



United Utilities
Lingley Mere Business Park
Lingley Green Avenue
Great Sankey
Warrington WA5 3LP

Telephone 01925 234000
www.unitedutilities.com

Joanna Whittington
Director – Gas Distribution
OFGEM
9 Millbank
London
SW1P 3GE

Direct line 01925 464130
Direct fax 01925 463957
Mike.Boxall@uuplc.co.uk

13th July 2007

Dear Joanna

GDPCR Initial Proposals

Historically, the process of determining price controls has been influenced by both the economic and political climate. The Gas Distribution Price Control Review is the first price control which also needs to consider the wider environmental impacts and sustainability. It is fair to say that the Government's Energy White Paper has shifted the balance of previous price controls. As a result, all the UK's regulated businesses will have a keen interest in the decisions and possible precedents set within the Gas Price Control.

It is important for both the regulator and the Government to recognise the unique position of distribution companies, in that they can be used as a vehicle for positive environmental change. Whilst the competitive supply market is likely to resist any higher costs or obligations, distribution companies are able to facilitate positive changes for UK PLC and evenly share those costs across the customer base.

This price control review represents the first full distribution price review since the sale. It is important to recognise that this market is substantially different to the other regulated industries. Whilst the companies have been segregated, very little historic reported data exists. Both the industry and the regulator must acknowledge the information gap and ensure that neither party acts in a manner which is unsustainable for customers or the country. In the summary section of the document, Ofgem suggested that its principle objective for the review was protecting interests of customers. Under the old paradigm, this is correct but Ofgem must also recognise its statutory obligations on sustainable development and secure supplies. In the current climate, this role has become even more important.

It is important that regulators recognise that companies' costs can, in certain cases fluctuate by more than RPI. The large number of infrastructure projects currently being undertaken and in development in the UK has caused increasing prices for skilled labour and contractors. The cost of materials has also increased faster than RPI. Regulators must target

their efficiency challenges to companies where they can be reasonably made rather than applying a broad brush approach to the entire cost base. We support the retention of RPI as the inflation factor but Ofgem do need to recognise that some costs consistently increase at rates above RPI (contractor costs, materials, labour). These costs need to be either recompensed as part of the price control or be included as a contract re-opener.

In the fourth consultation, two approaches (and a significant discussion of the merits of each) were presented with regard to regional cost adjustments. In the initial proposals, very little was discussed regarding the adopted approach. Regional cost adjustments should only be applied where there are consistent and significant variances from the UK norm and regulatory transparency about the mechanisms and supporting evidence is essential.

Ofgem have previously accepted that certain costs within a group can be shared but are not proposing to include singleton allowances. This places singleton companies in a disadvantageous position. Given the objectives of the sale of the GDN's (to create a comparative market for gas distribution to drive efficiencies for customers), it would appear to be counter intuitive to penalise companies for purchasing a single network operator and then failing to accept that certain legitimate costs are borne from this process. The use of LECG's grouped form of analysis to calculate indirect opex allowances (which appears to accept the principle of a singletons costs being greater) appears to reinforce this point.

We believe that there are some fundamental flaws in the approach to setting allowances using the comparative efficiency methodology adopted. From a pure data perspective, there are only four "real" data points (as a data point is likely to be effected by management decision making and does not allow for allocative cost assumptions). The entire modelling approach (especially using the LECG high scenario for indirect costs) attempts to model the "super GDN". This cherry picking approach is widely recognised as unattainable and will distort the "correct efficiency" view which Ofgem favours.

We believe that the introduction of the Innovation Funding Incentive is entirely correct. The introduction of the same scheme for the Electricity DNO's has provided opportunities for companies (like ourselves) to stimulate future efficiencies through research and development. Given the need to focus on sustainability, companies should be encouraged to explore efficiencies through sustainable process improvement. Whilst this mechanism adds further complexity to the current incentives system, it is entirely appropriate to drive positive behaviours from companies and we believe that regulators and companies are sophisticated enough to address any interactions between incentives.

We note your modelling assumption of the WACC for the initial proposals. The rate of 4.84 % (vanilla WACC) appears to be very low and unlikely to attract investors to fund infrastructure renewal. The driver for this reduction is the lower assumed cost of debt. Given the movement of interest rates over the past 6 months and the impact on the cost of debt, a reduction from 4.65% to 3.55% appears overly bold. In the initial proposals, Ofgem notes the concern that cost of debt rates can set at inappropriate long or short term rates. We share this concern but believe that the 3.55% cost of debt at a time where interest rates have markedly increased is incorrectly orientated towards the short term "discounted" rates. The initial proposals discuss the relative riskiness of the activities and how they compare with other energy networks and

regulated utilities. Ofgem must note that the decisions taken at this review may influence the perception of regulatory risk for the companies in other price control reviews such as DPCR5.

Ofgem have included a recommendation that GDN's take into account future revenue from new connections in determining the connection charge. We believe that this is a risky approach for the GDN's as they must carry the risk that this may be unfunded if connections estimates (which are likely to be lumpy and unpredictable) are incorrect.

Ofgem are proposing to include a discretionary reward scheme worth £4m per annum. In principle, this is an entirely sensible suggestion and is consistent with other price controls. However, the practicalities of the scheme appear to diminish given that the scheme is capped and is intended to cover both the extension of network and the environmental impacts of leakage. We feel that this does not provide sufficient incentives to drive the appropriate behaviours.

The proposed removal of the revenue driver is entirely appropriate given the movement towards energy efficiency and is consistent with Ofgem's aspirations at DPCR5. The only cautionary note is that companies should be able to recover efficiently managed costs associated with increased throughput (i.e. shrinkage) and Ofgem should ensure that this is always the case.

We believe the treatment of UUOL's costs is entirely correct due to the nature of the contract between the two. The current rules adopted within the DPCR4 framework do not recognise commercial contracts between related parties. Under the current methodology, companies are subjected to perverse incentives which encourage trade with external parties rather than the potentially cheaper or more skilled group member.

The proposed approach to non operational capital expenditure, from a purely academic perspective, is correct. Capitalising these costs, which are typically "lumpy" in nature and tend to be short life assets (tools, machinery and IT), removes the costs from the true operating costs of the business and avoids distorting the regulator's view of the comparative efficiency of the industry.

If you would like to discuss any of the above points, please feel free to contact me on the above number.

Yours sincerely,

Mike Boxall
Electricity Regulation Director
United Utilities Electricity PLC