United Utilities North West
Lingley Mere
Great Sankey
Warrington WA5 3LP

Telephone 01925 237000
www.unitedutilities.com

Joanna Whittington
Director, Gas Distribution
Ofgem
9 Millbank
London
SW1P 3GE

Direct line 01925 464130

mike.boxall@uuplc.co.uk

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Dear Joanna

Gas Distribution Price Control Review – Third Consultation Document

As with previous consultations on the review of the Gas Distribution price controls, there are a number of issues raised in your recent paper that are of wider interest to energy network companies. I would therefore like to comment on those aspects that have more general relevance. In the sections below, I will therefore provide a response to the issues raised in Sections 2, 3, 4 and 5 of your paper.

2. High Level Framework

a) Scope of the control – your review of the categorisation of revenue between price controlled, excluded and non-distribution activities is timely. Our recent experience in electricity distribution reinforces the need for careful consideration of the treatment of income for non-core services. It is important to consider not only the choice of whether to treat income as within the scope of the price control, but also to determine how to treat variations from forecast.

   We agree that services that are provided from a separate cost base should not be included in the definition of distribution services. These are more likely to be treated as de minimis and could be expected to be removed from the licensee's business if they grew to any significant scale. We also support the use of excluded service status for services which are not suitable for inclusion within the core price control, either because the volumes are not within the licensee's control (eg where services are requested individually by suppliers or their customers, or are provided via a competitive market where the licensee's share is uncertain), or because their costs can be separately identified.

   Excluded services can also be sub-divided in a different way. Some are provided from a cost base that is, at least in part, shared with the core price controlled

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Registered office: Dawson House, Great Sankey
Warrington WA5 3LW

activities. In such cases it is reasonable to ensure there is no double allowance for revenue. However, it will be more usual for additional costs to be incurred as a result of providing the excluded service. Even if some overheads are shared, most services require the use of additional operating or capital expenditure.

b) Correction mechanism – your proposal to increase the penalties faced by licensees whose variance of income against allowance exceeds 2% seems to run counter to your proposal to limit tariff changes to 1 April in any year. It would seem more appropriate to allow licensees greater flexibility to set the timing of their tariff changes (including the possibility in some circumstances of more than one change within a twelve month period) if you are to increase the emphasis of close adherence to annual revenue caps.

3. Assessing costs

You face a greater challenge in seeking to determine the efficient level of costs that each licensee needs to spend because of the limited availability of comparable historical data. It seems inevitable that this will mean that you can place less confidence in the results of any comparative analysis and the reliability of any benchmarks that could be derived. We would expect that you would therefore need to build in a greater margin of error in setting company specific allowances than would be the case where a larger data set was available. We would also expect that in these circumstances you would place more emphasis on the companies' own forecasts and your views (perhaps informed also by consultants) on the techniques used to derive them. These also seem the right circumstances in which to apply a sliding scale mechanism to reward accurate forecasting.

4. Outputs

We recognise the importance of reliable measures of business outputs and quality of service to customers. As well as being important indicators in their own right, they also represent an essential component of a regulatory framework that continues to offer powerful incentives for further improvements in efficiency. Whilst supporting the general direction of your proposals, we would urge you to ensure that any measures that have potential penalties attached are genuinely within the control of the licensee, and that sufficient funding is provided for any additional obligations.

5. Incentives

We support your ambition to use incentives to align the interests of the licensee with the interests of consumers. This is often a question of confirming priorities and the strength of financial effects can therefore have a marked effect on the behaviour of a licensee. During the seminar on 23 January you asked if all of the incentives proposed were justified. Aside from an examination of the merits of each individually, this also requires consideration of their interaction. So long as they present separate distinct incentives to pursue particular actions there need be no problem with multiple incentive schemes working side by side. The problem comes where the response to one incentive also triggers a reaction in another incentive scheme which may either work against the first effect or exaggerate it. In either case the response may not be that which Ofgem had intended. However more care is needed in calibrating incentive schemes where such overlapping effects are anticipated.

Turning now to the detailed proposals, we agree that the combination of a powerful capex incentive (incorporating a rolling mechanism to ensure equal rewards are available from savings made in each year of a price control period) and an information quality incentive are an appropriate way to encourage accurate capex forecasting followed by efficient expenditure. This is preferable to the intrusive use of a three pot model for designating capex after the event.

We can also see merit in a rolling mechanism to be applied to opex, so that again the incentives to improve efficiency are equalised across a price control period. We accept that it is not necessary to use a five year period in order to match the incentive power of the capex roller. It is also important that incentives do not discourage any initiatives that will improve efficiency. Customers may be better off receiving a smaller proportion of a larger total gain.

Given the separate arrangements for determining the workload volumes for mains replacement, continued incentives to ensure efficient delivery of agreed volumes seem appropriate. The scheme appears to have been successful in the current period, although further refinement could ensure more appropriate treatment of services.

We can see the conceptual attraction of incentives in respect of capacity output, but we can understand the wariness of companies to facing financial exposure while so many of the components remain uncertain. On top of the interaction between sources of capacity (such as transmission assets, distribution assets, storage or customer interruption contracts) there is another layer of interaction with the general incentives on capex and opex efficiency and shrinkage to be considered. We cannot claim to be experts in this field, but the challenge of correctly calibrating a new incentive scheme appears overwhelming, and it may be preferable to wait until there is some experience of the new market mechanisms working for a few years before trying to add a further layer of regulatory incentives.

Your final two proposals appear to be ones where you have rightly identified that the normal opex incentive may not work entirely to customers' interests. In the case of both asset records and Research and Development, there is a danger that the short term benefits available from reducing immediate expenditure will outweigh the lasting benefits (of accurate records or more innovation opportunities) that would result from higher levels of expenditure. We would therefore support secondary incentives that restore a balance with customers' long term interests.

I hope you find these comments helpful. I would be happy to discuss the issues raised with you if you wish.

Yours sincerely

Mike Boxall
Electricity Regulation Director