United Utilities Electricity PLC
Consultation Response

Electricity Distribution Price Control Review

Response to Ofgem Initial Proposals

August 2004

Contents

1 Executive Summary

The Price Control Review is a substantial project, which involves both a review of incentive arrangements and the assessment of future revenue requirements. Unfortunately, the many areas of progress on the framework for incentives and structure of the price control are undermined by the inadequacy of the basic allowed revenue provided in these proposals.

The assessment of future cost allowances falls far short of the estimate of costs included in our business plan submitted to you in December and January. This is most evident in the treatment of operating costs (including fault repairs) and the financial parameters related to cost of capital, tax and pensions deficits. We are broadly happy with the proposals for base capex (although both fault repair and pension costs will eventually be partly attributed to capex).

Your approach to quality of supply is also unsatisfactory. Not only do you make no allowance in your cost assessment for the different levels of service that companies provide to their customers, but you also set targets for the future that fail to recognise the value of service performance.

We have reviewed your proposals in the context of our earlier business plan submission and tried unsuccessfully to reconcile these. The evidence from your advisors PB Power and Ernst & Young does not justify the gulf between our plan and your proposed allowances. PB Power have confirmed the validity of our capex forecasts, whilst Ernst & Young have suggested only modest reductions in operating costs.

What does emerge from Ernst & Young is a recognition that inter-company comparisons are dangerous. Companies are aiming to provide different levels of service to customers, which has a significant effect on the costs they incur, and different emphasis between capital and operating costs. They also note that the merger of DNOs creates opportunities to reduce costs that are not available otherwise.

We have suggested ways to modify your modelling to reflect these aspects, which have the effect of narrowing the gap between plans and allowances to more reasonable levels.

On financial issues, our feeling that the proposed cost of capital was too low has been reinforced by Ofwat's Draft Determination last week which quoted a higher value and suggested the water sector was now less risky than electricity distribution. Your model has made a number of unreasonable assumptions on tax, which we hope to resolve through a working level review, whilst we urge you to acknowledge that the Distribution business elements of our pension fund deficits need to be funded through the price control.

In the rest of this paper we set out our detailed comments, accompanied wherever possible with proposals on how to move forward the draft methodology to deliver a more acceptable outcome.

In the sections below, we review the specific issues raised in your Initial Proposals paper. We have tried to comment objectively on each of the points raised, but this should not detract from our underlying concern over the combined package that has been presented. This is not acceptable. We believe it is quite possible to make relatively modest changes to your approach and to thus derive more realistic revenue allowances, which will then bear a more reasonable comparison to the estimates set out in the business plans we sent to you early in the year.

2 Timetable and Consultation Process

We appreciate the recent circulation of additional detail on the review timetable. This highlights the importance of August as the month within which we need to resolve our differences of understanding. We will arrange a series of working level meetings to review all those areas of your proposal that cause us concern.

We continue to support the commitment to transparency inherent in your approach. It is essential that your proposals are presented in a manner that allows us to rapidly understand the thinking behind them. Whilst you note that most of the milestones for March to June have been met, the failure to distribute copies of the financial model has been particularly frustrating, as we had to spend considerable effort trying to understand the source of your Initial Proposals. Our comments in this document have been written without the benefit of your model to verify our assumptions. Now that we have the model and your guidance notes, we hope to be able to follow your detailed calculations. It will be important for you to ensure that a current version of the model is issued with each subsequent price control review document.

3 Form, Structure and Scope of Price Control

3.1 Introduction

We are pleased to see that many of the areas of uncertainty in respect of the structure of the price control are being resolved. This should provide a more robust framework within which to consider the detailed proposals.

We agree that the RPI-X form of control has worked well for customers and other stakeholders, and we support the development, rather than replacement, of this approach. However as the overall control becomes more complex, it is important to ensure that incentives do not combine to give unintended messages to companies. There are instances where we believe this to be the case in your Initial Proposals. A more comprehensive review of the interaction between incentives is needed. This could be added to the work programme for the Incentives Working Group.

3.2 Form of Price control

Revenue Driver – we note your intention to incorporate EHV revenues within the definition of price-controlled revenues, but to attach no revenue driver. In principle we can understand how this aligns with the view that short-term EHV charges do not depend on kWh sales. However we can see a number of detailed issues to be resolved.

Your March paper suggested that revenue from new EHV sites would be excluded until 2010. We assume this applies equally to increases in supply capacity to existing sites. It will also need to be made clear how companies should respond to the closure, or reduction in supply capacity, of existing sites. Since 'allowed revenue' remains unchanged we would expect to recover any shortfall from one EHV site from other customers. This would most appropriately be achieved by smearing the effect across all remaining price controlled revenues. Clarification of these details is essential before we can confirm the acceptability of your proposed treatment of EHV revenues.

We agree that it is time to review the relative weights of LV and HV sales within the price controlled revenue. The current weights were established in 1989 as part of a much broader exercise that was, in part, designed to avoid instability in prices during the transition to private ownership. Since then the scope of the distribution business has changed and further changes (such as the removal of metering services) are now proposed. Many of these changes will have a proportionately greater effect on the costs of serving LV customers and our modelling suggests a very significant narrowing of differentials between LV and HV allowances is needed. There is no explanation of the derivation of the numbers in Table 3.1. While this represents a better fit to our assessment of the balance of costs than the weights currently used in our Licence, we still believe that further work is needed to develop values that will be robust through the period to 2010.

Price index – We support your proposal to retain RPI indexation.

3.3 Scope of the Control

Units distributed out of area – we support the proposed treatment of this revenue as excluded from price control. It is important that all Licensees face the same obligations.

Business Rates – We understand that you are now satisfied with the level of engagement from DNOs in the discussions with the Valuation Office Agency, and are content that the rateable valuation for UUE is reasonable. We therefore expect to be granted full pass-through of business rates with a similar treatment to NGC Exit Charges. If this is not the case, we need to be notified as a matter of urgency.

Revenue Protection – We agree that revenue from Revenue Protection services should be excluded from the price controls. However, it may also be the case that your review of responsibilities places new obligations on DNOs that will require additional remuneration.

3.4 Incentive Framework

We remain disappointed that the incentives for cost reduction are being substantially weakened at a time when the whole industry acknowledges that further gains are becoming increasingly difficult to obtain. You have not been able to achieve full clarity in respect of definitions of opex and capex from the last price control review, but enough work has now been done to specify more clearly the boundaries that should apply for 2005-2010. This should remove the argument for weakening incentives. Furthermore we are concerned that your proposals fail to acknowledge that ongoing cost reductions require initial expenditure on items such as training, system development or restructuring. It is therefore the net benefit that should be shared with customers, rather than the gross benefits indicated in the earlier work by Frontier Economics. From this perspective it is even more important to avoid any reduction in the 'gross benefit' since the facilitation costs are growing as savings become harder to identify. There is no recognition of the costs of delivering savings in the approach you have taken to cost allowances. It is important that you, with the objective of protecting customers' interest by increasing incentives for efficiency, lead this work and set out clear definitions for the whole industry.

We are encouraged by the suggestion in paragraph 3.27 that current opex incentive rates could be restored early in the next price control period. We suggest that the Incentives Working Group should begin to develop proposals immediately.

3.5 Dealing with Uncertainty

We welcome your confirmation that two of the key new areas of uncertainty will be managed through specific re-openers, based on the earlier ENA proposals. It is important to retain the efficiency incentive properties of allowances set in advance wherever possible. We believe the ENA suggestions provide for this, whilst protecting customers or companies from wildly inappropriate allowances. More recent evidence suggests we may need to add a third category of new costs to this mechanism to cover the move by BT to IP technology. We understand that this change will lead BT to withdraw support for our current point-to-point dedicated lines for protection and tele control and PMR. This will add substantially to our costs (£2-3m pa), but the timing of these changes is currently uncertain.

It is also worth noting that there are other areas of cost uncertainty where we accept that licensees should bear the risk of that uncertainty. (A list is included in our FBPQ.) In these cases a central estimate of the level of cost needs to be built into the price controls, with companies absorbing the risk of fluctuations from that level.

3.6 Losses

In principle, we agree with your desire to increase the incentive on DNOs to manage distribution losses by incorporating environmental cost in the overall value. However, such an incentive must offer the prospect of rewards for good performance as well as penalties for poor performance. This is currently not the case as:

- The targets are set based on a historical period, including artificially low levels of losses; and
- The prospect of new remote distributed generation biases the scheme towards penalties.

We believe both can be remedied through suitable modification of targets and more considered treatment of future distributed generation.

Target for losses: It is essential that targets are set at a level that allows companies the prospect of rewards for improvements in performance, as well as penalties for poor performance. We have had detailed discussions with your staff around the target setting process, and have suggested specific adjustments to take account of the inconsistencies in the historical pattern of reported losses.

Effect of distributed generation: We welcome your decision to revise the LAF floor to 0.997. This is consistent with your stated objective of balancing incentives in respect of distributed generation. However we are still not happy that this objective is appropriate.

Many of the most attractive sites for wind generation in our regions are in Cumbria, where generation already tends to exceed demand. New generators will therefore add to total losses, and your suggested ‘solution’ only ensures that the rewards from the DG Connection Incentive will offset the damage from the losses mechanism. This negates the positive incentive to DG which was your original intent, and is not consistent with Government policy to promote a low carbon future.

Our suggested solution is to treat Cumbria as a special case with a LAF floor of unity. This would retain the incentive to connect DG in Cumbria, whilst leaving the rest of the UUE region facing the same incentives as other parts of England and Wales.

3.7 Metering

3.7.1 Overall Approach

We support your desire for competition in metering services and have structured our businesses to take advantage of the new opportunities created for multi-utility metering service providers. As with competition in connections, so in metering the North-West of England is the area where competition is taking off first. We therefore, do not see the loss of market share as some academic possibility, but a reality of the current commercial environment.

The proposed approach to new metering price controls is broadly acceptable to us, but we remain extremely concerned by the potential for stranded costs in the distribution business in two particular respects:

a) MOp Restructuring Costs

The proposed approach to MOp costs will leave the biggest rewards with those companies that lose least of their former (100%) market share. This may reflect other aspects than the efficiency with which the service can be provided, and could act as an incentive to stifle competition.

We have previously suggested that a one-off restructuring allowance should be included within the main distribution control to reflect the costs the business will incur as a result of facilitating competition in metering activities. This allowance should be triggered by suppliers moving away from the distribution licensee following an open and competitive tendering exercise.

Our proposal is that the allowance should be paid in two stages. Half of the allowance should be recoverable through DUoS when the distribution licensee has been de-appointed for 25% of the MPAN's within its distribution services area. The remaining half should be recoverable when the licensee has been de-appointed for 50% of the MPAN's within its distribution services area. We have previously provided evidence that UUE is likely to incur restructuring costs up to £3m. We believe the amount of the restructuring allowance should be set at £2m (paid conditionally in two stages). This would establish the correct incentive framework for the DNO to facilitate competition and minimise any restructuring costs.

b) Prepayment Metering

It is already evident that there may be a particular problem with certain prepayment meter technologies, including the smartcard system that prevails in our area. The issue for the whole industry to resolve is how to manage any progression to a new technology. Prepayment is an area where it is clear that decisions on future options need to be taken by the supplier community. The meter is a small part of the overall product package that includes payment outlets and cash record management. DNOs cannot, and should not, lead this process as it primarily concerns the level and type of services suppliers wish to offer customers. In the meantime, there is a growing risk that supplier action will accelerate the stranding of prepayment devices given your current approach to termination charges within the regulated MAP contracts.

Termination charges are the most efficient, and most widely used, mechanism for resolving concerns over the premature replacement of assets under rental or leased contracts. Should you remain set against such a market-based mechanism, then a further adjustment should be allowed to the DRC calculation to reflect the limited working lives expected for certain prepayment technologies.

Whilst there are significant areas of the proposals for metering where there is common ground between us, there is still much to be done if the increasingly tight timetable for the remainder of the Review is to be met. The final price caps for MAP, the structure and level of the MOp price control and the associated Licence amendments all have to be finalised over the next month or so. It will be important that we are able to work closely with you to help resolve all the outstanding issues.

Our comments on the particular issues raised in the initial proposals are as follows:

3.7.2 MAP

We support the proposal for price-caps on the provision of a single rate credit meter and a prepayment meter and a licence condition requiring the DNOs to use a non-discriminatory approach for other meter changes.

Further work needs to be done to confirm the precise mechanics used to calculate the price caps.

We are disappointed that you have been unable to share the basis on which the published numbers were calculated, particularly as these create expectations in the market place. We are unable to duplicate your calculations with the information released to date.

3.7.3 MOp

The proposal for a total revenue control on MOp is overly complex. The key cost drivers of MOp costs are the statutory meter change programme, level of new connections and suppliers' policies particularly for prepayment / credit switching. These do not lend themselves to being incorporated as simple revenue drivers under the form of control proposed. On our analysis, the number of visits gives far better regression results than number of mpans but this suffers from significant definitional issues and is not easily verified.

We do not consider number of mpans is a suitable revenue driver and to use this approach would give rise to significant difficulties for United Utilities. In 2005/6, due largely to the statutory change programme, we are forecasting to undertake a greater volume of work than in 2003. By 2005/6 BGT will have de-appointed UUE as meter operator for around 25% of the MPAN's within our distribution services area. Therefore in 2005/6, under the form of control proposed, we will be faced with an increased workload with significantly reduced revenues which is unacceptable.

There are additional complexities in defining the scope of activities covered by the total revenue control, in identifying the balance between the different services provided, in attempting to normalise the data between different companies and in identifying fixed and variable costs. All of these must be resolved before the parameters can be set for the type of mechanistic control proposed.

We do not believe such complexity is necessary and a simpler approach needs to be considered for the two years in which restrictions will apply. A similar approach should be adopted as for MAP with two price caps governing the installation of a single rate credit meter and a prepayment meter within the standard timescale set out in the nhh MOp contracts.

In each of the two years affected, the DNO should propose the level of charge for these services based on predicted volume of services to be provided, allocation of overheads and a suitable margin. These volume predictions would be based on circumstances pertaining to the individual DNO regarding the extent of supplier unbundling in their area and the nature of the statutory change programme in the year. Where the level of charges are proposed to increase (including from the present 2004/5 charges) then the DNO would be required to provide additional information to explain the reason why it is necessary to increase charges. We would expect you to step in and propose alternative charges if you felt the increases were unjustifiable. The DNO would have the option to apply for increases part way through the year if there was some significant change during the year e.g. the dominant supplier unbundled its service requirements.

This approach avoids much of the complexity of a total revenue control. Extensive data on metering costs have been provided by the DNOs as part of the price control review which would enable you to make informed assessments of each DNO's proposed charges for 2005/6. You would only be required to undertake further work if a DNO proposed any increase in 2006/7.

Allowing DNO prices to rise as the volume of services declines is necessary to allow the DNO to finance its functions and to avoid market distortion through the cross subsidising of services. This does not guarantee recovery of the fixed costs, as more suppliers will rapidly unbundle if prices rise significantly. Nor does it allow the DNO to recover the costs of restructuring its business. It is the change in regulation, and not management inefficiency, that will cause costs to become potentially stranded. In these circumstances, it is appropriate to ensure that a DNO can recover those legitimate costs and not have to fund them from income received to properly fund its core distribution activities. This is a cost of making the transition from a regulated environment to a competitive environment, and part of the price of change that should be met by customers who are the beneficiaries of that change. This should be facilitated by a competition allowance in the main distribution control.

3.7.4 Associated Licence Changes

We largely support your proposals in this area subject to defining the detailed drafting and aligning with the final form of the price controls.

4 Quality of Service and other outputs

4.1 Introduction

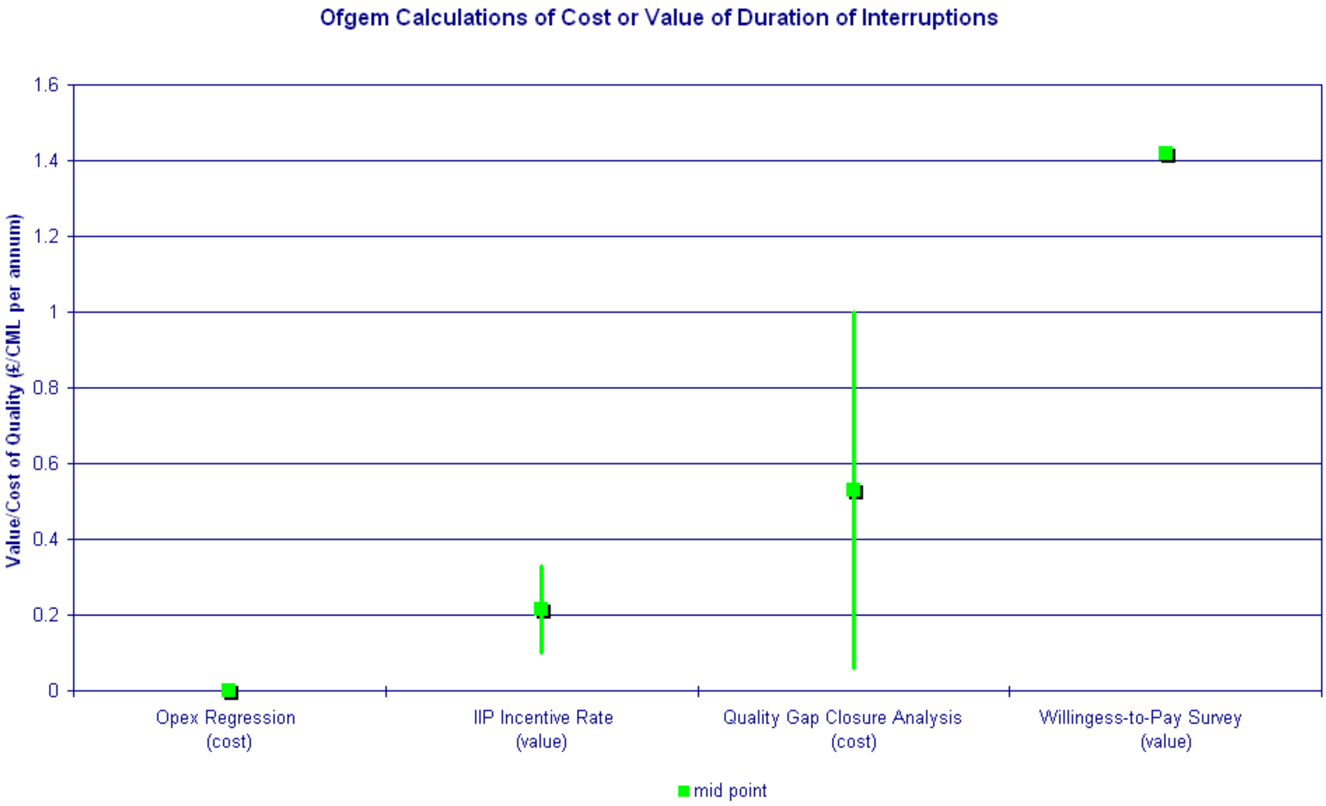
We are very disappointed with the approach to quality of supply set out in this paper. It has been a central theme of our previous correspondence that you should focus on the value for money derived by customers. This represents a combination of price and service levels. The two elements need to be brought together within the review so that costs are not compared without giving due weight to the outcomes experienced by customers. Your statutory duties require you to ensure that we can finance our functions. These must include the level of service we already provide to customers. We can see no evidence of this joined up thinking within your work, and we find it baffling that a company that has consistently been around the top of the value for money table should be treated so harshly.

4.2 Summary of results from the customer survey

The message from the customer survey is that customers do value the key elements of service that are measured and targeted through the IIP. The regional analysis indicates that customers in our region, if anything, place a higher value on a robust and resilient service than the national average. This supports the approach we have taken in the past, which has continued to balance service levels with cost reductions. It seems clear that our customers would not have thanked us if we had cut costs more aggressively and delivered a lower quality of service.

We find it disappointing that you are dismissive of the survey results, presumably on the grounds that it did not confirm your expectations. In our FBPQ we explained that we were happy to be persuaded of customers' preference in respect of both quality of supply and other investment initiatives (such as under-grounding for environmental benefits). We would now expect to see incentives to respond to customers' revealed preferences. We also expect you to demonstrate a more consistent approach to the valuation of service levels. As the chart below demonstrates, the Initial Proposals offer a wide range of unexplained differences in the value placed on incremental CML.

What is important is to have a consistent approach to valuation that clearly links the cost assessment work, allowances for improving service quality and the incentive rates in the IIS.



4.3 Revenue exposure to quality of service incentives

We support, in principle, the increase in the proportion of revenue exposed to service related incentive schemes. This was always our expectation from the original IIP. However, there seems little justification for the specific changes proposed in Table 4.1. As we have indicated above, there is evidence that customers would place a much higher value on a marginal interruption than is implied by the latest IIS proposals.

There is no good reason why the regional customer survey results should not be trusted. You should apply a consistent valuation methodology across the country. This may raise questions over whether customers' desire to pay more for better performance is entirely linear, but there is no clear evidence to the contrary.

4.4 Standards of Performance

Severe weather standard – we agree that the standards for restoration of supplies should be separated between normal and severe weather.

Semi-automatic payments – we accept that it is reasonable to expect companies to face a financial impact equivalent to the standards payment multiplied by the number of customers affected. However, we have previously provided evidence of the low percentage of customers who currently claim. It is therefore essential that companies are given sufficient additional revenue to match the expected payments that would be made as well as an allowance for the additional administrative effort. We can find no reference in your document to either of these issues.

Route for payments to consumers - we believe that it is important for customers that payments can be made directly by the DNO. This would provide the opportunity for the DNO to explain the reasons for failure against the standard when appropriate, and it would also ensure that the money is received by the affected party and cannot be lost in the supplier's accounts.

Compensation for HV connected business customers – we welcome your confirmation of the status quo.

Overall standards of performance – we support the removal of the Overall Standards and agree that reporting through extended RIGs will be a more effective means of monitoring performance.

4.5 Interruptions incentive scheme

Form of the incentive scheme – we welcome the move to a symmetrical scheme for interruptions, and we accept that customers are likely to be more greatly inconvenienced by unplanned interruptions. However, it will be important that the rewards for reducing the number and duration of planned interruptions do reflect customers' valuation. We note that the net reduction in the incentive rate is mitigated by the plan to sharpen incentives generally, but the evidence from the customer survey suggests that there will still be a substantial gap between the incentive rate and the marginal valuation of interruptions.

Setting targets – number of interruptions – we understand and accept your two-stage process for setting CI targets. The use of the disaggregated performance data to establish benchmark performance for each circuit type seems reasonable and the proposal to target companies to achieve the benchmark by 2020 will achieve a level of standardisation of performance that clearly does not exist at present. However it does not seem reasonable to then modify targets just because performance is currently ahead of target. To some extent this could be a consequence of a run of reasonable weather (or at least the lack of bad, but not 'exceptional' conditions).

Where we also disagree with you is in the financial consequences of these targets. There is a suggestion that companies must incur higher costs in order to move performance to benchmark levels. However, in your opex and capex cost assessment there is no acknowledgement that companies already achieving benchmark performance must already have higher costs than if they were falling short of the benchmark. Presumably performance ahead of benchmark could cost even more. This is quite obviously unfair. The iniquity of the approach is compounded by allowing some companies easier targets on the grounds that the costs of delivery are too high. This is done without obvious comparison with the willingness to pay work, and uses companies' own quality of supply scenarios rather than benchmark costs.

Setting targets – duration of interruptions – we are far less comfortable with the suggested approach to CML targets which seems to us to be logically flawed. The proposition is that a benchmark 'duration of interruption' can be applied to the target CI figures. However this is wholly inappropriate. Consider the example below:

If we consider a circuit which has 100 customers distributed along its length to a normal open point.

In the event of a permanent fault the circuit will incur 100 Customer Interruptions (not CIs per 100 customers).

Assuming there is a manually operated switch at the customer half way point - ie 50% of customers either side, then the circuit can be split at this point, typically within 1 hour enabling 50% of customers to be restored. If we assume the remaining 50% are off for repair time, say 2 hours, then we can calculate the total Customer Minutes Lost (not CML/customer) as –

50 customers x 60mins	= 3000 customer minutes lost
50 customers x 180 mins	= 9000 customer minutes lost
Total	=12000 customer minutes lost

The ratio of customer minutes lost / customer interruptions (= average time off) = 12000/100 = 120 mins / customer

With investment in a mid point Circuit Breaker and automation on the circuit, then in the event of the above fault scenario only 50% of the customers will now suffer a Customer Interruption, with the remaining 50% suffering an SDI (and therefore not contributing to reported performance).

Again assuming it takes 1 hour to reach site and a further 2 hours to complete the repair:

CI = 50 Customers

CML = 50 Customers x 180 mins = 9000 CML

The ratio of CML / CI = 9000/50 = 180 mins / customer

The investment made by the DNO has clearly improved customer service in that CI's have reduced by 50% and total CMLs have reduced 25%, however CML /CI has increased by 50%.

The above scenario illustrates two flaws in Ofgems' methodology:

1. Average time off supply is not a reliable indicator of performance: as illustrated above, initiatives such as automation and the introduction of additional protection zones significantly improve customer service but increase the average time off supply for those customers interrupted. In Tables 4.2 and 4.3 WPD, for example, consistently have higher CML and CIs than UU. The reason WPD achieve lower average restoration times is probably the higher CIs incurred.

2. The use of average supply interruption duration (CML/CI) as a calculation mechanism for allowable CMLs against normalized network configuration is again flawed; as the normalization does not take into account the impact of automatic devices downstream of the normalized circuit (this being the circuit emanating from a primary substation). Such devices significantly impact predicted network performance and cannot be ignored. Your suggested approach would incentivise DNOs to disable automation schemes which are designed to reduce CIs but have little CML benefit. To illustrate the point UU's performance is currently better than its CI target and therefore we could choose to disable autoreclose and automation systems with little risk of failing the target. This would not incur significant CMLs but would dramatically improve apparent CML / CI performance due to all the additional CI's incurred.

An alternative approach to CML targeting is clearly needed. Given the time constraints it may not be possible to develop a robust model from first principles. We therefore propose to modify your approach to remove the perverse effects shown above. Each company’s CML benchmark should be calculated from their CI benchmark by applying CML/CI factors for that company. This will at lease ensure that the result is not distorted by the different investment strategies used by other companies.

Another conclusion from your work on CML targets is that companies should be given an opex allowance to assist in reducing restoration times. Whilst this is one way of improving CML performance, the above analysis suggests that customers may often benefit more from an investment based approach. This would not only change the form of additional allowance, but also has implications for the cost assessment work. It further demonstrates why it is dangerous to compare costs between companies without fully taking into account the combination of opex and capex, reinforcing the conclusion that a true total cost approach should be used.

One other issue that emerges is that as network automation is increased, the average cost of restoration is likely to rise since a greater proportion of all restoration will involve physical work rather than simple switching. We have no idea where the £200 per fault figure (paragraph 4.42) comes from, but it seems very unlikely that this should be a constant across all companies regardless of the current level of system automation in place. It is not acceptable to pluck a value from one company’s unpublished submission and use it as if it is a benchmark cost.

Summary of targets and associated cost allowances – drawing on the assessment above we have two levels of comment on the summary tables presented in the Initial Proposals.

In absolute terms the proposed targets for UU are too low for both CI and CML:

- The CI target should be no lower than that implied by the proposed track towards the 2020 benchmark.
- The CML target should be based on an independent assessment of the duration of interruptions and not by applying an industry wide average restoration time. As a short term expedient you should use the CML/CI for each company to set CML targets.

UU has been treated unreasonably compared with other companies. This impacts on both the perception of performance used to establish upper quartile and frontier companies in terms of quality of supply, and more importantly, the link between service levels and costs identified in this section has no parallel in the cost assessment section.

Rewarding current best practice – as we have described above, improvements in average restoration times are not in themselves the best measure of performance. In our view, performance is best measured in terms of total CML, which does bring together the effects of network resilience, automation and restoration performance. We suggest that performance is better measured against existing IIP targets, since, whatever their limitations, they do represent the targets that companies were asked to drive towards.

Setting incentive rates – we can recall the debates during the IIP about the setting of the incentive rates, and the difficulty of squaring the constraints on % of revenue exposed with the desirability of values that were reasonably consistent between companies and with any evidence on customers' willingness to pay. It continues to frustrate us that there are such differences between the proposals for separate companies, and yet the cost assessment work does not recognise the possibility that quality of supply is a driver of costs. We find it difficult to comment on the detailed proposals until other parts of the price control framework have become more settled.

Audits and adjusting for inaccuracy – we remain wary over attempts to make more of the IIP reported data than is reasonable, but do accept that genuine errors should be corrected.

Frontier performance in this price control period – the discussion above explains why CML/CI is not a good measure of performance. We believe the qualification criteria should be CI and CML performance against the current IIP targets.

4.6 Storm arrangements

We are broadly happy with the proposed arrangements to cover periods of exceptional weather. However, as with other aspects of this chapter, we are not content with the financial arrangements. We again see the inconsistency of treatment of companies. There is some correlation between network resilience and company expenditure. Companies that have in the past experienced more severe customer disruption should not be given greater contingency funds than those who have invested wisely in network resilience. The allowance should be set on a flat £/customer basis, encouraging all companies to spend the money to best effect, whether that be in network strengthening or building up a 'compensation fund'.

4.7 Incentives for the speed and quality of telephone response

The current arrangements have encouraged companies to improve performance so that the survey results are concentrated into a tight band. We agree that this level of performance is now sufficient and it would be wrong to encourage companies to spend large amounts of money seeking further improvements. This supports the idea of moving to a scheme based on absolute performance with rewards or penalties only applying when performance falls outside the band of normal expectation.

4.8 Undergrounding in areas of outstanding natural beauty

We do not think it is appropriate to dismiss so lightly the prospect of further undergrounding for environmental reasons. At the least, you should be encouraging dialogue with Government to see whether there are actions consistent with the Social and Environmental Guidance that should be undertaken. Additionally it should be possible to establish a level of investment that is consistent with the lessons from the customer survey in the same way as has been done for supply interruptions.

4.9 Environmental reporting

We are happy to extend the reporting requirements under the RIGs and agree that no financial incentives should be attached at this stage.

4.10 Discretionary reward

Whilst we supported the principle of an additional discretionary reward, we are becoming concerned that the mechanisms to support could be unnecessarily elaborate. A simple scheme offering low value rewards at the discretion of either you or energywatch is all that is needed.

5 Distributed generation, the innovation funding incentive and Registered Power Zones

5.1 Introduction

We appreciate the efforts that your staff have put into the regulatory framework for distributed generation and we welcome the development of new incentives that will encourage some of the appropriate behaviours to support a move towards a low carbon future. We support the DG incentive mechanism as a suitable way to encourage the efficient and timely delivery of most generator connections, but we remain concerned over its impact on both high cost individual schemes and on infrastructure projects that could eventually stimulate more widespread development of distributed generation.

We also see merit in both the Innovation Funding Incentive (IFI) and Registered Power Zones (RPZ). We would like to confirm now our intention to participate immediately in the IFI and we will provide detailed proposals for 2004/5 in due course. We are also developing a Good Practice Guide which we will share with you as soon as it is available.

5.2 Distributed Generation Incentive

The risk-reward balance – we agree that the incentive scheme as proposed strikes an appropriate balance between risk and reward for the generality of connection projects. However, we remain concerned that it will not work effectively for high cost jobs (discussed below).

Micro-generation – Micro-generation – we continue to have concerns as to whether micro-generation should be included within the scheme- certainly for the next five years or until there is any significant penetration of these technologies. As we have previously suggested, it may be necessary to establish a different incentive rate, to maintain material incentives despite the small scale of these generators and/or to protect against the high cost per kW of any reinforcement that might be required. We will return to the practicalities of your proposals below.

High-cost projects – we are very unhappy with the way we now understand the £200/kW threshold would apply. We had assumed that once a scheme breached the threshold, the old deep charging arrangements would apply. However, we now understand that it is your intention for only the excess above the £200/kW to be charged on as an additional connection charge and that this contribution would be returned by the DNO over time through GDUOS. You have also added the £100,000 threshold for the operation of this arrangement, which effectively nullifies the £200/kW limit for schemes up to 500kW. We already have an example (quoted in the DG-BPQ) of a small project with reinforcement costs of £41,000 (equivalent to £273/kW) where these circumstances would prevail. It is clear to us that schemes with connection costs in excess of £200/kW may still look attractive to developers and therefore drag down the average return on the project portfolio. The elaborate system of thresholds and limits that you propose is distorting what should be a clear reward for the efficient connection of new generators, leaving a significant risk that a mixed portfolio of projects above and below the threshold could earn returns below the cost of capital even if all were 'efficiently delivered'.

As we pointed out in our March response, this has to be viewed against the design of the DG Incentive parameters, whereby schemes above £120/kW will yield returns of less than the cost of debt. Our concern is that, although we have been able to forecast (on a scenario basis in the DGBPQ) a view of the overall costs of our anticipated DG portfolio, at this stage we have insufficient evidence on which to predict the possible incidence of high cost schemes. We regard this as a risk issue rather than one of cost – although we believe that the implementation of an individual cap on high cost schemes would have negligible effect on overall DG forecast costs, it would be of significant help in making the incentive scheme acceptable to UU.

We suggest that an individual cap could be implemented very easily:

- The generator should pay all costs above the level of the cap (with no de-minimis) as a capital contribution
- The cap should be set at £120/kW, for consistency with the incentive scheme parameters
- The project should be treated under the incentive scheme as costing £120/kW
- This removes the need for the C2a term in the RIG and Licence algebra, simplifying the arrangements and reducing the possibility of the seemingly perverse situation where the pass-through capex becomes negative for individual projects (where C2a + C2b > 0.8(C2a + C2b + C3) in Figure 1).

O&M Costs – we welcome the promise of a review of O&M costs, which we anticipate will grow as the penetration of distributed generation increases.

Strategic investment – your explanation of the purpose of the incentive scheme in para 1.18 is helpful. We agree that it will not encourage strategic investment, and that the development of the network infrastructure is likely to be less coordinated than for demand (where the lumpiness of reinforcement is recognised in the way that load related expenditure is added to the RAB even while it is only partly loaded). Our concern has always been about the relationship between a narrow cost efficiency incentive and the wider public policy objective of a move to a low carbon future. We do not expect your proposals to encourage such a shift in the mix of generation technologies.

Ancillary service costs – the use of generators to provide ancillary services to network operators is likely to be of only limited consequence in the next five years (outside any RPZs). Consequently we accept your decision to make no adjustment in the current price control proposals, although we would expect to be able to make a separate claim if circumstances change dramatically.

Legal aspects – we had hoped that any new scheme would have been sufficiently attractive as not to cause concerns when considered against our statutory rights. As we have mentioned above, the added complications and qualifications to the incentive mechanism reduce the overall attractiveness of the package and we hope you will restore the benefits over the statutory minimum.

Updated connections boundary – we recognise the need to make changes to reflect the current policy position on the connections boundary. The diagram (in Figure 1) continues to confuse us. It is important to make it clear that the 'shared costs' are not defined as either C2a or (C2b + C3), but as the sum of these. Given that this is the intention we agree that the incentive mechanism should change, and we accept the pragmatic solution is Option 2. However, as discussed above, we believe that the scheme can be modified to remove the need for the C2a adjustment without affecting other scheme parameters.

Ongoing incentive for network access – we do not agree that the licence drafting work should include a network access adjustment. We strongly believe that any arrangements should be specific to the connection and use of system arrangements put in place, and not be part of a 'price control', although we support the need for a set of simple "groundrules", aligning generator arrangements with the Guaranteed Standards currently applicable to demand customers. This allows the appropriate commercial arrangement reflecting discussions on network design and costs at the local level. We understand that taking these incentive payments outside the licence algebra would cause us to lose the protection of these costs being covered by the floor on overall portfolio return, however, this change and our proposed changes to the arrangements for high cost schemes (outlined above) both have the benefit of simplicity and could therefore be acceptable to us as part of an overall package.

We have specific concerns relating to the application of such a scheme to microgeneration. If we are to proceed as suggested in the Initial Proposals Appendix then DNOs will need to set up a recording scheme to distinguish those domestic customers with microgeneration in order to identify their effect on the penalty arrangement for losses of supply. We can foresee considerable difficulties managing a system that accurately reflected the kW disconnected for faults. Furthermore we would contend that Guaranteed Standards and the IIP adequately protect these customers for lack of access to the network. As you know the mechanisms we have in place for IIP reporting simply count the presence of an MPAN. We would have to modify our systems to be able to distinguish between properties with and without microgenation, and there would be a considerable management overhead in maintaining this data to the level of accuracy required by the RIG. We therefore strongly believe that microgeneration should be excluded from the network access penalty arrangements.

Profiling pass-through revenue – it is important that the approach to the price control is consistent with the way we intend to charge customers. Consistency with demand pricing implies a RAB based approach, which will become increasingly important as our work under the structure of charges project drives consistency of price modelling between demand and generation users of our network.

5.3 Innovation Funding Incentive

We welcome the added focus on research and development and look forward to participating in the IFI.

Eligible IFI project – we agree that projects should, at the design stage, show expected benefits that exceed the expected cost. However, this assessment must be done from a company perspective. It is the role of other incentives to ensure that companies are encouraged to pursue actions in the long term interest of customers.

Eligible IFI expenditure – we accept the concept of only partial pass-through since this will ensure companies continue to have an incentive to work efficiently. There is no logic for a falling pass through rate over time. This introduces the risk that projects are not taken up in later years because the risks are considerably greater than in 2005/6.

IFI internal budget – we understand the concern that companies could establish significant internal R&D teams, if there is no restriction on internal spending. However, there will also be occasions when an internal solution is the most appropriate. One example, which we have already discussed with you, is engagement in collaborative projects where each participant contributes their own resources. (The proposed work on GenAVC where we would work with Econnect and others on this basis is an example.) It would be unfortunate if customers' money was wasted in the costs of alternative project structures, just to secure IFI qualification.

Use it or lose it – we accept that money not spent should be returned to customers, but it is important to recognise that it is in the nature of R&D work that not all projects will deliver benefits. This should not prevent cost pass through where the original concept was accepted as worthy for development.

Carry forward – we expect that a limited carry forward device will be sufficient, but this will need to be checked once we have some experience of operating these new arrangements.

Innovation good practice guide – we recognise the need for you to be satisfied that we have good internal procedures in place before IFI projects are approved. We hope to provide a draft shortly.

Review – we support the proposed review in 2007. This may provide an opportunity to fine tune the scheme and agree to preservation of the 90% cost pass through.

5.4 Registered Power Zones

We continue to support the concept of RPZs as a way to explore alternative arrangements for generator connection and operation. The proposed increase in incentive rates is helpful, but there are still aspects of the scheme that restrict its scope and reduce the prospects that RPZ will be developed.

Eligibility – we do not believe it is necessary to restrict RPZ to sites with new generation. There will be opportunities to consider changes to the way we manage networks that already have generation connected that could usefully be embraced in the RPZ definition. We also note that the definition of rewards entirely in £/kW terms will discourage small scale projects (since the administrative overheads will not be covered by the additional revenue allowance). This will put an effective lower limit of 5MW on any RPZ, which would rule out any projects in relation to DCHP. This is unfortunate as we can see a number of potential projects (both in voltage control such as design of HV tap changer schemes, design of LV networks, assessing the trade-offs between network asset sizes, voltage profiles, network length and losses, and in considering new technologies such as on-load tap changing distribution transformers).

Application and registration process – w e are pleased to see that a clear and consistent process will be established and that there will be a reasonably rapid timetable for processing applications. We look forward to your detailed drafts.

Good practice guide – we expect there to be separate requirements for the guide in respect of IFI and RPZ and there may need to be two separate documents. This was consistent with our understanding of your commitment in Table 5.57 of your March paper to produce the good practice guide for RPZ, whilst leaving responsibility on DNOs to produce the equivalent for IFI. However, we will be happy to help and provide input into the process of drafting.

Review – as with IFI we support a review of the progress with RPZ in 2007 as this will provide the opportunity to modify the arrangements if necessary, in order to secure more effective support for the development of new ways of working with distributed generation.

6 Cost Assessment

6.1 Introduction

This one chapter covers the bulk of the cost projections included in companies' FBPQs. The implication is that UU can reduce opex by about £100m and capex by £50m, (ignoring pensions or other new cost items), whilst matching enhanced customer service targets. These conclusions are reached with no direct reference to the detailed work within our business plan and with no attempt to explain how such profound changes in cost levels can be achieved.

We believe that the approach to forecasting opex, which is extended to include capitalised fault repairs and non-operational capex, is seriously flawed. A more reasonable approach would generate income allowances that more closely match our own business plans. Your advisors have not found any significant weaknesses in our forecasts. PB Power have validated our capex forecasts whilst Ernst & Young have identified only very limited scope for opex reductions. They also stress that inter-company cost comparisons are made less relevant by the clear differences in strategies being pursued by different owners. They note that some companies are aiming to be lowest cost, while others have a stronger focus on customer service requirements. This dimension is missing from your analysis.

UU is already one of the leading companies in terms of value for money. What matters to customers is the price they pay and the service level they experience. On this basis, UU can be seen to be in the top band of performers.

It is important for our customers that we are able to maintain this level of performance, and that unjustifiable price reductions do not lead to inappropriate service degradation.

Each step of your proposed methodology needs to be reviewed so that the result is a level of allowed income consistent with the financing of our service obligations.

We acknowledge that you have committed substantial effort to the assessment of companies' costs – both historical and forecast. This exercise has revealed the difficulty of comparison where there is no historical legacy of consistency in reporting, and no consensus on the definition of particular terms.

Information Collection – We sympathise with the problems you have had in compiling an appropriate data set and agree that more substantial annual reporting is a way to address some of the issues that have arisen. The proposal for an annual reporting framework consisting of a suite of cost, revenue and output reports coupled with abolition of the RAG's and regulatory accounts is one we support. We believe this framework should incorporate as much as possible of the regular reports required under the licence including those elements not directly linked to operation of the price control. In order to provide greater assurance and consistency an audit regime should be incorporated into the new arrangements. The "Reporter" used in the water sector provides a model on which to build. We would be happy to discuss in greater detail with you how this could be applied in the energy sector. We have attached a paper providing more detail of how Reporters operate.

In the meantime, it cannot be right to expose companies to additional risk because the cost evidence provided by others cannot be verified. It is essential that any cost allowances are tested against a company's cost requirements to avoid the risk that modelling inadequacies lead to unsustainable results. There is clearly a need to set a deadline for the resubmission of data (to reflect 2003/04 actuals and any other changes in circumstances), but this cannot be taken to remove our right to provide later evidence of any material changes that may emerge in the period before your Final Proposals are presented.

6.2 Operating Costs

We have consistently expressed concern at your analysis of operating costs. We see serious weaknesses in any disaggregation of costs, especially when so many definitional problems remain. It would be more reliable to review performance at a broader level, preferably through the development of value for money analysis that can simultaneously consider all costs (opex, capex, and finance) and service levels. However, we appreciate your desire to consider a range of different approaches and therefore offer comments on the methodology described in your proposals paper.

Normalisation – The complexity of the normalisation process is a sign of just how incompatible the original data was. Every adjustment introduces new opportunities for error, so that the final outcome must still be treated with considerable caution. In particular, we would draw attention to the adjustments for non-operational capex and capitalised overheads. In each case, the figures vary widely between companies and encourage a more complete aggregation of capital consumption and operating costs before comparing companies. For example, we have treated many of the costs of remote automation as IT, and therefore non-operational capital, whereas others may have charged the same costs to non-load related capex. This would distort any comparison of 'operating costs' only.

Also there are some issues that have not been addressed by the normalisation process, such as potential differences in the allocation of costs between fault and non-fault capex. We have previously asked you to have the table of normalisation data audited back to Regulatory Accounts, which themselves have been independently audited. Without this reassurance, our confidence in the result will be limited.

Top-down Benchmarking – Any benchmarking must establish a credible relationship between observed costs and their drivers. We have previously commented on the limited nature of the 'composite scale variable' as a driver of costs, especially as it fails to reflect the key factors of capital assets, quality of supply, and ownership, which we believe are important contributors to operating cost performance.

The CSV has been changed arbitrarily from that used in 1999. We see no particular reason for the weights you have used, and would point out that the even more arbitrary 1/3:1/3:1/3 weighting would generate a higher R^2 than the model you use. You have talked about undertaking work to assess DNOs' cost drivers since the last price review (this work was included in the original IIP scope) but we have seen no useful analysis to date. If this work is so hard to perform the chances of the real answer being even close to the arbitrary CSV must be considered very small. Following the discussion on 5th August, we are writing separately with detailed comments on CSV.

One further point on the functional form is that the assumption of a linear relationship is unnecessarily constraining and also creates a secondary problem in deciding whether to shift or tilt the regression line to achieve a 'frontier. We suggest a log-linear form will provide a better fit (with a higher R^2) and has the advantage that it would adjust to a frontier or quartile by subtracting a percentage of costs, rather than an absolute sum.

You also review a number of alternative approaches to regression, which take some account of total costs, quality of service and ownership. In our view these are not alternatives, but supplementary steps to improve the quality of the comparison. They need to be made sequentially, to build a more complete picture of comparability. We have previously provided you detailed adjustments that allow these steps to be taken within the framework of a comparison of operating costs. This has the advantage of minimising the changes to the approach you have followed, whilst improving considerably the information available to inform decisions on the levels of allowed revenue. We have already provided you with detailed proposals for these adjustments.

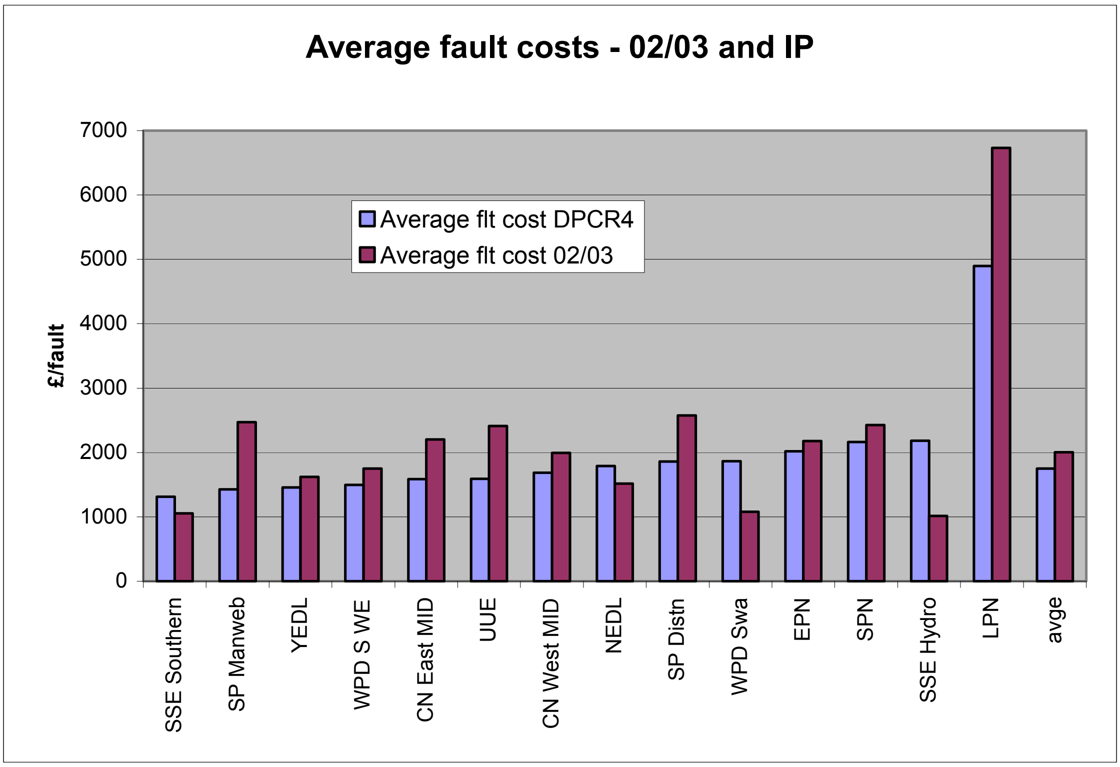
Once a reasonable characterisation of current performance has been established, it is still necessary to consider how to use this to help to set future allowances. Any attempt to derive frontier performance from the kind of benchmarking that can be undertaken with only nine independent data points is fraught with difficulties.

There is a common supposition that distance from an adjusted benchmark (frontier) is a measure of inefficiency. It is more accurate to say that the difference from the line of best fit is a combination of modelling error (including the effect of missing cost drivers, such as quality of supply) and inefficiency, and that it is not possible to specify the relative importance of these two aspects. As the target moves further from the average performer and closer to a 'frontier', the risk that the outcome includes adjustments based on error not inefficiency, will increase.

On these grounds alone it would be more appropriate to use an average regression line as the basis for future target costs. This will also make it easier to establish a future trend in cost levels, since sector wide trend analysis (such as TFP) usually estimates average performance, rather than that of any particular company.

This is also consistent with the setting of an average cost of capital for the sector, enabling an averagely efficient DNO to earn an average return.

Other Evidence and Judgment – We note that you have developed a tool which allows cost allowances to be adjusted to reflect particular needs. It is not only tree-cutting costs that require special consideration. The implied allowances for fault repair work that emerge from your modelling also run counter to expectations. The chart below shows the average 'cost per fault' allowed for each company.



As expected this shows the highest allowance for EDF-LPN where all faults will be underground cables with higher costs for location and repair. We would expect other companies with a high proportion of underground network to be towards the top end of this scale reflecting the type of work involved in fixing the average fault, but this is not the case. A fault repair adjustment is therefore essential.

This would take the form of an additional revenue allowance for those companies whose fault repair costs are forecast to be greater than implied by the simplified model used to assess total operating cost requirements.

As well as the focus on regression analysis, it is important to keep in mind the other evidence available to you in forming a judgement on the cost allowances for 2005-2010. These will include:

- Analysis and reports from Ernst and Young
- Analysis and reports from PB Power
- Customer prices and value for money analysis
- Customer survey
- Company submissions of FBPQ
- Company representations

These all need to be considered before a final judgement is made on the amount of income required. You have previously suggested that your own detailed cost analysis would provide a cross-check on companies' FBPQ data. What is now needed is to use the FBPQs to cross-check the regression output. In carrying out this check you should ask 'is it reasonable to change companies' forecasts so much?' and 'Do we understand the reasons for the differences?'

The final step in the assessment of opex is to consider the pace of change that is practicable. This has several components:

- *How much reliance can be placed on benchmark costs?* – The less confidence there is that the observed differences spring from inefficiency rather than modelling errors, the less the weight to apply to the benchmarks.

- *How much time, and/or money is needed to bridge the gap?* – Cost savings tend to involve changes in working arrangements that cannot be introduced immediately and may involve significant cost, (for example to restructure organisations, re-locate staff, etc).

- *What rate of improvement in efficiency can be expected over time?* – You assert that a 2% per annum improvement is achievable. This is suggested to be consistent with the PFP conclusions in CEPA's December paper. However, CEPAs conclusions are on the total improvement that the industry might be able to make in the next review period. This includes catch-up as well as frontier shift. Our own comments on the CEPA work showed that it was equally valid to conclude that electricity PFP growth would match GDP and that no additional gains should be anticipated. There is no evidence that any company can achieve cost savings at the level you propose. We, like other DNOs, did identify opportunities to improve efficiency in our FBPQ. However, these were offset by other areas where costs are expected to rise because of circumstances outside our control. The suggestion in paragraph 6.37 that some companies have provided forecasts that will validate your efficiency targets is not therefore correct.

- *Total opex allowance* –We agree in principle to the reversal of some of the normalisation adjustments and to the adding back of some cost categories. However as my e-mail of 7th June demonstrated, the present approach is inadequate. In particular it can not be sufficient to add back under the heading 'storms insurance and atypicals' less than the level of insurance costs removed earlier in the normalisation process. We believe a full analysis of all costs against the FBPQ submission is necessary to validate the final outcome.

6.3 Capital Expenditure

We note that work is in progress on the RAV roll-forward. We have responded to your recent information request and look forward to a discussion with you on the approach to determine final figures.

We are broadly content with the basic approach to load and non-load capex (excluding fault repairs and non-operational capex) that has been adopted. This uses consultants to validate our own forecasts and concludes that they are reasonably based. We have commented previously on the detailed report from PB Power, and here suggested how it should be used.

Given that PB Power have validated our forecasting approach, it is reasonable for you to use our figures to calculate future revenue allowance. The differences between our estimates and PB Power are small and well within the margin of accuracy of their models. Our own validated numbers should therefore be the basis of your subsequent work in setting allowances that reflect the quality of our forecasting. Specifically it seems more consistent with your intent for us to be allowed 105% of our own forecast costs. This approach would reinforce the incentive to the companies with the best forecasting methods.

PB Power's work concentrated on the Base Case we submitted in December 2003 and has not picked up the change we made to those estimates for work at Whitegate GSP. This was noted in our January FBPQ submission and needs to be reflected in any future allowance calculations.

One further change to ensure consistency of approach is for you to apply to all companies the adjustment you made to EDF Energy's data in Table A9. The replacement of oil-filled cables is an industry wide issue and we welcome your proposal to deal with this as a specific review topic. Although our proposed expenditure was a modest £8m, representing the minimum requirement to maintain compliance with current environmental legislation until 2010, this should be removed from the base forecast, and a separate allowance calculated in a manner consistent with your Final Proposals for EDF Energy companies.

ESQCR – We were please to have the opportunity to discuss the implications of the new Electricity Supply and Quality Continuity Regulations with you and DTI. We hope that it will now be possible to agree more precisely the requirements on DNOs, so that a consistent approach can be taken to establishing revenue allowances across companies.

Review of Future Capex - We are broadly content with the basic approach to load and non-load capex that has been adopted. This uses your consultants to validate our own forecasts and concludes that they are reasonably based.

PB Power's work confirms the validity of our forecasting approach. As a consequence, we suggest that, for those companies in the proposed 105% band, PB Power's work has essentially verified their forecasts, which remain a more realistic investment programme based on defined asset need rather than generalised modelling assumptions. Given the potential errors in the PB Power models, we suggest that these should not be used as the starting point for the calculation of additional revenue under the efficiency incentive scheme, and company forecasts used instead.

Given the above, we agree that it is appropriate to make adjustments to company forecasts to ensure comparability and we consider that two further adjustments are required to the UUE figures used in the Initial Proposals.

Firstly, we note that your view of the Base Case remains that which was submitted in December 2003. In our Alternative Scenario, we submitted a change to the Base Case comprising a single project at Whitegate GSP. This had the effect of raising our net Operational Capex submission from £598M to £610M, as presented in the March document.

We also note the exclusion of EDF Energy's fluid-filled cable submission for separate consideration in Table A9. UUE also has a large population of fluid-filled cables which will require replacement in the short-medium term. As PB Power do not consider this issue in their modelling, we suggest that all fluid-filled cable provisions are removed from the analysis pending your further review. This reduces our adjusted forecast by £8M.

This amount was considered to represent the minimum requirement to ensure continued compliance with environmental legislation in the DPCR4 period. We would wish you to apply a common approach to the treatment of these assets across all DNOs and appreciate an indication as to how this further analysis will be undertaken and its anticipated completion date.

Capex Allowances and Investment Incentives - We welcome your approach which maintains incentives for companies whose forecasts have been fully validated by PB Power. As discussed above, company forecasts remain the appropriate starting point for the incentive scheme. A number of adjustments are therefore required. The table below illustrates our view of an appropriate allowance.

Adjusted FBPQ	**£455M**
Exclusion of fluid-filled cables	-£8M
Inclusion of Whitegate project	+£12M
Amended adjusted FBPQ	**£459M#**
Efficiency scheme	+£22M
	£481M
Amend	
Future Pensions adjustment	-£18M*
Add	
Fluid-filled cable repl.	£8M**
Amended total	**£471M**

- still within 5% of PB Power's view hence qualifying for 5% efficiency scheme uplift
* - included at IP levels, pending further discussion
**- included at submission levels, pending your review

7 Financial Issues

7.1 Cost of Capital

The cost of capital assumption is a key component of the price review. The assumption in the initial proposals of 4.6% on a fully post tax basis (5.4% on a vanilla WACC basis) is to low, since it does not meet city expectations and if implemented will significantly damage investor confidence in the sector. UUE needs a cost of capital of at least 5.5% on a fully post-tax basis. This level is required to attract the appropriate funding for both equity and debt.

The initial proposals have generated negative sentiment from investors and this is a major concern for us. Investors are becoming increasingly wary of investing in UK utilities and there is an increased perception of risk in the industry. This results from:

- You reducing the opportunities and incentives for out performance, which is reducing expected actual rates of return.
- The significant increases in investment, which are changing the industry risk profile and cashflow characteristics. We are forecasting a 35% increase over actual expenditure in the current period, including investment to accommodate renewable generation. Increased investment will be encouraged at a higher rate of return.
- The aggressive efficiencies you have assumed for operating costs, which increase operational risks.
- Higher returns in other European utilities, which are attracting new investment away from the UK.

These are practical issues facing United Utilities and it is imperative that these risks are recognised in the cost of capital assumption, since otherwise debt and equity investors may choose not to invest in DNOs.

The main comparator in the UK is the water industry, where higher returns are available as well as the protection of Interim Determination mechanisms, which are not available to the DNOs. Ofwat has used a WACC of 5.1% on a fully post-tax basis in the draft determinations for the water companies and cited investor evidence that water companies are on a par or less risky than the DNOs. It is essential that your final proposals are consistent with Ofwat's views. Otherwise, there is likely to be the exit from equity already seen in the water industry, as a result of Ofwat setting the cost of capital too low in 1999.

There are recent regulatory precedents, e.g. CAA and ORR, which have used a cost of capital above the mid-point of their ranges. In these examples the regulators choose a higher value than the mid-point derived through the CAPM approach. This recognised the significant investment needs of the businesses, the limitations of the CAPM model and the 50% probability that the mid-point underestimates the true cost of capital.

To fund regulatory investment in the Group, UU launched a two-stage £1bn rights issue last year. This recognised the importance of equity investment by raising new equity from the market for UUE. However, this course of action carries additional cost and results in a higher cost of equity than reflected in the risk free rate and equity risk premium. You should signal support for a mixed funding approach through a specific increment to the cost of capital as suggested in paragraph 6.85 of the Appendix "Summary of responses to the March Policy Paper". NERA estimate the cost of issuance to be 0.3% and the CC allowed BAA a 0.75% premium on their cost of capital to enable a rights issue. This would signal the importance of equity funding, which is implied by your assumption of 60% gearing in the cost of capital calculation. New equity cannot be obtained to retain this ratio in a period of increasing levels of capex.

UU's current dividend yield of 8.7% provides real world evidence on the cost of equity and contrasts with the 5% figure used by Ofgem. We used this evidence in our assessment of the post-tax cost of equity of 7.9% in our FBPQ.

7.2 Tax

We are concerned that there appear to be serious flaws in the assumption for tax allowances in the Initial Proposals. It is important that these assumptions are robust and capable of being agreed with the Inland Revenue so that we have sufficient regulatory tax allowances to finance our expected future tax liabilities.

Paragraph 7.11 refers to treating capitalised faults and non-operational capex as opex for tax purposes. If this means that the relevant annual expenditure has been treated as tax deductible when incurred then this position is technically incorrect and incapable of being agreed with the Inland Revenue.

Also we are concerned that our review of your financial model and paragraph 7.11 of the initial proposals would indicate that you have overwritten UU's split of future capex across the various capital allowance pools.

The £140m equity injection in our FBPQ at the beginning of the price control needs to be taken into account in the final proposals when considering the actual level of gearing used in the tax computation. The impact of this equity injection is to take gearing below the theoretical level assumed in the cost of capital at the beginning of the control period. Furthermore, UUE does not guarantee any debt outside the regulated business. UUE's tax allowance therefore needs to remain based on a notional gearing of 60%.

It is imperative that the above concerns are adequately addressed. With this in mind it is important that working level meetings are arranged to discuss these and other tax matters so that you can incorporate reliable and accurate forecasts of future tax liabilities in the price control calculations.

7.3 Pensions

We are pleased that you have covered most of the issues we have raised previously on pensions. However, there remain two outstanding issues of significance to be resolved.

- The previous use of pension fund surpluses to provide ERDCs, enabling other employment cost efficiencies to be achieved. We are very clear in UU's case that there are no reasonable grounds for reassigning these costs to shareholders. Customers have benefited from the cost reductions. If a precedent is set for providing funding of redundancies by shareholders there will be fewer opportunities in the future for companies to justify cost reduction projects. The distribution proportion of the deficit should only be reduced by the value of any ERDC payments that exceed the minimum level specified in the ESPS terms and conditions.
- The allowance for the deficit recovery assumes a simple calculation by dividing the net deficit to be recovered by thirteen years. This understates the allowance since it does not allow for the discounting of future contributions.

We would like clarity on the pension assumptions in the final proposals. For example, we are uncertain of the value or source of the deficit figure used in the Initial Proposals. The pension assumptions in the Initial Proposals also omit UUPS from the calculations. Details of this scheme have been provided in our FBPQ and subsequent pension submissions. An allowance needs to be included for this pension scheme in the final proposals.

7.4 Financial Indicators

We agree with your choice of the three measures Ofgem are proposing to use to test financeability, subject to the threshold being set at a level consistent with an A3 credit rating. It would be dangerous to let ratings slip below A3, especially in light of the tightening of the trigger point in the new ring fence conditions. These new provisions require headroom in the indicators to allow for any downside scenarios.

In the FBPQ, we targeted financial indicators that we believe are appropriate to ensure that UUE is able to finance its activities and which are consistent with a low single A credit rating. We note that our choice of indicators and respective threshold levels are entirely consistent with your position set out in the initial proposals, with the one exception of FFO interest cover where we had targeted 3.25x rather than 3x.

You note, however, that these threshold levels are potentially conservative, as some agencies have suggested less restrictive ratios on some measures. In practice, credit investors base their investment decisions on the lowest credit rating, because of the asymmetric nature of the risks they face. What is important, therefore, in targeting a particular financial profile is to satisfy the threshold levels of all credit rating agencies not simply a subset of these. As a consequence, we believe the threshold levels in the initial proposals are unlikely to be conservative.

We note and agree that the three financial indicators do not fully capture the effects of capital expenditure requirements on free cash flow. We believe that this is an area of concern for the credit rating agencies; with Standard & Poor's in particular expressing views that they would expect to see slightly stronger cash flow indicators to compensate for this risk. As FFO interest cover is one of the more sensitive of the cashflow indicators we believe it is appropriate to target a threshold level of 3.25x.

In assessing financeability, you have made some key assumptions:

- Firstly, the assessment has been based on a model with initial gearing set in line with that used in the cost of capital assessment (i.e. 60%). This assumes that where a company's actual gearing is higher, that equity is available to improve the financial position. The validity of this clearly depends on the appropriateness of the allowed cost of equity and as such you need to be satisfied that this is set at appropriate level to attract new equity capital;

- Secondly, in excluding a fairly significant proportion of capital expenditure from the base modelling and considering this expenditure separately, the financial indicators that you are observing may well be artificially improved. The credit rating agencies will, out of necessity, factor in all capital expenditure obligations in assessing the financial indicators and concluding on a credit rating. We believe the importance of this is further reinforced by the concerns raised about effects of capital expenditure requirements on free cash flow. We, therefore, encourage you to seek further clarification on these important issues from the credit rating agencies.

It is important that when you make judgements on whether UUE can finance its functions then the whole of the distribution business and the full effect of all incentive mechanisms should be considered. The Initial Proposals exclude a number of areas of activity, such as metering, distributed generation, NGT exit charges and NTR. Further, the financial modelling excludes the effect of carry forward of previous price control adjustments such as from the losses incentive. Therefore the proposals do not represent the whole financial picture for the distribution business nor accurately predict the financial circumstances in the future. Additional costs and revenues need to be included in the final proposals to ensure that UUE can finance all its activities.

Further, consideration needs to be given to indicators in the period beyond 2010 to ensure that appropriate funding is provided in the new control, thereby allowing UU to finance its plan and meet the criteria used by the rating agencies. There is no reference in the Initial Proposals to you carrying out these tests.

8 Setting Price Controls

8.1 Introduction

Our review of the detailed mechanics used to construct price control proposals has been hampered by the delays in receipt of the financial model. Now that we are able to study the full model, we will be able to comment more extensively. We note the deadline of 13th August for replies on this matter.

8.2 Building blocks

We recognise the building blocks identified in your Initial Proposals and note the need for a company to be allowed sufficient revenue to finance its activities. The detail of the component parts within the building blocks must be derived in a manner that satisfies their intention.

8.3 Price Control calculations

Our comments on the individual elements within your calculation are either covered in the earlier sections of this response, or will be addressed in our separate note on the Financial Model.

9 Appendices

Appendix 1: Role of the Independent Auditor

INTRODUCTION

The purpose of this paper is to explain the role of the independent auditor (the reporter) for United Utilities Water, the regulated water and sewerage undertaker in the north west of England. The reporter has a primary duty of care to the Director General of the Office of Water Services (Ofwat), in providing an independent view of the performance of the regulated business in fulfilling its regulated functions. This occurs at price reviews, annually and on other ad hoc occasions as and when required by the DG.

The reporter role is a requirement of the regulated business Licence, Condition B 18.3.

The substance of this report is drawn from the Ofwat website, which sets out how the reporter role operates. Link reference:

http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/reporterstodirectorgeneral#2

UU has supplemented the report with commentary to explain how the relationships work in practice.

REPORTERS - GENERAL REQUIREMENTS

The Role of the Reporter

The reporter's and reporting team's role is to assist the Director General fulfil his statutory duties. The reporter and reporting team primary duty of care shall be to the Director. The reporter and reporting team also have a duty of care to the water company.

The Licence requires the reporter to be appointed by the licencee following competitive tendered applications and interviews with the Ofwat team. The DG approves the appointment and the terms of the contract between the reporter and licencee.

The reporter is therefore contracted to the licencee, but under the terms of the contract has clear accountabilities allowing for the independence of his opinion.

Required experience

The reporter's role assumes a relevant knowledge of the technical, operational, financial and regulatory aspects of the water industry. The reporter and key members of the reporting team will require detailed understanding of the regulated business of the water company. For new appointments such an understanding must be obtained in the first six months of the appointment.

Named individuals

The reporter and reporting team to be appointed shall be named individuals. A team shall assist the reporter. Each member of the reporting team must be appropriately qualified and be competent for their team role and in all respects be acceptable to the Director. The reporter shall take all reasonable steps to avoid changes in the team. Prior approval of the Director will be required for all changes in the reporting team.

In practice the reporter submits CVs to the licencee for endorsement, which in turn are submitted to Ofwat for approval. The approved individuals forming the reporter team.

9.1.1 General requirements

The reporter and reporting team:

- shall be <u>completely independent</u> from the water company;

- must not be engaged in consultancy studies or other service contracts associated in any way with the preparation of submissions for the water company during the period in which the certification responsibilities would be required;

- shall be required to give undertakings to the Director that information provided in the course of their work under the contract for the provision of services will be properly protected.

UU has not experienced any problems with these requirements. The reporter has allowed UU to inspect the arrangements to ensure that the undertaking to protect information can be met.

9.1.2 Level of audit

The reporter shall be responsible for deciding on the appropriate level of audit required to address the Director's guidelines or specific questions. The level of audit must be sufficient for the reporter:

- to satisfy himself or herself as to the adequacy of methods and procedures proposed and adopted by the water company to provide information in conformity with the Director's information requirements;

- to monitor and audit the water company's work to satisfy himself or herself that it is consistent with the methods, procedures, policies and assumptions stated by the water company;

- to test that there are coherent and explained links between the current submission and earlier relevant submissions from the water company;

- to identify the extent to which the methods and procedures adopted by the water company for the production of submissions:

- cover the scope of the work as outlined in issued guidance;

- apply a credible system of quality assurance;

- are adequate for producing estimates of expenditure needs (where appropriate).

- to test that the methods and procedures are followed rigorously and accurately by the water company;

To meet these requirements the reporter and reporting team regularly test the company's work and report on their findings to both the company and Director General.

Single level certification

It is not necessary for the reporter separately to validate company data or systems if this duplicates earlier scrutiny by the Auditors (the company financial auditors). The reporter will need to be able to confirm the adequacy of the scrutiny. The reporter shall acknowledge and report such validation. Any findings from such validation that have been incorporated in the report shall be identified.

The reporter submits a report on his findings to the Director General with evidence to support his conclusions. This usually follows one week after the water company has made its regulatory submission. Therefore audits are undertaken during the preparation of regulatory submissions by the water companyrather than later. However, this does not prevent the Director General requesting follow-up audits from the reporter should these be required.

Audit records

The reporter must maintain proper and adequate audit records cross-referenced to reports made to the Director. The audit records must be retained until the Director authorises their disposal. On termination of a reporter's appointment the audit records shall be retailed for a period of not less than seven years. The current reporter must be able to have access to these records during this period.

The reporter provides undertakings to the water company that these records are kept secure.

Comparative information

From time to time the Director will publish information on the comparative performance of the appointed water companies. The reporter is required to have regard to the relevance of such information and draw any interpretation, which may assist the process of certification and preparation of accompanying commentaries. Ie: the reporter also uses published information to inform the focus of his audit activity.

Water company policies

The reporter shall be expected to be aware of the water company's policies and assumptions underlying its approach to the submission.

Access to the reporter

The Director has direct access to the reporter and reporting team on any matters within the terms of reference of the appointment. This allows the reporter to maintain his duty of care to the Director General. The water company does not have the right to attend any meetings between the Director General and reporter.

Environment Agency, Drinking Water Inspectortate, Defra & Welsh Office

The Environment Agency, Drinking Water Inspectorate, the Department of the environment, food and rural affairs, and the Welsh Office shall have direct access to question the reporter and reporter team on particular matters that impact on their statutory duties with respect to the water company.

Confidentiality

From time to time the Director may require the reporter to maintain confidentiality of any communications to / from the Director or on any special investigations the reporter is carrying out. In normal circumstances the Director will expect the reporter to keep the water company informed.

The reporter shall ensure that information and data obtained from an water company or any consequential results of the reporter's work on any submission shall not communicated to other water company or third parties.

Duration of contracts

The contract for the provision of services for the reporter and reporting team shall extend for no longer than the period of a price review.

Annual performance review

The Director will carry out an annual review of the reporter and reporting team's performance with respect to the requirements set down by him in both general and specific terms.

Ofwat issues reports and recommendations to the reporter concerning the quality of his performance.

CONTRACTUAL ASPECTS AND OTHER RELATED MATTERS

Form of contract

The water company shall enter into a contract with the reporter and reporting team approved by the Director. This contract shall be consistent with the protocol for reporters issued by the Director. The protocol is set out in Ofwat's letter to managing directors ref: MD130. Link:

http://www.ofwat.gov.uk/aptrix/ofwat/publish.nsf/Content/reporterstodirectorgeneral

Remuneration

The water company shall pay all the costs for the work carried out by the reporter and reporting team. The remuneration of the work of the reporter and reporting team shall be based on time based charges within the fixed ceiling of costs for each particular audit or supplementary investigation.

Termination on poor performance

Where the Director is not satisfied with the reporter or reporting team's performance the contract will be terminated by the water company. The Director shall inform the reporter and reporting team in writing of the reasons for the decision. This correspondence will be copied to the water company.

Termination by the Director

If so directed by the Director the water company shall terminate the contract with the reporter, reporting team or member of the team.

Termination by the water company

The water company shall not terminate the contract with the reporter and reporting team unless the Director has approved the termination.

Unhindered access

It shall be the water company's responsibility to allow the reporter unhindered and timely access to the assets, systems, data, working papers, relevant personnel and other records associated with the carrying out of the water company's regulated activities.

The water company shall make facilities available, subject to reasonable prior notice and at reasonable hours, to allow the reporter for the purpose of carrying out a review required by the Director:

- to inspect and make photocopies of, and take extracts from, any books and records of the water company maintained in relation to the carrying on of the regulated activities;

- to carry out inspections, measurements and tests on or in relation to assets used by or any premises occupied by the water company maintained in relation to the carrying on of the regulated activities;

- to take on to such premises or on or in to any assets such other persons or such equipment as may be necessary for the purposes of preparing and completing a report.

The water company shall not be required to do anything which is outside its control; or to do, or allow the reporter to do, anything which would materially disrupt the water company's business (unless it is essential that that thing be done to enable the reporter to prepare his report).

Access to the Auditors

The water company is under an obligation to arrange for unimpeded access to and from the financial auditors as required by the reporter.

Responsibility for information submissions

It should be noted that the water company has sole responsibility for its submissions of information to the Director.

OTHER GUIDANCE

The quality framework

In carrying out a review of the water company's submissions the reporter must be fully conversant with the quality framework and guidelines under which the water company currently operate and will operate for the review period.

The water company is required to seek and obtain confirmation from the relevant quality regulator as to the timing and phasing of the quality compliance programme(s) projects. Reporters need to be able to confirm the status of each element of the compliance programme(s) has been confirmed by the relevant quality regulator.

Material Assumptions

In certifying the information submitted by the water company the reporter should ensure full exposure within submissions of **all material assumptions** that the water company has made. The reporter will be expected to comment on any material omissions including the consequences of the omission.

Material assumptions should be subject to scrutiny and where appropriate challenge. The extent of challenge is a matter for the reporter's judgement. In all cases the reporter's report should make clear the scope and extent of the challenge, and reported on in the commentary to the Director General.

In the areas of financial and accounting assumptions the reporter should obtain comfort from the water company's auditors properly to comment on the submission and to confirm that the assumptions are understandable and reasonable in the context of the information available at the time.

Allocation issues

The reporter should pay particular attention to the water company's allocation of projected expenditure between output purpose and cost matrix. This should cover the challenge of assumptions and compliance with those within the company.

High expenditure areas

The reporter's audit should be directed at those areas of the water company proposals where expenditure is projected to be and has been high. In this way the limited resources of the reporter can be directed at these areas that likely to have the greatest influence on the Director's determinations.

Adequacy of audit

In all areas the certification effort must be demonstrably sufficient to support any opinions given in the report.

Efficiency assumptions

The reporter should confirm or otherwise report on the water company's quantification of efficiency improvements in their projections. This applies to both operating costs and capital costs across all the output categories.

Areas of concern

Both in audit and challenge of material assumptions the reporter must address the areas of concern identified by Ofwat in the lead up to submissions. Normally these will be identified in specific guidance and correspondence, but the reporter should address issues or concerns raised in publications or at joint meetings between the parties.

Further explanations

The reporter shall provide such further explanation or clarification as the Director may reasonably require following receipt of the submissions and reporter's report. The reporter should be available to respond quickly to such requests.