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Dear Martin,

## **DPCR5 – Looking Ahead**

Thank you for your letter of 17 May. We welcome this early opportunity to discuss the approach to DPCR5 and to begin to explore what are likely to be the key issues for the review. We agree with your suggestion that some areas of work should begin now, even though the main review process need not start until 2008.

It was particularly helpful to hear you talk around the content of your letter at the Energy Networks Association's Regulation Group last week. I will try to develop some of the themes that emerged as I comment on each section of your letter separately.

### **1. Context**

It is important to recognise the context in which DPCR5 will take place. We readily acknowledge the progress that Ofgem have made in recent years in refining the approach to network regulation and price control. The degree of consistency that is emerging in your work on network monopoly price controls provides a firm foundation on which to build the next distribution review. This will also help to underpin stability in the regulatory framework and principles which will be increasingly important if, as you suggest, the business environment changes significantly.

The growing importance of climate change and the drive towards a low carbon future will shape the planning assumptions on which DPCR5 will be based. However there remains substantial uncertainty over how such policy objectives will play out in terms of distribution network usage. Although the general direction of policy may be clear, neither the particular instruments nor their effectiveness can yet be predicted with accuracy. For example, we cannot be sure how much renewable generation will emerge, or whether it will be connected at distribution or transmission voltages. Neither can we be confident that demand for electricity will fall in response to measures to reduce carbon emissions. A critical uncertainty surrounds the future of the transport market. Any move to replace oil with, non-fossil based, electricity could

more than offset improvements in energy efficiency in traditional domestic and business usage. This implies that the DPCR5 settlement must be flexible enough to support a range of possible outcomes.

You stressed, at the ENA, a desire for licensees to take a stronger role in developing plans of expected outputs, including more explicit liaison with local stakeholders. This is something we are keen to do, but we can foresee difficulties in reconciling local wishes with developing government policy, which only you may be aware of. It would be helpful to spend time developing a common view of how this process might work. We agree that the result should be greater clarity around expected outcomes, but this is likely to include a range of possible scenarios against which revenues can be expected to balance with projected costs. Collective work on longer term scenarios, as proposed in Robert Hull's recent letter, will give us a better basis on which to develop forecasts. As we explained in our response to Robert, our only concern in that area is that the proposed timetable is not sufficiently aggressive. As a foundation stone of DPCR5 it will be important that there are agreed results from the long term scenario work early enough in 2008 to inform initial work on DNO forecasts. A topical example of a public policy question would be the appropriate degree of flooding protection to apply to substations. Whilst this could be left to local discussion, it seems likely that BERR may wish to provide a steer based on national considerations.

## **2. Objectives for DPCR5**

We accept that the objectives of the review must flow from your statutory duties. The issue for us is to understand the balance that will be struck between potentially competing objectives. The more emphasis is placed on the sustainability objective, the greater the potential tension with the short term economic interests of consumers. This is an area where Ofgem and Government may wish to provide early clarity, either through redrafted statutory environmental and social guidance or through a public consultation process.

We are pleased to see you recognising the importance of investor confidence. This is another consequence of the stability of the regulatory regime that has been established in recent years. Your objectives should include sustaining that confidence especially since the need for additional investment finance is likely to continue to grow over the next five year period and beyond.

## **3. Roles and responsibilities of electricity distribution businesses**

We have always had the view that the distribution companies should be seen as providers of infrastructure to support competitive supply and generation markets. It therefore follows that this role should not be restricted to owning and operating distribution networks. DNOs already provide other services such as the Master Registration Service and the Data Transfer Network, without which the competitive retail market would be unable to function. We also see a continuing role for DNOs in revenue protection and urgent metering services, but acknowledge that there are greater development opportunities likely to arise from the Government's low carbon agenda. DNOs do offer a vehicle to provide unbranded and consistent services to all

suppliers (or other market participants). This may prove to be the most effective way to secure a timely role out of smart metering and has also been suggested as a device to spread customers' contributions to the cost of energy efficiency measures across a longer timespan than could be relied upon in supply contracts. We have no objection, in principle, to any such proposals so long as the investments we made were remunerated at an appropriate cost of capital, and we would welcome the implication that DNOs could be drawn back closer to the rest of the energy market.

It is also consistent with this view (of DNOs as a key part of the energy markets) that we should expect to be challenged to contribute to the wider objectives on carbon reduction. A standard way of defining a DNO's carbon footprint should be established and this can then form the basis for reduction incentives, with a carbon valuation consistent with that applied elsewhere in the market.

#### **4. Reducing emphasis on 5 year allowances set by the regulator**

We welcome your discussion of this topic. To an extent there has already been a reduction in the focus on the short term. However we are pleased to see you recognising whole life costs as an appropriate measure of value for money. We hope that five year investment plans can be seen in the context of longer term strategies, so that, as a minimum, we are able to use ten year plans to justify investment over the next five years.

DPCR4 also saw the start of a process which shifted revenue from basic 'allowances' into performance based rewards. Where schemes, such as IIS, provide clear and stable signals of the value to customers of variations in the level of service outcomes, they offer a valuable mechanism to link revenue with performance rather than inputs. This approach could be extended to other areas where outcomes, beneficial to customers, are measurable and within management control. Examples may include improved service levels for worst served customers or reductions in SF<sub>6</sub> emissions.

#### **5. Incentives – potential simplification and sustainability**

The development of the price control structure at DPCR4 has generally been recognised as an improvement. It has been characterised as moving from 'simple' RPI-X to a more sophisticated (RPI-X) + Y where the Y term allows for additions (or deductions) of allowed revenue to reflect performance against measures other than the simple volume drivers of units and connected customers. This has allowed Ofgem to introduce incentives around network performance, customer service, losses, generator connections, innovation and network undergrounding. Although the price control algebra looks considerably more complicated, it is well within a company's capability to separately manage the economic effects of each of these incentives so as to better deliver service across a number of headings. We had envisaged that the success of this approach may have led to a widening of its application rather than any reduction in the reach of targeted incentives.

From what you said at the ENA we are now less concerned that you were proposing to remove effective incentives, and we now believe your concerns were around the application of the basic 'revenue drivers' within the core element of the price control.

The issue here is the apparent incentive to increase the volume of sales, which may be considered to run counter to the government's low carbon agenda (notwithstanding our earlier observation on possible developments in the use of electric transport). We can see merit in exploring alternative arrangements for setting core revenue which avoid any perverse incentives, but still ensure that scale related costs are fully remunerated. We would expect to see a significant workstream within the price control programme to look at the interpretation and implementation of sustainability objectives, and this would seem to be the right place to examine this issue.

Of the measures introduced in DPCR4, the discretionary reward scheme is the least attractive to us, because it relies on short term regulatory judgements. It may be prudent to have such a device in reserve to allow rewards to be offered for performance in areas that did not appear, at the time of the review, to warrant separate incentivisation, but it seems less appropriate to declare such a mechanism as a potential source of arbitrary penalties as well. If companies' behaviour warrants regulatory intervention to reduce allowed revenue it should be done through a more formal process than one-off adjustments.

## **6. Process – better engagement with consumers and stakeholders, fewer documents**

We are pleased to see that you have already begun to plan research to improve understanding of customers' expectations of DNOs in the next price control period. We welcome the industry wide approach that is being taken and we will, along with other DNOs, contribute fully to this project. There will be an important role for Ofgem in merging the views of consumers as revealed by the research with the views of citizens as represented by Government in its energy policy. There will need to be general acceptance of an appropriate balance in order that business plans can be prepared and price control proposals developed on a consistent basis. We would imagine that any local stakeholder input should be defined as a variation against central assumptions that may have been developed at a national level. However, we would be pleased to consider alternative ideas on how to make the most of the views of local stakeholders.

Your review following the completion of DPCR4 indicated high levels of satisfaction with much of the process of that project. We were happy with the level of interaction with both Ofgem staff and Authority members that developed during the review. We hope that a similar open and constructive approach will be followed in DPCR5. Whilst we appreciate your desire to reduce the volume of consultation material published during a review, it is important not to lose sight of the fundamental importance of the process to our business performance. Consequently, we would not wish to see valuable steps in the process disappear. During the discussion at the ENA there was widespread concern over the suggestion that the September Update might disappear from the timetable. Unlike the water industry price reviews (where the interval between Draft and Final Determinations is typically only 2-3 months), we have become accustomed to an interval of more like six months between Initial and Final Proposals. Over this period, thinking on both sides tends to develop quite quickly and there is a great risk that Final Proposals would contain a lot of new

material and would be harder to understand without an interim step. At the least, there should be an update circulated to all licensees to aid that process, and to stimulate a round of discussions with each company affected.

## **7. Plans for 2007**

We are pleased to see that some of the foundations of the price review are being planned now, and hope to see considerable progress during the current year, not only on customer research but also on the development of long term investment scenarios. It should also be possible to begin to consider how the scope of distribution activities may need to be expanded to better serve wider market needs. We agree that the recent project to simplify the structure of the Distribution licence should make such a task easier.

We were among the companies who advocated early indication of the future of IFI beyond 2010 and are pleased that John Scott has acted promptly to extend the scheme into DPCR5. We believe that the same need for a smooth transition to the next price control period will apply wherever plans take some time to develop, or actions have long lead times before delivering benefits to customers. The IIS is another example. The investment case for additional assets to reduce interruptions or improve restoration times depends upon additional revenue available from IIS. Our own plans are already being constrained by the limited time period over which we can predict extra revenue. Confirmation of the continuation of IIS beyond 2010 would be helpful in our planning, along with an indication that your view of customers' valuation of increments in service performance had not reduced.

## **8. Views invited**

I hope that in reviewing each section of your letter I have covered most of the issues raised in paragraph 24. Perhaps the one topic to which it is worth returning is your discussion on moving the focus away from allowances. We have supported your initiatives to take a more arm's length approach to regulation, and have welcomed Ofgem's assurance that the intrusion into the GDN's investment expenditure was a one-off response to particular circumstances rather than a shift in preferred approach. There is a danger that reliance on external measures of asset management capability along the lines of PAS55 may lead to an equal burden of scrutiny albeit by a different auditor. We hope that this will not be the case and that it will be possible to give you a level of assurance that does not involve micro-management of our business. Alongside this is a strong belief on our side that we should be responsible for the risks that are within our control. Successfully managing such risks and delivering services that customers want to receive should be rewarded by returns that exceed your assumed cost of capital.

We do not want to be in a position where every pound we spend must be attributed to a particular allowance pot identified in the price control settlement but the route to avoid this is a clear agreement on our obligations to customers and a total revenue allowance that can be expected to cover all efficiently incurred costs.

I hope that you find these comments helpful. Please feel free to speak to Paul Bircham or myself if you would like to follow up any of the points we have made.

Yours sincerely

**Mike Boxall**  
**Regulation Director**