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Dear George

Thank you for the opportunity to give our views on menu regulation.

In summary, we support menu regulation provided that:

- the baseline is set in a transparent way
- frontier companies are given greater incentives to further out-perform than non-frontier companies, and
- subject to understanding and accepting how it will work in price limits.

### **Setting the baseline**

The nature of the menu regulation regime is defined by the way in which the baseline is set.

We welcome Ofwat's statement at the PR09 methodology workshop that the baseline must be a "reasonable central estimate" of a company's cost of delivering its investment programme. This mirrors your proposed approach under capex evolution. We understand your point that the difference between menu regulation and capex evolution is in the granularity and detail with which the baseline is set.

We agree that the baseline must be a reasonable central estimate and that it must be company specific. This means it will need to largely follow the approach to setting previous determinations, but we welcome the simplified process.

Clearly it is important that the baseline does take some account of likely future changes in capex. For example, on capital maintenance, allowing historical average expenditure as the baseline is guaranteed to not be a central estimate because it would largely ignore the costs of maintaining the significant additional asset base created since privatisation. We would therefore expect some use of the Common Framework. As we note below, we would expect Reporters to take a much more significant role in advising Ofwat of the baseline.



## **Incentivising Further Improvements in the Frontier**

We are also concerned that the mechanism significantly reduces the incentive for frontier companies to further outperform.

Under the current mechanism frontier companies gain an additional 50% for additional efficiencies achieved reflecting the fact that additional efficiencies will be harder to find and that all customers will benefit from them in the long-run.

Under the proposed mechanism there is no additional incentive for frontier companies to achieve efficiencies. If the baseline is a central estimate specific to each company and a frontier company chooses and delivers the 95% option, they will receive a reward of 32.5%. This is very different from the current 45% and no better than any non-frontier company who chose the 95% option.

Worse than this, if baselines are set for non-frontier companies assuming only partial catch-up to the frontier then the opportunities for out-performance through efficiency are greater for these companies than those at the frontier. In other words, frontier companies are likely to receive less incentive from the proposed approach to menu regulation than non-frontier companies. This is the complete reverse of the current situation.

To reflect current practice under a menu regime, companies judged as frontier should be offered a revised menu where all the rewards (and penalties) are 50% greater than the standard menu for frontier companies and 25% greater for Band A companies.

## **Scope, Timing and Implementation of Menu Regulation**

We agree that menu regulation should be limited to capital expenditure.

We also agree with the timetable you set out. However, we note that this will be challenging, particularly for Ofwat between August and December 2008 when you will need to assess 22 business plans in detail to produce draft baseline figures. To meet this deadline, we anticipate that you will need to rely much more heavily on Reporters than at PR04 and assure yourself that Reporters will be challenging companies' submissions. Critically, you will then need to accept Reporters' recommendations.

As you say the timing of rewards and penalties is important because they can impact significantly on other parts of the review process, most obviously assessments of financeability. We note that the allowed expenditure assumption currently appears weighted towards the assumption that the Ofwat baseline expenditure level is the "correct" level. This could exacerbate financeability problems, particularly for companies choosing options above the baseline and may lead to Ofwat needing to make financeability adjustments that you could have otherwise avoided. It is clear therefore that the mechanism chosen should be known from the earliest stage in the PR09 process as possible and also be as simple as possible.

## **Benefits Associated with Menu Regulation**

Finally, it is not currently clear from the consultation document what the overarching aim of your proposed approach is:

- is the mechanism an information accuracy incentive mechanism?
- or is it one that aims to offer companies ownership of their investment plans with a real menu choice that allows them to choose a risk/reward profile with which they are comfortable?

The title “menu regulation” suggests the latter, the proposed structure of the incentives leads on balance to the former.

We believe that menu regulation needs to achieve both aims. As currently structured, however, there is danger that the approach falls between the two stools by neither offering a real menu choice on the risk/reward profile nor offering sufficient incentives for companies to expose and adopt their central estimates of the likely spend.

We believe two changes are needed to address this.

### 1. Incentive to choose different menu options

We believe that a company might not reveal its central cost estimate because the incentive to do so under the current structure is not material.

For instance, a company that believes it can achieve 90% of the baseline will gain an incremental return of just 0.02% if it chooses 90% and delivers this compared to if it simply accepts 100% of the baseline and then delivers 90%. We do not believe any company will offer a 10% saving up front for such a minimal reward.

The structure of the rewards must therefore change if menu regulation is to deliver a genuine incentive on companies to reveal their central cost estimate and to challenge themselves to deliver further savings. We understand Ofwat’s concern that bigger rewards for lower menu options may mean lower penalties for the higher options. Nonetheless, we believe that it should be possible to construct a valid menu table that gives greater rewards without diminishing penalties. Indeed, we believe such a change is essential if menu regulation is to deliver in water.

### 2. Breakeven point

Setting the breakeven point at 100 implies that the Ofwat baseline is “correct” and that any company estimate that is above that is incorrect (for instance choosing a menu option of 105 and then achieving this results in a lower return to the company overall). This does not imply a real choice is in operation.

The Ofgem approach of setting the breakeven point at over 110 for electricity is interesting and significantly increases companies’ ability to choose between menu options and balance risk and reward. As part of developing the detail of menu regulation, it would be instructive for Ofwat to understand why Ofgem chose a point significantly above 100 in their price review. Indeed, if companies were to take on the risk of achieving additional outputs

between reviews and manage the minutiae then setting the breakeven point above 100 would be essential.

I hope these comments are useful as you develop the detail of your thinking on menu regulation. As ever we are happy to provide further explanation on the points raised in this letter. We also look forward to discussing menu regulation further at your workshop on 5 December.

Yours sincerely

A handwritten signature in black ink, consisting of several loops and a long horizontal stroke extending to the right.

Keith Harris  
Director of Finance & Policy