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Friday 22nd March 2013

Dear Stephen,

Consultation on Setting Price Controls for 2015-20 - framework and approach

Thank you for the opportunity to respond to this consultation. Our comments are in response both to the consultation document published on 28th January, and where applicable the further updates that were provided at the workshops on retail and wholesale on 1st and 12th March.

We believe that the consultation is an important step towards your aim of delivering a better price setting process. We support many elements of the proposed changes, in particular:

- The greater emphasis on companies owning their plans;
- The greater role for customer engagement and bringing customers' views into the process; and
- The use of more targeted incentives to give a greater push for companies to innovate in delivery and boost efficiency.

We have responded to your questions in detail below. The key issues we wish to bring to your attention are:

- Concerns about the proposed timetable;
- Making sure the incentives in retail are balanced correctly for the long term;
- Allocation of RCV between waste and water; and
- Getting the balance right between companies owning their plans and transparency of regulatory methodologies.

Timetable

Two key elements of the new approach are getting companies to take more ownership of their plans and incentives, and also to involve customers more in the planning process. We recognise that this presents a new challenge to companies, but it is one we welcome. However, fully responding to this new approach in time for a December submission will be challenging, and we are concerned that bringing forward the submission date might impact upon our engagement and governance processes.

Equally, we understand the challenge that Ofwat faces in delivering the post submission phase of the review and that there are other significant risks that would arise from a later submission.

One possible change to the process that might help mitigate these risks would be to move to a two stage submission. The outline timetable could involve a high level draft plan submission in early November, with a Final Plan submission in late March. This would allow companies more time for engagement and governance before the Final Plan, but would also allow Ofwat earlier visibility of the key elements of companies' plans. In essence it would give all parties more time and help mitigate some of the timetable risks. For companies to be able to submit draft plans early, the reporting requirements would have to be fairly light, with an acceptance that more detail would be forthcoming later.

Retail Incentives

We are concerned that the proposed approach to setting revenues based on the lower of average or actual cost to serve does not fully take into account dynamic incentive effects. For companies below average cost to serve, the proposed approach significantly reduces their incentive to further reduce costs in comparison to the customer wide benefit that would eventually result from such reductions.

Moving to a full average cost to serve approach would help redress this balance. The benefits to the wider customer base from efficient companies reducing their costs further would be significant, and over time outweigh the higher bills faced by some customers in the short term.

Allocation of RCV between Waste and Water

The allocation of WaSC RCV between Waste and Water could have a significant impact on the bills of WaSC customers that receive a sewerage service only. If too much RCV were allocated to the sewerage business, then these customers would end up paying for investments in water supply from which they are not benefitting. In effect they would be subsidising the water customers of the WaSC.

To avoid this misallocation, we suggest that a more detailed approach to RCV allocation is adopted that takes into account the relative expenditure in the two services since the allocation of an RCV in 1995. Alternatively an approach should be used that does not result in incidence effects for Sewerage only customers.

Transparency and Ownership

We understand Ofwat's desire that companies own their plans, and therefore the reluctance to set out details of the cost assessment methodology ahead of company business plan submissions. On the other hand, transparency in the assessment approach used by Ofwat would be very helpful in ensuring that the matters companies **focus** on in their plans are the matters most of interest to Ofwat. In addition, full transparency would help the engagement process with CCGs, and between Ofwat and Companies.

It is possible that the two step approach outlined above would help address this issue. Companies would submit their draft plan with full ownership. Publication of the assessment approach would then allow companies to adjust the **focus** in their plans to the areas where Ofwat is likely to have the most concerns. This would help both parties through the review process.

We hope that Ofwat finds these suggestions helpful. We provide more details on our views in response to the specific questions set out below.

Yours sincerely,

Mike King

Answers to Specific Questions

Delivering what matters – an outcomes-focused approach

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)?

We agree with the proposed approach. This will allow companies to develop the most appropriate regulatory incentive framework to support the delivery of their proposed outcomes.

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 agree that it is appropriate to set delivery targets related to each outcome for the five year price control period. In some cases this may be a target milestone, where the desired level of performance is not achievable within one price control period. It may be necessary in such cases to adjust incentive mechanisms to take account of performance against longer-term targets.

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?

One of the key benefits of the Outcomes approach is the ability for companies to respond to the wishes of their own customers and stakeholders, to develop targets and incentives particularly suited to their preferences. This would run counter to Ofwat imposing consistent performance commitments and incentives across all companies, and as such we consider that this should be avoided where possible.

However, we recognise the importance of some measures to various stakeholders, and the importance that transparency on these measures provides to regulators, investors, companies and their customers and stakeholders. Whilst target levels of performance and related incentives may vary across companies, it may be helpful to have a set of standard measures. Two examples of such measures might be leakage and customer minutes lost.

Notwithstanding the usefulness of identifying standard measures, we do not believe that Ofwat needs to adopt consistent incentives across such measures. This should be left as a matter for companies to address through their engagement process.

Defining retail (and wholesale) services

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?

Our preference remains that a narrower definition of retail be used than that proposed in the consultation. A narrower definition would not prevent new retailers from providing additional services to customers if that is what they desire, but would not force them to provide such services where it was not part of their key offering.

Rather than re-run the representations already made on this issue, we have contained our response only to issues not previously raised.

Network Customer Contacts

We are concerned that unless the wholesale company retains some capability to handle network contacts, entrants will see the proposed arrangements as anti-competitive. Whilst a new entrant will be able to receive contacts directly from the customer, it will in some cases need to contact the Wholesale company in order to achieve resolution of the issue. It is unlikely that entrants would wish to contact a customer service representative working in the retail arm of the incumbent in such cases. Given this, some facility for handling customer contacts will need to be retained by the wholesaler.

An additional consideration is that it is likely that some entrant retailers would prefer the customer to contact the wholesaler directly in the event of network issues as this would reduce its costs and allow it to offer a lower price. Clearly, any definition of the scope of retail would ideally not proscribe such an approach.

Demand-side water efficiency services

Our understanding of the proposed approach is that retail companies undertake water efficiency activities, but that wholesale companies pay for any additional activity they seek in line with their Water Resource Management Plans. At the retail workshop it was confirmed that the wholesaler would not have to use the retailer to actually undertake any such activity. Given that responsibility for expenditure and choosing the route of delivery actually lies with the Wholesaler under this approach, we are not clear why it is labelled as being within retail.

Customer-side leaks

A key issue in respect of the allocation of customer side leaks is the potential raised in Government for companies to adopt supply pipes. The potential consequences of such a change are considerable, and probably more easily managed if responsibility were to remain within wholesale.

Developer services

The allocation of customer contacts on new connections within retail was not considered in the original consultation. We are not clear as to the exact scope of the contacts being considered. The majority of contacts we receive are in relation to the provision of infrastructure. As such we believe they fit most neatly with the infrastructure company. There are also a number of definitional issues to consider such as which factors result in the contact being household retail as opposed to non-household retail.

A final consideration is how self-lay companies would regard new connections being transferred to non-household retail. It is possible they will regard this as being a retrograde step as it will transfer responsibility for new infrastructure from the Wholesaler (who is indifferent as to whether the infrastructure is provided by self-lay or the Wholesaler's contractor) to a Retailer seeking to make money by keeping control of the infrastructure provision.

Setting wholesale controls

For controlling wholesale revenues

Q5 Do you agree with our proposed scope for the wholesale 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 are not clear about the reasons for including connection charges and infrastructure charges within the revenue control. Currently, these charges are treated as capital contributions rather than revenue. Given their nature, a more appropriate treatment might be to take account of any differences in connection and infrastructure charges in the reconciliation of the totex baseline at the end of the period. We consider that this might be a more effective approach to mitigate any changes in these charges than the revenue control.

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?

We broadly agree with the proposed approach. We consider that the proposed adjustment for the costs of providing additional water adds undue complexity. The marginal costs of providing water depend strongly upon climate. For example, in a dry year, demand may fall due to a hosepipe ban, but costs could rise as more expensive sources have to be used. A simple adjustment would not reflect this complexity and is therefore probably not relevant.

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?

No comment.

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

We believe that companies will be self-incentivised to prepare accurate demand assumptions. Good forecasting will allow companies to manage price changes smoothly from year to year. Incorrect forecasts will result in larger changes to prices and could well be accompanied by customer dissatisfaction.

For cost assessment

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

As a general approach, the triangulation approach seems reasonable.

Our key concern is that the process should be as transparent as possible. This would be consistent with the recommendations of the Gray report. We do not believe CEPA's recommendation to keep the baseline derivation obscure is consistent with either Ofwat's duties or the Better Regulation principles, and as such should be disregarded.

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)?

We believe that enhancement expenditure should be excluded from the econometric modelling approach. Companies' expenditure on service enhancement, water quality, and balancing supply and demand will reflect their own individual circumstances and customer preferences. For example a company with a significant supply-demand challenge might be expected to have significant expenditure in this area, whereas a company with a surplus might have to incur very little expenditure.

For each of these areas of expenditure considerable oversight is provided by external bodies. This mitigates risk in this area and should give Ofwat some additional comfort in excluding them from the econometric modelling as part of a risk based approach to regulation. For example:

- The extent of expenditure to balance supply and demand is set out in the water resources management plan, and is subject to independent assessment by the Environment Agency;
- The extent of expenditure on water quality is subject to independent assessment by the Drinking Water Inspectorate; and
- Enhancement programmes are likely to have been scrutinised by the customer challenge groups.

<u>**How should we assess these costs?**</u>

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?

There are a number of areas where our costs are higher than average for reasons outside management control. This has been recognised in previous special factor adjustments, and we can provide evidence where this is the case. Previous special factors that have been taken into account include higher water treatment costs due to the nature and sources of raw water and higher costs due to traffic congestion within Bristol.

A key issue in respect of special factors is transparency over the models used to assess efficiency. For example, because of its geography Bristol Water has a relatively high pumping head that leads to significant additional power costs in comparison to an average company. No special factor was included for these additional costs previously, because the power costs model took this additional cost driver into account. Without visibility of the models, it is difficult for companies to assess whether or not areas of additional cost need to be specifically identified, or whether they are already accounted for.

<u>**For cost performance incentives**</u>

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.

We consider that it should be for companies to identify costs that they believe should be excluded from the general cost incentive framework. The criteria you have set are suitable factors for the company to address were it to set out a case for exclusion. In order to identify areas of expenditure where exclusion is appropriate, companies will need to have good visibility of the cost incentive framework. Given the currently proposed timetable, it is likely that companies will not have sufficient transparency at the time of Business Plan submissions. Consequently, any representations in this area may not be made until after draft baselines have been produced.

For cost recovery

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 do not believe MEA values should be used as a basis for splitting 2015 RCV between water and wastewater controls because this could lead to waste only customers of WaSCs effectively subsidising the water bills of the water supply customers of WaSCs.

We believe it is important that customers do not pay for investment from which they do not benefit. This means that the split in RCV should follow the relative expenditure that has occurred in each service, rather than the potential replacement costs. Waste customers should not pay for investment in water supply assets in a water service they do not receive. There is a danger that an unfocussed approach would lead to significant price increases for waste only customers. This would be difficult to justify on objective grounds.

A far more robust approach for splitting RCV would be to use actual expenditure and regulatory depreciation since April 95 to adjust opening water and waste RCVs based on the 1994 MEAV split between water and waste. This would ensure that the bills paid respectively by the water and wastewater customers of WaSCs reflect the costs they have actually incurred.

One particular concern in respect of the use of MEAV is the incorporation of private sewers into the WaSC MEAV. This will have increased sewerage MEAVs by around 50%, but have had only a trivial impact on RCV. Allocating RCV on MEAV post this transfer could lead to a significant increase in sewerage bills. Whilst this would be offset by a fall in water bills for jointly served customers, it would be very difficult to explain to sewerage only customers.

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

Such a simplification is possible from the price setting perspective. However, companies will still have to undertake a detailed analysis to determine the average capital allowance writing down rate they include in their plans. A simplified approach would make it difficult for Ofwat to robustly adjust the company assessment to reflect other elements of their Determination. This may be considered a significant drawback which needs to be weighed against the benefits of simplification.

The introduction of IFRS accounting in 2015 will lead to a significant change in the assessment of tax allowances for infrastructure expenditure. Given this, we believe that separate capital allowance rates should be included for infrastructure and non-infrastructure expenditure rather than one overall rate. This will not add significantly to complexity, but would enable a much better match between the simplified and the detailed approach.

Retail Controls for Household Customers

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

Accounting data for the precise definition of retail has not yet been produced. Given this, some caution should be exercised in the use of forecast data for retail costs and use of historic costs should be preferred.

To account for future costs, Ofwat could use a standard regulatory approach of starting from the current level of cost and adjust for input cost pressures and future frontier efficiency improvements.

The draft methodology appears to make an assumption that input cost pressures and efficiency will balance out. A more robust approach would be to make an estimate of each separately and adjust costs accordingly. This could be done either based on a forecast of RPI, or a forecast relative to RPI with cost allowances being indexed by outturn RPI.

A key driver for the introduction of separate controls for retail is to sharpen the efficiency incentives on this area of the business. Visibility of the improvements achieved will be useful to demonstrate the benefits of the changed approach. Such benefits would be much easier to demonstrate if the change in average cost to serve was compared over time taking into account the impact of inflation rather than in nominal terms. This would be difficult to justify if retail price controls were not themselves indexed by RPI. Overall, we believe the case for indexation of retail costs is strong.

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?

We agree with the criteria.

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

We agree with this option. Moreover, we believe that any adjustment made to ACTS should be applied on an industry wide basis.

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?

Ofwat should not set an efficiency challenge that is greater than a well-managed company can deliver. Given this some form of glide path is appropriate. A straightforward approach would be to assume that a company reaches ACTS in the final year of a five year period, and this would be in line with the c50% catch up to frontier over 5 years approach that Ofwat have used in their previous approach to efficiency.

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

We believe that companies below the industry ACTS should have their cost assessment based on ACTS rather than their actual cost to serve as this will preserve strong incentives for such companies to reduce their costs further and provide a better balance between the benefits of cost reduction that accrue to the company, and those that accrue to customers.

Consider a situation where a company below ACTS reduces its costs by £2m in the year in which ACTS is determined. This reduction will reduce the ACTS by £0.1m (assuming 20 equal companies) and will provide benefits to of £1.9m pa to customers of other companies as well as £0.1m to its own customers. The benefit to the company under an 'actual or ACTS' approach would be £2m (i.e. 1 years out-performance), but the NPV of the benefits to all customers is £40m to all customers plus another £40m to its own customers (based on a 5% perpetuity). In other words the benefits arising from the efficiency reduction are split 40 to 1 in favour of customers, and there is very little gain for the retailer to invest to achieve such cost reductions.

On the other hand, under a 'full ACTS' approach the benefits of any out-performance would be split 50-50 between the overall customer base and the company. This would provide much stronger efficiency incentives for companies and over time lead to much lower costs.

Different splits of the benefit between customers and companies could be achieved by basing companies cost allowance on a mix of their actual costs and ACTS. For example, the previous 30% split between customers and companies could be obtained by basing costs on (2*ACTS + Actual)/3.

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?

We believe a net margin should be used to remunerate household capital and risk.

We understand the concern about over-recovery of returns however we consider that this is largely misplaced. There is a wide evidence base that retail operations earn a return that is not simply a return on capital employed. Such returns are generally expressed as a margin on sales. For example, this issue has been explicitly addressed by Postcomm in respect of Royal Mail. Given that retail margins are not therefore related to a return on assets, the inclusion of retail assets in RCV in April 2015 should not impact materially on the retail margin allowed.

It is possible that a detailed assessment might identify two separate elements of the return for margin on sales and return on assets. In this case, the double counting issue could be avoided by ramping up the return on assets element from 20% in the first year to 100% in year 5 to reflect the short life of most retail assets. However, we are not sure that the additional complexity of this calculation would make a significant difference given our estimate that the return on retail assets amounts to less than 0.2% of sales.

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, although care needs to be taken to differentiate between the retail service and the services delivered by the wholesale company. This allocation of network customer contacts is a factor to consider also. Our preference would be for the version of the SIM used for retail to only relate to retail issues. Wholesale companies could propose and agree with their CCG a separate incentive measure to be used to incentivise handling of network customer contacts and other wholesale customer service issues.

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

We agree that the funding of these activities should be through the wholesale control. However, given this we do not see any merit in then allocating these activities to retail. Allocation to wholesale would not prevent new entrants offering such services to non-household customers if this was part of their offering, but would also allow retailers the freedom to not offer such services.

Retail controls for non-household customers

In setting the retail control for non-household customers, it is first important to be clear on which customers will be included within this control. In companies' reporting of household and non-household properties for the June Return, non-households included any property where there was an element of non-domestic use. However, this includes mixed use properties with a domestic element, which are protected from disconnection. Competitive tariffs and service offerings may be expected to include clauses for disconnection in the event of non-payment, in which case it would not be appropriate to include mixed-use properties within the non-household control.

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

We agree with this proposal. We consider that continuation of existing tariff structures will minimise any incidence effects on customers.

However, we recognise that the myriad tariff structures across the industry may create comparability issues for non-household customers wishing to compare tariffs. We would therefore propose that charges could be published by a series of consumption bands, even though companies may offer the same tariff for several consumption bands. E.g. 0-1Ml; 1-5Ml; 5-10Ml; 10-15Ml; 15-20Ml; 20-50Ml; 50-100Ml; 100-250Ml; 250-500Ml; 500Ml+. No movement of customers between bands or changes to company tariff systems would be required using this approach.

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

We agree that it is preferable for the tariff calculation methodology not to require a correction for actual changes in numbers of customers, particularly as the level of customer switching will be difficult to forecast in the early stages of market opening.

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?
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?

Ofwat can take two approaches in this area:

- Make a detailed assessment of costs and required margins and set default tariffs on this basis; or
- Use a high level approach to set default tariffs, within which companies will have to recover actual costs and profit.

A danger in the first approach is that the cost and margin allowance might not be sufficient to encourage new entry. Given this, our preference would be to take the second approach. This will allow actual costs and margins to emerge naturally out of the competitive market. From a regulatory perspective this is much simpler as the information requirements are minimal.

We do not believe any adjustment needs to be made as a result of concerns about over-recovery of returns. Any such adjustment would reduce the margin available for new entry and would risk being anti-competitive.

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?

Where customers are contestable and the market is operating correctly we do not consider that Ofwat should need to set a maximum limit on the gross margin available on default. If companies set such a default too high and then serve customers at this tariff they will lose customers to competitors.

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?

A clear link to RPI for default tariffs would be a significant help to new entrants. It would make it easier for them to advertise their services in comparison to the default tariff. If retail costs do not increase as fast as RPI, then competition will reveal this and ensure that the additional element is not passed through. If costs do increase at or above RPI, an insufficient cost allowance will prevent entry. Given the balance of these risks, an approach that fully reflects input price pressures should be preferred to one that ignores them.

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

We agree that the existing GSS standards provide a reasonable minimum level of service for non-household customers. The GSS provides for some areas of service which would be managed by the retailer (appointments, written complaints, account queries) and some which are managed by the wholesaler (interruptions to supply, restoration of supply, pressure standard). Where the wholesaler is responsible for the service area there may be a need for formal delineation of responsibility for performance level and payment in the event of failure between the retailer and the wholesaler.

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

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?

No comment.

Making better use of water resources

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

We consider that incentives for the importer of water are likely to be more important than incentives for the seller of water. A key concern of Importers is that in a drought the exporting company may prevent export of water in order to secure supplies to its own customers. An exporting company does not have the same degree of concern about the importer fulfilling its duties. Given the typical long-run nature of water trading agreements, short term incentives would have limited attraction to potential importers.

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.

The additional water available to the exporter gives its customers additional supply security against droughts that are worse than the exporting company's level of service. This additional security has some value to customers. The amount that the exporter 'credits' its customers from the export should not be below this, and thus sets a minimum amount for the proportion of profits that should be passed on to customers. A 50-50 share of profits above this threshold may be an appropriate approach.

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

We suspect that robust evidence in this area will be difficult to obtain. A key factor is the long-term nature of the buyer's risk and the resulting likely need for long-term incentives. Our view is that an incentive of less than 20% of import cost is unlikely to be viewed as attractive by importers.

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.

We are concerned that further analysis is needed in this area. Any incentives in respect of water trading need to be obtained either from the importer's customers or the exporter's customers. Any increase in the costs to importers could result in the scheme becoming more expensive than the next alternative scheme in which case the importer's customers would be better off if the alternative scheme were chosen. On the other hand, the exporter's customers lose the previous additional supply security from which they benefitted. The amount that the exporter 'credits' its customers from the export should not be below this. Any supply incentives need to come between these two limits amounts. How this is split may need to reflect the specific circumstances of an individual supply.

Q36 Do you agree with our preferred option for implementing the AIM?
Q37 Do you agree with our preferred limit to the scope of the AIM?
Q38 What evidence should we take into account in calibrating the AIM?
Q39 What are your views on our proposed phased implementation of the AIM?

Bristol Water does not have any Water Framework Directive 'Band 3' sites. Therefore we are not directly affected by AIM, and have therefore not considered it fully. Our initial reaction is that the AIM is in danger of becoming an over complicated incentive to which companies may not be able to effectively respond. It is possible that a reporting/reputational incentive approach may achieve the desired outcome more effectively and at lower risk.

Overall incentives, risk and financeability

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, but given that companies will themselves be developing Outcome incentives, it is important that companies have some early transparency on incentives so that they in turn can calibrate their outcome incentives.

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

Yes, we believe that setting WACC should be consistent with overall risks relevant to each price control. In setting the WACC there must be some element of future proofing to endeavour to make it appropriate for the period to which it relates.

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. We do have some concerns that the interaction between incentive calibration done at individual company level may not be fully aligned with the use of notional balance sheets. This issue needs to be considered carefully to ensure that there are not unintended consequences.

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?

A key issue in setting the WACC is the difference in relative risk between water only companies and the WaSCs. There may also need to be an adjustment to WACC to take into account the lower risk of the sewerage business compared to the water business.

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?

We agree that a single company approach should be used for wholesale and household retail.
Given the introduction of competition for non-household customers there may be a need to assess non-household retail financeability separately. Reasons include:

- Any support to the rest of the business from margins in non-household retail might be rapidly competed away and therefore cannot be relied upon to support the remainder of the business;
- Any shortfall in financeability of non-household retail could indicate that default tariffs are too low and therefore be a strong indication that there is a risk of a margin squeeze.

Assessing performance during 2010-15

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

Yes.

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

One important factor is the impact on customer prices. Customers generally prefer to have a smooth evolution of prices rather than prices that go up and down. Given this spreading the incentives so that they are the same amount in real terms each year over the period is probably the most appropriate approach.

Delivering price controls in 2014

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

The process outlined is:

- Assess proposed outcome commitments and associated delivery incentives
- Assess company's proposed costs associated with those commitments
- Assess company's approach to risk and reward (as outlined in Chapter 8)
- Assess company's plan for financeability

And the criteria are:

Criteria	Bristol Water comments
• whether the CCG has made a positive, and well-evidenced, assessment of how customers' preferences have fed into the company's business plan;	We consider that the phrasing of this criterion suggests that the Company's business plan will be assessed on the basis of the CCG's report. As the CCG is an independent body, it will be up to Ofwat to give the CCG strong guidance regarding Ofwat's expectations of how the CCG should present its assessment. To maintain the independence of CCGs we believe that the extent to which companies are expected to guide CCGs in production of their report should be minimised.
• whether the proposed package of outcome commitments and outcome incentives meets the methodology's minimum requirements;	We welcome the opportunity to take responsibility with our customers for proposing outcome commitments and incentive packages. Notwithstanding this, transparency in respect of what Ofwat sees as the 'minimum requirements' would be helpful for our governance processes.
• whether the overall ambition of the proposed outcome commitments is consistent with the company's track record of delivery;	OK
• whether the business plan's costs fall within cost corridors identified by our cost assessment models;	OK, assuming the cost corridors take into account any special factors companies may experience that are not reflected in the assessment
• whether the companies' approach to cost recovery – including its PAYG ratio – is within reasonable bounds;	OK
• whether the company's plans meet financeability tests.	OK

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

We believe evidence of customer support for the plan should form the key factor in the risk based review.

Two potential additional factors not considered in the list above are:

- whether the plan makes sufficient progress to long term customer requirements and is consistent with the company's long term strategy; and
- whether it is consistent with the long terms aims the Government has set out for the industry.

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

The current timetable suggests publication of the Final Methodology in June and Business Planning Expectations in July. For business plans to be submitted in early December it will be necessary for companies to present these to their Boards and CCGs in November. This is a very challenging timetable for companies and CCGs alike.

One possible approach to give both Ofwat and Companies more time is to bring forward submission of a limited plan to the start of November, but have this followed up by a final plan at the end of March. For this to work the reporting requirements of the November plan would have to be limited, and there would have to be acceptance that elements of companies' plans around the new areas introduced for PR14 might move between draft and final plans.

To ensure that the remaining timetable is met we suggest that Ofwat publishes specific deadlines for its remaining deliverables and holds itself accountable for ensuring they are met. The methodology presents a series of challenging issues to resolve and it would be most beneficial to focus on those areas where it is possible to reach a timely and beneficial conclusion before companies are expected to produce business plans. This might require deferral of work in some areas until after the conclusion of the price review. In addition, given the changes to the way price limits are set and uncertainty over the effects on customer bills we would urge Ofwat to try and provide as much transparency on its approach as it is developed.

The outline timetable includes a data submission in August. At present Ofwat has not set out any information in respect of the data required to be included in the submission. We are concerned that an extensive data submission in August might be a significant challenge from the perspective of Board governance and assurance, particularly as the final reporting requirements for the submission might not be available until late in July. It is important that any data requirements are specified well in advance of required submission dates to ensure that the data provided is of high quality with appropriate levels of assurance.

Building for price reviews in 2019 and beyond

As noted above we consider there are significant challenges to delivering the price determination in 2014. Given this, we believe that Ofwat needs to be cautious about the scope of the activities it focuses on during this time. We agree with Ofwat's view that implementing indicative network plus sub-limits is not feasible as part of PR14. Further development of incentives to be introduced post-PR14 should not be considered a high immediate priority.

Q50 Do you agree with our preferred scope for network plus?
Q51 Do you agree with our preferred option to implementing network plus?

As highlighted by Ofwat the scope and implementation of network plus is dependent on future Government legislation in the Water Bill, particularly regarding access pricing. We would urge Ofwat to delay developing an approach in advance of this legislation.

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

We continue to struggle to understand the issues that Ofwat is hoping to address by developing incentives in this area. Given this, we believe that more dialogue between Ofwat and companies is required to help promote understanding. We note the conclusion of the UKWIR report on Incentives to Optimise Water Networks[1] that "*Aside from supporting the development of competition, the need for additional incentives is considered low*".

The extent to which an additional network management incentive may be required in future will depend on developments in upstream competition. Given that these have not yet been set out by Government, we consider that developments on this area should be put on hold for the time being.

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

We would welcome greater clarity from Ofwat on what it is endeavouring to incentivise in this area and why it considers that an incentive is an appropriate approach. This will enable us to more effectively respond on this issue.

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

We agree with Ofwat's proposed approach to financial incentives for network information reporting. However, we would welcome the establishment of greater clarity and understanding of the issues and need for change in this area ahead of developing a reporting framework.

[1] UKWIR Report Ref 13/RG/05/37, page 32