

Annex 1

Thames Water's views on the Framework and Approach for PR09

Key Issue Reference	Thames Water's view	Reasons for position
<u>Chapter 2. Introduction: the framework and process for setting price limits</u>		
2.1.1 A long-term framework and 2.1.2 Strategic direction statements	Support with qualifications	<p>We welcome Ofwat's commitment to long-term planning and the introduction of Strategic Direction Statements.</p> <p>However, we have concerns about whether Ofwat's regulatory approach provides the appropriate forward looking incentive-based framework to meet the future long-term challenges of the industry. Ofwat's regulatory approach is characterised by extensive planning and reporting, detailed output targets and penalties and an ongoing erosion of upside potential across a range of mechanisms including capex and financing, its approach to logging down and shortfalling. This is in clear contrast to other regulated sectors and risks driving a regime focussed on regulatory compliance rather than the delivery of customer priorities.</p>
2.2 The process for setting price limits	Support with qualifications	<p>An RPI –X regime provides the greatest incentives and maintains stability. However, Ofwat's application is significantly more bureaucratic and complex than in other regulated sectors in the UK. In general the incentives provided by</p>

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		Ofwat's regime are weak relative to those in other regulated sectors. These issues need to be addressed
2.3 Risk and uncertainty	Significant concerns with approach	<p>We accept that the water industry is a low risk industry relative to the economy in general. But it is not clear that water companies are lower risk businesses than other regulated sectors such as gas distribution or electricity transmission.</p> <p>Arguably, the scale of required water company capex, Ofwat's moves to introduce competition, Ofwat's shifting of the balance from positive financial incentives to negative sanctions fines and penalties, and the scale of methodological change in the regulatory framework all point to a significant degree of regulatory risk for water companies.</p> <p>In this context the consultation document provides little comfort that Ofwat will put in place an appropriate incentive based regime for PR09 that will offer genuine rewards for companies that achieve significant costs efficiency and deliver outputs most valued by customers.</p>
2.3.1 Notified Items	Support retention of notified items as a mechanism to	We agree with retention of Notified Items as a mechanism to cater for risk and uncertainty. We disagree with the proposal that existing notified items should be dropped:

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	<p>cater for risk and uncertainty. But disagree with Ofwat's conclusion that existing items should not carry forward at PR09.</p>	<ul style="list-style-type: none"> • Uncertainty remains over IFRS adoption, companies need a mechanism to adjust prices should tax costs change as a result • Uncertainty also remains regarding associated costs of the Traffic Management Act and Lane Rental, so this should be retained as a notified item • Bad debt costs should remain a notified item as there is uncertainty as to the implications of the ban on disconnections at a less benign stage of the economic cycle <p>Our position is therefore that the current notified items should be retained.</p> <p>There are a number of specific new items where there is a potentially large impact and limited management control, where we propose Ofwat should adopt a notified items:</p> <ul style="list-style-type: none"> • Transfer of private drains and sewers. • Initiatives to promote competition. • Climate change mitigation and adaptation

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Chapter 3. The right outcomes for consumers		
3.2 Understanding consumers' preferences	Support broad principles but have concerns over Ofwat capability in this area	<p>Welcome Ofwat's intention to require companies to adopt a common approach to understanding customers' preferences.</p> <p>It is essential that Ofwat avoids reliance on mechanistic approaches to scoring companies' CBA cases at the expense of abstracting from the depth of qualitative and quantitative analysis provided. This will require Ofwat to deploy significant resources in this area.</p>
3.3 Sustainability	Clarification required	<ul style="list-style-type: none"> • Sustainability is more than simply taking climate change into account. Other key sustainability issues of particular relevance to our industry include water use, river quality, biodiversity and waste disposal amongst others. Clarification is needed on how the non-monetisable benefits associated with more sustainable investment in these areas will be accounted for. • The new UKCIP08 climate change scenarios will not be available until 15th November 2008. Because the scenarios will be completely different from previous ones, probabilistic new models will need to be developed together with the detailed understanding of what they mean and how to incorporate

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		<p>them into our planning processes. There is insufficient time to incorporate the new scenarios into this PR.</p> <ul style="list-style-type: none"> • We support the use of the UKWIR guidance on quantifying greenhouse gas emissions and would like to bring to Ofwat's attention that UKWIR have recently updated and improved the workbook. • We would welcome unequivocal clarification on Ofwat's position with respect to the development of renewable energy options • There are incompatibilities with Ofwat's proposed mechanism to deal with renewable energy generation and the limitations of the Carbon Reduction Commitment, which need to be resolved. • The proposed approach to dealing with renewable energy generation has implications for the delivery of our statutory duties where development of our sites requires planning permission. For example in London if planning permission is required as part of the delivery of a development to achieve a statutory output between 10 and 20% of the asset's energy requirement must be delivered by on-site renewable energy. If this can not be achieved via natural synergies with the appointed business [e.g. CHP] then other technologies would have to be deployed. According to Ofwat's proposed approach this would not be funded under Price Limits, which would in effect mean that, the business/shareholder would have to pay for part of the delivery of a statutory duty from its own funds. This conflict needs to be resolved.

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3.4 Justifying proposals for service and investment	Support but with qualifications	<p>Welcome Ofwat's intention to require the use of CBA across all investment types. This has been Thames' intention from the inception of our asset planning and investment optimisation systems development and associated business processes to support PR09 cases, aligned with the Common Framework.</p> <p>We would however expect Ofwat to provide support to companies in dialogue with the Environment Agency, who take a very different view on the method for estimating benefits of investment.</p> <p>We welcome Ofwat's intention to handle large capital projects separately. This is consistent with Thames approach, for example the bespoke studies we are undertaking on Tideway and UTMRD.</p>
3.5 Base service outcomes – maintaining service	Qualified support / further clarification required	<p>While we agree with the broad principles set out in this section, Ofwat have provided very little detail on their intended methodological approach.</p> <ul style="list-style-type: none"> We would welcome greater transparency of the scoring system used to assess our capital maintenance plans at sub-service level. The methodology paper implies that the first companies will have of the scoring

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		<p>system will be following draft business plan submissions.</p> <ul style="list-style-type: none"> In relation to odour from the sewage treatment process we support Ofwat's requirement for companies to use a CBA approach to support investment proposals. However, we would welcome clarification from Ofwat that the costs related to encroachment should be included in such CBA assessments. Moreover, given the wider political and stakeholder sensitivities generated by odour which cannot be defined by monetary values, CBA should not be used in isolation to support abatement investment cases.
<p>3.8 Setting the scope of the quality programme (inc. WFD)</p>	<p>Support with qualifications</p>	<p>We broadly accept the approach that Ofwat is expecting companies to take in terms of developing their approaches to the WFD, although we believe complete compliance with some of requirements will not be possible considering the level of uncertainty still surrounding the implementation of this Directive.</p> <p>Specifically, whilst we will endeavour to produce the best estimate possible under the circumstances we do not believe it will be possible to produce a</p>

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		<p>“realistic timetable” to 2027 for the achievement of WFD objectives. Rather, the pace of programme delivery will need to be developed to reflect the level of clarity companies have on the specific requirements.</p> <p>The revisions to the change protocol approach are also welcome and may well help overcome smaller elements of uncertainty such as identifying the correct sites to invest further nutrient reduction at. However, the proposed protocol will not address the larger uncertainty issues where the scale of the potential outputs means they can not be exchanged for schemes put forward in the business plan. For example, potential investment requirements driven from water resource and priority-hazardous substance investigations and outcomes of policy decisions made after the final business plan is submitted. Consequently, while helpful in the short-term, it will not solve the problems that companies face in developing realistic action plans to 2027.</p> <p>The potential outcome of measures not being compatible with a change protocol is that the deadline to achieve the WFD's goals may not be achieved without significant logging up at best and an IDOK at worst.</p>
3.9 Sewer Flooding	Support principles but clarification required	We support use of CBA to support reductions in the risk of sewer flooding.

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		<p>However, further clarification is required from Ofwat in terms of what is meant by "clear empirical evidence"... of what consumers value most. Unless further clarification is provided we will assume this refers to a requirement for companies to undertake willingness to pay research.</p>
<p><u>Chapter 4. Understanding the costs of delivery</u></p>		
4.4 Menu Regulation		<p>Ofwat's proposal for menu regulation are centred around the reasonable desire to incentivise companies to submit more accurate business plans. However the proposals put forward extend beyond this objective and alter a number of broader aspects of the regulatory regime, including:</p> <ul style="list-style-type: none"> • reducing the overall strength of capex efficiency incentives; • reducing the overall level of remuneration that companies receive when they invest; and • cash flow implications from the approach to sharing efficiency improvements. <p>We do not believe these impacts should be aims of menu regulation or that any of these changes would be justifiable.</p>

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		<p>More generally, the consultation document and supporting papers provide little detail on Ofwat's proposed application of menu regulation. Regulatory best practice and due process would suggest that it is incumbent upon Ofwat to provide far greater detail on the application of such a significant new regulatory proposal before seeking confirmation of companies' support.</p> <p>It is not clear how capex efficiency targets are to be set for companies under menu regulation or how Ofwat will make assumptions about the level and timing of embedded catch-up efficiency when setting the baseline.</p> <p>If Ofwat goes ahead with menu regulation Thames' would expect that full details of the methodology be published well in advance of the August deadline for submission of draft business plans.</p>
4.5.1 Operating Expenditure	Support with qualifications	<p>We support the general principle of roll forward operating expenditure with adjustments for efficiency, enhancements and other cost driver changes. There are three principal areas that need to be addressed.</p> <p>1. Believe that there is a need for Ofwat to establish an additional and explicit cost line dedicated to input prices. The breakdown of all company costs is</p>

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		<p>significantly different from RPI. Input prices are a large driver of total opex costs and so increased transparency in company reporting of these costs would enable a more thorough explanation of company plans and performance. Transparency and due account of input price inflation is consistent with recommendations of the UKWIR report "Review of the Approach to Efficiency Assessment in the Regulation of the UK Water Industry".</p> <p>2. In relation to power costs specifically, it is unclear that these are entirely within companies' gift to control. We believe that Ofwat should therefore consider development of a retrospective price correction mechanism to allow for greater risk sharing.</p> <p>3. It should be for companies to demonstrate accurate forecasts of cost increases and decreases. This means that Ofwat should not explicitly rule out exogenous cost factors.</p>
4.5.2 Pensions	Disagree. Pension costs should be clearly funded on a cash contribution basis.	<p>Since the 2004 Price Review there have been a number of significant changes in pension legislation and funding variables which impact upon pension costs and in how those costs are accounted for. In particular:</p> <ul style="list-style-type: none"> • A fundamental change to the pensions regulations governing the funding of pension schemes (including Pensions Regulator oversight);

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		<ul style="list-style-type: none"> • Further improvements to life expectancy; • Considerable volatility in investment markets; • Changes in how pension costs should be accounted for through adoption of FRS17. Only ongoing service costs now pass directly through the P&L as Opex, with contributions to recover any deficit position being accounted for separately on the balance sheet. This divergence of Opex and cash cost must be specifically recognised within Ofwat's pricing methodology. <p>Given these changes we believe it essential that Ofwat confirm within its pricing methodology that pension costs continue to be funded on the basis of the cash cost (i.e. contributions paid by the Company) required to fund the Company pension scheme on a continuing going concern basis.</p>
4.5.4 Opex efficiency	Requires revision	<p>We welcome Ofwat's intention to continue to spread the level of required efficiency catch-up over time.</p> <p>However, we believe Ofwat's current approach to efficiency analysis is inappropriate. The four main areas that need to be addressed are:</p> <ol style="list-style-type: none"> 1. The current approach assesses companies' efficiency in relation to

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		<p>controllable opex costs. On the basis of this analysis Ofwat then applies an efficiency challenge to companies total opex costs – i.e. to non-controllable opex as well as controllable. This is clearly a methodological error that requires revision for PR09.</p> <p>2. In the derivation of efficiency targets we expect Ofwat to be transparent and provide all available evidence with appropriate reconciliation so that all steps and adjustments can be clearly seen and understood by companies well in advance of final determination. This is not explicit in the consultation.</p> <p>3. Catch-up efficiencies derived from Ofwat's econometric models should be revised to reflect the findings of past performance and the UKWIR report on time series. In particular the 60% of opex model residuals should be seen as representing the upper limit of what should be classed as 'inefficiency' and a lower figure should be included for AMP5 given much of the industry efficiencies will have already been driven out. This is essential if efficiency targets are to be set with due regard to the long-term serviceability and sustainability of service to customers.</p> <p>4. Finally, In line with the Ofwat's spirit of methodological evolution we would expect Ofwat to use the "Check list of best practice" developed during PR04 refined to take account of recommendations in the UKWIR report "Review of the</p>

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		Approach to Efficiency Assessment in the Regulation of the UK Water Industry” and ‘Application of time series analysis to efficiency”. The setting of efficiency targets should take due account of the opex-capex interactions.
4.5.5 – 4.5.9 Assessing capital expenditure		See menu regulation
4.5.10 Managing Investment Cycles		<p>Welcome Ofwat’s acknowledgement of the need for an overlap programme between AMP5 and AMP6. This will enable companies to deliver the most efficient profile of investment to the benefit of customers over the longer term.</p> <p>Is clear that the arguments for ensuring an efficient profile of investment across AMP5 – AMP6 apply equally to the AMP4 – AMP5 transition.</p> <p>We are therefore developing proposals for schemes to be included in an AMP4 – AMP5 overlap programme and urge Ofwat to take these into account in PR09.</p>

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<u>Chapter 5. Financial Assumptions for setting price limits</u>		
5.1.2 – 5.1.4 Current Cost Depreciation	Support.	<p>We support the proposed approach to CCD funding and the updated approach to the comparison between current cost depreciation and maintenance non-infrastructure expenditure. Moving the asset base for comparison five years on to 1997/98 will help ensure a more meaningful and up to date comparison. Clarity on how the test will be applied has been provided in the Data Consultation paper.</p> <p>We note Ofwat's requirements to reconcile MEA revaluation and associated CCD projections to the current MEA as per June Return, however we seek more clarity on materiality of detail and explanation within "Other" column for movements that cannot be appropriately defined for Tables B7-13 and B7-14.</p>
5.1.5 – 5.1.7 Infrastructure renewals charge	Disagree - Thames believe that Ofwat should retain an historical component to the calculation of IRC.	<p>The inclusion of an element of historical performance in the calculation of IRC reduces exposure to uncertainty implicit in forecasts of IRE, uncertainty would be increased if the IRE forecast horizon were to be extended to 15 years. Retention of the current approach, where a combination of 10 year forecast and 5 year historical performance is used as the basis for IRC, would provide more appropriate basis for IRE to be funded.</p>

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		We seek further clarity on how Menu regulation will affect the IRC used in the Final Determination. If companies chose a higher IRE expenditure level than assumed in the baseline, will this be reflected in the IRC allowed?
5.2.1 – 5.2.10 Overall approach to setting the cost of capital	Support overall approach in principle.	<p>We support Ofwat's proposed approach in principle to setting the cost of capital, drawing upon established CAPM methodology and adopting one overall WACC and notional gearing level for the industry.</p> <p>However, in application of these principles:</p> <ul style="list-style-type: none"> • Ofwat should continue to focus on its statutory duties to ensure that companies are able to meet their licence commitments and finance their functions; • In setting the cost of capital, and when testing for financeability, Ofwat must take a long-term view of sustainable funding methods. It should not assume that the circumstances in the debt market today will exist forever; • Assumptions on index-linked debt should therefore be limited, there being a clear danger in reliance on an uncertain market which is dominated by a very small number of investors and monoline insurers. Indeed, the conditions seen in the index-linked debt market over the last two years have ceased to exist, the recent 'credit crunch' and impact on the monolines has removed liquidity in the market;

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		<ul style="list-style-type: none"> Decisions on how to finance investment should remain with companies, a broad range of investment sources should be available to ensure that companies are able to respond to changing market conditions.
5.2.7 Indexing the cost of capital	Disagree.	<p>We reject the proposal to index the cost of debt, in principle, on the grounds that companies are best placed to manage the impact of interest rate risk and that passing this risk to customers would, in the words of the Competition Commission "erode one of the core foundations of RPI-X regulation"</p> <p>The Competition Commission ("CC"), within their 2007 report to the Civil Aviation Authority on the economic regulation of London airports firmly rejected the debt indexation concept, the main grounds for that rejection being:</p> <ul style="list-style-type: none"> "[A] guiding principle in price control design is that risk should be allocated to the party that is best able to manage it - either by reducing size, likelihood or both". The CC considers that "companies, not customers are in a better position to manage the risk of changes in interest rates through the way in which they borrow. As evidence – one can look at treasury management activities and benefits this produces in terms of financing efficiency"; "Indexation would start to erode on of the core foundations of RPI-X regulation, i.e. that shareholders are asked to manage risk for periods of

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		<p>five years at a time – without offering sufficient benefits to justify the apparent sub-optimal allocation of risk”;</p> <ul style="list-style-type: none"> • “Practically the risk free rate [RFR] and cost of debt are not strictly observable”. Need to consider range of market evidence hence the CC is “wary to define formulaically the RFR or cost of debt”; • “A company’s financing costs will not typically move in step with market rates. Many companies raise at least a proportion of debt on a fixed-rate basis, insulating them from market movements and potentially negating the need for an automatic adjustment mechanism”; • An indexation mechanism would require a regulator to define a basket of debt to form the index, taking it directly into company’s financing arrangements; • Indexation of price limits via RPI already partially links prices to changes in borrowing costs. Indexation may lead to double counting of the effects. <p>Following publication of the CEPA report, Water UK commissioned First Economics to undertake a review of the indexation of debt proposals and the CEPA findings. The First Economics report disagrees with the findings of the CEPA report on the following grounds:</p> <ul style="list-style-type: none"> • “Headroom: CEPA appears to us to have significantly overstated the

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		<p>headroom in the cost of debt allowances made this year by the CC and Ofgem;</p> <ul style="list-style-type: none"> • Definition: CEPA's proposed cost of debt benchmark risks combining mutually inconsistent measures of the risk-free rate and debt premium into an aggregate cost of debt that lies below the actual rate of interest paid by water and sewerage companies; • Matching: because it concentrates on only a subset of the types of debt that companies can issue, CEPA's proposed benchmark could quite easily exaggerate or misrepresent the changes that occur generally in the debt market in future; and • Risk allocation: despite CEPA's contention that optimality in risk allocation is not a key issue, we can see no reason why customers should be asked to bear interest rate risk when companies are well placed to manage such risk on their behalf." <p>The First Economics report supports our view that indexation of the cost of debt should be rejected and concludes that:</p> <p>"When devising its methodology for PR09 we think that Ofwat should follow the lead of the CC by focusing its attention on obtaining the best possible forecasts of the costs of debt during AMP5 and then asking companies to bear future interest rate risk on customers' behalf. The principle that risk should be</p>

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		<p>allocated to the party best able to manage it has long been a core foundation of the water industry' regulatory regime and in the long term should lead to customers paying lower prices than under any alternative regulatory rule. Accordingly, we find that there is no basis for a move away from the PR04 methodology and so recommend against indexing the cost of debt in line with prevailing market benchmarks."</p>
5.2.10 Capital Structure and Treatment of taxation	Support, subject to concerns regarding impact on cost of capital associated with any assumed increase in gearing above that set at PR04.	The Competition Commission has supported the view within its recent review of airports that the vanilla WACC increases with gearing. Thus to the extent that Ofwat increases industry notional gearing then equity should be compensated for the additional risk being assumed – this could be achieved by sharing the tax benefits of additional gearing equally between customers and companies.
5.3 Financeability	Support Ofwat continuing to test for financeability. However, we do not agree with Ofwat's conclusion that market mechanisms (equity injection and index-linked debt) provide the preferred solution.	<p>In principle, our position can be summarised as follows:</p> <ul style="list-style-type: none"> • Ofwat must continue to focus on its statutory duties to ensure that companies are able to meet their licence commitments and finance their functions. This requires Ofwat to do all it can to limit regulatory risk and to ensure that the cost of capital is set at an appropriate level; • A broad range of investment sources should be available to companies, requiring long term regulatory commitment to match the long term nature of investment; • Decisions on how to finance investment should remain with companies;

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		<ul style="list-style-type: none"> • Issues of financeability should be addressed through targeted revenue uplifts rather than simply be left for companies to manage through equity injections or further issuance of index-linked debt. <p>Ofwat also propose taking a more flexible approach to financial ratios – we would support Ofwat refreshing its view of what constitutes investment grade ratios and what level of gearing is consistent with investment grade in how it conducts its financeability test for the industry.</p> <p>However, this must be informed by the ratings agencies (as proposed) and be published in advance to ensure consistent application across the industry.</p> <p>In reality the issues of financeability and cost of capital are interlinked, whilst the mismatch in cashflows within the regulatory mechanism is the prime driver of the financeability issue, the allowed cost of capital set by the regulator must be appropriate in order not to magnify the problem.</p> <p>Looking in more detail at each of the proposed solutions for financeability:</p> <p><u>Revenue Uplifts</u> – This is Thames' s preferred approach on the following grounds:</p> <ul style="list-style-type: none"> • Provides earlier returns to address inherent mismatch of cashflows in

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		<p>the regulatory regime within a theoretically sound process;</p> <ul style="list-style-type: none"> • Allows issue to unwind when the capital programme falls in the future; • Clarity from Ofwat on the method of uplift, in terms of how an NPV neutrality is achieved will be required. <p><u>Additional equity</u> - rejected on the following grounds:</p> <ul style="list-style-type: none"> • Does not address regulatory/political risk that additional future returns will be available to investors; • There may be practical limitations within the market at the time when additional funds are required, and how does this solution operate practically in the context of the new type of equity investor (private equity and infrastructure funds)? • Ofwat should not prescribe how a company should be financed and should avoid making modelling assumptions for dividends that could unsettle the capital markets; • Management should be free to determine its own policy to ensure the most efficient mix of debt and equity funding (including retentions) for its own circumstances. Ofwat should not assume that the financeability gap could be closed by equity injection; • Uncertainty as to how will rating agencies will view this solution. Will they accept a regulator's (and perhaps company's) future expectation of cash flow from equity injection as a satisfactory measure to regain

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		<p>investment grade rating?</p> <p><u>Index-linked Debt</u> – whilst it appears reasonable to assume a certain degree of index-linked debt when testing for financeability we would urge Ofwat to exercise caution in determining how far index-linked debt can go in addressing financeability issues on the following grounds:</p> <ul style="list-style-type: none"> • Only certain credit ratios are improved through adoption of index-linked debt; • Whilst companies have taken advantage of recent market conditions, Ofwat must ensure safeguards are in place such that debt structures are not prescribed for markets to exploit; • Ofwat should not assume the continued availability or liquidity of the index-linked debt market. The recent 'credit crunch' has already restricted availability and the impact on the monolines (themselves restricted in number) may further reduce supply. Indeed there is currently no liquidity in the market; • Potential increased costs; • Does not address regulatory/political risk of restriction to future, higher, returns.
5.4 Notified Index	Agree in principle, subject to inclusion of sufficient ex-ante allowance for the notified	We agree with Ofwat's proposal to adopt the infrastructure output price index (IOPI) instead of COPI for Capex at PR09.

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	<p>index increasing by more than RPI</p>	<p>We agree that this index is more closely linked to the utility industry but it is more volatile compared to COPI. Therefore it is very important that Ofwat should ensure sufficient ex-ante allowance for movement in the new index is added to the RCV at PR09.</p> <p>As the new index is more closely linked to utility sector, the frontier shift element of the efficiency targets becomes difficult to justify as companies would effectively be asked to outperform their own index.</p>
<p>5.5. Revenue Forecasting</p>	<p>Support in principle, but further clarity and engagement required in agreement of the detailed operation of the revenue corrected price cap and billing incentive mechanism</p>	<p>We cautiously welcome the Revenue Corrected Price Cap but more information is required on the exact approach to be adopted. In particular with respect to the proposed 'billing incentive', which in its detailed form, must incentivise companies to find and bill missing supplies as well as properties. It is therefore essential that companies are fully engaged in the development of the detailed mechanisms through which the Revenue Corrected Price Cap and billing incentives operate.</p> <p>As part of development of the detailed mechanisms it is essential that companies have a clear understanding of exactly how revenue risk is shared symmetrically with customers under the proposals, a series of worked examples would be helpful in this respect.</p> <p>In addition, Ofwat should also consider how the cap should be reflected (if at</p>

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		<p>all) in the regulatory accounts year on year and to support the industry in its discussions with accounting and tax authorities to ensure that the benefits of the cap are not offset by accounting or tax treatment.</p> <p>Thames would also welcome the introduction of a water efficiency incentive as a component of the Revenue Corrected Price Cap, where any company outperformance on water efficiency targets is duly rewarded.</p> <p>We welcome Ofwat's proposal to reduce the level of detail required in revenue forecasting. However, we are mindful of the increased reporting requirements for metered non-households, the Revenue Corrected Price Cap and the billing incentive which should be kept simple to avoid a net increase in regulatory reporting.</p> <p>We support the provision of a tariff basket model. However, we seek clarification of the timetable for release. Ideally, this model will be available for us to use by April 2008. We also request that we have visibility of the logic applied in the model to understand the processes involved in calculating K factors and bill values.</p>
Aquarius	Clarity required	We would welcome clarity on Ofwat's planned timetable for issuing the version

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		of the Aquarius model to be used for price setting at PR09. The model is a fundamental element of the price setting process and it is important that the final model, reflecting the revised methodology for PR09, is issued in good time for companies to finalise their draft Strategic Business Plans. Ideally such a model should be available from April 2008, and, practically, this may require release of earlier versions for testing and familiarisation in the first quarter of 2008.
Regulatory Capital Value	Clarity required	The methodology consultation document does not refer to the process by which opening RCV balances will be agreed with companies, nor when this is planned to take place. Agreement of opening RCV balance is a fundamental part of the price setting process, taking in views on outperformance, logging up and down, and other factors affecting the RCV. The methodology document to be issued by Ofwat in March 2008 should set out the process within which such opening balances are to be agreed and the timetable for this.
<u>Chapter 6. The incentive framework – delivering outputs and reducing costs</u>		
6.1.2 Rolling incentive mechanism for capital expenditure and outperformance	Urgent clarification required	The consultation provides no information on how the rolling incentive mechanism will operate alongside menu regulation. It is unclear how Ofwat expects companies to provide meaningful comments on

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		an incentive mechanism (or respond to it in their business planning approach) when there is no clarity about how it will operate.

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6.1.3 OPA	<p>Support</p> <p>Thames would support replacement of OPA.</p>	<p>Welcome intention to review OPA (Overall Performance Assessment). For most companies OPA fails in its intended purpose to incentivise good service as companies are unable to predict their relative performance or where Ofwat will set performance bands.</p> <p>The OPA also perversely incentivises service improvements which are lowest cost per OPA point – these may not be the improvements that are of most value to customers or for which they are willing to pay.</p> <p>We believe OPA should be replaced with a set of customer focussed performance metrics. In line with precedent in other regulated sectors we would urge Ofwat to tie a greater range of financial adjustment to performance against such customer focussed performance metrics in order to establish greater incentives for companies that deliver outputs most valued by customers.</p> <p>Furthermore, we believe that the customer service outcomes to be delivered by companies should reflect what their customer base most values as identifies by cost benefit analysis and customer willingness to pay. A set of national customer outcomes are likely to be irrelevant / insufficient.</p>