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Dear Joanna

GDPCR Second Consultation

I have been following with interest the work on the review of gas distribution price controls, and particularly the evolution of thinking within Ofgem's Networks Division. Although there are inevitably some areas where the differences between the gas and electricity networks require solutions that would not be applicable to DNOs, there are many where parallels can be drawn and it seems appropriate for me to comment on your work.

In the short attachment to this paper I have provided comments on those elements of Chapters 2, 3 and 4 of your consultation, where it appeared relevant to comment. If you would like a discussion with someone not directly involved in the process, I would be happy to arrange a meeting with you.

Yours sincerely

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United Utilities Response to GDPCR Second Consultation

CHAPTER TWO

Question 1: Should Ofgem retain the form, structure and scope of the current price control during the one year control?

We support the use of RPI-x based price controls and therefore agree that the general form of the current control should be retained for the extension year. However we welcome the proposal to treat shrinkage costs separately as an appropriate response to recent uncertainty around the costs of wholesale gas.

Question 2: Should Ofgem introduce a new revenue driver other than the volume driver and, if so, what variable should it be linked to?

It is appropriate for allowed revenue to vary to reflect changes in underlying costs. However it appears difficult to apply this principle where the majority of costs are fixed, at least in the short term. This suggests that a reduced proportion of revenue should depend upon volumes of gas distributed. The potential use of alternative revenue drivers should emerge as BPQ cost estimates are examined.

To the extent that a traditional kWh revenue driver is used, it will be important to take adequate account of the changes in the supply market likely to result from both the substantial increases in energy prices and the continuing focus of Government energy policy on reductions in usage and particularly in carbon emissions.

Question 3: What revenue and/or costs should be treated as excluded/de minimis/pass through? What principles should be used to classify revenues and/or costs as excluded/de minimis/pass through?

Table 2.1 provides a helpful framework for review of the treatment of particular costs. We would expect de minimis activities to be those undertaken by the licensee, which did not fall within the definition of gas distribution. As well as the categories of excluded service that you have identified, we would expect to see a third which covers the costs of services provided at the request of a third party which are not part of the core distribution service. Excluded services should embrace all activities where costs or volumes are sufficiently uncertain as to make it impractical to include them within an overall revenue cap. Some valuable principles have been established in the electricity sector for identifying excluded services. These should be mirrored in any review of gas distribution services. Finally we would expect pass-through items to include all areas where costs are not within the control of the licensee, including those that have been regulated elsewhere (such as in a transmission company's price control).

Question 4: Should Ofgem link some or all of allowed revenues to a price index other than RPI?

It should be recognised that underlying utility costs are rising significantly faster than RPI. This can be seen when RPI is decomposed to reveal the effective rate of cost movements affecting goods and services. The costs of services are rising markedly and network operators typically purchase more services than goods. Achieving efficiencies above RPI is

therefore becoming increasingly harder and should be recognised when setting efficiency targets.

Whilst the simple use of RPI is easiest for customers to understand, it may be less relevant where a licensee's cost base is markedly different from the portfolio that contributes to RPI. Furthermore network operators charges are borne initially by other market participants rather than end customers, so a more complex approach to indexation may be more readily understood.

Question 5: Should Ofgem specify certain issues that could be the subject of a reopener and, if so, which issues?

We agree that as far as possible price controls should be set ex ante, based on central estimates of costs, with uncertainty covered through an appropriate cost of capital. However, this general approach is less easy to apply at times when there are significant uncertainties around specific developments. In these cases, we can see the merit of agreement with companies on potential reopeners, where special treatment of certain classes of expenditure may be needed within the make-up of price control allowances, subject to an efficiency test.

We agree that a specific re-opener, as adopted for DPCR4, is the most appropriate way to handle the uncertain impact of the Traffic Management Act.

CHAPTER THREE

One year control issues

Question 1: Is our approach to carrying out ex-post assessments of historical efficiency appropriate?

The ex-post efficiency assessment proposed demonstrates a greater degree of micro management than seen in previous price control reviews. However we recognise the particular circumstances that have made this necessary. There is one aspect of your approach that does cause concern. This is the risk that companies are disadvantaged by the disaggregation of expenditure. Your measure of 'efficiency' is absolute, so that costs above the efficient level are always disallowed, but it is not possible for any aspect of a company's investment programme to be more than efficient. In practice your calculation of efficient unit costs must include some average of jobs completed with different actual unit costs. In this calculation there are therefore instances of costs below the 'efficient' level. This concept is not carried through to your review of company performance. As such it could be argued to be asymmetric.

Question 2: Is our proposed regulatory treatment of our conclusions on efficiency appropriate, transparent and practical?

Subject to the reservations expressed above on the analysis of a company's expenditure, we believe that the approach you have adopted is a reasonable response to the circumstances.

Question 3: Is our initial view on how to set capital and replacement expenditure allowances for 2007-08 appropriate?

The prime source of information on future investment requirements should be the companies' own forecasts. Consultants should be used to verify the validity of those projections rather than generating their own forecasts independently.

Question 4: Which of our options is most appropriate for setting the operating expenditure allowance for 2007-08?

Without more rigorous analysis of historical expenditure it is unlikely to be reliable to rely on rolling forward actual levels of expenditure. It would seem more consistent with the principles of incentive regulation to extend the current allowances by applying a simple factor. A 2.5% efficiency improvement would appear to be unreasonably tough in the current environment of costs increasing at a faster rate than RPI.

Main control issues

Question 5: Is our proposed approach for setting capital and replacement expenditure allowances for 2008-09 to 2012-13 appropriate?

The approach set out in para 3.47 seems reasonable. Our comments under Q3 above are equally relevant to the longer-term forecasts.

Question 6: Is our proposed approach for setting operating expenditure allowances for 2008-09 to 2012-13 appropriate?

It is appropriate to use a range of tools to assist in determining operating cost allowances. As in electricity distribution, there are a limited number of data points from the gas DNs to conduct comparative analysis. As with DPCR4 it will be necessary to acknowledge the limitations of benchmarking and to ensure that the cost allowances are adequate for each company. The implications of singleton companies must also be recognised.

Question 7: How should we deal with the uncertainty surrounding the level of costs associated with the Traffic Management Act (TMA)?

Please see response to chapter 2, question 5 above.

Question 8: What are your views on our principles for assessing GTMS replacement costs, SOMSA exit and ongoing system operation costs?

It is important that each licensee is able to finance its operations. The efficient costs of all aspects of service should be included in price controls.

CHAPTER FOUR

One year control issues

Question 1: Is Ofgem's initial view on how to update the mains replacement incentive mechanism for 2007-08 appropriate?

No comments.

Question 2: Is Ofgem's initial view on rolling incentives during the one year control appropriate?
Question 4: Should Ofgem carry out any further work on incentives as part of the one year control review, other than that set out in paragraphs 4.1 to 4.23?
Question 6: Is it appropriate to adopt rolling incentives and an information quality incentive mechanism for capital expenditure for gas distribution? If so, what should be the features of the incentives?

We support the use of 'rolling incentives' for capital expenditure that are symmetrical for upsides and downsides but we do not believe that it would be appropriate to reduce the power of such incentives compared with those employed in the recent DPCR4. A strong capex roller should mean that detailed ex-post assessment of efficiency is not required. The roller must make allowance for justified overspends, resulting from factors that could not be foreseen at the time of the price control review. Appropriate revenue drivers can be used to capture such expenditure, for example from connections and load-growth.

We would expect an outcome that delivered a similar proportion of benefits to customers as is anticipated in the DPCR4 settlement.

We believe a 'sliding scale' incentive mechanism has merits as an effective methodology for encouraging companies to conduct accurate forecasting and it is therefore appropriate that it is included as part of the GDPCR. It will be interesting to see how companies respond in circumstances where the mechanism is declared in advance. In DPCR4 the concept was only introduced after companies had made their initial forecasts. There is a danger that companies will try to second guess Ofgem's consultants rather than develop the most appropriate forecasts.

It is essential that there is a focus on delivery of outputs that can be maintained through additional incentive schemes, for example the IIS and DG incentives as applied to DPCR4.

Question 3: How should Ofgem determine shrinkage allowances? Should Ofgem adopt one of the options presented in this chapter or a different option?

No comments.

Main control issues

Question 5: Should the interruptions and NTS offtake incentives on the GDNs be part of the overall RPI-X price control or separate incentives with caps, collars and sharing factors? How should the price risk for each of these incentives be addressed?

We believe that, where possible, incentive mechanisms should be 'packaged' to allow them to interact and generate efficient trade-offs. This is likely to be the case, for example, with incentives relating to efficient capex investment.

Question 7: Should the mains replacement incentive mechanism be carried forward in its current form, adjusted for particular factors such as service pipes, or abandoned in favour of a more generic incentive?

No comments.

Question 8: Is it appropriate to adopt rolling incentives for operating expenditure for gas distribution?

It is important to establish an appropriate balance between incentives on opex and capex. Otherwise companies will be encouraged to seek reward through reallocation of costs rather than pursuing true efficiency improvements.

Question 9: How can the quality of service arrangements be improved? In particular what are your views on the high level options proposed by Ofgem for the quality of service and outputs arrangements for 2008-2013?

The IIS has been effective in encouraging optimisation of service performance for DNOs. Whether a similar scheme would be as effective in gas distribution is uncertain. It would appear prudent to begin by ensuring the consistency of reporting before going on to propose new financial rewards and penalties.

Question 10: What are the advantages and disadvantages of the different approaches to setting capacity outputs and providing appropriate incentives for efficient behaviour by the GDNs in the next price control?

No comments.

Question 11: Are there any other areas where outputs or output based incentives for GDNs should be developed including safety and the accuracy of gas pipeline records? If so, what should they be?

No comments.

Question 12: Does any aspect of the operation of a GDN require more investment in technical innovation than occurs at present?

The Innovation Funding Incentive (IFI) scheme as part of DPCR4 has reinvigorated research and development in the electricity distribution sector and has encouraged greater collaboration with manufacturers and academia. We do not see why similar benefits cannot be gained within gas distribution, especially if the lessons learnt from the early stages of IFI can be applied immediately to the gas DNs.

Question 13: Should Ofgem consider any other form of incentive mechanism in the context of GDPCR?

No comments.