Setting price controls for 2015-20 – framework and approach.
An Ofwat consultation

Consumer Council for Water Response **March 2013**

1. Introduction

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

2. Executive Summary

2.1 As an over-arching objective, the new framework for price controls must

- Focus on the delivery of outcomes that have been identified from evidence of customers' preferences and priorities of service.
- Ensure that incentives are applied to ensure the outcomes are delivered efficiently and represent best value to customers.
- Ensure the package of retail and wholesale incentives work effectively as a coherent package ensuring there is consistency between the retail and wholesale businesses with a focus on fixing customers' problems.

2.2 We have a general concern (not related to the answers to the consultation questions) that the framework paper lacks detail in several areas, which makes it difficult to fully evaluate how the higher level principles will work in practice. We took forward to seeing this detail emerge, but are mindful of the increasingly tight timescale for this price review.

2.3 We also note that the timescale between the issuing of Ofwat's baseline efficient costs and Final Determinations may be challenging for Customer Challenge Groups (CCGs) to effectively evaluate proposed company costs against these baselines.

2.4 We support

- Financial penalties and rewards applied to drive the delivery of outcomes that reflect customers' priorities. This would be particularly effective for outcomes set by companies relating to customer satisfaction with the service delivered and the value for money this provides. Incentives applied to customer satisfaction related outcomes would drive improvements across a range of retail and wholesale activities and ensure companies are accountable to their customers.

- Parameters applied to outcome delivery incentives to reduce the risk of disproportionate rewards and penalties.

- Scrutiny and calibration by Ofwat to ensure that the package of incentives for each company will work coherently with no perverse or unintended consequences.

- The use of the 'average cost to serve' (ACTS) approach to setting household retail prices, with a 'glide path' towards a longer term aim of using 'most efficient/best observed cost' to serve.

- A cap of the level of reward a company can achieve under the water trading incentives Ofwat proposes.

2.5 We do not support

- Financial incentives applied for the reporting of 'network plus' data as customers will see no benefit from this during 2015-20. Regulatory data reporting should not be subject to financial rewards.

- How the Abstraction Incentive Mechanism (AIM) will be implemented in terms of:
    - the potential conflict between the company and Environment Agency customer 'willingness to pay' evidence that may define the level of financial reward within the incentive;
    - the potential inconsistency this incentive may have with other incentives relating to the security of supply; and
    - the risk of companies being doubly rewarded through revenue correction and the AIM when customers have helped reduce abstraction through greater water efficiency.

2.6 We would like to see

- Further consideration of the inflationary pressures in some retail costs over the price control period. With no indexation the retail price controls may be a 'blunt instrument' that could lead to a deterioration of service standards for customers.

- Sufficiently ambitious and challenging measures and incentives for the delivery of outcomes. Both CCGs and Ofwat will have a role in the process to challenge companies to ensure that there is no 'easy gain' in proposed incentives.

- Trade offs in the delivery of different outcomes (or milestones) only allowed where a company has over-achieved in delivering an outcome that is a customer priority. In this case, such an over-achievement can act as a trade off against the under-delivery of an outcome that has a lower level of customer priority (based on evidence of customers' preferences).

- SIM applied as an industry wide incentive across retail <u>and</u> wholesale as this reflects the customer experience across the value chain. This would strengthen the incentive for companies to deliver further improvements and resolve customers' problems. We would also like to see SIM reviewed periodically to ensure it remains challenging with sufficient measures and increased rewards and penalties.

- A company that has applied to have its household retail prices adjusted on the basis of evidence of economic deprivation in their area of supply should only allowed to do so if it can demonstrate that it is following best practice in revenue collection and bad debt management.

- A requirement on companies to demonstrate to their stakeholders the range of options for utilising a surplus water supply for customers' benefit, with a clear evaluation of the costs and benefits. This would allow an evaluation of the benefits of a water trading exports, helping to ensure that water trading incentives do not lead to a bias against other options for using a surplus.

- In the totex approach to cost recovery, an avoidance of any over-allocation between wholesale expenditure applied to 'pay as you go' charges and the Regulatory Capital Value. There must be an appropriate balance between costs carried by current and future customers.

- No price increase for customers of companies that are below the ACTS (these companies should also receive efficiency targets that will continue to drive improvements).

- Ofwat address the risk of companies deliberately allocating costs in such a way as to artificially inflate the ACTS for either household or non-household customers.

- Further consideration of an alternative retail price control approach for non-household retail prices for Welsh companies, to drive efficiencies in the absence of a competitive market.

- Revenue adjustments allowed across the price control period within the wholesale price control, but with constraints to prevent significant impacts on customers' bills and to incentivise companies to forecast demand as accurately as possible. This will help reduce the risk of a 'spike' in prices in subsequent price controls due to five years' worth of revenue adjustments being applied at once. This approach must also have

    - customer support; and
    - transparency and clarity for customers, with close monitoring to ensure the mechanism is used appropriately.

- A cost of capital for 2015-20 that will subsequently not be seen as 'over generous' or 'risk averse' with a fairer balance of risk carried by investors and customers.

3. Outcomes-focussed approach

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

Yes, though the nature of incentives must be driven by evidence of the value customers have placed on each outcome, taken from companies' 'willingness to pay' research and other evidence from customer engagement.

A financial incentive (with rewards and penalties) should be applied if
- there is evidence that customers view a particular outcome as a priority;
- there is sufficient input from the CCG, supporting the application of such an incentive;
- there is no existing incentive mechanism to drive the delivery of the outcome; and/or
- a reputational incentive alone would not be strong enough to drive a company to deliver the outcome.

Outcomes relating to companies' statutory programmes are sufficiently incentivised through the penalties that can occur through non-compliance.

While all non-statutory outcomes should reflect customer preferences, the delivery of lower priority outcomes should be incentivised by penalties only or non-financial incentives.

Outcome incentives must also be sufficiently ambitious and challenging for companies to achieve to drive greater service improvements and efficiency for customers. Both CCGs and Ofwat will have a role in the process to challenge companies to ensure that there is no 'easy gain' in proposed incentives.

Trade offs should only be allowed where a company has over-achieved in the delivery of an outcome (or milestone) that is a customer priority. In this situation, it would be acceptable for this over-achievement to 'trade off' against the under-achievement of an outcome that is a lower priority to customers. The level of customer priority for each outcome should reflect robust evidence of customer preferences.

However, it may not be possible to 'trade off' the non-delivery of outcomes relating to statutory requirements due to the risk of infraction or enforcement proceedings.

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?

Many outcomes will be long term aims that cannot be delivered in full within a five year price control. Outcomes should be the basis of a company's 25 year strategy, of which the five year Business Plan is a part. Evidence of customers' willingness to pay should help set the pace at which outcomes are delivered, with incentives applied to the outcome to further drive its delivery. This is reflective of **Option 1** on page 43 of the consultation paper.

We believe Ofwat should apply parameters to set maximum levels of penalty and reward that can be applied to an outcome incentive. This will act as a safeguard against any disproportionate incentive impacts on customers.

Companies should also be transparent in reporting their progress in delivering outcomes, with a requirement for companies to publicly report this progress.

There is a lack of detail in the consultation paper to show how Ofwat will assess either a company's own proposed outcome delivery incentives in its Business Plan, or how the views of the CCG in its report will be taken into account in Ofwat's assessment. We would appreciate greater clarity from Ofwat on this.

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?

As many companies are intending to increase customer satisfaction as a priority outcome, we would like Ofwat to apply a consistent incentive across all companies to drive this. This could increase the long term legitimacy and sustainability of the industry in customers' perspective.

The achievement of such an outcome should be a reflection of customers' view of both the value for money and separately the quality of service covering all company activities across the value chain.

There is an opportunity to apply two-sided financial incentives to drive the delivery of 'customer satisfaction' outcomes, which would in turn encourage further improvements in customer service and customer communication across the customer base (not just those who have had cause to contact the company, which SIM measures). This would help improve company board focus on customers, and align companies financial performance with improved customer satisfaction, particularly value for money.

Consideration would need to be given as to how customer surveys and other tools could be used to consistently measure customer satisfaction with value for money (CCWater's annual tracking surveys could be used for this purpose).

We agree that SIM should continue to be applied as a consistent incentive across all companies. In our response to question 21 we make recommendations for how SIM can continue to drive customer service improvements into the next price control and beyond.

Ofwat also recommends using the AIM as a consistent incentive. We have concerns with how the AIM may be implemented set out in our responses to questions 36 to 39.

4. 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?

We agree with the approach of adopting a consistent definition of retail across both the contestable and non contestable price controls. We note Ofwat's decision to include network calls in the definition of retail. This should lead to a single point of contact for customers regardless of whether their reason for contact is related to network or retail.

We support

- the inclusion of demand-side water efficiency measures and customer side leaks. We feel that these added value services will provide the retailer with the opportunity for a greater margin within the contestable market and could potentially drive savings for a switching customer.

- the use of incentives to encourage wholesalers to reduce consumption through the outcomes and associated measures companies are currently developing relating to sustainable and secure water resources. This will complement retailers' work in promoting greater water efficiency.

- the proposals to split developer services between retail and wholesale. This should place responsibilities on both the retail and wholesale businesses to meet developers' expectations, and address the need to improve services to this sector of business customers.

We have concerns about the responsibility for activities associated with meters being split between retail and wholesale, where a company plans to roll out compulsory metering.

While the wholesaler may determine the proposed metering strategy on a demand management basis, in embarking on a compulsory metering programme companies must consider the impact on customers' bills in order to determine the pace and scale of the programme and in order to identify what support may be required for those seeing a significant increase in their bills.

Successful implementation of such a strategy relies on sufficient and effective customer communications and the practical support to customers that can be provided. This means the retail business is an enabler for the wholesale part of the business' proposed strategy.

There is a risk with the current proposed retail definition that the retail costs outlined above may not be taken into account by a wholesaler that may focus primarily on installation and maintenance costs. Meanwhile, the retailer may only focus on post installation costs – meter reading, billing etc. We would like Ofwat to provide a reassurance that, for any company proposing a compulsory or selective metering programme, consideration is given to the wider cost implications on the retailer as well as the wholesaler.

The use of SIM and the allocation of customer side leak repairs and water efficiency only partly address this.

Setting wholesale controls

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? Are there any revenues of the regulated wholesale business you think should be excluded from this scope? If so, please give your reasons.

Our response to question four sets out our view on the activities that should fall within the retail business. We agree that water and wastewater activities that fall outside of the proposed scope for retail should fall within wholesale. We agree that wholesale controls should now include revenue collected from connection charges, to

- ensure this source of revenue is also regulated; and
- ensure that this is subject to the same efficiency challenge as costs associated with other areas of the wholesale business.

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 agree that the water wholesale price control should limit each company’s total wholesale revenues, on the basis of the efficient costs of delivering relevant outcome commitments. These costs will be based on a prediction about demand during the price control period.

We recognise that actual demand is likely to differ from forecasts. While the Revenue Correction Mechanism has addressed this in the past, this can lead to an increase in charges at the beginning of the next price control period if the demand forecast was too low.

We support a smooth profile of prices across the control period and recognise that an adjustment mechanism to allow for a correction to be applied during a price control period may help achieve this if it is symmetrical. This would help ensure that the wholesale charges paid by customers are more accurately reflective of both demand (in terms of consumption and metering) and associated costs, and reduce the risk of

- a bill increase in the first year of the subsequent price control period if demand forecasts were too low; or
- companies achieving a revenue ‘windfall’, which may not be adjusted for a number of years.

However, we do have some concerns with this approach:

- allowing adjustments during a price control period could lead to significant price instability for customers. Constraints on the level of adjustment a company can apply should help address this, as well as incentivising companies to be as accurate as possible with their demand forecasts;

- the risk that customers could be misled when they are informed of future prices, when companies could apply to alter their wholesale charges. Consideration needs to be given as to how this will be communicated to customers.
- the risk that such adjustments are not made transparently. There needs to be a clear process so that a company's evidence for the change can be seen and (if necessary) challenged by CCWater and stakeholders; and

We would also like to see a review of the process at the end of the price control period so that any further adjustments can be made and the effectiveness of this new process is assessed.

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

We question why wastewater wholesale revenues are not subject to the same uncertainty in demand forecasts as the water wholesale service, when wastewater network and treatment costs can be affected by such factors as climate and changes in water demand.

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

Companies must be incentivised to provide a 'best estimate' of future demand and headroom, with associated costs in Business Plans.

This could be achieved through a robust challenge to companies to demonstrate how demand forecasts have changed. There must be compelling evidence to support a request to adjust wholesale prices.
The use of constraints to restrict the level of adjustment (as suggested in our response to question six) could act as an incentive for companies to avoid 'gaming' as they would be unable to adjust charges outside of these parameters.

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

Yes. While we do not have a comment on the 'mechanics' of these models, we expect the baseline, as a principle, to be sufficiently challenging so as to incentivise greater efficiencies through 2015-20, and to move companies toward the frontier efficiencies established by the best performing companies. In the lead up to the baseline costs being delivered by Ofwat, CCWater will challenge companies' proposed 'high level' costs as Business Plans are developed.

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?

We agree that costs associated with new or emerging obligations should be excluded from the model to avoid the baseline giving a distorted picture of efficient costs. We are aware that some costs associated with the implementation of Water Framework Directive requirements may not be costed before Final Determinations. We would like to see, where possible, any new or emerging obligations excluded from cost assessments before Final Determinations are made in 2014.

Q11 What special factors should we consider 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 costs?

Q12 Do you agree with our criteria for excluding costs from the general cost performance incentive framework? What type 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 on these costs.

In response to both questions, as a principle, companies should be incentivised through the menu approach to move toward frontier efficiencies. An adjustment away from this must be based on robust evidence where a company can prove that its own costs are affected by factors outside of its control.

We expect Ofwat's proposed approach to how such 'special factor' costs will be assessed to emerge later this year. We expect this to show how companies will be incentivised to ensure such costs are efficient.

Q13 At what point should we take the Modern Equivalent Asset (MEA) values to split the 2015 RCV in order to set water and wastewater price controls?

It may be preferable to use asset values at the end of the current price control period as this should reflect an up to date calculation of the value and depreciation of company assets.

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

As a principle, whichever method is adopted, any over-estimation of the tax assumptions should be returned to customers (consistent with Ofwat's approach to cost adjustments mentioned above). We would also welcome greater transparency of the tax paid by companies in the way company accounts are reported to Ofwat.

5. Retail controls for household customers

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

A combination of historic and forecast data should give a comprehensive assessment of the ACTS over the price control period because

- historic data gives a measure of actual company performance and will reward those companies that have a demonstrable record of efficient delivery of services.
- forecast data will allow for an assessment of the impact of inflation on future costs.

However, in order to address the incentive for 'gaming' by companies to obtain a more preferable adjustment, Ofwat should

- avoid disproportionate loading on either historic or forecast data.
- ensure that companies are not allocating inappropriate costs to household retail services as this could artificially inflate the ACTS for these customers, leading to a higher than necessary price limit. There is also a risk of costs inaccurately allocated to retail/wholesale and household/non-household, which could distort the price controls.

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

The three criteria seem appropriate to ensure that any adjustments are robustly assessed. However, when determining whether a company is affected in a way that others are not Ofwat will need to take a view as to how this will be defined.

For example a company may seek to adjust its retail price by arguing that there is a high level of deprivation relative to the size of customers' bills in its area of supply. We think it is important that companies remain strongly incentivised to undertake effective revenue collection at an efficient cost. Companies that have not demonstrated that they are achieving such 'best practice' in their management of revenue collection (as evidenced by both bad debt levels and debt recovery practices) should not be allowed to adjust their retail price on the basis of economic deprivation.

The incentive for the ACTS to deliver greater efficiencies for customers in the uncontestable market will be weakened if companies have too much flexibility in adjusting their retail price cap before it is set.

Consideration should also be given to the denominator used to calculate the ACTS. Our response to Ofwat's 2012 consultation on retail price controls[1] stated that the denominator should be based on the number of customers billed by a retailer, with an adjustment made to reflect economies of scope where a retailer can issue one bill for two services (water and sewerage). This will give companies an incentive to adopt the most efficient approaches to billing.

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

Yes. Given the different levels of metering across the industry and the varying impact on costs this has, we agree that there should be a separate calculation of metering costs, where:

- the costs are material;
- decisions on metering levels are outside the retail business' control; and
- there are differences in efficient cost drivers between companies with higher or lower meter penetration.

Separating metering costs in the ACTS calculation will also prevent companies being dis-incentivised from promoting metering due to the higher costs involved in dealing with metered customers.

We agree that providing companies with an allowance for their metering costs based on the average cost of retail services and levels of meter penetration is reasonable and should ensure companies are also driven by efficiency incentives in these areas.

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) in what form?

A 'glide path' would be appropriate to ensure that companies who are significantly above the ACTS do not find themselves struggling to meet a target to the extent that it will impact on their delivery of services to customers.

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

We believe it is important that companies below the ACTS continue to reduce costs and thereby move to the ACTS.

Ultimately we would like Ofwat to set a direction towards a most efficient/lowest observed cost to serve approach. Using a glide path for companies above the ACTS will set them in the right direction and a most efficient benchmark can be a natural progression in the medium term.

[1] CCWater's response to Ofwat's consultation on retail controls for the 2014 price review (August 2012), page 7 http://www.ccwater.org.uk/upload/pdf/ccwresto2012PR.pdf

Publishing a table identifying company A as a frontier company in terms of the ACTS could incentivise other companies to remain at the forefront of the industry. Any deterioration in service would also be made public prompting questions from Ofwat, CCWater and others about why the company has allowed this to happen.

We do not agree that any additional financial incentives are needed on top of the ACTS approach.

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?

A margin will be needed in the retail control to ensure that companies are not disincentivised from capital investment in retail activities when it is needed in assets such as IT billing systems. Since much of this activity will be customer-facing any underinvestment could result in deterioration in service.

We agree that the single margin rule is the most appropriate way for Ofwat to remunerate companies for their investment in retail activities as

- it accounts for existing retail assets that may currently be allocated to the wholesale control; and
- allows a return on new investment allocated to retail between 2015-20.

We question how Ofwat will set this margin in cases where some capital assets are shared between the retailer and wholesaler.

We also support the safeguarding against a double return on assets, and agree that the rate of depreciation in retail assets is greater as many retail assets such as IT systems have a shorter life.

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

We agree that the SIM should be retained, but with the following modifications:

- the incentive should measure the effective resolution of customers' problems across both retail <u>and</u> wholesale businesses, as the proportionate impact of the rewards and penalties (as the level of revenue in the wholesale business is greater) could help drive further improvements for customers across all business activities. There needs to be a strong incentive on the wholesale business to work with retailers to fix customer problems.
- an increase in the rewards and penalties imposed as a result of a company's SIM score to further strengthen its role in driving improved customer service.
- a review of the current form of quantitative SIM to ensure that it continues to fix customers' problems, by addressing issues we have identified:
    - companies are sometimes reluctant to communicate with customers in case it attracts negative SIM points; and

  - the potential burden for companies to separate household and non-household customers, especially ‘all lines busy’ and ‘calls abandoned’.
- penalties and rewards should be based on the individual company performance over the period against their base year position rather than comparative analysis.
- stronger service measures to keep the qualitative SIM survey to compare company performance and deliver a reputational incentive.
- periodic reviews of the SIM to (initially) address the stakeholder concerns with inconsistency of reporting as highlighted in the horizontal audit carried out by Halcrow, and in the longer term, to ensure the SIM is sufficiently challenging to achieve any incentive rewards.

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

No. We would prefer that “added value” services such as water efficiency and customer side leak repair be the responsibility of the retailer. The provision of these services is likely to provide a greater margin for retail companies within the contestable market, therefore it could provide an incentive for customers to switch supplier. Leak repairs form part of the retailer’s responsibility for demand management, alongside meter reading and billing.

A company with an outcome focussed on managing water resources will be incentivised to manage demand through wholesale activities, which should alleviate any concerns that funding these activities through retail will lead to wholesalers ignoring water efficiency initiatives.

Retail controls for non-household customers

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

While we agree with Ofwat’s intention to ensure that the introduction of default tariffs should result in a minimum level of disruption and confusion for customers, we are unsure of what Ofwat means by ‘rolling over’ tariffs.

We would like Ofwat to ensure that customers are not automatically placed onto the default tariff but have it as a “safety net” alternative to their existing tariff to ensure that there is a maximum price/minimum service level option open to them.

It will be important to carefully consider the communication of the availability of default tariffs to customers to ensure they understand the change that has occurred within the pricing of water and sewerage charges and are able to make an informed choice. This will be particularly important for small to medium enterprises, which may not initially have choice in the early days of the new competitive market for business customers.

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

The average revenue control approach seems a reasonable way to limit the potential risks of a large difference between projected and actual customer numbers. We would want to avoid a situation when high levels of customer switching supplier had an adverse effect on bill levels.

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?

As indicated by our answer to question 23, we prefer an approach where customers remain on their current tariff and are provided with the option of a switch to the default tariff as a safety net. Therefore we would favour the use of current/historic costs to assess companies' operating 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?

A net margin allowance would give scope in the default tariff for the retailer to provide a sufficient return to investors on any capital spending on new retail assets. However, when calculating the net margin, Ofwat must reduce the risk of excessive returns and encourage greater efficiency.

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

There would need to be a level of regulatory protection with constraints applied by Ofwat if

- the costs used to identify a required margin level are not reflective of efficient costs, or
- the proposed margins indicate a company is considering a higher tariff for customers less likely to switch when the market opens.

We would like Ofwat to provide an assurance that its assessment of companies' proposed default tariffs, and the gross margins within them, will safeguard business customers.

Q28 Is there evidence that demonstrates that the costs of providing retail services to non-household customers are driven by uncontrollable changes in input process? 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?

- We agree that RPI indexation should not apply to retail price controls for households and non-households, in order to encourage the efficient delivery of retail services. However, we would like to see further consideration of the inflationary pressures in some retail costs over the price control period. With no indexation the retail price controls may be a 'blunt instrument' that could lead to a deterioration of service standards for customers.

  We do not have evidence of any input costs associated with serving non-household customers that are driven by uncontrollable factors. However we would like Ofwat to advise if any evidence is received as a result of this consultation.

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

Yes. We see little benefit in introducing an alternative system that would need to cover the same aspects of service and would effectively be GSS under a different name. GSS works as a minimum baseline for service delivery from water and sewerage companies because it has the benefit of having been developed by Ofwat in consultation with the companies and other stakeholders.

Most companies have their own service levels that meet or exceed the GSS and we would expect these to continue and improve as the companies compete for business.

We would like Ofwat to periodically review the service standards offered by companies (differentiating between the differing standards for household and non-household customers) to ensure they meet customers' expectations. As enhancements to the GSS are offered by more and more companies this could see the "baseline" service increase.

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

We would expect any incentive to be targeted on improving value for money and the quality of service for customers, along with the use of SIM to drive customer service improvements.

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?

We note that Ofwat is considering the use of the ACTS model for non-household retailers in Wales. We are concerned that this approach may be less effective in a market that lacks a sufficient number of comparators to drive further efficiency. We would like to see further consultation of this issue by Ofwat, to ensure Welsh business customers are served efficiently without the presence of a competitive market to drive this.

The alternative of using information gathered from non-household retailers in England would involve more onerous information gathering and it is unclear how the costs associated with this would be met.

Making better use of water resources

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

We agree generally with the preferred option of targeted incentives for exporters and importers of water, given that in principle, their intention is to address:

- barriers to importing that might not be fully addressed by other aspects of the price control framework.
- an import incentive (although temporary) to stimulate perceived bias to trading.

We expect these incentives to consider evidence of customer preferences relating to the security of supply, and address potential clashes between water trading and outcome delivery incentives. Examples include:

- a company that has established an outcome relating to the security of water supply may be averse to selling any of its surplus water if it wishes to be certain about achieving this outcome and obtaining any financial reward associated with it.
- the selection of incentives for water trading could also lead to perverse results. If the company has a surplus, it could be faced with two options: use this surplus to support low flow schemes or, use the surplus to get rid of/postpone an expensive resource development scheme. The potential benefits of these options could be eliminated if companies are strongly incentivised to sell their surplus to neighbouring companies.

To address these issues we propose that companies consider <u>all</u> potential options to deal with surplus water resources, and not only those that offer a financial reward. During the decision making process it is important to continue to have customer support and buy-in through the CCGs.

We think it is worthwhile to emphasise that for a company to consider a water trade, this should be based on **surplus** water resources and not on headroom, given that this is used as contingency measure.

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.

Water trading incentives need to ensure that any benefits achieved by companies are shared with customers in a transparent way. This means informing customers that their company is exporting/importing water, reassurance that security of supply will not be affected, and a share in any financial success obtained by an exporting company.

Without sharing the benefits of an export, customers may find themselves in a situation where they have responded to a company's request to reduce their water usage to maintain security of supply only to then see the water company share the resulting surplus with a neighbouring company or third party.

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

While companies should be incentivise to enter a import arrangement where this is the most efficient option to address a supply/demand issue, customers must be protected from over-paying for an import, or for a disproportionate reward a company may receive for entering an import arrangement. The evidence Ofwat uses to asses this should be measured against these principles.

Incentive rates can be informed by evidence of customer 'willingness to pay' for company actions relating to the security of the water supply.

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.

<u>Cap on total incentive rewards for imports:</u>
We agree that setting a cap on the incentive rewards for importers may prevent importing water companies from relying too much on imports to achieve the supply-demand balance, particularly if the contract terms mean the import is reduced during periods of water scarcity in the exporter's area of supply

<u>Company by company reporting against a trading and procurement code covering water resources:</u>
We agree in principle with the idea of companies reporting against such a code, as it could help to identify (and act upon) efficient and non-efficient trading practices. This code could include a template designed by Ofwat to ensure consistency across the industry. Amongst other things, the code could set out how companies might share their increased profits from selling water with their customers, for example through lower bills, and guidance about what happens with imports/exports at times of drought.

We also agree with the idea of developing a 'de minimis' criterion for a trade to qualify for a water trading incentive.

The consultation document mentions the 'de minimis' criterion, but does not appear to suggest a maximum threshold or level for trades to take place. As such, we propose Ofwat looks into a 'maximum' criterion as well, to increase the protection for both sets of customers:

- for exporting customers, to protect them against the potential negative impacts trades could have on their security of supply, and
- for importing customers, to protect them from over-reliance on imports.

Finally, the options mentioned in the consultation focus on the potential financial incentives for encouraging efficient trades. There does not appear to be any mention of how these approaches might be affected by a change of circumstances, such as if drought affects the security of supply of a company in the trading chain. This issue would have to be considered in the company's Water Resource Management Plan and may also require Ministerial guidance (issued jointly with a drought order) to set out how companies would be expected to act within existing trading arrangements were they to be affected by water resources issues themselves.

We have some concerns about how this apparent conflict between a company's business interests and customers' priority of a secure and reliable water supply will be overcome through the use of workable bulk supply contracts. We would like Ofwat to consider this further before introducing new water trading incentives.

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

We have a number of concerns about how this incentive could lead to unintended consequences for customers and the environment:

<u>The use of customer evidence to define the financial incentive</u>. We support setting the level of the reward to match customers' 'willingness to pay' (WTP), although we accept that this could result in a low incentive or no incentive at all if WTP is low or non-existent. In the latter case, we would suggest using a reputational incentive, although doing so will also have some drawbacks – it may not be strong enough for companies to change their abstraction patterns and/or may not achieve the expected results if the type of incentive (i.e. financial or reputational) is not consistent across the industry.

<u>The source of customer evidence</u>. We would like clarification on how Ofwat (and companies) will reconcile the data resulting from the WTP surveys carried out by the EA with that obtained by companies, since the methodologies and questions might be different. What happens if both sets of data have conflicting results? For example, national data could show *some* willingness to pay, whilst companies' data might show no willingness to pay for environmental improvements at all.

<u>Potential inconsistency with other incentives</u>. We accept the fact that companies need to be more sustainable in their operations and abstraction is one of the areas that needs to be looked at for this purpose. However, there seems to be a big obligation on companies to change their abstraction patterns (where they have a choice, as stated in the consultation) to avoid abstracting from sources at the highest risk of environmental damage. We question what could happen in instances when companies would require huge investment (as well as customer support and buy in) to be able to change their abstraction patterns? Would the (non) financial incentive be greater than the penalty/costs of not doing so?

While we support the principle of dis-incentivising over abstraction to help protect the environment we would also like to see companies encouraging greater water efficiency by customers, without any risk of bills increasing because the company has received a financial reward for reducing abstraction.

As stated in our response to Ofwat's consultation on wholesale incentives from 2012[2], we note that as a long term target the EA will be reviewing abstraction licences (as per proposals in the draft Water Bill) and we view the AIM as a 'stop gap' which may be withdrawn when such a review concludes.

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[2] CCWater response to Ofwat's consultation on wholesale incentives for the 2014 price review (September 2012), page 11 http://www.ccwater.org.uk/upload/pdf/ccwreswholesaleincetives.pdf

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

In principle we agree with the limits to the scope of the AIM. As the consultation document suggests, this simplification reflects the lack of robust data and scientific uncertainty regarding the flow levels and environmental damage to support a more complex system.

In responses to previous consultations on the AIM we have supported targeting areas where abstraction reduction is needed. As such, we welcome Ofwat's proposals to limit the AIM to those sources (surface and groundwater) which are more vulnerable to over-abstraction, based on the WFD criteria.

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

We suggest that Ofwat looks at the following evidence when calibrating the AIM:

- Customer willingness to pay for environmental improvements (addressing our concerns set out in our response to question 36).
- The EA's Environmental Flow Indicators (and associated baseline conditions) at the relevant sites to calibrate the flow threshold to determine if the company gets a penalty or reward under the scheme.
- We also agree with the scope to enable adjustments, to take into account events that fall outside of companies' control, such as droughts or increased rainfall.
- The penalties incurred by companies should be used to pay for remedial action(s) needed to address any environmental damage caused by over-abstraction.

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

We support the proposed trial period for this incentive where rewards and/or penalties will not be implemented. This 'adjustment' period should allow for testing the effectiveness of the available data and how it's used by companies; and to ensure that the concerns described in our response to question 36, along with any other unforeseen adverse impacts from this incentive, are identified and addressed.

We would like to see safeguards in place to ensure that customers are not penalised by the AIM. We still have concerns that if customers reduce their demand, they may be penalised (financially) more than once if companies achieve an incentive through the AIM if:

- the abstraction reduction is a result of customers being more efficient in their water use, and
- an adjustment is made either during the price control period or at a subsequent price review if the revenue forecast is incorrect and an uplift is applied, and the company also receives a reward under this incentive. This potential 'double whammy' for customers must be avoided.

The combination of these two factors would send a negative message to customers, as companies would be rewarded twice for the customers' goodwill. As a result, any benefits obtained should be shared with customers to avoid this.

6. 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. The use of a notional company analysis can act as a 'baseline' with calibration applied to reflect an individual company's circumstances.

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

As an underlying principle, the full package of incentives (industry wide and company specific outcome delivery incentives) should work together as a coherent package and not 'clash' or lead to unintended consequences. We are supportive of Ofwat's stated intention to ensure this happens.

We also agree with Ofwat's objective to conduct quantitative analysis of incentives with a view to calibrating the overall incentive package so that risks are allocated the party best placed to manage them. Our views on the allocation of risk in the cost of capital are detailed in our response to questions 43 and 44 below.

Q42 Do you agree with our broad approach to setting the Weighted Average Cost of Capital (WACC) for wholesale services, given our proposals for the remuneration of retail services in chapters 5 and 6?

We agree with the broad approach to setting the WACC as this established method is understood by investors.

In our response to Ofwat's July 2011 discussion paper on the cost of capital and risk mitigants[3], we suggested that an individually set WACC for each company (taking into account individual companies' financial structures and historical gearing levels) could be introduced. This could also involve an approach where companies propose their own cost of capital, subject to a challenge by the CCG and a benchmark assessment by Ofwat. This would similar to the menu approach for total expenditure (and capital expenditure at PR09).

This would be advantageous to customers in that
- the proportion of customers' bills that reflects the cost of capital would be a more accurate reflection of actual financing costs.
- companies' proposed cost of capital would be subject to challenge, using comparisons between companies' proposals and knowledge of market conditions. This would address the risk of companies' 'gaming' in their cost of capital proposals.

[3] CCWater's response to Ofwat's discussion paper on the cost of capital and risk mitigants (July 2011) http://www.ccwater.org.uk/upload/pdf/CCWater_response_-_Ofwat_cost_of_capital__-_FINAL.pdf

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?

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?

To address both questions, in our response to earlier Ofwat consultations through the Future Price Limits project[4], we have consistently raised concerns that the cost of capital set by Ofwat at previous price reviews has been higher than necessary to enable efficient companies to finance their functions. This is borne out by the gains companies have made through accessing equity and debt and a far lower rate than Ofwat assumed.

Customers must gain some benefit from cost of capital reflected in their bills, which results from the low risk and well understood regulation in the sector. Below we make three suggestions as to how investment risk could be better assessed to customers benefit:

- **Equity risk**. A key material component of the cost of capital assessment is the equity beta. We consider that, based on evidence of companies' achievements in the equity markets since the 2009 Final Determinations, Ofwat's assessment of risk in the WACC has been over-generous in the past compared to the equity financing companies have achieved.
  We note that in the consultation Ofwat is open to using market evidence to cross-checking its approach to the cost of equity with other approaches. We would like Ofwat to consider a revised approach to assessing the equity beta. Our own analysis points to an equity beta of no more than 0.5 (compared to 0.94 set by Ofwat at PR09). Were Ofwat to reassess the equity beta to that level, we believe that this would be a better reflection of the actual risk recognised by investors, and consumers would benefit through a reduced impact on bills.

- **Small company premium**. We also note Ofwat's intention to use market evidence to determine whether a small company premium for water only companies is justified. Company outperformance against the WACC shows that the smaller water only companies have been able to access the capital markets and achieve lower rates than Ofwat assumed. This success may be influenced by the parent company/corporate structure that several companies form a part of. This suggests that either a removal or reduction of the small company premium should be considered at PR14 for companies that have benefited from the level of risk investors have placed on companies that have the protection of a larger corporate structure.

- **Cost of debt**. While Ofwat proposes to continue using its established approach to assess the cost of debt used, we question whether an index-linked approach to setting the cost of debt (similar to the Ofgem model) would deliver greater benefits for customers.

[4] The full suite of CCWater responses to Ofwat's Future Price Limits consultations and discussion papers can be found here http://www.ccwater.org.uk/server.php?show=nav.1289

We would also welcome consideration of a ‘gain/share’ mechanism that would allow for any significant outperformance in capital financing to be shared with customers. This would help increase customer legitimacy and confidence in the sector.

7. Assessing performance during 2010-15

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

We agree that the adjustment to companies' allowed revenues for 2015-20 price controls should be spread across the next price control period and should be made on a case by case basis. In previous reviews, evidence from consumers' views has shown a preference for 'smoothing' prices across the price control period. This approach to implementing 'legacy' adjustments will help facilitate this.

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

With the exception of SIM, the legacy tools that could drive an adjustment relate to wholesale business activities so should be applied to the wholesale price control only.

We would like to see the SIM applied to retail and wholesale (with adjustments applied across both businesses) because the customer service performance measured by the SIM reflects the customer experience of both retail and wholesale business activities. Both businesses need to be incentivised to work together to fix customers' problems.

8. 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?

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

In answer to both questions, we agree that Ofwat should be setting a high bar for companies to pass before they receive reduced scrutiny of their business plans. Customers will need to be reassured that targeted regulation has not allowed companies to gain approval for their plans without appropriate checks and balances.

As 'primary criteria' companies must ensure that their plans are informed by customer views at every stage and are acceptable to customers. We welcome Ofwat's confirmation that the views of the CCGs will be taken into account. We would like Ofwat to provide more detail on its expectations for CCG reports and how they will be used in its determinations.

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 timetable is challenging particularly given that the final baselines are unlikely to be published until after the Draft Determination stage giving companies a short window of opportunity to make their menu choices. Companies that have fully embraced the outcome based approach to developing their strategies and built their business plans around customer priorities and willingness to pay evidence should have costs associated with delivering against these targets.

This should lead to an approach whereby they adjust their spending plans to fit the baseline rather than focusing their plans around Ofwat's likely assumptions.

However we have some concerns at the proposals that CCGs will be expected to revisit companies' plans following the draft determination and challenge companies' costs based on the information provided by Ofwat at this stage. We welcome the commitment to share information with the CCGs to allow them to challenge the companies' plans effectively but would expect comparative data to be made available much earlier, and in an easily accessible format, so that CCGs can robustly challenge companies as they are preparing investment proposals for their business plans.

9. Building for price reviews in 2019 and beyond

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

In the interest of minimising costs and complexity we would agree that aligning the scope of network plus to the existing business units identified though Ofwat's accounting separation work would be the most appropriate approach to take.

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

We question the cost burden involved for companies in providing this information at the current time and the limited benefit that it would bring for customers. Therefore we welcome Ofwat's intention to continue to develop its work in this area and to await the results of reforms to charging and access pricing in the draft Water Bill. A proposed date of 2017-18 for the introduction of non-binding sub-limits seems a reasonable timetable to allow the regulator to develop its approach.

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

We agree that it would be better to focus primarily on the water business in the first instance rather than introducing network management incentives for both the water and wastewater business. There are greater opportunities on the water side for gaining efficiency through best practice and it may be possible to transfer some of the lessons learnt through the process for a future incentive for wastewater network management.

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

Ofwat's approach seems a sensible way to balance the need for consistent, specific reporting against the current limited understanding of the way each company works. Refining the reporting requirements once the regulator has collected the initial information will help to make sure the most relevant information is collected. Piloting or testing any reporting requirements ahead of the possible introduction of a network management incentive in 2019 should help to iron out any problems encountered through the different styles of company information.

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?

As the objective is to obtain information that will allow Ofwat to see how each company currently approaches network management the initial information gathering should be non-prescriptive and invite companies to provide any and all relevant information. Ofwat should then be in a position to make a judgement on exactly what parts of this information they will want to specify for companies to provide. However, the regulator may wish to consider issuing a framework within which companies should report this information in order to ensure that the data is received in a manageable format.

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

No. We are not in favour of financial incentives for network management reporting as we do not believe that customers should see an increase in their costs for which they will see little or no benefit in the short term.

However we question how such an assessment will be made when Ofwat has proposed an evolutionary approach which will see initial information gathering before specific information requirements are refined. Companies who do not currently collect detailed information on network optimisation, or have access to it in the way Ofwat could require, could incur costs in data acquisition and analysis that Ofwat does not allow them to recover because the information is still deemed to be not of a high enough quality.

Rather than set incentives at this stage it may be more appropriate for Ofwat to work with the companies on a collaborative project to set out current and planned future practices.

Enquiries

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