Northumbrian Water Limited response to Ofwat consultation: 'Setting price controls for 2015-20 – framework and approach'

Overview

Introduction

We welcome the opportunity to comment on Ofwat's proposed methodology. Our response builds on the comments we made at our one to one meeting with Ofwat on 15 March and takes into account discussions at the recent retail and wholesale workshops, which we found very helpful.

Generally, we support the aims of the draft methodology. However, there are two significant areas where we do not agree in principle with the proposed approach and where we believe changes are required. We also have concerns about the lack of detail in the methodology at this late stage in the process and the deliverability of such a wide range of complex new approaches in the time available. This introduces significant risk and uncertainty to the execution of the periodic review. Our main concerns are summarised below.

Main concerns

<u>Calculation of Average Cost to Serve (ACTS)</u>
The approach proposed to the calculation of ACTS for the household retail control is inappropriate. The use of a new denominator for retail properties served, which has not featured in previous consultations, results in a major bias in favour of Water only Companies (WoCs) and some customers paying more than they should.

We believe the approach, which would result in WaSCs being unfairly treated and significantly under-funded for retail activities, is demonstrably wrong in principle. We understand that this view is shared by all Water and Sewerage Companies (WaSCs) and many WoCs. It is essential that the approach is amended to introduce a robust and fair approach for companies and their customers.

We explain our reasoning before our response to question 15 (as there is no specific question on this in the consultation).

<u>Proposal not to index retail costs</u>
We strongly believe that retail costs are subject to input price pressures and this should be recognised in some way in price controls. We are pleased that Ofwat appears to be open to evidence in this respect. Our views are set out in our response to question 19.

<u>Scale of workload and short timescale to execute the periodic review</u>
Ofwat proposes to introduce a number of new approaches, which are significant and complex (e.g. regulation by outcomes, delivery incentives, four price controls, totex and menu regulation). These and other approaches are mapped out at a high level in the consultation document and there remains significant work to do to convert these into practical and implementable methodologies.

The draft methodology does not address a number of important areas, some of which may be covered in the forthcoming business plan information consultation. For instance, Ofwat has not been clear about the continuance of serviceability as a regulatory mechanism.

Similarly, the draft methodology does not contain any details of the approaches to be adopted for cost assessment. It is important that these approaches and the associated data requirements are adequately covered in the business planning consultation so that companies can factor this work into their project resource plans.

Following publication of the draft methodology, Ofwat signalled its desire to move the business plan submission date forward to early December, while at the same time indicating that publication of draft business planning requirements has slipped until after Easter. For the process to be workable it is important that there is no further slippage, with business planning and cost assessment data requirements being clarified as part of the consultation in early April.

The workload and very tight timescales, both for Ofwat and the industry, introduces significant execution risk.

<u>Comparability of data for cost assessment</u>
It appears Ofwat will require certain information from companies to populate cost assessment or comparative efficiency models, though there is no clarity about this at present. We have concerns that late specification may present companies with difficulty in providing data in the format Ofwat requests it, or in the timescales required. Although well managed companies will have a wealth of good quality management data available, this will not necessarily be produced to the same specification across the industry whereas, for comparative assessment purposes, the ability to make like for like comparisons is key.

Company-specific issue: pensions

We have a company-specific issue regarding the treatment of pensions for Northumbrian at PR14. This requires further discussion with Ofwat in the context of the new price setting methodology. In general, we accept that pension costs should be included in the totex approach. However, it should be recognised that we are in a different position to other companies.

At PR09, Ofwat adopted a standard approach to calculating the allowance for pension deficit contributions. However, in an effort to avoid increases in bills that might prove to be unnecessary depending on market conditions, we adopted a different approach in our business plan, which was discussed with Ofwat and accepted. Consequently, our allowance for pension deficit recovery was significantly lower than for other companies and resulted in lower prices for our customers in 2010-15

This course of action was taken on the understanding that the company would not be disadvantaged should the difficult conditions for pension funds persist, resulting in the need for an additional allowance at PR14. In our view, companies should not be penalised for aiming to manage pressures on customer bills and we believe it is only reasonable that our regulatory allowance for pensions is placed on the same footing as other companies. We would welcome confirmation of this principle from Ofwat, and the opportunity for detailed discussions on the options for achieving this outcome in conjunction with the new price setting methodology.

Conclusions

Our main concerns are summarised above and our detailed comments on each of Ofwat’s questions follow this overview.

Our intention has been to make this response as helpful and constructive as possible. Where we feel there is a more appropriate way for Ofwat to achieve its aims, we have proposed an alternative approach and explained our reasoning.

We feel there are several technical areas where Ofwat could simplify its approach and make the overall task easier for all parties. We have noted where this is the case.

We are happy to correspond or meet with Ofwat to provide further information about our response or help Ofwat develop its approaches further.

Response to consultation questions

Delivering what matters – an outcomes-focused approach

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

We are supportive of an outcomes-focussed approach, with outcome delivery incentives that reflect customers' views and priorities. The illustration of the incentives process in figure 2 of the draft methodology document is particularly useful in helping us understand the approach and communicate it to the Customer Challenge Groups (CCGs).

We generally agree with the process as outlined, though further clarification of the approach concerning delivery incentives is essential to allow this area of business planning to be properly progressed. This is a new and complex area requiring careful consultation with the CCGs and our Board and timescales to do this are becoming very short.

From updated information shared by Ofwat at the retail workshop on 1 March 2013, we understand companies' business plans now need to be developed, discussed with CCGs, approved by Boards and published by early December this year. This means we need to be finalising our proposals in late summer, only six months away, ready for Board endorsement and production of the document. Time is extremely tight.

It is our intention to produce a targeted and evidence based business plan that is acceptable to all our stakeholders. However, there are certain crucial aspects of the plan that are heavily reliant on information about Ofwat's methodology that we do not yet have, including particular aspects of the approach to delivery incentives.

It is important to understand by April 2013:

- Which of the legacy regulatory incentive mechanisms (delivery penalties) will remain in place for 2015-20 (eg. serviceability shortfalling). This is necessary to enable companies to decide if there is already a satisfactory incentive mechanism in place that obviates the need for a further incentive.

- What core (or consistent) outcomes, measures of success and delivery incentives will be applied across all companies, if any. We would wish to avoid spending time developing and consulting on delivery incentives in any areas that will, ultimately, be specified by Ofwat.

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

We strongly support long term planning of the delivery of benefits, where there is data and knowledge to support this. For example, delivery may be phased over more than one period to manage the impact of expenditure on customers' bills or to take account of delivery constraints. In such cases the proposal to deliver over more than one period needs to be recognised at the price review but it is not essential that incentives are set beyond the end of the first period, at this stage.

An example of this is our developing proposal to further reduce drinking water discolouration in the North East over AMPs 6 and 7. The scale of the work required will take longer than 5 years and phasing spreads the impact on bills.

We agree that, given the challenges in applying this new delivery incentive approach, the most appropriate and pragmatic way forward is option 1 – using regular short term incentives. In many cases, and as in the example described above, this may coincide with the end of a review period even though delivery of the outcome might continue into the next period. Adopting option 1 does not prevent companies from proposing the delivery of outcomes phased over more than one control period. We support Ofwat's suggestion that companies may wish to pilot longer term targets.

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

Areas where cross-industry comparability is required do lend themselves to requiring consistent measures, performance commitments and incentives. The service incentive mechanism (SIM) is an example of a measure requiring comparability.

There are some areas of service that are common across companies and could lend themselves to common performance metrics and delivery incentive design, though common performance commitments (i.e. targets) may be a step too far, as all companies are at different starting positions and outcomes should reflect customers' requirements, which may differ.

Existing KPIs published annually by companies with their Risk and Compliance Statements, and a number of serviceability indicators, may fit into this category and could be adopted across the industry with common delivery incentive design. This would also assist comparisons of service across the industry.

We are happy to develop our own metrics and incentives. However, if Ofwat does intend to set consistent performance incentives, it should signal the measures in this category by April 2013 to avoid wasted work for companies in developing their own approach.

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 majority of the proposals, in particular the allocation of meter ownership and trade effluent monitoring to wholesale.

Assuming demand-side water efficiency and customer side leaks are defined as helping contestable customers use less water to reduce their bills, we agree that these should be retail activities. The retailer has the direct relationship with the customer and this will be a key value-added service offered by retailers. Clarity about what should be included in the default service level regarding these services is required.

We understand Ofwat's desire for these services delivered to households to be allocated to retail, in a similar way as for non households. If the wholesaler requires water efficiencies to be achieved, for example as part of Water Resource Management Plan requirements, it should be possible for the wholesaler to contract with the retailer to deliver those services. We welcome Ofwat's support for this approach at the recent retail workshop.

Provided such payments from wholesalers to retailers can be classed as offsetting part of the ACTS in some way (e.g. negative opex or opex contributions), then there should be no disincentive for the retailer to promote water efficiency for households.

We do not agree with the attempt to split developer services between wholesale and retail. The customers for developer services are very different from customers for water & sewerage services. They receive a different service that requires direct contact with the wholesale business, as it is network related.

Allocation of these costs between wholesale and retail has not been attempted to date in the accounting separation work and could be very complex. The consultation does not say whether all developers would be treated as non households (in which case a default tariff would be difficult to derive).

If the allocation is to non households, we do not see how developers could switch to another retail licensee. In our view, most retail licensees are unlikely to want to deal with developers, unless they are also a Self Lay Organisation – this approach would effectively be introducing a barrier to entry.

In our view, the existing self lay approach is a much more appropriate way to introduce choice for developers as it is already tailored to the service provided.

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?

As we have noted in our response to question 4, we feel there should be some areas allocated to wholesale that are proposed to be partly retail.

We think the wholesale revenue controls should apply to total regulated wholesale business revenue.

We note Ofwat propose that developer contributions recovered through connection charges and infrastructure charges are to be treated as income in the revenue cap. However, Ofwat do not mention the associated developer contributions under the Discounted Aggregate Deficit (DAD) calculations. For completeness, we suggest that these should also be included in the revenue cap.

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 welcome the removal of the tariff basket and the inclusion of larger users in the overall revenue control. We also welcome Ofwat's proposal to take into account the variation in costs due to varying demand (the revenue yield). We also agree that the whole mechanism should be symmetrical. The proposal for an in-period revenue adjustment for demand variations instead of the current Revenue Correction Mechanism (RCM) is welcome in principle, although there are some technical issues to address.

We note that, under a revenue control mechanism, customer charges will not be as predictable as at present and communications around this will need to be handled carefully by companies.

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

We feel that there should be a revenue yield element for sewerage as with water. There are material short run variable costs from providing sewerage services that can be calculated from accounting separation data.

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

This can be achieved by Ofwat using a neutral net present value (NPV) 'true-up' approach to all revenue variations, for the full 5 years of revenues, similar to the approach for Capital Expenditure Incentive Scheme (CIS) and RCM.

Cost Assessment

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

Whilst we generally agree with the process, we do have some specific concerns.

Ofwat refers to advanced econometric models and models based on previous approaches. Ofwat state "we do not propose sharing details of the models at this stage". At previous reviews, Ofwat models were made available and this added to transparency.

Without having access to the models, companies have no way of assessing their fitness for purpose which, in turn, creates regulatory uncertainty. We believe it would be appropriate for Ofwat to commission independent assurance of its models. Greater transparency on cost models would also assist CCGs in challenging company cost assumptions and proposed efficiency targets.

There are also practical concerns over data availability for the models and the timing of data provision. The late specification of required 'cost data' and the short period to provide this data (around six weeks), creates concern that data may be poorly specified and may not, in practice, be available in the same format from all companies. Difficulties with data availability or comparability could potentially impair the reliability of the models.

We would welcome confirmation that, in adopting a totex approach, Ofwat is moving away from the traditional approach of adopting a base year for operating costs. This has implications for the way information is presented in business plans.

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?

Previous econometric models have excluded non-controllable costs such as abstraction charges and business rates. These exclusions should continue with the excluded costs simply added back to the post assessment costs.

Enhancement capex costs do present a potential problem for an econometric model as all companies will legitimately have different levels. It is likely that these will have to be excluded from the models and assessed in a different way.

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?

We do not support a culture of special factor creation and believe that Ofwat should be very wary of recreating a special factors' 'cottage industry'. However, it is important not to place undue confidence in models without regard to their statistical reliability. We would support an appropriate tolerance level adjustment to cost variations, taking into account the statistical reliability of the model and the fact that companies' costs may vary, to an extent, due to their operating environment. This kind of approach has been applied in the past, and has the advantage of transparency and simplicity.

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.

We agree there may be some costs where the cost, timing or output is too uncertain to include in general performance incentives. This could apply to enhancement capex or opex.

Cost Recovery

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

We were surprised to see this proposal in the draft methodology, as a split of the RCV to 2015 between the water and sewerage service already exists. This was used by Ofwat at PR09 to set the indicative water and sewerage price limits. This is shown in Report 9 of the PR09 Financial Model.

This RCV split was meticulously calculated by Ofwat based on the capex since privatisation. Each Periodic Review, the 'opening RCV' letters from Ofwat (e.g. the letter from Robert Lee: 9/12/08) give a water/sewerage split. This split has been used to set customer bills since that time. Not to use this split seems to us to cause extra work that is not necessary.

In our case, the proposed methodology in the consultation paper would result in a transfer of £80m from the Water RCV to the Sewerage RCV, causing incidence effects simply due to using a less robust allocation than previously.

We do not think such a change is necessary, or warranted, when a well established split already exists and is in use.

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

We agree that simplification of the tax calculation at price reviews is possible and should be pursued. The majority of the tax calculation relies on the capital allowances pools brought forward, which the companies can average in a simple way. We strongly agree that a single rate for the capex post 2015 for each service is a helpful simplification to an area that has a non material impact.

Ofwat is correct in noting that below ground assets will have a different tax allowance and will require analysis on a company by company basis.

Retail controls for household customers

Calculation of ACTS

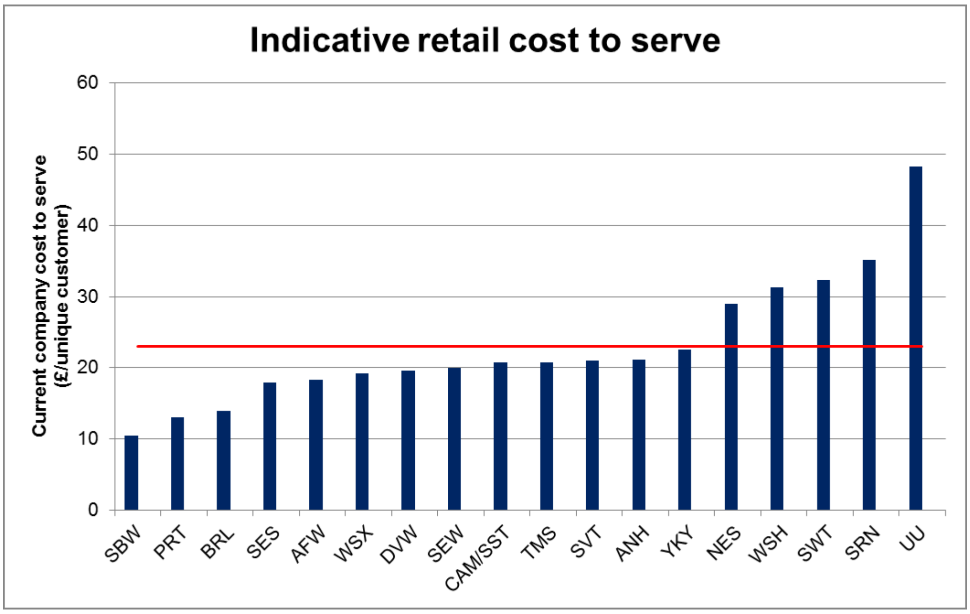
We have a serious concern about Ofwat's use of the unadjusted number of unique customers as a denominator for setting ACTS. In the July 2012 Retail consultation, Ofwat set out four options for the denominator:

Option 1: Number of households billed for water
Option 2: A two averages approach for WoCs and WaSCs
Option 3: Households billed for water plus households billed for sewerage
Option 4: Option 3 with an adjustment factor for economies of scope of joint billing

NWL favoured Option 4 and we understood that, when Ofwat collected the number of unique customers billed, it was with a view to proceeding with Option 4.

Instead, Ofwat has simply used the total number of unique customers as a denominator. This was not included in any of the options above and appears to have been suggested by one water company. Indeed, at the recent retail workshop, that water company recommended an adjustment for bad debt such as we propose.

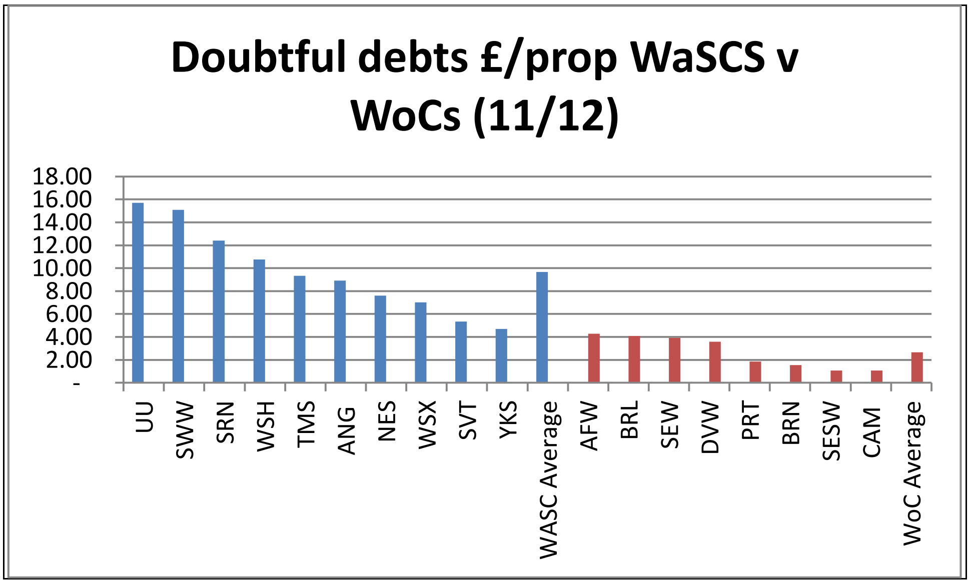
The flaws in Ofwat's proposal are best illustrated by the graph presented by Ofwat at the City Conference in January 2013:



Using Ofwat's proposed denominator, there is a clear bias towards WoCs. In this flawed analysis, eight of the nine lowest cost companies are WoCs whilst the nine highest cost companies are all WaSCs.

The problem lies with the denominator (the 'per property' figure) in the ACTS calculation, which simply counts a combined water and sewerage customer as 'one', the same as a water only customer. This misses the critical point that, when one customer does not pay a combined water and sewerage bill, bad debt costs are around double those for a water only bill. Given that bad debt costs make up 40% of household retail costs, this is a significant issue. Whilst Ofwat is correct that billing itself should not be significantly more costly for a water and sewerage bill, retail costs are much more than just billing costs.

The graph below demonstrates the variation in bad debt between WaSCs and WoCs.



For 2011-12, the average bad debt per property for WaSCs was £9.68 and the average for WoCs was £2.67.

This points towards applying an adjustment factor in line with Option 4 in the original consultation – an approach supported by the majority of respondents, including CCWater.

Case study from a customer point of view

Assume ACTS = £25 (same for water only and combined water/sewerage)

Customer 1 – receives separate services, with retail costs of £20 each. As each of these are below the ACTS of £25, they are judged efficient. Customer 1 pays £40 in total.

Customer 2 – receives a single combined service, total retail cost £30 (including bad debt costs for both water and sewerage). As this is above the ACTS, it is reduced under an efficiency adjustment. Customer 2 pays less than £30 in total.

Thus, we arrive at the position where a £40 total cost is judged efficient, whilst a £30 total cost is inefficient.

This is a clear illustration of the illogicality of Ofwat's current proposal – some customers would receive prices that are higher than they should be and some lower than they should be, depending on whether they were supplied by separate or combined suppliers.

In conclusion, this approach is not supportable; it is illogical and would result in WaSCs being unfairly treated and significantly under-funded for retail activities. It would also generate inequitable prices for customers. It is essential that the approach is amended to introduce a robust and fair approach for companies and their customers.

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

The ACTS should be based on historical data. This is because using forecast costs for company comparisons would be unreliable. The methodology should make it clear which year is the base year for the ACTS calculation. We are assuming this will be 2013/14 but this will require the rapid use of costs and property figures produced in June/July 2014.

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

We agree with the principles that the impact of the factor must be material and it must be outside of a company's control.

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

We agree that the ACTS will need adjusting for the level of metering. We also agree with Ofwat's preferred option of adjusting retail costs before calculating the ACTS. Subject to reviewing the proposed calculation, we agree to the principle of basing the adjustment for metering on an allowance using the average cost of providing retail services and the level of metering penetration.

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

A glide path seems appropriate for those above the ACTS and is consistent with historic Ofwat approaches to setting efficiency catch-up targets (e.g. companies could be expected to catch up 60% of the difference between their actual position and the ACTS over the five year period to 2020).

We think there should be a positive incentive for companies to outturn below the ACTS. We do not agree that companies below the ACTS should receive an allowance based on their actual costs. A symmetrical approach could be applied with these companies receiving an allowance on a glidepath from the ACTS (i.e. the industry average) down to their actual cost. This would provide a positive incentive for being below ACTS rather than just a penalty (in the form of an efficiency adjustment) for being above.

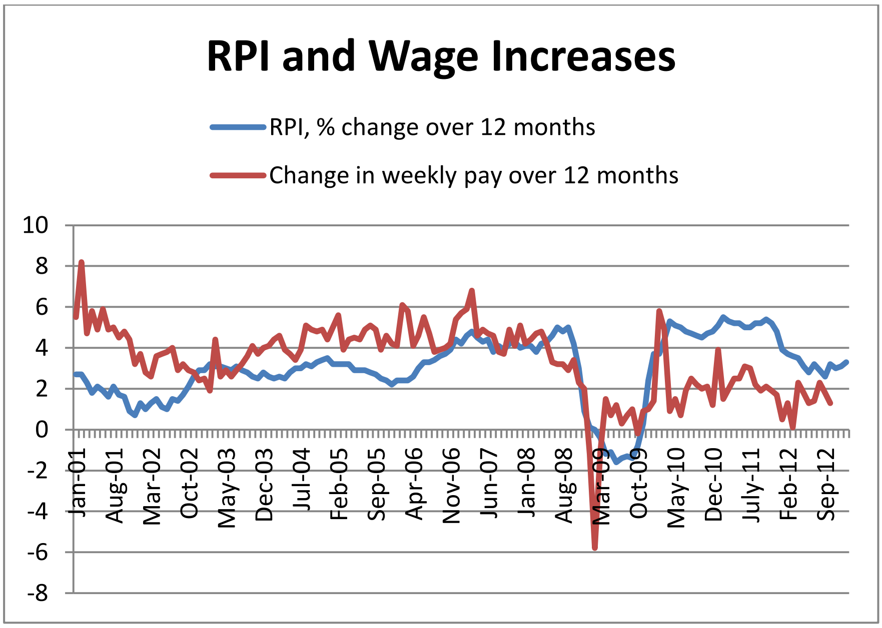
Q19 How should we set a forward-looking efficiency challenge for those companies below the industry ACTS?

Ofwat has indicated that it does not intend to allow Retail Price Index (RPI) indexation of the retail controls. Ofwat refers to the 'scope to reduce costs' and that it would 'expect efficient retailers to innovate' which are both examples of efficiencies. For a company to absorb inflationary pressures reflects a very significant efficiency of around 2-3% per year.

It is clear that retail costs are subject to input price pressures. The bulk of retail costs consist of bad debts and salaries (for customer services & meter reading).

All other things being equal, bad debt will tend to rise with revenue, the major driver being wholesale prices, which are subject to RPI indexation.

Whilst salary increases in the UK have recently been lower than RPI (during the last four years of economic recession), over the long run salaries increases tend to run higher than RPI as shown on the chart below (source: ONS data).



The chart shows that are only three months in over 12 years where there has been zero wage inflation.

The RPI is a measure of the change in prices of goods and services in the UK after the efficiencies of predominately competitive markets have been applied (i.e. RPI is a post efficiency index). Thus, any forward looking efficiency challenge would be double counting if it were applied alongside the absorption of inflation as proposed.

In conclusion, we favour the third option referred to in Section 6.5 – a pre-set measure for indexing efficient household retail costs that recognises input price pressures. However, this may take the form of an ex-ante real input price assumption rather than ex-post indexation using RPI or a similar index.

The input cost real price effect assumption should be kept separate from any efficiency assumption (although clearly the two will act in opposite directions).

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 agree there is a requirement for an allowance for remunerating retail capex post 2015. However, we do not yet fully understand Ofwat's proposal for a single margin approach. It is not clear to us whether this would be set at an industry level and whether there would be any adjustment for a company's forecast or actual level of retail capex. Major 'lumpy' expenditure areas such as a new billing system to improve customer service will require significant upfront investment for which a company will need to be confident it can recover its expenditure in some way. We would welcome a worked example as a way of promoting debate in this area.

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 with retaining the SIM for households. We note that the SIM, in its current form, covers both the retail and wholesale business. For households, these remain part of the same business, so retaining SIM is reasonable. If such a move was considered suitable, Ofwat may also take the opportunity to review sample sizes as currently they are small and on the low end of statistical robustness.

We also support moving towards a qualitative only approach to SIM. This, as well as being outcome-based, is the better measure of customer satisfaction. Care would be required to ensure surveys are robust and repeatable.

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

We agree with this proposal. As Ofwat states, requirements for further water efficiency expenditure will be driven by supply/demand balance requirements, which is a wholesale duty.

Retail controls for non-household customers

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

We agree with this approach. This is because it will minimise incidence effects and allow company specific cost reflective tariff structures to be retained.

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

We agree that, for non household retail, using an average revenue control is more appropriate than a total revenue control.

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?

Given the proposal to roll over existing tariffs, the use of company historical costs seems appropriate. Any use of industry averages or the lowest costs would undermine the market for customers switching to more efficient providers from those above the average or most efficient.

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

We agree with the use of a net margin. The non household retail market will need to be attractive both to new entrants and to customers considering switching. The current Water Supply Licence (WSL) regime has stalled, in part due to insufficient margins to attract interest. In our view, to launch a market with credibility, the margins should be significant enough to generate the interest of customers and new entrants including non water retailers. These margins are likely to be competed away under a functioning market, so they should only be temporary. The margins in the Scottish water market appear to be the most appropriate benchmark subject to a cross-check against a notional, standalone, retailers' profit expectation.

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 favour the minimisation of regulatory involvement in this area. The third option set out by Ofwat in section 6.4.3 involving companies setting their own default tariffs based on allowed recoverable costs plus net margin appeals to us as it minimises regulatory involvement and ensures that all customers are attractive for competition.

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

See our response to question 19. In addition we make the following point for non household costs:

We understand that when a market is established, input prices will be reflected in the offerings made to customers. However, there is a risk that, if default tariffs are not adjusted for rising input prices in some way, the default tariff could become lower than the market price (or even lower than the cost of providing the service). This would act as a barrier to entry and to effective competition.

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

We agree that GSS standards are a good starting point, but they predominately relate to the wholesale business, so may be insufficient to define the default retail service in full.

It might be appropriate to allow companies to define their own default level of service, which could be described as ‘GSS plus’. In this way, companies could match the default tariffs to the default service with both based on rolling-over the existing arrangements.

Q30 What aspects of service should we target in setting a service incentive for non household customers in Wales?
Q31 Are there other options for setting an efficiency challenge for non-household retailers in Wales we have not considered? If so, what are they? Which approach do you think best meets our objectives?

We have no comment on these questions.

Making better use of water resources

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

We agree with the proposals to increase incentives for water trading, with one proviso - see our response to question 35.

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

The proposed move from 30% lifetime profits retention to 50% seems reasonable. In our view, the simplest way to implement this would be to allow companies to retain revenues for more than one price control period.

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

The proposed incentive for importers appears complex. A bulk supply import should be chosen if it is lower cost than the next best alternative. The incentive to make this choice should be the retention of an appropriate proportion of the costs saved.

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 do not agree with the preferred approach for securing efficient trades. The preferred approach seems to us to introduce complexity and uncertainty. It also requires the regulator to get involved in what should be a commercial transaction between two parties. The proposal seems to offset the importers incentive against the exporters’ incentive. This undermines the exporters 50% retention incentive (see response to question 33) and could reduce the likelihood of water trading actually happening, particularly if this uncertain Ofwat intervention came at the end of a negotiating process.

As we note in our response to question 34, retention of a proportion of the cost savings should be a sufficient incentive for the importer. If this is adopted, in our view, there is no need to offset this against exporters’ profits to ensure efficient trades.

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

A single outcome incentive rate in year one (when only a shadow AIM will be used) seems reasonable. This will keep the process simple when there might be early teething problems. However, once more fully understood, a tiered AIM rate might be more appropriate. This is because in a dry year, when customer demand is high, a water company might have no option but to abstract from both the preferred and alternative source. A tiered rate would mean that the company is then not overly penalised where it has no other option.

Using national rather local willingness to pay values seems reasonable. Local data is likely to be absent or at best sparse.

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

We agree that it is appropriate to focus on those sites that are proven to be adversely affected by abstraction. Given the number of band 3 sites, we believe that it is reasonable to look at a sub-section of band 3 sites (i.e. the worse effected sites) rather than all band 3 sites.

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

Environmental Flow Indicators (EFI) are precautionary and so it does not follow that actual flows below the EFI at Q95 will always cause significant adverse effect. Therefore, evidence of effect should be taken into account when setting the AIM threshold.

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

A phased approach seems sensible given the identified uncertainties. We would suggest the following approach:

> **Year 1**
> Shadow AIM applied but companies' AIM performance is not published.
>
> **Year 2**
> Shadow AIM applied and companies' AIM performance is published.
>
> **Year 3 onwards**
> AIM applied - companies would incur financial AIM rewards and penalties.

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?

This appears to be a logical approach. Given that Ofwat intend to commence with analysing notional companies, we suggest that this analysis should be shared with the industry to test the assumptions underlying it before applying it to individual companies.

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

We agree that this is the correct approach for retail and wholesale controls. We believe the wholesale business should be evaluated as a single entity – any attempt to separately analyse the risks between the water and sewerage service would be unreliable in our view - the majority of risks arise across the services (including, broadly speaking, issues such as input prices and climate change). Financeablity needs to be considered at a whole business rather than a service level.

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?

We agree that the WACC should be used for the wholesale business.

We agree that allowing net margins for retail is more appropriate than a WACC approach.

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 agree with Ofwat's criteria on page 125: whether risks are systematic, asymmetric and what proportions are borne by companies are all important factors.

We also support the use of RORE as a cross check on the cost of equity used in the WACC calculation and to calibrate incentives.

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

We agree with the use of a financeability cross check. In our view, it is in part a cross check on whether the WACC has been set correctly. For example, a WACC that causes financeability issues for the majority of the industry has probably been set too low.

We note and support the reference to a comfortable investment grade rating and we encourage Ofwat to discuss with the ratings agencies and the industry how this might be defined.

Assessing performance during 2010-15

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

We generally agree. The CIS and the Change Protocol are primarily wholesale tools. Any SIM adjustment will have to be allocated to the wholesale business because adjusting the retail controls would be disproportionate and complex. We assume the RCM is part of these legacy adjustments and will be applied to the wholesale business.

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

Provided the spreading of adjustments is NPV neutral, this may be an appropriate approach. For example, adjustments due to the RCM are best smoothed over the five year period, as they arose over a five year period.

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?

Like any good business, we are getting on and producing a sensible business plan that is acceptable to our customers. This includes implementing a robust and innovative approach to governance and assurance aimed at giving our Board, the CCG and Ofwat comfort that our plan is robust and based on good information.

We value having the freedom to set out our plan in the way we think presents it best, rather being required to follow a format specified by Ofwat.

We strongly support a risk-based approach to scrutiny of business plans. The emerging criteria appear appropriate but, at their current state of development, remain very high level. Criteria at a greater level of granularity would be helpful.

It will be important that we meet Ofwat's expectations in terms of the level of detail submitted in, or with, our business plan to support the initial scrutiny it intends to undertake. This is especially important given there is only one business plan for PR14 (i.e.no draft as in previous periodic reviews). Therefore, an indication of the level of detail Ofwat expects to see in/with business plans would be very helpful. This will ensure the post business plan part of the PR14 process progresses as smoothly as possible.

Given the extremely tight timescales (see also our response to question 1), it is essential that there are no delays in publishing the business planning expectations consultation (which has already slipped from March 2013), or in the publication of the final methodology in June 2013.

In principle, we expect Ofwat to endorse company business plans that are well founded, supported by customers and other stakeholders and demonstrate real value to customers. In some cases, Ofwat may assess that this applies to some elements of the plan but not all.

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

As mentioned above, we support the concept of risk-based regulation. Ofwat needs to be transparent about the process for assessing business plans, applying different levels of scrutiny and requesting further justification of proposals.

In our view, Ofwat needs to take into account the level of challenge and assurance already applied to the submitted business plan through the company's independent assurance and CCGs. In this respect, as mentioned above, we are implementing an innovative approach to business plan assurance to provide our Board, Ofwat, CCGs, customers and other stakeholders with the confidence they need in our proposals.

As well as setting out the criteria for assessing business plans more clearly (see our response to question 47 above), it is important that the process for Ofwat scrutiny is clear and transparent. It is important that companies and other stakeholders understand the process that will be followed and that companies are subject to consistent challenge and decision-making.

To minimise duplication of effort and to avoid gaps, Ofwat needs to be very clear about which areas of challenge are the responsibility of the CCG and which are the responsibility of Ofwat.

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 it is not possible to draw up a draft baseline before business plans are submitted. We also agree on the desirability of companies being able to make a genuine menu choice against a baseline.

Given this, we support Ofwat's proposals for menu timetables.

Building for price reviews in 2019 and beyond

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

We agree with Ofwat's proposal to defer network plus to the period 2015-20. In our view, Ofwat still needs to make the case for this mechanism which has the potential to add significant complexity. Development in this area needs to align closely with the forthcoming Water Bill.

Q52 Do you agree with our preferred scope for network management?
Q53 Do you agree with our preferred approach to implementing network management?
Q54 Given our objectives for network management reporting over the period, what questions should be included in the first round of reporting within business plan requirements?
Q55 Do you agree with our preferred approach to financial incentives for network information reporting?

We welcome the change of focus to identifying information requirements. We think questions in the business plan reporting requirements should focus on establishing a high level understanding of how the company currently undertakes network management. We support the proposal to defer the further development of information requirements to the period 2015-20. We would support a collaborative approach to developing information requirements and incentives as our shared understanding evolves.

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Northumbrian Water - Water Efficiency, Customer Side Leaks and the Average Cost to Serve calculation – Annex to the PR14 Draft Methodology Response

The case for excluding expenditure on 'Customer Side Leaks' and 'Demand Side Water Efficiency Initiatives' from the 'Average cost to Serve Calculations (ACTS).

Customer Side Leaks

In general, industry expenditure on customer side leaks is driven by company free customer supply pipe repair policies. These vary between companies and are generally reactive – they are usually triggered by customer contact.

As part of the 2009 Periodic Review Final Determination, Northumbrian Water committed to a major programme of customer supply pipe repairs in the Dagenham area (projects database ref 7214). This was an integral part of the requirement to maintain leakage at the Sustainable Level of Leakage (SELL), a wholesale duty. Ofwat agreed with the requirement and allocated the expenditure to operating costs (as the work was on customer assets). Expenditure on supply pipes in Dagenham in 2011/12 was £1.3m (net of customer contributions).

These supply pipe repairs are pro active and deliver outputs well beyond the customer side leaks policy. Thus, NWL is delivering an obligation that most of the rest of the industry does not appear to have. We note in the PR09 Final Determination, Ofwat refer to six companies delivering enhanced water efficiency projects.

Whilst this could be taken as a case for a special factor, we prefer the approach of excluding customer side leaks expenditure for the whole industry when calculating ACTS and setting the glidepath targets, then adding back the actual expenditure. This is on the grounds that customer side leaks is not a standard obligation across the industry and cannot be compared on a unique billed property basis.

Demand Side Water Efficiency Initiatives

Whilst the whole industry appears to have been set water efficiency targets, there does seem to be very different levels of activity designed to meet them. For example, Welsh Water have not allocated any expenditure to water efficiency in 201/11 or 2011/12. Companies that have previously delivered water efficiency schemes are likely to find it harder to make further gains than those who have not.

Conclusion

In the recent PR14 Draft Methodology retail workshop, Ofwat confirmed that they would accept the wholesale business paying the retail business for water efficiency work related to the wholesale business targeted outcomes. This was in part a recognition that retailers would not themselves have an incentive to encourage water efficiency for non contestable (household) customers. Indeed, under the ACTS efficiency challenge, there could have been a disincentive to incur such expenditure.

NWL has made the case for excluding these two areas from the calculation of the ACTS in the 2012/13 and 2013/14 cost assessment years. We hope that this note explains our position, but we are happy to continue this discussion in any way that would be constructive.

We appreciate Ofwat's open mind on this issue and the way in which these issues are being considered.

Crawford Winton
Financial Regulation Manager
Northumbrian Water
March 2013