and the incentive regime for that element of expenditure would change from a delivery to an efficiency emphasis. This indicates that the regime proposed may be capable of demonstrating flexibility whilst maintaining a common set of principles.

We believe that this framework could usefully be applied when considering current stakeholder requirements that potentially require additional investment, such as Distributed Generation. We would be pleased to explore these concepts in more detail with Ofgem.

6. Distributed Generation (D2, Chapter 5)

We welcome Ofgem's novel proposals for an incentive scheme to assist in the development of Distributed Generation. This will stimulate debate within the industry on an appropriate way forward. We will be providing a separate response to your paper on Innovation and RPZs, but comment here on some of the points raised in your DPCR consultation.

We see a distinction between incentives to behave in a particular way, and incentives to undertake a particular task as efficiently as possible. Whilst accepting that Ofgem have a duty to secure efficiency, we believe this needs to be interpreted with prudence, especially where aspects of behaviour or service may be jeopardised. We, therefore, welcome Ofgem's recognition that where the financial risks associated with a particular category of expenditure (such as DG) are higher, a premium return on that expenditure may be appropriate.

We also welcome Ofgem's recognition that 'premium returns' may also be appropriate where network consumers require additional investment in particular areas. We have tended to distinguish between infrastructure enhancements designed to open access to known resources (such as an additional 132 kV line into south Cumbria), and investment driven by a specific project (but not recovered entirely through connection charges)such as a reinforcement triggered by one project that can then support further new connections. In the current environment there is a more urgent need to encourage DNOs to kick start work on network transformation than to demonstrate that there could be no lower cost way of reaching the same outcome.

We are disappointed that Ofgem believes a mechanism to share the costs of network transformation across the UK lies outside the scope of their remit. Such a scheme would reduce Ofgem's concerns over the risk that stranded costs could fall on demand customers. Although the exact mechanism UU originally outlined may no longer be appropriate without supporting legislation, we still believe that costs should be shared equitably across all GB consumers and not loaded on those demand customers living in areas where the potential for DG is highest.

Incentives for Network Access and Investment (5.24 – 5.35)

We are pleased to see the development of Ofgem's thinking in this area. The option of assured pass-through of costs to the RAB would provide protection to a DNO but would not stimulate a more positive attitude to Distributed Generation. It would still be the case that other investments (that improved quality of supply or facilitated opex reductions) would be more attractive to a capital constrained company.

In principle we can support the proposed hybrid approach although we recognise the potential difficulties in calibrating the incentive mechanism. Our initial view is that investment projects for distributed generation will involve greater construction cost risk than for more familiar demand related investments. Allowing cost recovery at the 'normal' cost of capital would therefore already incorporate a scaling-down factor when compared to the overall rate required by shareholders. Consequently a £/kW allowance, bringing out the 'used and useful' concept, combined with addition of the investment cost to the RAB, would represent a genuine incentive to invest.

The structure of the £/kW reward would need to be considered in light of information gathered in the DG-BPQ. It may be necessary to separate according to connection voltage and generation type.

We believe it is particularly important to ensure DNOs invest in major projects that open access to renewable resources. These pump-priming investments may not immediately be attractive if a significant proportion of revenue depends on capacity take-up and the operation of a £/kW allowance triggered by a used and useful test. It may therefore still be necessary to have some major investment projects treated in a different way or with an accelerated reward mechanism.

Incentives for Network Operation

Sophisticated network management is unlikely to be widespread before 2010 except perhaps in RPZs and we therefore agree that it will not be necessary to introduce arrangements similar to those in gas and electricity transmission at this stage.

During the next price control period however, it will be necessary to put in place a mechanism for the Opex treatment of any disbursements made to DG for "ancillary services" including system security services.

7. Quality of Service & Other Outputs

The scope of output measures (D2, s4.11 – 4.13)

We welcome Ofgem's proposal to review the scope of output measures. It is important that companies' performance is assessed against a range of measures that reflect customers' priorities. However it will also be appropriate to consider performance against broader measures set out in social and environmental guidance from DTI. It would not be surprising if Ofgem's customer survey revealed distinct differences in perspective between individual customers and Government, representing the broader social good.

We also see value in an analysis of the agreed output measures to determine the underlying requirements. These can be split between:

- absolute levels of minimum performance (as with GS)
- absolute levels of average performance (as with OS)
- variable levels of performance linked to cost (as with IIP)

It would be useful to consider if any OS targets are truly absolute requirements or whether they should more appropriately be included in IIP, with variable performance acknowledged through marginal rewards and penalties.

Rewarding frontier performance (D2, s4.31 – 4.32)

As in our comments on cost comparison we are sceptical of the value of rewarding frontier performance on specific output measures. What should matter is value for money. Offering additional benefits for raising quality has the same drawbacks as rewarding low cost performance per se. Any system of rewards (or penalties) should be consistent with the broader thrust of Ofgem's incentives, which we assume will focus on value for money. It is not immediately obvious to us that the companies with the "best" quality performance or the "best" cost performance should be held up as examples deserving additional rewards.

Treatment of GOSPs (D2, s4.18–4.20)

As mentioned above the scope of Guaranteed Standards should reflect those elements of service at the individual customer level that can be specified in absolute terms. In these cases, failure to deliver should be accompanied by some recognition of the inconvenience to customers. Companies should be allowed sufficient revenue to meet all such obligations and in that case shareholders, not customer revenues, should fund payments to customers. Such payment should act both as an acknowledgement of poor service to customers and as a penalty to companies. However they should be set so as not to exceed the expected costs of avoiding the failure for an efficient company.

Treatment of exceptional events (D2, s4.21-4.22)

The events of last October have forced a more careful scrutiny of the treatment of exceptional events. We welcome proposals to align more clearly the arrangements under GS and IIP. In principle, the approach to the October storms was helpful although the companies might reasonably have felt that insufficient attention was paid to the detail of how comparisons could be made. The use of a single frontier company as a benchmark has all the risks that have become evident in this means of comparing operating costs, and we hope that a more reasonable benchmarking methodology can be adopted in the future.

We anticipate increased interest in network resilience in the wake of the recent problems in North America. It is important that any changes in standards (either for quality of supply or network resilience) are fully reflected in the cost allowances for companies.

Incentives for the speed and quality of telephone response (D2, s 4.40-4.41)

We believe Ofgem to have acted sensibly in their handling of the telephone response element of IIP. The inadequacies in data have been recognised and the value of rewards/penalties adjusted accordingly. We now see evidence of a measured programme to improve understanding of the data, which could contribute to more meaningful comparison of performance. We continue to believe that there are absolute levels of performance that would match customers' expectations. As with the quality of supply measures we therefore believe that the IIP should operate against a known reference point (and not the average of all companies). Targets that can be quantified in advance provide a more robust basis for incentive measures than an ex-post average of other companies' outturn.

8. **Assessing Costs**

Ofgem's approach to Assessing Efficiency and Assessing Forward Costs (D2, s6.2 – 6.47)

The consultation document lists a number of cost drivers, described as the main drivers. Ofgem should update this list after receipt of responses to the Historical Business Plan Questionnaire, which requests views from companies on cost drivers. In particular, we believe that the number of faults is a major cost driver. Ofgem's explanatory variables used in regression and other econometric analysis needs to take account of this further information from companies compared to that used at the last review.

We welcome Ofgem's proposal to use a range of techniques for assessing efficiency and projecting future costs. It is also important for Ofgem to set out a transparent process describing how these will be used to set future revenue. This work on assessment of costs will be quite involved and lengthy due to the wide range of techniques proposed. It would be helpful to have a plan of the work that is proposed and the deadlines involved so that we are able to comment on initial results at an early opportunity.

We note that Ofgem have recognised the importance of consistent use of the Regulatory Accounting Guidelines and that there have been inconsistencies in DNO's interpretation of DPCR3 accounting policies. It is possible that not all DNOs have related back to the PKF definitions from 1999 in reporting opex. Ofgem should continue to work with DNOs to ensure consistency of data and should tighten scrutiny of company submissions. Going forward the approach taken should be changed to minimise further confusion and avoid the need for complicated adjustments

Ofgem must be satisfied that any data upon which direct comparisons between companies are made is consistent. Otherwise the conclusions and implications for allowed revenue setting will not be robust. We would also encourage Ofgem to make adjustments for quality of supply and other factors. It is especially important that adjustments are made for mergers and for the impact of capex spend on opex

The consultation paper describes Ofgem's previous approach to mergers within the sector and it identifies that benchmarking will be undertaken at both the DNO level and the DNO Group level. Using analysis that assumes 14 independent companies is now no longer a fair comparison. We therefore welcome Ofgem's proposals to conduct comparisons on the basis of the observation of eight separate management teams and merged organisations. This approach is consistent with Ofgem's desire to encompass a range of analysis.

The Use of Bottom Up and Top Down Modelling (D2, s6.48 – 6.52)

In principle it is appropriate to consider both bottom up and top down modelling of costs. It is particularly important that consistent data is used in bottom up modelling due to its sensitivity to any inconsistencies in data definition and categorisations. It would be consistent with the building block approach for Total Cost Modelling to be used for comparison and not for setting revenue. In the long term however, Ofgem may wish to consider using TCM for setting revenue.

Improvements to the Approach taken at the Last Price Review (D2, Chapter 6)

We welcome an open-minded review of the comparative techniques used at the last review. We support the consideration of DEA and Stochastic Frontier analysis as proposed in the Consultation. We would also recommend that a Principle Component Analysis be conducted to determine the most significant cost driver. This will allow Ofgem to test and validate statistically its choice of variable(s). As discussed earlier, we believe that the number of faults should be included in the list of cost drivers being considered.

We hope to be able to comment on the initial results from the work being conducted by Cambridge Economic Policy Associates and would welcome a meeting to discuss openly the conclusions being drawn from their analysis. Since this area of analysis will be so important in influencing the outcome of the price review, we consider transparency and dialogue in this area to be an essential feature of a successful price review.

Over-use, and indeed continued use, of the "frontier company" approach to set revenue might threaten the sustainability of the sector by driving all companies to unreasonably low costs levels. We believe that Ofgem should continue to use a variety of approaches to inform their assessment efficiency and setting of costs. A move towards including Total Cost Modelling is welcome, particularly if it includes recognition of the importance of quality output in influencing costs.

Use of the ARM survey (D2, s6.62 – 6.63)

We welcome Ofgem's work on Asset Risk Management and are pleased that a number of our approaches have been identified in the final industry report.
We believe that Ofgem should complete the updated ARM survey by December, in order to give confidence in DNOs' approaches to forecasting network investment requirements and hence capex submissions. We are developing what we believe is an industry leading approach to asset risk management based on probability and consequence of failure. We would be keen to share this approach with Ofgem as either part of their ARM update or separately. UU would also like to work with Ofgem to further develop the survey.

Use of Total Factor Productivity Analysis (D2, s6.55)

We welcome the use of Total Factor Productivity Analysis at least as a “sense check” of the overall conclusions from Ofgem’s analysis. We suggest that Ofgem considers focusing on the overall figure appropriate for the sector, rather than specific values for each DNO. Comparative efficiency analysis can then be used to gain insight into specific values for each DNO.

Reviewing Companies’ own Cost Projections (D2, s6.53 – 6.54)

In reviewing companies’ own cost projections, Ofgem need to appreciate that the drivers of future costs may not be apparent from a review of the history.

We are pleased that Ofgem aims to place greater reliance on companies’ views of forecasts and recognises that the sophistication of DNOs’ forecasting processes has improved since the last price control review.

We support the use of scenarios in forecasts to deal with issues such as distributed generation and quality improvements. We strongly recommend that these scenarios are designed by to ensure a consistent approach across all companies. By enabling companies to submit comments on the draft scenarios, a final set may be developed that is approved by all DNOs. Work on detailed scenario development needs to commence as soon as possible as part of the process of finalising the Forecast BPQ