



Setting price controls for 2015-20 - business planning expectations. An Ofwat consultation

Consumer Council for Water Response

May 2013

Introduction

The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage consumers in England and Wales. CCWater has four regional committees in England and a committee for Wales. We welcome the opportunity to respond to Ofwat's consultation on its business planning expectations for 2015-20.

Executive Summary

We support:

- Incentivising high quality business plans through a focus on customers rather than the regulatory process.
- Ofwat's guidance on the assessment criteria, which should allow companies to deliver a good business plan.
- Retaining the three assessment categories and publically announcing which companies' plans have been ranked in which category.
- A risk based approach to reviewing business plans based on high level 'testing' of outcomes, risk and rewards, affordability, financeability and costs.
- Proportionate regulation for "small companies" and the introduction of a threshold at which they will be subject to the same tests as other companies, while acknowledging the potential risks this brings.

We do not support:

- Removing the resubmission category or delaying announcement of plans that fall into this category.
- Disregarding the ranking achieved by a company's retail business element when determining the overall company ranking.

We would like to see:

- A high level of customer acceptability (confirmed through robust evidence) as a key assessment criteria. In order to meet Enhanced or Standard status, a plan must show evidence that a high level of customers approved the plan. By adding customer acceptability as a test, the approach to business plan assessment will be consistent with Ofwat's 2011 policy statement on '*Involving customers in price setting*' which stated that, especially if a company's proposals will have a significant impact on customers' bills, Ofwat will wish to see evidence and be assured that there is '*customer buy in*'. If there is not a high level of customer acceptability for a business plan, it cannot be viewed as credible for customers.
- The separation of the "Affordability" and "Financeability" tests.

- Companies required to produce business plan narratives written in a way that is understandable to customers.
- Ofwat publish as soon as practicable its high level definition of Enhanced, Standard and Resubmission status, and the key areas of plans that will be tested, to ensure companies are focussed on this as business plans are developed in the lead to the December 2013 submission.

An incentives-based price review

- 1 Q1 Do you agree with our definition of a high-quality business plan? Is anything missing? Is there anything you think we should change?
 - 1.1 We welcome Ofwat's aspiration to ensure that companies' business plans are focussed on delivering good outcomes for customers and to move away from the previous focus on the regulatory process. Requiring companies to set out how they intend to share outperformance with customers is also a positive move towards a fairer water industry environment which gives greater consideration to an appropriate balance of risk and reward between a company's customers and shareholders. CCWater has called for companies to share such outperformance with customers in the past, and we are encouraged by the Ofwat chair's recent statements on this issue. We look forward to working with Ofwat on how this can be taken forward.
 - 1.2 As part of the definition, we would like Ofwat to go further and say that the outcomes must be based on sound evidence of customers' priorities and that the business plan should demonstrate that the price and investment package for which the company proposes to deliver its investment programme is acceptable to customers (based on sound evidence from market research). We do not consider that a company plan could be considered high quality if it fails to do this.
- 2 Q2 Do you agree that our preferred package of reputational, procedural and financial incentives will incentivise high-quality business plans? If not, what do you think we should add to the package, or change?
 - 2.1 We are not sure that the incentives in their current form will be sufficient to drive companies to submit the highest possible quality business plan. We question whether the short-term reputational boost and extra time to begin investment planning derived from attaining Enhanced status will be sufficient. The level of acceptability that the company's customers have given its plan should be a strong indicator that the plan is of a high quality. A company should be incentivised further to deliver a high quality plan if it knows that customer acceptability will be a key test when the plan is assessed. In addition to this, a strongly incentivised outcome in a company's plan based on delivering greater customer satisfaction with value

for money would reinforce further the need for the plan to be acceptable to customers. This would be particularly effective if such an outcome has a financial incentive attached to it, so that any potential financial benefits for the company are aligned with increasing customer satisfaction.

- 2.2 We note that Ofwat will not issue details to companies on how it will assess data and set benchmarks for the 'enhanced', 'standard' and 'resubmit' categories. We agree that this is an appropriate approach at this stage of the price review to prevent companies opting for the 'lowest common denominator', and instead strive to achieve the highest quality Business Plan they can deliver.
- 3 Q3 Which of the options (elements earn procedural and financial rewards; two category approach; two-process approach for retail; later decisions on resubmissions) do you think we should use, if any? Why?
- 3.1 None of the alternative approach proposals seem to have advantages which outweigh the disadvantages of adopting them. Introducing rewards for elements rather than the overall submission will make the process more complex and we would question whether adding complexity is something Ofwat should be considering given that this is the first year of a new price review process and there are already a number of complex changes to the methodology that it needs to work through.
- 3.2 Removing the resubmission category would lessen the impact of the incentives for companies to submit good plans by removing the consequences for delivering unsatisfactory plans. We also feel that, due to the tight timescale which already exists in the process, making a late decision on whether a plan falls into the resubmission category would not be workable. A plan requiring resubmission is likely to require significant revision in order to address the potential customer detriment it might deliver and as much time as possible should be devoted to this within the process. There would be a considerable impact on the workloads of companies, Ofwat and the CCGs (which would likely need to reconvene to consider the impact of the decision). A plan which falls into the resubmission category will be subject to the highest level of scrutiny and so Ofwat should begin this process as soon as possible.
- 3.3 If Ofwat decides to implement the three category ranking assessment process it should ensure this is finalised and set out to companies as soon as practicable as business plans are now being prepared. This statement should also clearly set out what the benefits to the company in achieving the higher ranking will be, and also the consequences of falling into the resubmission category. Introducing sub-categories is only likely to lessen the incentives and add confusion to the process. We agree that the overall

ranking of a plan should reflect the lowest assessment of each of the five elements, (so if one element was ranked as 'standard' and the other elements were 'enhanced', the full plan receives a 'standard' ranking). This will act as an additional incentive for companies to ensure all of the proposals in each element are well-evidenced, justified and with appropriate information provided to allow for an assessment.

- 3.4 We consider that the tests against each element should cover both retail and wholesale investment and cost proposals. Retail activities still account for a considerable proportion (circa 10%) of the overall service received by customers, so this should be included in the assessment.
 - 3.5 To strengthen the reputational incentive further, Ofwat should also publicly announce the business plan ranking to inform customers of how well companies have listened to their views and responded with the five year plan. This should be timely to ensure sufficient time for any resubmission of the plan and subsequent further challenge by local CCGs.
- 4 Q4 Do you think that our proposals will be effective in meeting our objective of handing back ownership of the business plans to company Boards?
- 4.1 Companies will understandably be apprehensive about signing off a plan when they are not sure of the assessment criteria that Ofwat will be using to judge it. While it is to be hoped that companies will counter this uncertainty with their own robust internal assurance processes, it is possible that this uncertainty may have the effect of leading companies to deliver safe, unambitious plans that deliver no more than the bare minimum for consumers. This underlines the importance of Ofwat setting out its definition of the Enhanced/Standard/Resubmission status and the key assessment tests early and with the minimum of ambiguity because this will help incentivise companies to propose innovative solutions that offer value for money in their plans.
 - 4.2 We welcome the requirement for the companies to submit a commentary alongside their business plans which provides the rationale for its investment proposals. We would urge the companies to make certain that this is written in a way that is easy to understand for its customers - or to provide a summary document which does this - so that it can demonstrate clearly to bill payers why investment is required and where it is proposing that its customers' money is to be spent. The narrative must also show where the company's proposed investment and associated service levels meet customer preferences, with clear evidence proving this to be the case.

The risk-based review in detail

- 5 Q5 Do you agree with the four high-level groups of tests (outcomes, costs, risk and reward, affordability and financeability) are the right ones? If no, what do you think we should add or remove?
- 5.1 No. CCWater believes that customer acceptability is the key test to show that the company is delivering a high quality plan that is acceptable to its customers. Ultimately this will also help ensure that the regulatory process itself is delivering the right results.
- 5.2 We also believe that the tests for affordability and financeability should be kept apart. While we agree that affordability and financeability are two key elements that should be tested and that there is a link between them, we would like to see these two elements separated. Affordability is likely to be linked with the acceptability of a plan because the reason some customers may find a plan to be unacceptable is highly likely to be because of the impact on their bills. An assessment of affordability involves consideration of a range of customer evidence beyond the company's proposed ratio between 'pay as you go' cost recovery (i.e. current customers) and costs applied to the RCV (i.e. future customers). We welcome the acknowledgment that where there will be a degree of dependency between some of these areas the tests will take account of this.
- 5.3 Ofwat should set a separate overarching requirement for a company's plans to be acceptable to a significant proportion of its customers as one of its high level tests. Companies are required to show this as part of their customer engagement and, while this forms one of the tests under the "outcomes" element, this should be made more prominent within Ofwat's business plan requirements.
- 5.4 In chapter 4 of the August 2011 policy statement on 'Involving customers in price setting', Ofwat states that, '*if a company's proposals would have a significant impact on bills or service levels...we will place more weight on the need of assurance of customer buy-in when we consider whether to accept the company's proposal¹*'. The statement goes to say that Ofwat would look at customer acceptability even if no significant changes are proposed by a company, though with less intensive scrutiny. We believe that in order to be consistent with this statement, Ofwat should introduce an extra business plan test based on evidence of the customer acceptability of a company's proposals.

¹ 'Involving customers in price setting – Ofwat customer engagement policy statement' (August 2011), chapter 4 http://www.ofwat.gov.uk/future/monopolies/fpl/customer/pap_pos20110811custengage.pdf

- 5.5 A plan cannot be said to be acceptable unless the investment it delivers, and the price this will cost, is supported by a company's customers. Failure to achieve this will bring into question not only the validity of the business plan itself but could serve to discredit the work of the customer challenge groups and the new regulatory approach that introduced them into the price setting process. CCWater will be contacting companies to set out our expectations for their business plan acceptability research and the level of acceptance that we feel they should be aiming for as a minimum.
- 6 Q6 Do you think we have set out the right tests in each group? If not, what do you think we should add or remove?
- 6.1 As set out above, Ofwat should introduce a further test based on customer acceptability of plans, consistent with the 2011 policy statement on customer engagement. Of the consultation paper's proposed tests against five elements of the Business Plan, we agree that they reflect other fundamental components of the investment and price package. Below we comment further on each of the five tests:
- 6.2 **Outcomes.** The test of company outcomes must acknowledge the degree to which these are shaped by and address the priorities for investment identified by a company's customers. We welcome the commitment to addressing this by requiring a company to demonstrate that it has communicated effectively with its customers, that its performance commitments represent value for money and that the delivery incentives balance the risk held by companies and its customers.
- 6.3 **Risks and rewards** Ofwat's approach to the assessment of risk seems reasonable. We would expect companies who submit plans that argue for a different level of risk than that which is common across all companies to have a high bar to pass in terms of providing evidence that clearly shows the regional variances to be outside of their control, meaning they should be assessed differently.
- 6.4 **Affordability and financeability.** As per our response to question five, we would like to see affordability and financeability tested separately rather than as one unified test. A plan that is financeable may not be affordable to customers, and vice versa. We will be looking for Ofwat to ensure that companies' plans strike the right balance between current and future bill payers. Equally investment must be planned in a sustainable way that does not hold the threat of significant and unavoidable increases in later control periods, with the associated burden for future bill payers.
- 6.5 **Costs.** We agree that companies should be incentivised to deliver plans that propose efficient costs. By offering the 'reward' of an earlier delivery of

both totex menu incentives and an early draft determination, companies should be incentivised to submit an ‘enhanced’ plan. We note that, before business plans are submitted, Ofwat will not provide companies with details of how costs will be assessed and how menu baselines will be set. This should result in companies proposing the most efficient costs for delivering required outcomes, which may be more efficient than the Ofwat baseline costs that will follow later. This approach to incentivising efficient costs should help reduce the risk of ‘bidding’.

- 7 Q7 Do you think our proposals for business plan assurance will be effective in meeting our objective of handing back ownership of business plans to company Boards?
- 7.1 Companies must have confidence in the quality of the plans that they are submitting. It is to be hoped that the need for these plans to be signed off by the entire board will ensure that there is a robust internal checking procedure in place that will lead to a credible, transparent and accurate projection of investment needs for the five year period. See also our response to question four.

Delivering focused information requirements

- 8 Q8 Our objective in specifying the data tables (and the August submission) is to ask for all of the information we need, but no more than we need. Do you think that we have achieved this? Is there any information that you think we might not need? Is there any information that you think we will need but we have not included in the data tables?
- 8.1 We think companies are best placed to debate the relevance of the information being requested by Ofwat.
- 9 Q9 We aim to collect data on a consistent basis from all companies. Are the data tables clear and well specified? Are there any areas where we need to look again at the way we have asked for the data to remove any ambiguities in the request?
- 9.1 We do not have a comment in response to this question as the ease of use of the data tables is an issue for companies to address.

Application to small companies

- 10 Q10 Do you agree with our proposal to continue to set price limits for new appointees using a relative price control? If not, what alternative do you prefer?
- 10.1 Continuing with the current arrangements and setting a relative price control for new appointees is the simplest and most effective way of

ensuring that the customers served by these companies are not disadvantaged by receiving their services from a company other than the incumbent provider. As a condition of their appointment these new appointees will have already committed to deliver the services to their customers at an equivalent or lower level than the incumbent company and we would not want to see this benefit compromised. Given the size of the new appointees we believe that it would not be in keeping with Ofwat's stated "proportionate regulation" approach to PR14 to determine a separate price control for these companies.

11 Q11 Do you agree that we should set Cholderton & District Water its own simplified price control?

- 11.1 Yes. The small number of customers served by Cholderton, and the size of the operation at the company itself, makes the adoption of the same level of regulatory scrutiny as that carried out on other incumbent companies an unnecessary burden for Ofwat and the company. The current simplified process has not caused us any concerns in the past.
- 11.2 That said we would still expect Cholderton to develop its business plan in consultation with its customers and are working with the company to run a customer challenge group proportionate to its size and to reflect local interests in order to consider its customer engagement plans and the development of its plans for the future.

12 Q12 Do you think that we should develop a new small company incentive? If so what form do you think this incentive should take?

- 12.1 Yes, in principle it would be reasonable to introduce an incentive for those small companies (Cholderton and the new appointees) that cannot see an impact from the incentives available in the current regulatory process. We would need more detail on what this would constitute before making a final decision. Smaller companies must undertake customer engagement to identify required outcomes. We would expect the highest priority outcomes for customers of smaller companies to be subject to incentives to drive their delivery. However we agree that the range of measures and associated incentives would need to be proportionate to the size of the company.

13 Q13 Do you agree with our proposal that small water companies should not be subject to separate wholesale and retail price limits?

- 13.1 As with our answer to question 10 above, we support the use of a proportionate regulation approach to small water companies. We agree that a combined price limit should apply to the smallest companies as it is questionable whether the retail element of their business are large enough to warrant a separate price control.

14 Q14 New appointees are growing in size. In the future do you think we might need to adopt a different approach to regulating their prices and services? If so what circumstances should prompt a change of approach?

14.1 There may be a need to reconsider the approach to regulating new appointees. Ofwat would need to take into account a number of factors when considering this:

- Customer satisfaction with both the service and value for money for these companies (evidenced through customer views or other sources). A lower level of satisfaction should prompt regulatory intervention.
- An appropriate size threshold for introducing a new system of regulation.
- The potential regulatory burden on the company - making sure this does not affect its service to customers.

Any price setting would need to be undertaken on a site-specific basis where a new appointee operates across a number of sites in England and Wales so that the specific local circumstances are taken into account.

Enquiries

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