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25 March 2013

Dear Stephen,

**CONSULTATION ON FRAMEWORK AND APPROACH FOR THE 2014 PRICE REVIEW**

We welcome the opportunity to comment on the framework and approach for the PR14 Price Review.

We have accepted the challenge laid down to own our business plans, and we are fully committed to meeting this challenge. The package of measures and incentives that we are developing is being carefully considered and discussed with stakeholders and our Customer Challenge Group. We believe the package will incentivise the right behaviours to stimulate innovation, ensure that customers receive the outcomes they value, and be consistent with the principles set out by Ofwat. However, it will be *a package*, providing a balance which we believe will be acceptable to all parties. We understand that it is our responsibility to fully justify this package and explain to Ofwat any interdependencies. We therefore expect that Ofwat will consider these factors before attempting to amend elements of the package, particularly to standardise any measure or incentive across the industry which may not fit well with our other proposals.

One of the biggest issues within the price control methodology is the assessment of costs and application of a menu approach. The work is complex and there is much to do but we feel this can work within the proposed timetable provided the following takes place: (a) Ofwat sticks to its proposed timetable for the August 2013 data submission, with early clarity about its reporting requirements; (b) Ofwat makes clear what information it requires companies to provide in their business plans; and (c) Ofwat shares the detail of its cost assessment tool immediately after submission of business plans.

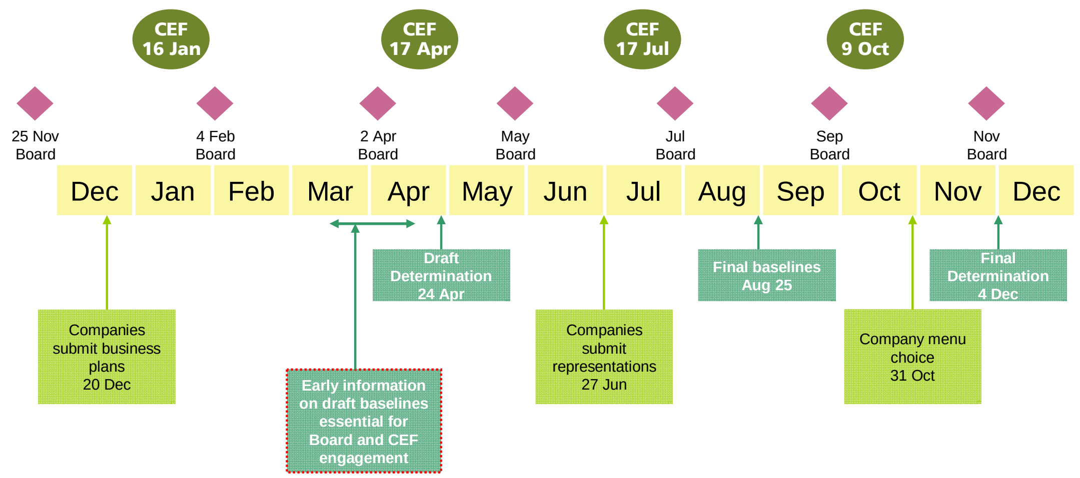
This last point would enable transparent and collaborative development of methodology and could also serve as a mechanism by which information can be shared by both sides from a position of trust: Ofwat because it reduces the risk that companies will use knowledge of the models to their advantage in submitting business plans; and companies because it reduces concerns that

Ofwat might reduce baselines to reflect efficiencies offered up by companies in their plans or apply catch-up/ongoing efficiencies in a manner that does not recognise the efficiencies offered up, thereby penalising the company.

While we understand that Ofwat has yet to finalise menu parameters, companies need to know the basic form and overall strength of the incentives that Ofwat proposes to put in place for cost out-performance so they can calibrate their overall packages of outcome incentives properly.

It is clear from Ofwat's timetable in the consultation that the 2014 timetable is very challenging for both companies and Ofwat. Ofwat has asked companies to think about how this might be adjusted. We are fully committed to delivering to the timetable, and as we explained during our recent meeting with Ofwat, early sight of dates will be key to ensuring that Boards and the Customer Challenge Group can properly engage with the process. We are very supportive of the use of menus, and it is clear that to implement menus properly, menu choices must be made before the Final Determination. We have proposed a revised timetable that we think allows Ofwat to carry out the necessary work, and we have included this below. To mitigate the risk of companies being asked to submit large amounts of further evidence, it is important that Ofwat clearly sets out the criteria on which it will be assessing plans early in the process.

**Alternative 2014 timetable to allow for Board and CEF engagement**




An annex to this letter sets out our views on the consultation in more detail and contains our responses to the questions Ofwat set out in the consultation document.

We look forward to working with you to agree the detail of the 2014 timetable to ensure Ofwat can deliver on its commitment to an effective baseline setting and menu choice, in which Boards and Customer Challenge Groups can fully engage.

Yours sincerely

Jean Spencer
**Regulation Director**
Enc.

# Annex – Anglian Water's response to the framework and approach consultation

# 1 Outcomes and Delivery Incentives

## 1.1 Cross company comparisons and incentive packaging

Cross company comparisons are a useful tool for Ofwat in assessing the proposals made by companies. However, Ofwat must be mindful that companies may set different incentives or measures for a number of reasons, for example:

- the relative importance to their customers based on differing Willingness To Pay
- the appetite of various stakeholders (including customers and the company) for risk
- the behaviour the company is trying to incentivise
- how the measure or incentive fits within the overall package of incentives being proposed.

We think it is important that Ofwat does not introduce a ‘levelling’ of outcome / incentive schemes during its assessment of plans as this would undermine the intent to reflect local priorities arrived at through engagement with our stakeholders and customers.

Companies should be developing outcomes and incentive mechanisms which work together as a package and be able to demonstrate that their proposals are appropriately balanced to their customers and stakeholders. We think therefore that caution needs to be exercised in making changes to a subset of the incentive mechanisms without consideration of the impact on the whole package. We understand that it is our responsibility to fully justify this package and explain to Ofwat any interdependencies. We therefore expect that Ofwat will consider these factors before attempting to amend elements of the package, particularly to standardise any measure or incentive across the industry which may not fit well with our other proposals.

## 1.2 Answers to specific questions

*Q1 Do you agree with the process for deciding on the nature of the incentive (non-financial, one- or two-sided and for allowing trade-offs where appropriate)?*

The incentive design framework (decision-tree) set out in the consultation appears helpful but in practice we have found using it is not always practical. We also feel it is unnecessarily constraining.

It seems to suggest that in most cases a financial penalty will be the default, with justification required to move away from this position. This underestimates the role and value of some reputational incentives.

We think that financial value-based incentives, based on customers’ Willingness to Pay, may not always be appropriate, especially where the values are very high (e.g. for drinking water quality) and may result in companies being overly risk averse.  We raised our concerns about the potential for value based incentives to promote risk averse behaviour in our paper "Outcome delivery incentives over multiple price controls".

We agree that marginal costs and benefits are the right way to set committed levels of performance.  However, companies and Ofwat will have to be pragmatic in how this can be applied to the outcomes approach in this transitional price review.

*Q2 Do you agree with our proposal to consider delivery incentives for the next five years?  If not, how should we use longer-term delivery incentives?*

We understand the practical reasons why Ofwat has proposed this, however companies will still need to demonstrate how their plans and incentives will drive a long term sustainable business.

*Q3 Under what circumstances do you think we should set consistent performance commitments and incentives across all companies?  Are there particular examples where consistent incentives would be beneficial?*

Ofwat should provide more detail on the operation of the consistent incentives (Totex, SIM, AIM and possibly leakage) as soon as possible, so that we can ensure that they fit within the overall package of proposed incentives that we are designing. This is very important if we are to engage effectively with customers and our CCG in business planning timescales.

We continue to believe that SIM should be a qualitative only measure. This would be consistent with an outcomes-focused approach.

Minimum standards for leakage akin to current leakage targets are not unreasonable, but companies should be free to determine what incentives are appropriate and to set more challenging targets (and incentives) if supported by customers.

We would not propose further consistent incentives.

# 2 Defining retail (and wholesale) services

## 2.1 Consistency between Household and Non Household

In our response to Ofwat's Consultation on Retail Price Controls, we expressed the view that the split of activities and services between wholesale and retail need not necessarily be the same for Household and Non Household Retail.

We continue to hold this view. Imposing the same split for Household and Non Household retail may create more difficulties than it solves. The situations are fundamentally different given the need to consider the requirements of a competitive market on one hand, compared with the need for effective regulation of an integrated business serving domestic customers on the other. In particular, we remain to be convinced that the potential for adverse incentive effects of applying an Average Costs to Serve approach to activities such as water efficiency can be avoided.

Furthermore, the supposed difficulties of splitting the recovery of wholesale revenues between the two sides of the market may be overplayed. Companies will need to allocate revenues fairly between the two sides of the market, as they do now. This seems desirable to ensure that households do not subsidise businesses and vice versa. Nor does it seem impossible to manage.

## 2.2 Principles of allocation

The Framework consultation is rather unclear about the rationale for and implications of the allocation of activities and services between wholesale and retail, both for the three activities being consulted on and for the two further activities that are "split". We think that the discussion would benefit from identifying some clear principles, such as:

- activity should be distinguished from services and cost. The consultation talks about activities and services but for price control purposes it is where the cost should be allocated that is important.
- cost should be allocated to the party that is making the decision whether to incur it, or has an obligation to incur it.
- correct allocation should consider the potential for competitive markets to develop for services associated with the overall retail market and should consider the impact on competition in those markets.

## 2.3 Market effects

It is worth unpacking this last principle. We think that the allocation of costs within the wholesaler's overall revenue control should ideally not create undue risks of unfair competition on that market, for example by conferring an undue advantage on a wholesaler that is dominant in a market for services related to the provision of water to customers. Such related markets might include the provision of metering, disconnection or leak repair services, for example. The advantage might come from the inclusion of revenues derived from these activities within an overall price control.

Decisions ought to take into account the likely importance of the competitive market concerned. If a market is potentially small with limited potential to deliver customer benefit, worrying about making competition effective is less of a priority.

Clearly, whatever regulatory arrangements are in place, all parties, but especially dominant ones, will need to have regard to competition law and in practice these considerations may be more important than its response to the regulatory regime.

This is not a straightforward area, and it is relevant to market design as well as regulatory design. We have included, as an Annex to this paper, a note which explores these issues in more depth.

## 2.4 Answers to specific questions

*Q4 Do you agree with our definition of retail? Specifically, do you agree with our preferred option for demand-side water efficiency services, customer-side leaks and developer services?*

We answer this in two ways: (i) on the assumption that a consistent split is required and (ii) that it isn't.

If there is to be a consistent split we agree that customer side leaks and demand-side water efficiency activities should be allocated to retail. This is driven by the fact that these will be competitive differentiators in the Non Household Retail market. However this will require some mechanism to be put in place such that the level of activity decided on by wholesalers and the associated costs can be reflected in the wholesale price control – and to avoid the incentive for underspend driven by the inclusion of such costs in the ACTS mechanism. At its workshop on 1 March, Ofwat presented a slide which aimed to explain how this was to be achieved in respect of water efficiency. Further clarity here would be welcomed, as well as how this would be applied to customer side leaks.

If our assumption on the consistent split is relaxed, then we believe that the costs of these activities attributable to households should be included in wholesale.

In practice, the distinction between these two options is quite subtle. In both cases, the wholesale price control needs to reflect the costs attributable to the decisions that the wholesaler makes as to the level of such activities.

For developer services activities, we think all activities and costs should sit in wholesale. The purpose of the developer services function is more closely aligned to providing wholesale-type services i.e. infrastructure and connections, rather than retail-type services such as meter reading and billing. Splitting developer services activities introduces an unnecessary interface, which would increase costs with no associated benefit to companies or developers. There would of course need to be equivalence processes to ensure a level playing field for insets but this is no different to the case today.

The definitions of wholesale and retail services proposed should apply to the whole period 2015 – 2020, and changes should be avoided, because companies will be making specific investments to support the current split of wholesale and retail activities.

# 3 Setting wholesale controls

## 3.1 Cost assessment and efficiency

We support the general approach proposed but note that it is complex and there is much work to be done.

Ofwat is concerned that companies will use early information about the specification of whatever models Ofwat uses for cost assessment to their advantage. It intends, therefore, not to share the model details at this stage. We would be most concerned, however, if we were unable to understand the basis for Ofwat's baselines once they are given to us. We were pleased to be assured at the wholesale workshop on 12 March that the model details would be released at the very latest with the draft baselines.

We feel there are benefits to all of adopting a transparent approach to cost assessment ahead of price setting, particularly given the acknowledged stresses in the timetable. We suggest that Ofwat might release its models as soon as companies have submitted their Business Plans in early 2014 to give the maximum time for companies to engage meaningfully with Ofwat in the setting of draft baselines, and contribute helpfully to the development of cost assessment tools.

We note the new submission of cost assessment data in August 2013. We presume this is to provide data to inform Ofwat's new and historic models and that it may possibly include capital investment unit cost data. Early confirmation of reporting requirements will increase the quality of our submission.

The consultation makes no mention of Ofwat's proposed approach to frontier efficiency. The industry is likely to bring forward proposals on this, as it did at PR09.

## 3.2 The use of menus

We support the use of menus and of the proposed process in 2014 for us to be able to discuss the baselines with Ofwat and, in particular, to be able to make a final choice about the balance of risk and reward. In order that this is effective, and for the Board to be engaged in this process, we will need firm dates for Ofwat to issue their Draft baselines and Draft Determinations so that we can set up Board meetings and appropriate Governance arrangements.

We note that the incentive parameters of the menus are yet to be determined. However, companies do need to know the basic form and overall strength of the incentives that Ofwat proposes to put in place for cost out-performance. CEPA has proposed an incentive rate at the break-even point of 45 – 50%; this number needs to be confirmed so companies can calibrate their overall packages of outcome incentives properly.

## 3.3 Price control mechanics

The separation of binding water and wastewater price controls means that all building blocks will need to be assessed separately, including the return, and hence RCV. Current customer tariffs and bills already imply an existing RCV split and so a fundamental change in the allocation of RCV could have incidence effects. Our own cost allocation models, which are used to ensure revenue recovery across customer classes reasonably reflects costs, uses NMEAV at 31 March 2008 a basis for allocating return, which gives some comfort that incidence effects might not be large in our case.

## 3.4 Adjustment factors

The adjustment factors which, as we understand from the recent workshops, would be based on short run marginal cost of water delivered and metered connections respectively, seem unlikely to give rise to large adjustments in allowed revenues. We believe that a marginal cost adjustment is appropriate in a short-term mechanism and we are currently looking in more detail at both the likely financial and bill impact of such adjustment factors. But we are also looking at the practicalities and costs of the additional mechanism. We support it in principle but have an open mind over whether the additional complexity in calculation is actually justified.

It would in any case be desirable for Ofwat be more specific about the costing standards that companies should apply in proposing the adjustment factors, which will, we assume, be part of its formal determination of prices at PR14.

## 3.5 Achieving allowed revenues

Potentially, there will be a greater impact on customer bills from making adjustments to recover allowed revenues than from the impact of variations in allowed revenues themselves. We are broadly supportive of the flexibility offered to companies and the consequent accountability on companies to explain their charges to customers.

We can also see how the mechanics of this would be operationalised in terms of an annual wholesale charges scheme, based on a forecast of outturn so that the lag between outturn and correction is not too long.

## 3.6 Depreciation of long-lived assets

We welcome the proposal to allow companies to select an appropriate PAYG ratio and depreciation rates for existing RCV and new assets. However, it appears that the “run-off” of existing RCV includes the write down of infrastructure assets (currently this part of the RCV is effectively maintained in perpetuity with maintenance spend and the Infrastructure Renewals Charge balancing over a 15 year period).

This seems consistent with a move to IFRS accounting standards but has some potentially large cashflow, intergenerational equity and financeability consequences that the existing infrastructure renewals approach was designed to deal with. Other things being equal, average depreciation rates which account for the very long lives of underground assets would have the impact of deferring revenues, although this may be partially offset because removing infrastructure renewals accounts results in less expenditure being capitalised. One response might be to accelerate depreciation, but it is not clear whether an artificial shortening of asset lives is desirable or sensible.

We will need to do modelling to fully understand this, but it would be helpful to know whether Ofwat has any expectations about how companies should set these financial parameters, and whether in particular it has views on the consequences of a run-down rate, which is substantially shorter than that implied by the average remaining economic lives of the underlying assets.

## 3.7 Presentational issues

The K-factor under a revenue control is different conceptually from a K-factor under the existing price control. It is in effect, one step further removed from the bills that customers pay because it cannot be seen as a price. This may need careful explanation to customers and others and should increase the focus on explaining the impact on bills. Clearly it is for companies to manage this but Ofwat should also be mindful of it when publicising its determinations. In particular, where year on year revenue increases as a result of growth this will be part of K, but will not in itself result in a change in customers' bills.

## 3.8 Answers to specific questions

*Q5 Do you agree with our proposed scope for the water and wastewater controls, given the proposed scope of the retail business we have defined in chapter 3? Are there any revenues of the regulated wholesale business you think should be excluded from this scope – if so, please give your reasons?*

We have commented separately about our views on the proposed scope of the retail business.

We broadly agree with the proposal to include revenue from all relevant wholesale services within the revenue control. Currently infrastructure charges are determined separately from the overall price control under Condition C of each company's licence. We assume that these licence provisions will be removed. We also agree that this area needs to be reviewed in the light of potential changes to the law. We note that the accounting and taxation treatment of infrastructure and connection charges has been the subject of attention at previous price reviews, with companies opting for different approaches.

*Q6 Do you agree with our proposal for a mixed revenue and revenue yield form of water wholesale control, including our proposed adjustment mechanisms to smooth allowed revenues within the control period? Are there any adjustments you would suggest?*

See Section 3.4 above. We are broadly comfortable with these proposals.

*Q7 Do you agree with our proposed simple revenue control for wastewater wholesale services? Do you have any evidence that suggests a revenue yield element should also be included?*

We have an open mind about this. The absence of a wastewater adjustment is perhaps difficult to explain when there is an adjustment for water and vice versa. We have no evidence at this stage which would clearly support including an adjustment, but we continue to examine data which might support a robust relationship between volume and cost or point to other more relevant cost drivers. Pending better evidence, we agree that the cost drivers associated with wastewater seem more complex. Strength of load can be a more important cost driver than volume, as used in trade effluent charges, but an adjustment which takes account of this could be complicated.

*Q8 How do you suggest we incentivise companies to prepare and update accurate demand assumptions to apply our proposed forms of wholesale control?*

As regards Ofwat's supervision of companies' revenue predictions and revenue corrections, we would argue that less is more. We would not support introducing specific monitoring measures at this stage. It would be preferable for Ofwat to review how companies have responded to the challenge before deciding whether any action is needed.

*Q9 Do you agree with our draft process for developing baselines? If not, how might it be improved?*

We are making our own assessment of costs at the same time as Ofwat is developing its own tools for baseline setting. The draft process will be improved by both sides sharing their approaches as soon as any risks from gaming are deemed to have passed. We will describe our approaches in our business plan and suggest that Ofwat releases the details of its tools as soon as possible thereafter so that discussions about the relative merits of the different approaches can begin.

The process will also be improved if Ofwat can be very clear about the information it expects to extract from companies' business plans to inform its models. We will 'own' our plan and focus it at our customers rather than the regulator but we cannot second-guess what information the regulator may be expecting the plans to contain so Ofwat needs to be explicit about its data needs.

*Q10 What areas of expenditure do you consider we should exclude from the general cost assessment methodology (that is, advanced econometric models and econometric models)? How should we assess these costs?*

Ideally cost assessment models will include all areas of expenditure. However, differences between companies and their particular investment drivers mean that the inclusion of certain types of costs will reduce the quality of models. These costs are better excluded from the cost assessment methodology and dealt with in a separate manner. Costs will also have to be assessed separately if their future levels are likely to be materially different from their historical levels.

Modelling results should guide which costs to exclude. In other words, if a poor totex model is improved by the exclusion of certain costs, a different method for assessing those costs should be adopted. The following cost types feel like strong candidates for exclusion, as they vary quite significantly between companies: expenditure on enhancements, sludge treatment and disposal costs (as past attempts at modelling have not been able to consistently model expected costs), EA costs and business rates.

The means of assessing excluded costs will vary according to the availability of data and we are still developing our thoughts on how we will do it ourselves. The loss of comparative data that was previously gathered through June Returns is an undoubted hindrance. Our approaches may rely on evidence from benchmarking activities, unit cost comparisons from the historical June Return datasets and models based on panels of our own data.

*Q11 What special factors should we consider for your company as part of our cost assessment? What criteria should we use to assess whether we need to take account of these in our view of your costs?*

Adjustments for company-specific factors will be necessary only where such factors have not been accounted for in model specification so until we see the specification of Ofwat's models we cannot be clear what adjustments we might seek. However, we have previously provided evidence for adjustments for the following factors that have been unaccounted for in Ofwat's efficiency models: the rural nature of our operating region; our level of meter penetration; the costs of treating groundwater for drinking water supply; the costs of removing phosphates from sewage; our large number of sewage pumping stations; and the costs of sludge transport. Some of these may well be candidate special factor claims again. Also, if CEPA's econometric models include enhancements then an adjustment is likely to be needed for growth, the WFD and other quality drivers.

*Q12 Do you agree with our criteria for excluding costs from the general cost performance incentive framework? What types of costs should we exclude from the general framework? Please explain how these meet the cost exclusion criteria and how we should incentivise cost performance for these costs.*

In principle we think all costs should be subject to the general cost performance incentive framework but agree that any costs meeting the criteria proposed should be considered for exclusion. At this point our view is that there are unlikely to be many.

*Q13 At what point should we take the MEA values to split the 2015 RCV in order to set water and wastewater price controls?*

We support the use of net book values from the reported regulatory accounts at 1 April 2010 to minimise the incidence effect of the adoption of private sewers in 2011. Using more recent net book values would result in the RCV split being distorted towards waste-water as a result of private sewer adoption. We also believe it is more appropriate to use the MEAV allocation at 1 April 2010 as no RCV value was attached to the transfer of private sewers and this would reduce the possibility of unwanted movement in customer bills.

*Q14 Do you agree that it is possible to simplify our approach to calculating tax?*

Yes. This seems a reasonable approach and we should be able to identify suitable writing down rates for each price control.

IFRS will be mandatory for all companies from 2015. Consequently, actual tax charges will be calculated on this basis, and should therefore be reflected on this basis in the price control. We would like further clarity about whether it is intended the tax charge is to be calculated at a whole-business or individual price control level.

# 4 Retail control for Household customers

## 4.1 Indexation

There are good arguments in principle for allowing retail price controls to be indexed by RPI. It is open for businesses operating in competitive markets to uplift prices to reflect input cost pressure. Whilst in some cases companies choose to fix prices over more than one year, the resulting prices reflect the risk in so doing and examples of where prices are fixed for more than two or three years are rare. We think that indexation of price controls provides an equivalent mechanism for regulated sectors, and do not find the arguments against doing so convincing[1].

Notwithstanding this point of principle, we believe that if indexation is not to be allowed for then price controls ought to allow for input cost pressures. We believe that one practical way of achieving this would be via an annual recalculation of the Average Cost to Serve (ACTS). Companies could then have the option of whether to adjust prices to reflect this. We continue to look at the pros and cons of this idea in more detail.

## 4.2 Use of forecast or historic costs

On balance we believe that it will be more appropriate to use historic costs to calculate companies' relative efficiency under an ACTS approach. This has the advantage of being based on verifiable figures. However in calculating the resulting price control allowances allowance should be made for input cost pressures which are likely to result in future costs being materially different from those used in the ACTS assessment. The annual adjustment mechanism referred to above would facilitate this.

## 4.3 The denominator

Clearly this is a polarising issue and there is no right answer. The use of unique customer numbers has some merit because it seems entirely unreasonable to assume that there is no economy of scope in serving dual service customers. However, this results in the situation in which price controls allow for twice as much cost to serve customers served by two companies, compared to those served by a single company, which also seems incorrect. We think that it may indeed cost a bit more overall to serve such customers in total, but not double the amount.

Reflecting on what we heard at the workshop, it seems that a compromise might be a better option. We believe Ofwat should revert to Option 4 in the original retail consultation in which an (essentially arbitrary) factor is used to reflect economies of scope for PR14. This would seem to be somewhat fairer in principle and could be adjusted in the light of emerging evidence. Our inclination would be to make the factor closer to 1 than 2, say 1.3, to reflect an assumption that there are, or at least should be, economies of scope. Clearly this would benefit from further analysis.

[1] A forthcoming report by First Economics for Water UK will examine these issues in more detail.

## 4.4 Adjustments to ACTS

We support the adjustment to the ACTS for meter penetration. We are working on determining the appropriate cost factor to use in this adjustment but it would be useful for Ofwat to clarify how it intends to make the adjustment, perhaps with a worked example.

We support, in general, the case that was made at the 1st March workshop that the basic ACTS calculation should better reflect the cost drivers of bad debt, in particular the size of the bill, which is for the most part determined by the wholesale charge.

Like Ofwat, we remain to be convinced about the case for an adjustment to reflect the impact of deprivation on bad debt and hence ACTS. We note that the evidence so far is generally at a very granular level within the company areas, rather than at the level of the region served by each company. Other things being equal, one might expect a flattening out of differences in debt performance via a portfolio effect within companies' regions. However, we fully support the need to gather evidence. Should that evidence support an adjustment, we believe that this should be effected by a normalisation mechanism (adjusting all companies' costs).

## 4.5 Answers to specific questions

*Q15 Should the ACTS be calculated on the basis of historic cost data or forecast cost data?*

Historic costs, subject to the ability to allow for input price pressures.

*Q16 Do you agree with our proposed criteria for assessing other adjustments to the ACTS? Are there other factors we should take into account, and (if so) how?*

It appears sensible to allow for other adjustments in certain circumstances, but we are nervous in general terms about the scope for creating a special factor industry which seems to be contrary to the general intent of simplifying regulation.

We think that there should be a "high bar" for any adjustment.

We also think Ofwat should consider whether, where a case is made, the appropriate response should be an adjustment to the costs of the company that has made the case or a normalisation of all companies' costs. This is important because it impacts the relative positions of companies that have not considered the impact of the particular factor, and potentially might drive companies to make counter-cases.

This was clearly an issue under the old comparative efficiency regime, solved by Ofwat being extremely reluctant to allow special factors to the frontier companies.

It also raises the question of whether companies should have the opportunity to comment on others' special factor claims.

*Q17 Do you agree with our preferred option of applying an industry-wide adjustment to the ACTS for levels of metering?*

Yes. See comments at 4.4 above.

*Q18 How do you think we should apply the ACTS for those above the industry ACTS? Do you think that we should use a glide path and (if so) of what form?*

A glidepath approach seems reasonable. The form of the glidepath should be informed by a reasoned view of achievable efficiency gains during the 5 year price review period.

*Q19 How should we set a forward-looking efficiency challenge for those companies below the industry ACTS?*

If the ACTS is not indexed using RPI then there is already an efficiency challenge inherent in the ACTS, and there is a good argument that a further challenge would be excessive. Even if Ofwat does allow indexation using RPI, there is an inherent productivity challenge within that although less than if no indexation is allowed. There is in any case a strong incentive for companies with better than average costs to beat their revenue allowance.

Overall, we do not believe any forward-looking efficiency challenge is needed for these companies.

*Q20 Do you think we should use a net margin to remunerate household retail invested capital and risk over the period 2015-20? How can we avoid over-recovery of returns and take into account any implicit margin that exists in the difference between efficient retail costs and the retail price?*

Yes. A specific net margin should be set. This needs to be calibrated such that the level of risk faced by efficient retailers is appropriately remunerated. This margin will not be zero, even if the absence of competition risk means that it may not be a high number. In similar situations in other industries where retail businesses are regulated, regulators have allowed margins of the order of 0.5% to 2%, for example:

- profit allowance in rail franchises with no cost or revenue risk – 1%
- Ofgem's calculation of a profit margin for a hypothetical GB energy retail business facing no volume or upstream price risk – 1.5%.

Ofwat is adopting an ACTS approach which will incentivise companies, along with the operation of the revenue control itself, to become more efficient. We think that Ofwat should let this incentive work, and avoid incorporating into the margin a further, not very transparent, efficiency adjustment.

We agree that the net margin needs also to allow for financing physical and working capital. We also agree that it should be adjusted to allow for the fact that some retail margin is being remunerated via RCV in the wholesale price control, albeit the relatively short lives of these assets would mean that this is substantially unwound by the end of AMP6.

*Q21 Do you agree that we should retain the service incentive mechanism (SIM), in a modified form, to encourage good customer service for households?*

Yes, but due to weaknesses in the quantitative measure that we have commented on previously, we believe it should be a purely qualitative SIM.

*Q22 Do you agree with our preferred option of funding additional water efficiency services and customer-side leaks through the wholesale control?*

We set out our views on how activities, services and costs should fall between the wholesale and retail controls in Section 3.

Applying the principles we set out there leads to the conclusion that the wholesaler, who is making the decisions to undertake such activities, should have appropriate costs allowed in the wholesale price control. How that is to be achieved in a framework in which the activities have been allocated to the retailer needs to be clarified. We did not fully understand the proposal made at the 1st March workshop and it appears unnecessarily complex.

# 5 Retail control for Non Household customers

## 5.1 Objective for default tariffs

We think that it is an important point of principle that the default tariff is a safeguard for customers while competition gets going, not an opportunity to set efficiency targets. This principle should underlie the thinking about the details of how such tariffs are set, including the level of margin allowed for and the approach to determining costs in building up the overall amount of revenues on which default tariffs are based.

In particular, we think that the default tariffs should be indexed in order to avoid erosion of margins, damaging the potential for entry to the market.

We strongly support the continuation of existing tariff structures, to avoid significant incidence effects and to reflect company specific cost drivers.

## 5.2 When default tariffs are set

Default tariffs are to be set on the basis of an overall amount of revenues which will be determined as part of the price determination. These are then converted into a default tariffs which are specific to companies. This process is akin (but obviously very different in intent) to the setting of charges to recover a revenue requirement under a revenue control.

We think therefore that it will be most practical to set default tariffs after the Final Determination in a timeframe similar to that over which the Charges Schemes are finalised. This might be helpful in easing pressure on the timetable in 2014 but also means that a simpler approach can be used (below).

## 5.3 How default tariffs are set

We are slightly bemused by Ofwat's approach to use a "corridors" approach to setting default tariffs. It seems unnecessarily complicated. The important element of regulatory judgement here is setting the net margin. We would propose an alternative approach whereby Ofwat sets a net margin for a complete set of industry tariff bands on a lowest common denominator approach.

In other words if company A has an existing tariff banding of 0-5ML and 5-15ML, and company B has a tariff banding of 0-10ML and 10-20ML, then Ofwat could set a net margin % at the four bands (0-5ML; 5-10ML; 10-15ML; 15-20ML)

This could then be applied by companies in setting its defaults. Ofwat could set the net margin percentages as part of its determination, or of it feels that it needs to work closely with the companies to do this, it could be done after the determination.

## 5.4 Default Service Levels

It is proposed that default service levels should be "based on GSS" (the Guaranteed Standards Scheme) . However, the GSS do not define the overall service provided to non-household customers under each of the existing tariffs, but only a relatively narrow proportion of that service. Furthermore the levels of service currently offered to customers in some tariff bands are significantly better then GSS or consist of elements which are above what might be seen as a minimum. The provision of account manager services is an example. It will therefore be necessary to adjust costs back to a level consistent with a minimum in order to set default tariffs. This will inevitably involve some estimation or modelling of costs. We are currently looking at how to define a complete service level description for each customer class and assessing how to define robust costs for each.

The alternative, which is to assume that the current level of service within a tariff band is effectively the default service seems unreasonable. Companies will have invested in improvements in order to achieve better customer service outcomes and in preparation for a competitive market.

## 5.5 Answers to specific questions

*Q23 Do you agree with our preferred option of rolling over existing tariff structures to form default tariffs?*

Yes. We agree that companies existing tariff bands and tariff structures should be rolled forward to avoid potentially significant incidence effects.

*Q24 What are your views on our approach to customer churn under the proposed form of control for default tariffs?*

We agree with the proposed average revenue control approach. In fact given our view of the purpose of the default tariff regime, we see no alternative than to express the control as a price. A total revenue control in this context is entirely inappropriate.

*Q25 What approach should we take to determine the aggregate level of Operating costs to include in the non-household retail control? For example, should we use historic costs or forward-looking costs?*

We agree with the proposal set out in the consultation: to base operating cost assumptions on current levels of costs, adjusted for material expected changes.

*Q26 Do you think we should use a net margin to remunerate non-household retail capital employed and risk over the period 2015-20? How can we avoid over-recovery of returns and take into account any implicit margin that could exist in the difference between efficient retail costs and those used to set default tariffs?*

We think that Ofwat should use a net margin approach. We note that in Scotland, a net margin approach was taken and the margin was revised upwards before any significant entry took place. This indicates that in order to incentivise entry, there needs to be a margin sufficiently attractive for new entrants to enter the market.

*Q27 What constraints, if any, should we place on companies' ability to set the gross margin levels for individual default tariffs for non-household customers?*

See 5.1 to 5.3 above.

*Q28 Is there evidence that demonstrates that the costs of providing retail services to non-household customers are driven by uncontrollable changes in input prices? Are these difficult to predict? Given this, what is the appropriate approach in non-household retail controls for 2015-20 for uncontrollable changes in input prices?*

See 5.1 above. We assume the retail controls that Ofwat is referring to are the default tariffs, as prices in a competitive market will adjust to reflect input prices. We do not think that there is a significant risk of uncontrollable changes in input prices for retail services, as the majority of the uncontrollable costs are borne by the wholesaler, which is subject to a separate price control.

*Q29 Do you agree with our preferred option of setting the default tariff minimum service level using the existing GSS standards?*

See 5.4 above.

*Q30 What aspects of service should we target in setting a service incentive for non-household customers in Wales?*

This is for Ofwat and stakeholders in Wales to determine.

*Q31 Are there other options for setting an efficiency challenge for non-household retailers in Wales we have not considered? If so, what are they? Which approach do you think best meets our objectives?*

This is for Ofwat and stakeholders in Wales to determine.

# 6 Making better use of water resources

## *6.1 An example of real life barriers to water trading*

We note that Ofwat intends to introduce water trading incentives to help remove the barriers to trading. In delivering our AMP5 obligations, we have considered a trade with one of our neighbours. The barriers we have encountered relate to uncertainty over the availability of the upstream water resource, rather than any barriers that could be overcome through economic regulation. The issue arises as we would use water that is currently licensed within an existing abstraction licence, held by the neighbouring company, but which they currently do not use in full. Because the level of abstraction would be increased from that source in order to supply the water to us, the Environment Agency may apply sustainability reductions to that licence under the 'no deterioration' principle. This principle applies to any source where an increase in abstraction over historic levels is proposed, and represents a much more significant barrier to trade than any cultural or economic barriers.

Notwithstanding these resource availability barriers, in principle we support the incentives for water trading. We would however sound a note of caution over the balance and interaction of the import and export incentives in their proposed form. This is because as they are currently structured, they may disincentivise some efficient trades, and encourage some inefficient trades.

The import incentive may disincentivise some efficient trades in the following way. The trade would be deemed efficient if the cost of the import is less than the cost of the next best alternative. However, under the proposal, the equivalent of the importer's incentive would be removed from the allowed revenue of the exporting company. Depending on the rate that is set for the importer's incentive, this could discourage the exporter from agreeing to the trade, as any benefit from profit could be negated by the reduction in allowed revenue.

The import incentive may encourage some inefficient trades in the following way. The companies might agree a trade at a price above the cost of the importer's next best alternative. This is because the importer's incentive would make the trade attractive to the importer, such that it benefited from importing the water rather than using the cheaper next best option. This is because the import incentive would outweigh the corresponding totex / menu penalty from implementing a trade at a higher price than had been allowed in revenues. Even though the corresponding amount is taken from the exporter's allowed revenue, if the price agreed was high enough the exporter would still retain a proportion of the profit and so would also be incentivised to trade. However, the importing company's customers would pay more than they would if the (cheaper) next best option was selected. We do not think that it is Ofwat's intention that customers pay more to allow otherwise inefficient trades to take place.[2]

These impacts are a consequence of allowing for an additional amount of revenue to pass to the importing company. Clearly, in calibrating such incentives, Ofwat will need to balance the desire to overcome a perceived trading barrier with the risk that customers pay more than they would have done otherwise.

We also caution against the cap on incentives as this introduces uncertainty over rewards. It is unclear how the exporting company's revenues would be treated if the importing company had reached its cap. Likewise, we do not support the potential withdrawal of any incentive as this also introduces uncertainty.

We do not think there should be a de minimus criterion for a qualifying trade. We think the criterion for a trade taking place should be the efficiency of the trade, not the volume of water traded.

We support a trading and procurement code, if it aligns with the EA WRMP requirements and competition law.

## 6.2 Answers to specific questions on water trading

*Q32 Do you agree with our preferred option for implementing water trading incentives?*

We support the implementation of an export incentive, but we think that the import incentive as it is currently structured might prevent some efficient trades from taking place, and incentivise some inefficient trades, such that prices to customers would increase.

*Q33 What are your views on the sharing of export profits that the incentive should aim to deliver? Please provide your reasons and supporting evidence where possible.*

We agree that increasing the proportion of profits a company keeps would act as a greater incentive to trade and that the approach looks sensible.

*Q34 What evidence should we take into account in setting incentive rates for importers (buyers) of water?*

As we have set out, we think the importer's incentive in its current form may not be fully aligned with promoting efficient trading. In setting such an incentive rate, the willingness of customers to pay for increased water trading should be taken into account. As the incentive is added to allowed revenues this means that all customers will contribute through higher bills to the incentive. We do not think that the corresponding amount should be removed from the exporting company's revenue as this may stop some efficient trades taking place. So the willingness to pay of both sets of customers, those of the importing company, and the exporting company, should be taken into account.

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[2] We have undertaken some simple modelling of the respective positions of importers, exporters and their respective customers, which we would be happy to share with you once complete.

*Q35 Do you agree with our preferred approaches to securing efficient trades and protecting the interests of customers? Please provide your reasons and supporting evidence where possible.*

As we set out above, we think the way the import incentive is currently structured may encourage inefficient trades that lead to customers paying more than they otherwise would, and that it may discourage efficient trades.

## 6.3 Abstraction Incentive Mechanism

We support the principles of the AIM in targeting damaging over-abstraction, and agree with the narrow scope that focuses on the most damaging abstractions, although we think there should be more integration with the EA's RSA programme. We agree that an incentive value based on national willingness to pay data is simplest (and cheapest) but we think that it is more likely that willingness to pay will vary by region, with a higher willingness to pay in the south east of England where water is more scarce. This means that abstractions in the south east may be under-valued.

We note that there are many abstractors of water from the environment, and caution that other abstractors' actions may affect the level of reward / penalty a company can earn. There is a strong possibility that a company will be unsure whether its actions will lead to a penalty or a reward.

We think that the timescale for implementation in 2016-17 is ambitious given the current uncertainty over Environmental Flow Indicators.

We welcome the further engagement planned on calibration issues and think this should also include more detail about how and when the incentive would be applied. We also caution over the level of administrative activity this incentive might create for a correspondingly small environmental benefit. We think that Ofwat should be open to reviewing evidence gathered on the impact of the AIM, and review the need for such an incentive based on that evidence.

## 6.4 Answers to specific questions on AIM

*Q36 Do you agree with our preferred option for implementing the AIM?*

We agree that the preferred option seems the most pragmatic to implement, but think there should be further alignment with the EA's RSA programme, such that sites identified in the RSA programme would also be sites where the AIM would apply.

*Q37 Do you agree with our preferred limit to the scope of the AIM?*

We agree the scope should be no wider than Band 3 sites, but think that the selected sites should be consistent with the EA's RSA programme, be limited to those where the water company is the sole abstractor, and the AIM should only apply if the abstraction is above a certain volume. This is to avoid creating costly administrative tasks where the resulting benefit to the environment would be very small.

*Q38 What evidence should we take into account when calibrating the AIM?*

We think that Ofwat should not rely heavily on the EA's National Water Environment Benefit Survey due to issues of principle and detail with applying the data to the AIM. We understand that some updating or disaggregation of this data may be taking place at the present time. Our comments below relate to the original survey.

The survey took place in 2007. Since that time, there has been an ongoing economic crisis, with many households seeing a drop in income in real terms. The water industry has seen two dry winters, leading to widespread (but not national) hosepipe bans, and faced a real prospect of severe supply restrictions in the event of a third dry winter. People are becoming more accepting that the climate is changing, and the science surrounding this and wider environmental issues has improved. Generally, environmental issues are becoming more important to people. Any of these factors could have an effect on overall willingness to pay for water environment improvements, and the combination of them is likely to be very significant.

The scope of the study was restricted to non-market benefits of WFD improvements, as stated preference techniques are most suited to measuring such benefits. Benefits relating to the use of the water body as a resource for abstraction are specifically excluded from the study as they are categorised as a market benefit, as people will only benefit through a reduction in their water bill. Whilst this is logical, the implication is that the data is being applied to value something that was specifically excluded from the study, and that respondents did not consider when expressing their willingness to pay. It should also be noted that this is a single issue study which would tend to over-value the willingness to pay.

In the recent Wholesale workshop, Ofwat introduced the concept of a 'cap and collar' to the rewards and penalties a company could earn. We do not think that this approach should be followed, as this would introduce more administrative tasks and would dilute the effectiveness of the AIM, which is being introduced to counteract any potentially environmentally damaging abstraction increase in response to the water trading incentive.

*Q39 What are your views on the proposed phased implementation of the AIM?*

We agree that the implementation should be phased but we think that 2016-17 is too early for the incentive to become financial due to the uncertainty around EFIs.

# 7 Overall incentives, risk and financeability

There is ongoing debate about the approach taken by companies to financing their businesses and about Ofwat's regulation in this area. Not all of the ideas that have been expressed recently by Ofwat in public or in private are fully explored in the consultation on Framework. These ideas include matters such as the need for more (or more visible) sharing of out- and under-performance with customers, measures to secure the legitimacy of the financing model more generally; appropriate approaches to the correction of regulatory error; and the potential for setting company-specific costs of capital. We think that a thorough airing of all aspects of this debate is to be welcomed including the key question of customer legitimacy but also taking into account the potential impact on incentives and cost of investment of a change in existing arrangements.

We are playing an active part in contributing to this debate and in providing evidence to inform it. Our work in this area is by no means complete but we expect to be developing concrete specific proposals to test with customers and stakeholders as we continue to develop our business plan.

We therefore do not comment further on these matters in this response. However, it is crucial that all of these matters are adequately and transparently addressed and a clear position reached in a timely manner in respect of the 2014 Price Review. Furthermore, our comments below should be seen in the light of a much wider ongoing debate.

## *7.1 Risk assessment*

We support Ofwat's proposals to make risk assessment a central part of its assessment of companies' plans and we think that the approach sketched out looks sensible, in principle. In particular we support the use of scenario-based modelling to test our plans. We agree that such analysis should be used to inform incentive calibration, the approach to remunerating risk, and financeability. We are however concerned about the practicalities of Ofwat undertaking bespoke risk analysis on all companies in the time available to it to assess plans.

It will be for the companies primarily to demonstrate how their plans balance risks and benefits to customers, shareholders and others. We are working now on how we will do this and expect that if this work is robust, and clearly expressed in our plans, and demonstrably supported by customers and stakeholders then there may be less need for Ofwat to undertake its own risk analysis.

In order for this to be achievable, companies will need to understand, as early as possible, the broad calibration of cost assessment and other consistent incentives so that they can be factored into an overall package.

For these reasons, we think that joint working between companies and Ofwat on risk analysis would be a good idea, especially in undertaking the quantitative aspects. We would welcome the opportunity to be involved with this, noting that it would build on existing joint initiatives in this area, for example the

Indepen modelling work. We see this, initially, as a technical "how to do it" exercise, at least up to the point that companies submit business plans, at which point it might focus on developing shared understanding of the risk aspects of their specific plans.

In relation to the risk factors themselves, we would agree, at a high level, with most of the analysis of the impact of the changes on risk set out on pages 123 and 124 of the document. However, we think that the conclusion drawn that companies face a reduced risk overall somewhat prejudges the outcome of the analysis proposed.

## 7.2 Return on Regulatory Equity (RORE)

We would support the use of RORE as a cross-check of the overall financial package in business plans. We had, in any case, planned to use this sort of analysis in our business plan. It might be useful if there was a consistent, well-understood basis for calculating and / or presenting such analysis. Ofwat might consider spelling out its proposed approach to calculating RORE in detail.

Clearly RORE analysis is only one factor which would be considered in assessing plans. But it would be useful if the potential responses to RORE were explored in more detail. The consultation states that the analysis would be used to inform decisions on incentive rates, and we see that it could also inform a wider calibration of key financial parameters in the plan, such as the allowed return on equity and the notional level of gearing.

## 7.3 Remunerating risk in the retail controls

The consultation rejects a return on capital approach for setting allowed returns to retail. We note that the Water Industry Commission for Scotland (WICS) used just such an approach for setting returns for Business Stream and would suggest that such an analysis might still play a role, even if just as a cross-check. This would especially be the case if payment terms were such that working capital was significant.

More generally, we remain unclear as to the extent to which the retail businesses are to be treated as separable "stand-alone" businesses for the purposes of setting relevant financial assumptions such as net margin. We think that this is essential in terms of the Non Household Retail business as such businesses will need to operate on a level playing field with entrants. It is less clear what the approach to Household Retail is.

## 7.4 Remunerating risk in the wholesale controls

There is a strong flavour in the approach as written, and in papers and at recent events, that the approach to setting the allowed rate of return is not finalised. We broadly agree with the traditional WACC based approach set out in Section 8.2.3 but if there is to be a change, this needs to be spelt out in some detail when the Framework is finalised. If a materially different approach is envisaged this should be the subject of further consultation so that all stakeholders have a fair opportunity to consider the potential merits, disadvantages and impacts of the change.

## *7.5 Financeability*

Ofwat is clear that financeability tests and ratios will be looked at from the perspective of the aggregated cashflows across all price controls. We agree with this approach.

Whilst the ratios used for this assessment have not been stated, we think that Ofwat will need to assess whether existing ratios, which are based on those that the credit rating agencies see as important in their evaluation of credit quality, remain appropriate, for example the post maintenance interest ratio cover.

Whilst there are a number of changes to the regulatory methodology, it seems to us that the fundamental underpinnings of credit quality in the industry remain broadly unchanged. In particular, the vast majority of returns will continue to be based on a Regulatory Capital Value, and the overarching principle of financial capital maintenance remains: allowed revenues continue to reflect operating costs and depreciation of RCV charges.

Nevertheless, there are changes at a detailed level, in particular in relation to how depreciation is calculated and how the RCV is updated under a totex regime. Clearly it is for the rating agencies to draw their own conclusions as to how these detailed changes impact their assessments. However, it is worth noting that there may be unintended consequences where ratios are used in covenants in banking documents or debt instruments. We would welcome dialogue with Ofwat on how best these might be avoided.

Ofwat is clear that its preferred solution to a financeability issue is likely to involve the assumption of equity raising, consistent with decisions at PR09. Equity has a part to play in principle, but we think that more consideration might be given as to whether such an approach needs to be moderated in any way by, for example, placing quantitative limits on the amount of equity that can reasonably be assumed to be raised, or by dividends retained in the business. Ofwat could perhaps examine trends in metrics that are of interest to shareholders (such as EPS or EBITDA/Equity) as part of its overall financing package, especially if it is assuming equity raising as a financeability fix[3].

We welcome Ofwat's intent to examine the financeability of activities covered by the retail price control in its own right, but other than a brief reference on p129 this theme is not discussed further, and the 1 March workshop left us with an impression that this might not be seen as important. We think, as discussed in 7.3 above, that the retail businesses ought to be looked at, as far as possible, as stand-alone businesses and that their financeability assessed separately. However, we accept that there are a number of consequences of this which would need to be worked through. What, for example, are the appropriate ratios? What capital structure should be assumed? We intend to look at such issues in preparing our business plan.

One further point, which relates to the financeability of the whole business and the Non Household Retail business, is what assumptions, if any, are to be made about the impact of competition in assessing financeability.

[3] A forthcoming report by First Economics examines these points.

## 7.6 Answers to specific questions

*Q40 Do you agree we should develop the balance of our proposed incentives using initial quantitative analysis of notional companies, and refine the calibration of incentives to reflect individual companies' business plan proposals?*

Yes, in principle this seems a sensible approach. However, the variation in companies' proposals might make this a large task. As suggested in 7.1 above, a joint working approach here could be useful.

*Q41 Do you agree that we should evaluate the overall risks relevant to each price control in assessing the allowed returns?*

Yes. We see this as an essential element of the periodic review.

*Q42 Do you agree with our broad approach to setting the WACC for wholesale services, given our proposals for the remuneration of retail services in chapters 5 and 6?*

Yes, but see our comments above in relation to clarity of the methodology.

*Q43 In setting the WACC are there specific considerations we should bear in mind taking account of the profile of relevant risks to wholesale service provision?*

We have commented above about the importance of risk analysis, and its impact on cost of capital assessment.

*Q44 Do you agree with our broad approach to assessing financeability? Are there specific factors we should take account of in the next price control review?*

See comments at 7.5 above.

# 8 Assessing performance during 2010 - 2015

*Q45 Do you agree with our preferred option of implementing adjustments for legacy tools through wholesale controls?*

We agree that in the interests of simplicity adjustments for legacy incentives should be made through the wholesale control.

*Q46 What factors should we take into account when determining whether to spread adjustments over the price control period?*

The key factor should be to avoid unduly large steps in customers' bills. Our plan will include a proposal for how they should be made once we know the value. Should the adjustments net to a relatively small value they could safely be made in year 1 but if the number is larger it should be applied gradually over the price control period in the interests of bill stability.

# 9 Delivering price controls in 2014

## 9.1 Commitment to specific key dates

We welcome the proposed process for baseline setting and menu choices and agree that the timetable is achievable as long as Ofwat commits to dates so that Boards and CCGs are able to engage and internal planning can proceed. We note the introduction of a cost assessment data submission in August 2013. In order to ensure that submission is complete and robust we need sight of the data requirements as soon as possible. We understand that the timetable for publication of the Business Planning Requirements already appears to have slipped, and we reiterate the need to have sight of these as early as possible.

We note the absence of a capital investment cost base and that Ofwat is undecided on its approach. We question whether the econometric modelling that may replace it is sufficiently robust, transparent and developed. We would be willing to work with Ofwat to help develop these models. We also reiterate our willingness to work with Ofwat in developing a robust financial model.

## 9.2 Answers to specific questions

*Q47 What are your views on our emerging criteria for identifying high quality business plans? Are there other criteria we need to consider?*

The example criteria refer to whether the CCG has made a satisfactory assessment of how customers' priorities have fed in to the plan. We think the focus should be on how companies have ensured customers' priorities have been fed in to the plan, rather than the CCG report, as the CCG is independent from the company.

We note that Ofwat does not intend to reveal the thresholds for an acceptable plan, although it is anticipated that companies can provide supporting evidence if elements of their business plan are likely to sit outside those thresholds. It will be important for companies to have early sight of which elements they will need to provide supporting evidence for, such that they can make best use of time and resources in developing their plans.

*Q48 What factors should we take into account in further developing our process for a risk-based review?*

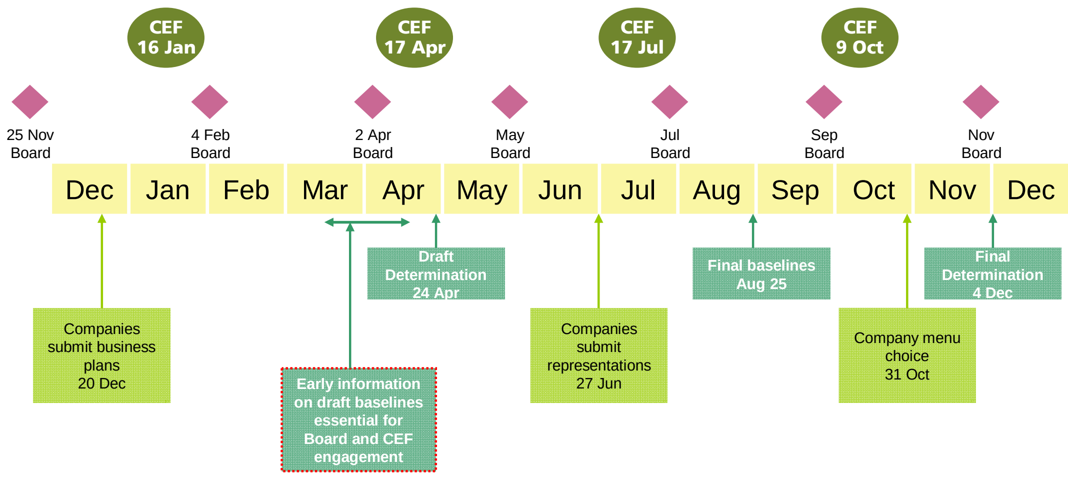
It will be important that the assessment that Ofwat makes of business plans is transparent, and that the criteria against which Ofwat assesses plans are set out before that assessment is made.

*Q49 Is the timetable we propose for introducing menus feasible? How could we improve it? What can we and companies do to address the challenges of the timetable to allow companies to make a real effective menu choice?*

We welcome the proposed process for baseline setting and menu choice but recognise that the timetable is challenging for both Ofwat and companies. We would welcome early sight of firm submission dates to enable us to plan Board engagement around this timetable. This will help a great deal in enabling us to make a real, considered and meaningful menu choice.

At our recent one to one meeting, we proposed a revised timetable for 2014, and this is included below. We reiterate the need for early sight of information on draft baselines, as this is essential for the Board and our customer challenge group to engage properly in the process. Our proposed timetable allows more time for Ofwat to consider business plans and set draft baselines, without significantly affecting the companies' timetable. It creates this time partially by a slightly earlier delivery of business plans and partly by a compression of the time allowed for Ofwat to issue its Final Determination once companies have made menu choices. We see this as primarily a mechanical exercise, which can be achieved relatively quickly. The pressure on the timetable would also be relieved if, as we suggest in Chapter 5, the setting of default tariffs was undertaken after the Final Determination.

## Alternative 2014 timetable to allow for Board and CEF engagement



# 10 Network incentives – building for 2019 and beyond

We think that network incentives should be aligned to the direction of travel articulated in the Water Bill, and we support the principle that defining what these incentives should look like should wait until the legislation has been published. We support the principle of financial incentives for providing good quality information.

## *10.1 Answers to specific questions*

*Q50 Do you agree with our preferred scope for network plus?*

We agree with the scope of the water and sewerage network plus sub-limits.

*Q51 Do you agree with our preferred option to implementing network plus?*

We agree that it would be useful to introduce separated revenue accounting within the next price control period, but we do not see the need for introducing a non-binding sub-limit part way through a price control period. It is unclear what purpose this would serve over and above the separated revenue accounting.

*Q52 Do you agree with our preferred scope for network management?*

We agree with the preferred scope for network management, although we note that particularly in the sludge unit, there is the potential for future competition, and so we would regard any information in this area as commercially sensitive.

*Q53 Do you agree with our preferred approach to implementing network management?*

We agree that a phased approach, where the requirements are developed over the next price control period, is appropriate. This will ensure the network management incentive will be aligned with the direction of travel anticipated to be articulated within the Water Bill.

*Q54 Given our objectives for network management reporting over the period, what questions should be included in the first round of reporting within business plan requirements?*

We note that the questions are intended to be open ended and about network management practices and models. We think the questions should be informed by the types of competitive markets envisaged in the Water Bill, such that information and, in the longer term, an incentive can be appropriately targeted.

*Q55 Do you agree with our preferred approach to financial incentives for network information reporting?*

We agree that providing financial incentives will incentivise reporting of high quality information. We note the intention to claw back the incentive if the information is not of sufficient quality. Ofwat will need to set out clear quality criteria at the outset so that companies know what the definition of high quality information is. In particular, it would be useful to have early sight of the extent of bottom-up cost collection and allocation anticipated. It is important that companies have clarity over what is required, and the criteria used to assess the information, as companies will be making investments and incurring expenditure in order to collect the information.

# 11 Annex: A non-household market perspective on the allocation of activities between retail and wholesale

Ofwat has asked consultation questions about the allocation of activities and services between its wholesale price controls and its retail price controls. It consults about the approach to three activities: developer services, customer side leaks and water efficiency. Two further activities are to be “split” between wholesale and retail: metering and disconnections.

This note deals with all of these, but it only considers the implications for provision of services to businesses in the context of market implementation. Our thoughts on the implications for households can be found in the body of our response.

**Household and Non Household retail**

Imposing the same split on household and non-household retail may create more difficulties than it solves. The situations are fundamentally different given the need to consider the requirements of a competitive market on one hand, compared the need for effective regulation of an integrated business serving domestic customers on the other. We set out in the body of our response why we believe that imposing a consistent split of activities between retail and wholesale across both the household and non-household segments may not be useful, because of the different considerations that need to be taken into account. We do not rehearse these arguments here but instead focus on the non-household contestable segment of the market.

The supposed difficulties of splitting the recovery of wholesale revenues between the two sides of the market may be overplayed. Companies will likely wish to allocate revenues fairly between the two sides of the market, as they do now. This seems desirable to ensure that household do not subsidise businesses and vice versa. Nor does it seem impossible to manage.

**Principles**

Before turning to specific services, we suggest some applicable principles which we believe should be borne in mind.

First, activity should be distinguished from services and cost. The consultation talks about activities and services but for price control purposes it is where the cost should be allocated that is important.

Second, the cost should be allocated to the party that is making the decision whether to incur it, or has an obligation to incur it.

Third, the correct allocation should consider the potential for competitive markets in services associated with the overall retail market and should consider the impact on competition in those markets. The allocation of costs within the wholesalers’ overall revenue control should ideally not create undue risks of unfair competition on that market.

Fourth, decisions ought to take into account the likely importance of the competitive market concerned. If a market is potentially small with limited potential to deliver customer benefit, worrying about making competition effective is less of a priority.

Applying these principles in practice will not be clear cut and pragmatic choices will be needed.

We go on to discuss how these principles might apply to various activities in the remainder of the paper. We attempt, in each case, to draw a conclusion as to the question of allocation of costs, services and activities. We find this relatively straightforward in some cases and less so in others.

However, we think that in all cases our conclusions are contingent on a further conclusion as to the potential importance of the relevant service markets. We think that it will be useful to form a view of how important such service markets might be, in finalising decisions about the regulatory treatment, and also in deciding how such markets should be considered in the market design. We are developing a view on this, based on an analysis of available evidence and we will be looking to update this note in due course.

## The services

The note considers the five specific retail activities in which markets are or could be important:

- disconnection services
- demand-side water efficiency services
- repair of customer-side leaks
- metering services
- developer services

## Disconnections

### *Types of disconnection*

Disconnections encompass two distinct activities:

- locking off the supply and/or removing a meter, which is primarily undertaken in order prevent supplies to customers for debt management reasons
- disconnecting a service pipe at the main, which is primarily done to protect other customers from water quality issues.

Our experience shows that most of the cost incurred in disconnection arises from the second of these. We think that this is fundamentally a wholesaler decision and activity (ie whether the wholesaler is undertaking or possibly sub-contracting the activity). Costs of this should be allocated to the wholesaler in the price control because it will be making these decisions.

### *Interrupting supplies to manage debt – is a market envisaged?*

Retailers will be making the decisions to interrupt supply in order to manage bad debt. Retailers should therefore face the costs of those decisions. It is essentially the buyer of the service.

The retailer may undertake these activities itself or contract with third parties do so. In other words a market for such disconnection services may be envisaged. The sellers in that market may include the wholesaler and if this is the case there would be a payment from the retailer to the wholesaler. The wholesaler would be a seller in this market.

***Treatment of costs in the wholesalers' price control***

So how should the costs incurred by the wholesaler in providing these services to retailers be treated within its price control?

The costs could be covered by the wholesale revenue control. But this might place the incumbent wholesaler at a significant competitive advantage in the market for providing these services compared to other service providers in the market. These advantages stem from: the guarantee of cost recovery implicit in the revenue control (the strength of the guarantee depends on the precise form of control); lower financing costs that are available; and the potential ability to arrange tariffs such that losses in a disconnection market are offset by gains elsewhere.

An incumbent wholesaler is likely to be dominant in the market for disconnection services and will need to heed the requirements of competition law (i.e. market foreclosure) regardless of the regulatory arrangements in place.

However, regulatory arrangements might be more "market-friendly", for example by subjecting the contestable activities conducted to a separate price control arrangement. Prices charged to retailers for disconnection services might be subject to a protective price control (such as a default tariff) rather than being included in the revenue control. This is akin to the control that will be applied to incumbent retailers in the market for water retailing services and has the benefit that such a price control (i) does not guarantee recovery should the incumbent lose market share and (ii) allows the price to be set to encourage entry to the market for disconnection services, if that is seen as desirable.

Such an arrangement, although adding complexity, might be justifiable if it is considered important to design for an effective market in disconnection services. An alternative is of course not to do this, and to let a market emerge if it is able, without making any particular regulatory arrangements. In this case, an allowance for costs of disconnection could be included in the wholesale revenue control, with the consequent risk that efficient entrants are excluded.

Ultimately this is a policy question which will need to be determined considering matters such as:

- how much value to customers encouraging a market in disconnection services is likely to generate
- the potential impact of a market on other important outcomes for customers, such as maintaining water quality
- the extent to which wholesaler provision is likely to be a feature of or risk to the market.

These questions affect both market design and regulatory design and therefore need to be considered at an early stage.

***Technical assurance***
However the retailer decides to procure disconnection services, a wholesaler may still need to undertake a technical assurance role (for example, to ensure that water quality is protected) over the disconnection activity performed on its network by a third party. Costs associated with these activities should be allowed for in wholesale price limits.

***Wider applicability to other potentially contestable markets***
The foregoing discussion is applicable wherever associated markets may emerge in which incumbent wholesalers are effectively competing with third parties to provide services to retailers.  We turn to some of the examples now.

***Conclusions on disconnections***
Activities and costs relating to the interruption of supplies for the management of debt should be allocated to retail.  Activities and costs associated with the permanent disconnection of supplies for water quality purposes should be allocated to wholesale.

**Demand side water efficiency services and customer side leak repairs**

We agree with the majority that these services should be presumed to be provided <u>for</u> (undertaken or bought in) by the retailer because they are an essential component of a market offering.

The wholesaler may also be a “buyer” of water efficiency and leak repair services.  It will, in planning to achieve a sustainable long-term balance of demand and supply, rely to an extent on demand reduction.  It will want to forecast what overall demand reductions will emerge from the retail market and may strike contracts with retailers to deliver a certain level of demand or leakage reduction.  This will require retailers and wholesalers to have effective interactions and the tension may well drive innovation in this area.

Provision of such services to retailers may be provided by the retailer themselves, by third parties or conceivably by wholesalers.  Therefore analogous issues in relation to the need for markets to be designed in and the appropriate regulatory arrangements would arise. In turn these would give rise to similar sorts of policy questions.

***Conclusion on water efficiency and customer supply pipe repairs***
Retailers will be responsible for determining the level of activity in relation to fixing of customer side leaks and water efficiency.  Each retailer should face the costs of these decisions.

However we think that the wholesale control should allow for the costs consistent with the level of activities that it can justify as the most efficient way of meeting its supply-demand obligations.  All competitive retailers will face such charges but it will be open to each to negotiate and deliver a different level of activity to its customers.

## Metering

Metering involves a more complex set of services and activities but the conceptual issues discussed above are equally relevant. The fact that meters are essential for the retail market to operate effectively adds another dimension.

The value of a potential metering services market and the consequent benefits to customers might be greater than for the other potential service markets discussed above due to the asset values involved. Experience in the energy markets (where problems emerged as a result of ineffective consideration of metering issues) suggests that it is very important to decide at the outset whether or not to plan for a market in metering services.

The current activity/service split envisaged by Ofwat is for retailers to undertake meter-reading and wholesalers to own, install and maintain meters[4]. But it also says that there may well be benefit in allowing retailers to choose who installs, repairs and maintains meters, as is the case in Scotland and there should be scope for third parties to carry out the activities. It says that "retailers should have a role in decisions on meter functionality and capability". Whilst we broadly agree with this sentiment, understanding what it means for market and regulatory design does not seem straightforward.

### *Meter reading*

We think it is sensible that meter reading is a retailing activity, because it is essentially customer-facing. It seems reasonable that retailers might contract with third parties, possibly including the wholesaler, to provide these services. Therefore the points raised above in relation to the other services could be equally applicable to meter reading.

If the wholesaler is not reading meters then it will wish to have some processes in place to assure itself that the reads are accurate. These are likely to be required for effective market function, but also need to be allowed for in price controls.

### *Both wholesalers and retailers need the data provided by meters*

As well as meter reading, metering services including ownership, installation, maintenance, and repair are required to provide such data[5]. The discussion of where the right place for such costs of these services to be allocated is made complicated because both wholesalers and retailers need meters. Or more accurately, both wholesalers and retailers need <u>the data that meters provide</u>, specifically:

- a wholesaler will need meter data to (i) enable it to bill for wholesale services by volume or capacity (peak) (ii) so that it is effectively able to forecast and perhaps manage demands and hence make effective network operational and investment decisions (iii) to manage leakage and (iv) to check that the amount it is paid by retailers is accurate

[4] Meters should be taken to include data loggers, where necessary for wholesale tariffs.
[5] Other services such as data communication, data aggregation, calibration and technical assurance can be envisaged but are not considered further.

- a retailer will need meter data in order to (i) charge customers for its services on a volumetric or capacity basis (ii) to check that the amount it is paying wholesalers is correct and (iii) for its own demand forecasting and leakage management activity and (iv) to provide to its customers

From this it is obvious that the precise data needs will be different between the parties. This means that both retailers and wholesalers should "have a role in decisions on meter functionality and capability". Moreover, there will be more than one retailer requirement for any particular wholesaler, and more than one wholesaler requirement for any particular retailer.

***A market for metering services?***
Ofwat's consultation suggests that it is envisaging a market for metering services, presumably one in which:

- wholesalers and retailers are buyers of metering services (and/or the data meters provide)

- wholesalers, retailers <u>and third parties</u> are potential sellers of metering services (and/or the data meters provide).

This is a complex situation and as in general, markets are quite good at providing solutions in complex situations, there is an argument for encouraging a market for metering services.

A full market solution would place no restrictions on who would be allowed to do which activity. Contractual arrangements between the market participants could allow for any activity, including meter ownership, to be conducted by any of the parties.

However, there are lesser versions. For example, ownership of the meter might simply be "allocated" to the wholesaler as a regulated activity. This might make sense, if it is thought that keeping retailers asset-light is desirable. It might also have benefits in dealing with existing metering stock.

There are a range of market design decisions that could be taken but it would also be possible simply to let a market emerge and not specifically plan for one. There are risks that this approach results in less benefit to customers, even though all parties would need to comply with competition law.

***Impact on the retail water market***
There are obvious interactions between metering and the market for water itself. An obvious one is that poorly designed metering arrangements can be a significant barrier to customer switching. This might point to being more prescriptive about metering, for example obliging wholesalers to ensure that they have the meter data they require to enable switching.

***Cost recovery***
Both wholesalers and retailers need to recover the efficient costs of the metering services each requires to operate in the market for retail water services and to cover its licence obligations.

A retailer would need to recover its metering costs in the market. It will price its services to customers to recover these costs and it is incentivised to find the most efficient way of meeting its needs. The more effective the market, the better it will be able to do this.

For a wholesaler this means that some allowance should be made in its wholesale price limits. We think that this allowance should reflect the costs of providing the data that it needs, which in turn should accommodate an assumption about what that data is. We do not believe that this should be a restrictive assumption. It should allow for more complex capacity related tariffs which might require more sophisticated meters or data loggers to provide. A wholesaler could in this case, for example, make a case for a higher cost of meter data on the basis that it allows for more efficient network operation and investment because it allows wholesalers to incentivise demand profiles which reduce network costs.

### *Wholesale-retailer transactions*

A retailer may choose to undertake metering activities itself or procure them from a third party, which might be the wholesaler.

Lets say that it chooses to source metering services from the wholesaler, who itself needs meter data to bill the retailer. We might unpack the payment that the retailer makes to the wholesaler into:

- an amount that represents the appropriate charge by the wholesaler to the retailer to recover the costs of providing the meter data it needs to fulfil its wholesale obligations (e.g. for its tariffs) – this would be a charge which recovers its allowed regulated revenues; and
- an amount representing the additional charge for providing the retailer with the additional data that it needs – which would be a charge for services in a contestable market.

In this case one needs to think about the need for one charge to allow for appropriate regulated cost recovery and at the same time not distort a potentially contestable market. This is not impossible but we would argue it needs explicit consideration as to how price limits ought to cover the costs faced by wholesalers.

### *Conclusions in relation to metering*

The discussion above leads us to conclude that in relation to metering:

- Regulatory and market design are very interlinked and both need to be solved together
- The potential benefits of an effective market for metering services needs to consider potential value to customers, impact on other outcomes e.g. switching, and the risks surrounding wholesaler provision in the market. However, there appears to be a reasonable case for wanting to design for an effective market in metering services.
- Reasonable costs of providing for meter data it requires to fulfil its obligations should be allowed for under wholesale price limit, without unduly limiting its flexibility in setting its wholesale charges

## Developer Services

Lastly we turn to developer services. The discussion here is substantively different from the foregoing because in this case we are dealing with an activity which is essentially wholesale in nature – it facilitates extension of the network. Competition exists already for these services in the inset market, this competition being between existing integrated (ie wholesale/retail) incumbents and organizations seeking to become integrated incumbents. It is also a market which is, to a large extent associated with the extension of the network to household customers, although there are insets which are wholly or primarily commercial.

Ofwat's preferred position is that *"customer facing aspects of developer services should be included in retail. These activities include providing developers with information about new connections and responding to questions about changes in infrastructure. We think that this activity would benefit from the more customer centric approach that a retailer would provide."*

***"Customer-facing aspects"***

We understand that in this context the customers referred to are developers. But these customers seem a wholly different type of customer to the commercial customers that will be serviced by retailers in the NHH market. Moreover it will be the wholesale that has the obligation to serve developers and this would suggest that it should face the costs.

It is desirable that good service to developers be encouraged but we observe that Anglian Water, an integrated company, has made substantial improvements to services to developers. The inset market has been a factor but also the customer focus brought about by the SIM which has impacted throughout the business. Further regulatory measures are being considered including Guaranteed Service Standards for developers.

***Information on connections and responding to questions on changes to infrastructure***

These are pre-development services, which also include the provision of offsite infrastructure needs that would be triggered by the proposed development. The focus of this service is on enabling sustainable development which means:

- Managing risk to wholesale and its customers of under capacity leading to low water pressure, sewer flooding or pollution; the latter being a particular risk due to the lack of connectivity between wastewater catchments and the right to connect
- Aligning with the planning process to manage the wholesale risks above through planning conditions – as per previous case law recommendation (Welsh v Barratt Homes)
- Aligning with strategic planning process (as a statutory consultee to Local Plans) to avoid inefficient piecemeal approaches to infrastructure provision
- Aligning with supply demand strategy; WRMP and emerging Drainage Strategy Framework

All of these are wholesale activities that require access to wholesale planning tools such as water and wastewater infrastructure capacity models. Allocating these pre-development activities to retail would in practice result in a customer facing team in retail, and a duplicate retail facing team in wholesale that would also co-ordinate the activities above, and deal with inset enquiries from other retailers. It is hard to see this being efficient. It is likely that both these teams would also manage business retail enquiries. This duplication would not deliver efficiency to pass on to customers, in fact the opposite is likely.

Given the above, it is hard to see the logic of including any developer services activities in retail at all. Perhaps it is instructive to consider the point of view of an entrant retailer. Why would it concern itself with serving the needs of developers which interact primarily with a wholesaler or its competitors?

***Competition for insets***

We therefore believe that developer services ought to be considered part of the wholesale business. However, recognising the existence of a competitive inset market, and the numerous problems which currently beset it, there is a strong argument for treating the developer services which are contestable within a separate ring-fenced entity within wholesale. Anglian Water has already taken steps to implement such ring-fencing.