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Dear Martin

Consultation on United Utilities modification proposal UU/2008/002.1: Proposal to introduce payments for the adoption of connection assets

I write in response to your consultation dated 17 August 2007. You have rightly set our proposal in the wider context of competitive markets for the construction and adoption of connection assets. I therefore propose to address the issues raised in your letter, where this complements what has already been written in our Modification Proposal.

You have noted in paragraph 4 that United Utilities did not consult with the industry before we submitted the modification proposal to the Authority. Whilst it is true that we did not publish a formal consultation paper, we have discussed our ideas informally with other industry parties over a period of several months and have also sought informal views from our customers. These discussions played an important part in shaping our ideas and gave us confidence that our proposals would be welcomed by connections customers.

Your questions are set out in two blocks. The first cover the specific issues arising from the Modification proposal, whilst the second are on more general policy issues.

Does UU's modification proposal better achieve the relevant objectives? Specifically:

- **Is the proposal more cost reflective than the current methodology?**
- **Does UU's proposal restrict, distort or prevent competition in distribution?**
- **Does the methodology proposed by UU provide sufficient clarity and transparency about the valuation and application of asset adoption payments**

Our Modification Proposal sets out the reasons why our proposed approach better meets our licence obligations. Specifically we believe it is more cost reflective to ensure that total charges to customers are aligned as closely as is practical to the costs of providing their connections. It is not possible to do this without taking account of future DUoS revenues as well as connection charges. Our proposed Asset Adoption Payments will help us to achieve this holistic view in determining connection charges and in offering fair recompense for assets provided for adoption. They therefore represent a significant improvement in cost reflectivity.

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By improving the cost reflectivity of our charges we should also have a positive effect on competition, since the failure of a dominant player to charge on a cost reflective basis could be expected to damage the prospects for open competition.

The publication of Asset Adoption payments and the criteria for their application will provide complete transparency and may further assist in the development of competition by encouraging our competitors to take a similar approach. This would give customers much greater visibility of the alternatives available to them when they contemplate the options for new connections. Our proposed Condition 4B statement will provide information on our methodology and our payments and also include a section of worked examples to help minimise any uncertainty in customers' minds about the treatment of specific instances.

Have we correctly captured the main issues raised by UU's modification proposal, and more generally by adoption payments in Annex 1?

We comment below on the specific issues raised in Annex 1 to your letter. We are not aware of any other major issues that are not covered by your letter.

Extent of competition – Do adoption payments play a role in the development of a competitive market? Is competition now effective? Are adoption payments now appropriate in order to reflect developments in the licensee's business?

Competition in connections and network ownership is a reality within United Utilities' Distribution Services Area. The extracts from the Connection Industry Review 2006/7 which you quote provide only a partial picture of the market, which has been developing quite quickly in recent years, particularly in the north west of England. Competition first emerged in the market for construction of new connections. Here, recent data has shown that UUE's share of new connections is now at around 50%, with a further 35% won by UU's competitive connections business. By definition, these jobs have been won in competition with other connections providers, and in all likelihood the same applies to some of the work undertaken by our 'statutory' connections service.

You have chosen to focus on the more recent area of competition – that of network ownership. Here we are also beginning to see evidence of competition but it will inevitably take some time for this to be revealed in the scale of completed connections reported in the Connections Industry Review. We currently have 42 connection and use of system agreements in place with licensed distribution network operators covering approximately 16.8MVA (this represents approximately 15,500 domestic connections or roughly a full year of new domestic connections). The level of interest has dramatically increased recently and in the last three months we have provided 14 offers of points of connection to licensed distribution network operators with a combined total load of 2.5 MVA. It is in the nature of such work that it will be several years before such projects are seen through to completion and the Connections Industry Review inevitably lags the true position in the market.

Asset adoption payments are undoubtedly a driver in the decision making process for asset adoption, however they are not the only one. The reputation of the network owner (with both developers and end customers), timeliness and quality of adoption arrangements, and enduring customer service will also be taken into account. We are aware that competing network owners do regularly offer asset adoption payments and that they are therefore an established feature of this market. However it is as important to us that asset adoption payments will allow us to better meet the relevant objectives in Condition 4 of our licence.

Effect of average assumptions – Are the assumptions used by UU reasonably representative of the majority of connections? What are the impact of the proposed methodology change on customers and competitors whose connections are not closely reflected in the modelled assumptions? Does the combination of adoption payment and UoS boundary charges have anti-competitive effects?

Our asset adoption payments are derived from the future revenue stream expected from the application of our DUoS tariffs. The real question here is therefore not whether the average assumptions in our tariffs are appropriate for the customers served on that tariff, but whether the characteristics assumed in converting tariff revenues into adoption allowances are robust.

Our tariffs are constructed from ‘yardstick costs' which are calculated separately for ‘customer related costs' (which typically are recovered through fixed charges) and network related costs (which can be recovered in kVA, kWh and kVArh charges). Network related yardsticks are calculated as £/kVA and, where necessary, converted into p/kWh or p/kVArh. Asset adoption allowances are presented as £/customer and/or £/kVA and therefore align well with the underlying cost yardsticks. Furthermore, it is only the costs of more remote network assets that are included in kWh or kVArh charges. Those closer to the connection point are usually recovered through availability charges on a £/kVA basis. Hence, the structure of Adoption Payments aligns well with the source yardstick costs, and we would not expect to see significant distortion in the allowances offered on a site by site basis.

We are aware of the risk that over-generous adoption payments could have a damaging effect on competition in network ownership and have therefore ensured that our allowances are derived directly from the relevant elements of our tariff yardsticks. Adoption payments are only proposed where all of a particular asset category (within our yardstick model) is offered for adoption. We have therefore erred on the side of caution so as to minimise the risk of offering excessive payments that would unreasonably squeeze competitors' margins. This approach means that we do not offer more than is appropriate and it reduces the potential for overpayment. United Utilities' use of system charging methodology describes our approach to reflecting the costs of using our network into use of system tariffs. When combined with asset adoption payments we believe that there are no competition related issues.

Potential for discrimination and double-counting – Is there currently an issue of potential discrimination in UU's charging methodologies? Is there currently an issue of potential double-counting in UU's charging methodologies? Is the proposed modification the most appropriate way forward? Is there any alternative approach to be considered, that would better meet the relevant objectives? Does UU's proposal result in a shift in the connection boundary and, if so, is this appropriate?

Any changes in charging methodology that shift the balance between connection and use of system charges inevitably introduces the potential for discrimination between customers based on the timing of their original connection to our network. This can manifest itself in the double charging of some customers and the under-charging of others. Given the existence of a cap on revenue from most DUoS charges, such distortions do not necessarily cause an over-recovery in total, only a realignment of relative charges between customer groups.

Our proposed solution is certainly not the only way to resolve this issue. Constructing different tariffs according to the initial connection date would be one other way. We do not believe that it is necessary for us to convince you that our proposal is 'the most appropriate way forward', only that it better meets our obligations than our current approach. We are sure that this is the case.

The final question is not explained in the text of your consultation and is puzzling to me. The 'connection boundary' defines the extent of new asset construction taken into account in connection charging policy. This is not necessarily the same as the definition of where the construction of assets is contestable, and where assets must be constructed by the licensee (since new connections can include the construction of reinforcement assets). It is not necessary for the boundary used for connection charging purposes to be the same as that used in use of system modelling. Indeed to aim for the same boundary introduces the prospect of misalignment for previously connected customers. The important thing is to be aware of the possibility of double charging and to introduce a mechanism to address this. This is precisely what our proposed approach will achieve. It should ensure that, whoever provides connection assets, the end customer will not be charged more than once for those assets.

<u>Exclusions from the methodology</u> – Are the exclusions appropriate and have UU sufficiently justified these?

Our Modification Proposal set out the rationale for the exclusions in Appendix C.

<u>The customer perspective</u>

Before closing this response, I think it may also help to look at our policy proposals from the customer's perspective. Your consultation provides an analysis of network ownership competition and licence obligations, but does not really consider the impact on end customers. The direct effect of our proposal will be to reduce the connection charges paid by most new customers. However, the benefits can also be seen under a number of headings:

Fairness – by reflecting expected future tariff revenues in adoption payments we can substantially reduce the risk of customers 'paying twice' for the same assets. We can also avoid the need to have separate tariffs for customers connected after 1 April 2005, compared with those for customers connected before that date.

Timeliness of charging – connection assets form part of distribution networks that typically have very long lives (many of our assets are expected to last for 40 years or more). Under current arrangements, there is a danger that the initial connecting party could pay too much for these assets. By including some of the cost of connection assets within the Regulatory Asset Value (RAV), which is recovered gradually through DUoS tariffs in future years, we can ensure that customers' charges better reflect the usage of assets. This is better than allowing the cost burden to fall disproportionately on the first user.

Competition – we are aware that other licensed distribution network operators offer adoption payments in order to secure new distribution assets. By publishing adoption payments we can increase the competition for asset adoption and thus ensure that customers are offered full value for connection assets provided on their behalf. We would also hope that this move would encourage other licensed distribution network operators to make a similar move, improving competition and value for customers across the rest of Great Britain.

Transparency – by publishing adoption payments, and explaining their derivation, we will be taking another step towards clearing confusion over the nature of tariffs and connection charge policy. It is clear that network operators can only recover their costs through charges for connections or for use of the system. Our policy makes more explicit the link between these two sources of revenue. We also believe that all licensed distributors should publish the basis of their adoption payments, further adding clarity around the choices available to customers and ICPs.

I hope that I have provided sufficient evidence to support our proposal, and to allow you to confirm that you will not be using your right of veto under paragraph 6 of condition 4 of our licence. Please do not hesitate to give me a call if you have any questions or queries on the detail in our modification proposal document.

Yours sincerely,

Mike Boxall
Regulation Director