

Gemserv response to the Consultation:
“Setting price controls for 2015-20 –
framework and approach”

March 2012



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26th March 2013

To: Stephen Beddoes, Finance and Networks Division, Ofwat

Dear Stephen,

Gemserv is pleased to respond to this critical consultation. This follows our previous response to the consultation document “Future Price Limits – A consultation on the framework” and to the “Consultation on retail controls for the 2014 price review”. In these we set out our support for Ofwat’s proposal to create separate price limits for the wholesale and retail activities of the water companies operating in England and Wales.

We believe that separate price controls are an essential building block for the establishment of a fully competitive market for business customers in England, consistent with the policy conclusions of the Government’s Water White Paper, “Water for Life” and the contents of the draft Water Bill. We support Ofwat’s approach to set two binding controls for retail customers, one for non-household customers and one for household customers, and to adapt the non-household controls to reflect the different policy positions between England and Wales. We also support Ofwat’s proposal to create two binding wholesale controls, one for water and one for wastewater.

We view the current consultation as a critical supporting element in driving the reform in the water market, delivering customers’ needs and developing a more sustainable water industry. This is an opportunity to ensure that Ofwat and the industry have a joined up approach to the price controls, market reform and sustainable development agendas. Given the Government’s intention to drive competition into the retail and wholesale elements of the water industry, it is essential that any price controls are designed to fully support this agenda and to deliver effective competition.

Gemserv is keen to share its views on how the various elements of the business architecture could be designed for the new business environment. We are ready to support Ofwat as it develops its plans for market design, governance and operational arrangements, in co-operation with the stakeholders in the High Level Group including the water companies, Defra, the Water Industry

Commission for Scotland (WICS), and the Scottish and Welsh Governments. The design of retail and wholesale price controls are integral to the overall market design. It is critical that these are designed to facilitate the functioning of the market in a way that optimises the needs of the various key stakeholders and ensures a fit for purpose set of market arrangements.

Gemserv has considerable experience and expertise in these areas as we have evolved from a company created by market participants in 1998 to design and support the code arrangements for the retail electricity markets in Great Britain. We have been at the core of many market arrangements in electricity and have built up a unique expertise that has been applied in GB gas, the environmental sector, the energy sector in Europe, and in water in Scotland and in England and Wales. In Scotland we were selected by WICS to develop the retail design for the world's first competitive retail water market. We worked with Ofwat during the development of the Customer Transfer Protocol and delivered a report on the transferability of Scottish market systems into the English market. In addition to our experience at market level, many of our staff and associates have worked at company level as strategic and operational practitioners in the utilities markets, including water. We are currently actively participating with some water companies in England to help facilitate some of the earliest switches of customers above the 5MI threshold.

1. Response and Overview

We are pleased to submit our responses to your questions in the attached appendix, but also offer the following overview remarks to place our views in context.

Retail and wholesale price controls in the delivery of the UK Government's market reform policies

The development of price controls is a key element in the overall regulatory and market design, but will need to be closely aligned with policies in the following areas:

- **Charging policies:** The Water White Paper and associated draft Water Bill proposes the abolition of the existing cost principle in the water supply licensing regime. Assuming the new Water Act is passed, development of new charging structures will need to be implemented that directly link with the wholesale price controls and default tariff arrangements.

We are concerned that the consultation document indicates that the charging structures are being designed later than the business retail market is due to be opened. Given our experience of competition roll-out in other markets, the charging structures need to be consistently designed and delivered at least one year in advance of market opening to facilitate market competition in other words delivery in 2016 for 2017. In addition, as Ofwat has made clear that metering activities can be contestable, it is essential that the controls and charging policies are flexible for those market players who wish to unbundle these activities in future.

- **Competitive market inter-operation:** We previously raised this issue and remain concerned that the documents so far issued by Ofwat are silent regarding the potential need for central market bodies and systems and for individual company preparations to interface with competitive market processes and databases.

We suggest that allowances are made in both the retail and wholesale controls for the costs of competition set-up and operation. Costs will vary depending upon the design model selected. The Defra business market competition Impact Assessments made estimates of the costs of competition establishment, which need to be reflected in the controls. Retailers will need to be able to switch suppliers on behalf of their customers and interface with settlement arrangements.

While it can be expected that the majority of costs will fall on the wholesale side, there will be retail interface costs. In other markets, allowances for competition preparation (set-up costs) have been made within the price controls, or as supplemental arrangements in addition to the controls. Similarly, other markets have decided to set up a central market body that will need to be funded. For example in the electricity market funding for central retail market operations is by way of fees levied by the body on distribution and incumbent and new entrant retail companies, which are required by licence conditions to accede to the Master Registration Agreement. We would be happy to explain the details of these and similar arrangements in the gas market to Ofwat if this would be helpful.

Currently the allowances made in the Defra competition Impact Assessments are substantially discounted values which we assume need to be recovered from market players or licence fees. We would welcome clarification as to Ofwat's current thinking in this regard.

Achieving a consistent baseline for the price controls

A critical factor in achieving a set of controls which are fit for purpose in the era of retail competition is to ensure that a consistent baseline is used in the new retail and wholesale controls. We note and are generally supportive of the approach Ofwat has defined to separate wholesale and retail activities, but believe Ofwat guidance will be needed regarding accounting separation and cost allocation.

Given the need for a consistent approach we suggest:

- A review of the baseline for retail and wholesale costs for each company to ensure that the methodology used by different water companies to allocate costs is fully consistent and includes the relevant activities defined as retail and wholesale;
- The development of a policy guidelines document that ensures a consistent basis for cost allocations between companies, between retail and wholesale activities, and between household and non-household costs;
- Appropriate allowances are made for systems and corporate overhead activities in retail costs, in order to avoid subsequent challenges to the price control structures (which occurred in other markets);
- The need to ring-fence out of area retail activities from those in-area, in order to avoid challenges over cross-subsidies; and
- Ofwat encouragement for companies to identify, within their cost allocation methodologies, which departments and staff are badged as retail and which as wholesale for the purposes of the staff costs included in the controls.

Gemserv would be pleased to discuss our views further and to contribute to work being undertaken by Ofwat to develop its price control, charging and wider market reform agendas, and would be pleased to be in touch with you further in this regard.

Yours sincerely,



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Appendix: Gemserv's Response To The Consultation

Questions

Delivering what matters – An outcome-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)?

Gemserv fully supports the principle of setting output based incentives in the new price controls. We believe that the incentives and framework should reflect customer views as well as Government policies e.g. the introduction of competition and the development of a sustainable water sector. We think the framework should be adjusted to reflect this. The opportunity exists to use the incentives-based approach to underpin delivery of policy initiatives which may not be in the water company's direct financial interest, where a regulatory framework is needed.

The incentives should therefore reflect the value of the delivery of an outcome from wider stakeholders/ from society as a whole as reflected in Government policy. As an example, water companies may need to be incentivised to promote water efficiency in order for customers to reach the Government's target of per capita consumption, reflecting views on the supply/ demand outlook for water. In energy a series of regulatory initiatives are in place to incentivise companies to promote energy efficiency and demand side management.

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?

Gemserv believes that this is a pragmatic approach that reflects the fact that the price control framework will need to be reviewed for the following price control period if a separate approach to unbundling resource management from wholesale controls is to be adopted.

Given the Government's intention to drive competition into the retail and wholesale elements of the water industry, delivery incentives can be used to fully support this agenda.

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?

Given that a new approach is being introduced in respect of the use of incentives utilising relatively new and untested Customer Challenge Groups, this may mean that some consistency and guidance across companies on the use, nature and scale of incentives is needed.

Ofwat and its Customer Advisory Panel could play a guiding role in this regard. In terms of two key Government policy areas, the introduction of retail competition, and the need to drive lower carbon usage, companies could be guided to reflect delivery against targets for these on a national basis. For example, as retail competition is expected to be delivered in 2017, companies could be required to ensure they are fully prepared to facilitate switching with a series of measures to reflect this. As all companies will be required to be ready, this could be a nationally agreed incentive.

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?

Gemserv agrees with Ofwat's approach to define retail activities and to, by default, define the rest of regulated activities as Wholesale. However, we believe that there is merit in re-stating what is viewed as a regulated as opposed to unregulated activity to ensure clarity. We are unsure, for example, of whether activities such as renewable energy and smart metering are clearly seen as Wholesale regulated activities or not.

Gemserv agrees that the core services of billing, payment handling, non-network calls, debt management and meter reading should all be included

within the retail control. All these activities were defined as retail in the price controls used in the Scottish water, gas and electricity markets.

We are unconvinced, however, of the argument that network calls should be the responsibility of the retailer, as this will require new entrants to have 24/7 call centre activities, adding to their costs with no tangible benefit and the retailer is unable to resolve the customer's enquiry directly regarding network faults. In addition, there are public safety issues involved and major events and incidences require manpower to be drawn from other areas to ensure standards of response are maintained as there is the potential that the retailer will not have 24/7 coverage. We therefore suggest that network calls are dealt with in the wholesale control, but recognition made that emergency calls may nevertheless be made to retailers which will have to be dealt with. Ofwat will need to consider requirements for appropriate emergency telephone numbers on water company communications, including customer bills, once it has settled the policy discussion on this aspect.

We agree that Trade Effluent matters should be dealt with by the wholesale business, as this is a regulatory function of the water companies.

In respect of metering services, we would agree that meter ownership and metering operation services remain the responsibility of the wholesale business, but that metering services are contestable so that retailers can exercise choice and bring competitive pressure to drive better costs and service standards. This would mean that payments are made to wholesalers for delivery of services and the meter itself, but where retailers wish to contract with others, the service can be unbundled from the core wholesale charge.

We agree that the ability to control temporary disconnections and reconnections should be the responsibility of the retail business function, as this is one of the key tools available for retailers to manage debt in the contestable market. It may be reasonable that the responsibility for debt management activities in their entirety should be assigned to the retail control and incentives provided for proactive debt management assigned to the price controls. Incumbent distribution businesses may be one of a number of accredited organisations which are authorised to undertake these activities and required to provide these services on request to retailers. A code of practice to control interactions

between retailers and accredited organisations should be developed. This would mirror the approach undertaken in the energy market, where a number of companies specialise in delivering connection and disconnection services.

Given that demand management services involve direct interaction with end customers, we agree that this activity should be focused on retail. In energy, the focus on demand management largely post-dates the lifting of price controls but suppliers are seen as the key interface to drive energy efficiency and demand reduction initiatives from Government as part of its climate change policies. In energy Carbon Emissions Reduction Target (CERT), Community Energy Saving Programme (CESP) and Green Deal initiatives all directly impact suppliers and link with smart metering roll-out, which is the responsibility of suppliers. However, demand reduction also impacts distribution businesses and there are some initiatives being delivered by distribution companies through the Low Carbon Network Fund.

As a result it is important that any water efficiency initiatives are considered across the retail and wholesale activities, with the right balance of measures and incentives deployed. In Scotland's water market a number of suppliers attempt to differentiate their services by using a proactive approach to demand side management. We therefore suggest that responsibility for demand management services should be allocated to the retailer. This does not however, preclude the use of water efficiency initiatives in distribution activities, and it is anticipated that network leakage targets would continue to apply on the wholesale side of water businesses.

Regarding customer side leaks we agree that responsibility for these should rest with the retailer to allow those who wish to offer added value services in this respect. However, we question whether there could be merit in viewing these as unregulated activities outside the price controls in order to encourage competition.

In terms of other corporate activities, including IT, we believe that an appropriate proportion of these costs should be allocated to retail if a level playing field with new entrants is to be maintained.

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 agree broadly with the scope, noting the provisos we have made about the definition of retail activities above. We believe that a clear definition of non-regulated activities should be made to ensure clarity. We note that the approach used to define retail means that all common services and corporate overheads will be contained in wholesale unless an appropriate allocation of costs is made to retail. If all these costs are included in wholesale and reflected in wholesale charges it is likely Ofwat and the companies may face a Competition Act challenge from new entrants.

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 do not have strong views on this, but pose the issue that the controls should incentivise companies to drive water efficiency. We agree that regular annual adjustments are preferable to a five year revenue correction mechanism.

We believe that explicit allowances for the costs of implementing competition should be made in the price controls and further discussion of this issue is required. Companies will need to provide registration and settlement services for the new market; in other markets this has been provided for in distribution price controls.

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

An annual exercise to forecast demand would seem appropriate. An incentive on demand forecasting accuracy could be considered, using for examples from other markets, such as the price controls for the National Grid system operator.

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

Given that an accurate base year is an essential building block, there is only limited discussion of cost allocation in this consultation. This was a major issue in other utilities markets.

We are not convinced that all companies are allocating costs between retail and wholesale in a consistent way. A further degree of disaggregation is needed between wholesale water and wastewater, and between retail activities for household and non-household sectors.

In addition, costs of out of area activities must not be recovered in the price controls otherwise the company will potentially face Competition Act challenges. We believe a full activity cost exercise is needed and a comprehensive cost allocation guidance document for companies to follow is in place.

Given the need for a consistent approach we suggest:

- A review of the baseline for retail and wholesale costs for each company to ensure that the methodology used by different water companies to allocate costs is fully consistent, including the relevant activities defined as retail and wholesale;
- The development of a policy guidelines document which ensures a consistent basis for cost allocations between companies, between retail and wholesale activities, and between household and non-household costs;
- Appropriate allowances are made for systems and corporate overhead activities in retail costs, in order to avoid subsequent challenges to the price control structures (which occurred in other markets);
- The need to ring-fence out of area retail activities from those in-area, in order to avoid challenges over cross-subsidies; and
- Ofwat encouragement for companies to identify within their cost allocation methodologies, which departments and staff are badged as retail and which as wholesale for the purposes of the staff costs included in the controls.

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?

Given the comments made about contestability of metering and connections, we would propose that these should be excluded from the general models and separately treated in the controls. If new entrants are to be allowed to use third parties for such services, the ability to unbundle the costs of these services should be provided in these controls. We also think that corporate overheads should be separated from wholesale costs, as an appropriate element of these needs to be allocated between wholesale and retail activities.

A further issue which we would raise is that Ofwat was earlier planning a separate sub-control on resources but has moved away from this approach. How will charging policies work where a retailer brings its own water resources? Should water resource costs be unbundled from the core wholesale (network) charges?

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?

Whilst we are not a water company, we would point out that there will be a need for market arrangements to facilitate competition. These may include both company based and central market costs which need to be accounted in advance and as market reform is implemented in 2017.

We previously raised this issue and remain concerned that the documents so far issued by Ofwat are silent regarding the potential need for market arrangements, including the likely need for expenditure on competition at market level and at individual company level. We suggest that allowances are made in both the retail and wholesale controls for the costs of competition set-up and operation. Costs will vary depending upon the design model selected. The Defra business market competition Impact Assessments made estimates of the costs of competition establishment that need to be reflected in the controls.

For cost performance incentives

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.

Competition costs need to be separately accounted for, but as they are new costs they will need to be separately assessed. Any costs of corporate overheads which should be allocated to retail activities should be excluded.

Retail controls for household customers

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

Gemserv believes that the new price controls should be based upon a consistent view of costs, with an appropriate set of cost allocations applied. We understand that historic costs have been compiled with some variability in accounting treatment. We therefore proposed that a baseline year for household retail costs should be consistently calculated, using the agreed definitions of retail as set out in this consultation when finalised. We also believe that three other factors should be carefully accounted for:

- A consistent view of corporate and other overheads be applied, including allowances for IT;
- Household and non-household costs should be separately accounted for; and
- Any costs for out of area activities should be excluded.

We suggest that Ofwat consider that the basis of the ACTS should be household costs in order to avoid accusations of cross-subsidy from new entrants. Otherwise expenditure in-area or out of area on marketing activities could be fully recovered from the captive customer base.

We agree that using forecast costs could have some disadvantages and would suggest a consistent, correctly allocated baseline year would be preferential.

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 that making appropriate adjustments for different levels of metering penetration will be important, if the controls are to avoid providing perverse incentives against further roll-out of metering. We note for further consideration that the costs of dumb and Automatic Meter Reading/ smart metering are significantly different and raise the question of whether a further adjustment should be made to reflect this and to ensure no bias against more advanced metering.

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

Yes, with the provisos of the comments made in the previous answer. Overall, there should not be significant regional factors in assessing the costs of metering.

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?

We think that a recalculated set of base year costs should be undertaken and the issue then considered. If there are very large differences in ACTS then a glide path perhaps over the period of the control would be a reasonable approach.

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

This could be done by use of an incentive mechanism to combine improved cost to serve and improved customer satisfaction (to ensure costs are not cut to the detriment of customer service).

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 that it is sensible to allow for a retail margin in both the household and non-household price controls but without adding to the total cost base of the

companies. This will need to be linked with Ofwat's consideration of a revised basis for calculating wholesale charges, following the expected abolition of the cost principle in the Water Bill. In order to avoid over-recovery of returns, a calculation will be needed regarding the returns on the retail element of the Regulatory Capital Value and this will need to be netted off any retail operating margin.

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

The service incentive mechanism (SIM) has been a helpful tool to encourage good customer service for households and should be retained. An option exists to link performance on the SIM to the incentive mechanisms to be introduced into these price controls.

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

We are not sure that this is appropriate given that these could be viewed as retail services for end customers. If the approach is extended into non-household customers this could become anti-competitive and a barrier for new entrants.

In the energy market it has been difficult to ensure that the right incentives are in place for companies to invest in energy efficiency measures. If in the water market water efficiency measures are funded from the retail control, there could be a limited effort made to increase water demand management from the relatively modest level implied in the historical average cost to serve. In practice, if the Government/ Ofwat require companies to increase efforts in this regard a special allowance could be made in the price controls. Special arrangements have existed in the energy market with the CERT, CESP and Green Deal schemes. As a key player in the Green Deal arrangements, Gemserv would be pleased to provide more information on these schemes for Ofwat if requested. Defra, Ofwat and the companies need to define requirements for a water saving policy over the years of the control, and Ofwat needs to reflect these requirements in any adjustment to the average cost to serve.

Retail controls for non-household customers

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

As in the household market we believe that costs should be appropriately allocated in a consistent way to ensure that the foundation of the market is sound and not open to subsequent challenge. If it can be demonstrated that existing tariffs are based upon a sound foundation, including a share of overheads and excluding costs incurred out of area, then these could be used as the basis of the default tariffs. If not, adjustments should be made to the base year and the default tariffs should be based upon these revisions.

We agree that, in principle, default tariffs should be based upon a published set of wholesale charges, plus operating costs and a retail margin. We note, however, that a new set of wholesale charges will need to be put in place once the Water Bill has passed into law. Default tariffs need to be consistent with these.

As in our earlier response, we think that Ofwat needs to ensure a consistent charging structure for wholesale charges between companies and to standardise the approach. This will simplify the arrangements for new entrants and for the industry in its future settlement arrangements.

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

We support the view that retail price controls should be lifted once competition can be demonstrated to be working and self-sustaining. In the meantime we broadly support the methodology Ofwat has proposed. In other markets, however, incumbent companies suffering losses have not been able to recover their total costs against the whole customer base, and at SME level a set of published tariffs was retained for a number of years into the competition period.

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 in the household sector, we favour an approach which uses the finalised definition of retail, ensures a consistent allocation of costs by companies

between household and non-household activities, excludes costs incurred out of area, but includes a consistently defined share of overhead costs. We think an exercise should be undertaken by Ofwat and the companies to ensure a consistent baseline, and we do not think using forward looking costs provides advantages over this.

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?

As indicated earlier, we support a set of default tariffs built upon a consistently structured set of wholesale charges, correctly calculated retail operating costs with an appropriate retail margin. As all historic capital associated with retail has been included in the overall RCV to ensure that companies are not remunerated twice, it is necessary to calculate the return already provided for on the non-household element of the RCV and ensure this is netted off from the allowed retail margin in the non-household price control.

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?

We think Ofwat should set an expected level for non-household retail net margins, using evidence from net margins in the Scottish water and energy markets.

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?

We do not think there should be uncontrollable unforeseen costs, and the controls should be based upon companies' views of relevant efficient costs of providing non-household services. However, two other factors should be considered. The first is that the costs of setting up for non-household competition is allowed for and accounted for appropriately. These may be central market costs or local costs depending upon the market design chosen.

Most of these costs would probably fall in the wholesale control. The second is that costs incurred by companies in setting up and competing out of area should be excluded from the price controls.

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

Yes this seems appropriate but it would seem sensible to consider alignment of the GSS standards between England and Wales and the Scottish market in this respect.

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

We note that a strategy paper for water in Wales is in preparation by the Welsh Government and this should provide input. A SIM style approach linked to incentives could be considered. Given that Wales may not have a competitive market, there should be specific measures informed by customer research.

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?

A costs challenge based upon the costs of competitive market retailers in England would help to spread the benefits into Wales. A service challenge replicating some of the innovation undertaken in the competitive market could also be added (e.g. variety of payment methods, online billing and payment rewards etc).

Making better use of water resources

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

Gemserv supports Ofwat's approach towards implementing water trading incentives over the price control period. We note that these include incentives for exporters, incentives for importers and the phased introduction of a simplified AIM. We think these are pragmatic moves which will in time be replaced with a more wide-ranging reform of abstraction licensing. We note that at present water resource pricing is based upon an administrative cost which does not reflect the position on water resource scarcity. Clearly there could be a

number of approaches developed to tackle this in the medium term, including the use of more tailored resource costs reflecting the relative scarcity of water in a particular location (shadow price approach).

In terms of making progress with the AIM, we note that the availability of a database of water resources, starting with sites designated by the Environment Agency (EA) as Water Framework Directive “Band Three” sites, would assist Ofwat and the EA as they study these issues and implement the AIM. We would be delighted to advise Ofwat and the EA on how such a database could be structured and developed.

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.

In order to offer a view on this we would need to understand in more detail the costs (resource and transportation) of an export project, and the potential revenues and margins available. We would be pleased to participate in further evaluations of this.

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

We observe that this would be a temporary incentive designed to reduce the behavioural and cultural barriers to trading. Companies should be encouraged to set out in their water resource management plans their needs for additional resources which could be reflected in imports and export potential. As companies should be selecting the most cost effective overall sources of supply, we think transparency of costs of different supplies coupled with a modest trading incentive only would be appropriate.

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 understand Ofwat’s concerns and support the proposal that each company should report against a trading and procurement code covering water resources. Genserv has experience in developing codes elsewhere which could be utilised if required.

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

We agree with Ofwat's pragmatic approach and preferred option for introducing the AIM. We believe the proposal to run this as a shadow AIM for one year will help build understanding of the mechanism before going live with the incentives.

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

An initial reduced scope of the control is sensible but, in due course, other factors can be added when better data is available leading to a more calibrated approach.

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

We would suggest using EA as the independent source of such data.

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

We agree with starting with the worst 50 sites, but then suggest a review and to extend the mechanism to a further tranche of sites. We would be happy to support Ofwat/ the EA if support is needed to manage a database of sites and act as an independent agent.

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?

We agree.

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

We agree.

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 agree that the approach for setting the WACC for wholesale services seems correct.

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

We think that the possibility of unbundling metering from the wholesale controls should be considered.

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 noted and agreed with the concerns expressed to Ofwat's Chairman about the high levels of gearing of some companies, as reported in his recent lecture. We think the regulator has a responsibility to ensure that the financial structures adopted by the companies are compatible with the innovation and competition initiatives which the UK Government has assessed will deliver benefits for customers.

Assessing performance during 2010-15

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

Gemserv agrees that, as most of the adjustments apply to wholesale activities, they should be made to the wholesale controls. Regarding the adjustment for SIM, assuming this significantly impacts retail costs calculations, we do not have any evidence to disagree with Ofwat's proposal to make this adjustment to wholesale controls.

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?

We think that Ofwat's criteria needs to have a clear assessment that the baseline costs upon which much of the controls are based have been correctly calculated. Each plan should also contain details of the actions and expenditures planned for setting up the fully competitive business market in 2017.

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

We suggest that Customer Challenge Groups, as they are new and facing this as a first time activity, may need support from Ofwat in determining how to assess the company's business plans. Ofwat may find it useful to interact on these matters with new entrants and business customers to ensure that the plans are challenged by important new stakeholders of the distribution businesses.

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?

We agree that the timetable set out by Ofwat is challenging but is achievable.

Building for price reviews in 2019 and beyond

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

No, we think that metering activities should be split out so that the opportunity to unbundle this from the network controls can be realised. We also believe that there should be greater clarity as to the treatment of corporate overhead costs, including IT.

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

We agree that implementing an indicative network plus sub-limit during 2015-20 will create greater transparency around the costs and revenues associated with network activities. This should assist Ofwat in its work on charging structures, which we note will need to be developed in advance of the opening of the market in 2017.

Regarding cost structures for network plus we would urge that a consistent approach is undertaken across the companies, and that companies should be required to publish a schedule of charges using a consistent structure. This will facilitate new entry and reduce complexity of systems development and interoperability. These are key factors in designing a functioning competitive market.

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

Yes. If the UK Government's ambitions for water resource competition and Ofwat's plans for water trading are to be realised, water resources need to be separately accounted for. We also agree that in order to move forward with the OFT sludge recommendations, it is necessary to separate sludge from wastewater network costs.

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

We strongly agree that there is a need for companies to report consistent and specific information. We believe Ofwat needs to set out clear guidance on activities and cost allocations, beyond the principle level.

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?

Ofwat needs to assure itself that all companies are adopting a consistent approach to costs and note which activities are included in network management. A set of KPIs on network management should, in our view, be developed so that efficiency calculations and benchmarking exercises can be undertaken.

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

We share concerns with some respondents that incentives are needed for this purpose, as it would be expected that such data is needed by companies to manage their networks.