



United Utilities
Dalton House
104 Dalton Avenue
Birchwood Park
Birchwood
Warrington WA3 6YF

Telephone 01925 534550
www.unitedutilities.com

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

Direct line 01925 534504
Direct fax 01925 534571
paul.bircham@uuplc.co.uk

22nd October 2007

Dear Joanna

GDPCR September Update

It is a pleasure to be corresponding with you again. Thank you for the opportunity to comment on the September update which provides companies and interested parties with an opportunity to understand the development of Ofgem's position since the publication of the initial proposals. It is very useful to have the opportunity to understand areas where progress has been made, to have visibility of topics where debate has not resulted in a change to Ofgem's opinion and also to highlight areas that are still to be resolved. From this point of view, it is a valuable part of the process which should be continued in other price control reviews.

I note that Ofgem has not made any adjustments within the cost of capital to recognise the relative riskiness of distribution businesses. Delaying this decision until the final proposals increases regulatory uncertainty and does not allow constructive debate on the level of relative risk levels between the sectors. This is a prime example of how the September update can improve the price control review process. In addition to our concerns regarding the low levels assumed for the cost of debt set out in our response to the initial proposals, we are also concerned about Ofgem using increasing levels of gearing. It is becoming increasingly difficult to determine whether regulatory assumptions on gearing merely reflect current practice or a gradual increase through successive reviews is becoming a self-fulfilling prophecy.

I question your continued use of a dividend yield assumption of 3.5% in the price control. This is inconsistent with the assumption for the assumed cost of equity used within the WACC. Assuming a level of retained profit to fund future business requirements may artificially distort financeability test results and could result in yields being set at an inappropriate level that may dissuade investors.

The use of a 2.5% p.a. productivity assumption might be appropriate for GDNs given the recent sale process, but this figure is high compared to other sectors such as electricity distribution where competition over successive price controls has already materially driven down prices.

I support your recognition that some key costs faced by GDNs have been seen to increase at a quicker pace than the Retail Price Index and that it is appropriate to include an uplift to allowances to reflect these. Similarly, I welcome the recognition of the increasing costs of environmental remediation and waste management that will result from changing statute and environmental standards.

I am concerned that your reliance on “bottom up” analysis may not properly recognise that differences in companies’ operating models can distort costs allocated to indirect costs and opex within the current modelling approach and hence fundamentally distort analysis. This may lead to the creation of a false frontier which, in parallel with an aggressive productivity assumption, may place unrealistic pressures on GDNs. Your move to using upper quartile rather than frontier costs in adjusting for cherry picking effect through “top down” analysis will go some way towards mitigating this, but may not fully adjust for the possible distortion. We do welcome, however, your recognition that frontier companies should benefit from their position by being set allowances larger than their current spend rate.

We welcome your recognition that companies within the same ownership group are able to create synergies by sharing support costs. However, it is important to recognise that analysis based on simple ratios of costs to denominators will not always correctly assess the extent to which fixed costs can be shared within ownership groups and may overestimate the savings that can be made by GDNs. I would continue to question whether the use of revenue as a denominator in calculations will correctly determine fixed costs, as I doubt that revenue will generally be a true driver of indirect cost activities.

I welcome the introduction of specific allowances for training and apprentices. These will allow the industry to be proactive in terms of training and development and will help companies to better manage labour costs in the future. Similar support for DNOs in DPCR5 will be essential if companies are to be able to grow their skill base in order to meet the government’s Energy Policy objectives.

I am very concerned to note your continued use of a “sum zero” approach to the calculation of regional cost adjustments. Whilst it is appropriate to recognise the increased costs incurred by companies operating within the London area, the assumption that any calculated increase in London costs must be offset by an equivalent decrease in costs elsewhere is at best, questionable. To implement this

type of methodology would require much more detailed analysis, the basis of which must be made public.

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

Yours sincerely,

Paul Bircham
Electricity Regulation Director
United Utilities Electricity Limited