

## Setting price controls for 2015-20 – framework and approach

This is Sembcorp Bournemouth Water's (SBW) response to Ofwat's consultation.

Discussion at our company meeting has provided some assurance and clarity regarding some of our concerns but for completeness we lay them out below and throughout the response.

Before responding to Ofwat's specific questions we firstly we set out our key concerns; issues we believe seriously threaten to damage and potentially discredit the entire price review process.

These areas are:

- Timetable
- Setting the wholesale baseline
- Legitimacy to customers and CCGs
- Opacity of the process

### **Timetable**

Timetable slippage has now reached levels whereby the integrity of the process is at threat. Ofwat's reluctance and/or inability to commit to firm dates is exacerbating the situation.

Companies are continuing to engage with customers and CCGs but are nearing points where they need clear and immediate visibility of firm dates and business plan requirements to stand some chance of delivering business plans that satisfy Ofwat's expectations for a risk-based process.

Dates must be firm and Ofwat must adhere to them. Further slippage cannot be considered an option.

At its wholesale workshop on 12 March Ofwat presented options to address the increasing criticality of the slippage of the timetable and asked for companies' comments.

Option 1 – as methodology consultation

Option 2 – bring forward companies' submission dates by 1 month

Option 3 – combine menu with final determination

Option 4 – any other suggestions

We suggest:

- It may be possible for SBW to submit an 'early sight' form of its business plan at the end of November. This would be considered a draft and subject to minor

revision. Early submission would subject to early visibility of firm dates, expectations and data requirements. It is not necessary for consultation documents to be perfect. Early sight of the detail is critical. It will also be subject to being able to rearrange scheduled Board meetings.

- Board dates have been scheduled around the original timetable. To further facilitate early submission assurance processes on a draft could be deferred until into early 2014.
- We do not object to moving menu choices to the end of the process and combining them with the final determination but we are unclear how this would work in practice. Ofwat must very clearly state in advance of any decision to adopt this approach how it will deal with any changes companies may make to their own plans in light of the final determination. If all parties are willing to take this risk as a trade-off to other timetable risks the underpinning rules should be absolutely clear.

In addition Ofwat should:

- Make the process simpler and focus on 'what matters'. Allow all parties to do their part well and deliver a high quality process that reflects what customers want and need. Customers will benefit from less complexity and lower cost in the long run.
- Defer Network Plus and Network Management and remove them from the submission requirements.
- Look to make best use of the available time. For example data assurance processes involving boards can be lengthy so to reduce this burden business plan data collection should be combined with the KPI process. To do this Ofwat must bring forward publishing its cost-assessment data requirements to around early May.

### **Setting the wholesale baseline**

We have significant concerns over the process for setting the wholesale baseline. Without an accurate baseline menu choice becomes irrelevant. We support the menu approach but have not been assured by the consultation document that the proposed process will result in an appropriate and fair outcome. Discussion at our company meeting provided better assurance but for completeness we lay our concerns out below.

- The process is opaque. With no visibility of details companies are unable to comment on what may be significant factors in the modelling.
- It is crucial that baselines are company-specific and not based on industry spend. Previously the use of industry spend has created clearly perverse outputs such as WOCs being classed as inefficient when they have low bills and low spend. If company-specific modelling is not fully adopted then some of this modelling anomaly could be addressed by splitting WASC and WOC analyses.
- Ofwat intends to use forward-looking projections from companies' business plans to inform future spend. Whilst it is unclear from the consultation document

whether any changes to baselines will be based on company-specific data or industry information we now understand that Ofwat will use company-specific data. All companies will have significant differences in future spend profiles and it is essential that these are incorporated in to the modelling.

- Ofwat asks whether it can rely on companies to provide it with 'clear and compelling evidence' in their business plans. Companies will, but the timetable squeeze exacerbates the likelihood of Ofwat not having the time or resource to give this evidence the appropriate level of consideration and pass-through to any baseline adjustments.

### **Legitimacy to customers and CCGs**

It is now clear that Ofwat intends to maintain greater control of the business plan process and be less light-touch than was originally interpreted by companies and CCGs at the commencement of the FPL process.

We agree that companies should be accountable and own their business plans, but this must be coupled with being given autonomy. Ofwat cannot retain authority whilst wanting companies to assume responsibility.

At the outset it was understood that outcomes and incentives and associated business planning implications should be set and tested on the assumption that Ofwat will accept companies' proposals if customers clearly support them. As a result of this no longer appearing to be the case:

- The change to a more controlling approach will increase the perception of risk to companies considering setting themselves challenging outcomes and incentives.
- CCGs have been disenfranchised from the process. This would be helped by Ofwat providing clear guidance on what it wishes CCGs to focus on.
- The lack of available information both before and at business plan submission, and the uncertainty that proposals will be funded, is also likely to provoke caution and risk-aversion.

It is unclear how, when assessing business plans Ofwat will test itself to ensure it has the balance with customers wants and needs correct. Clarification would assist the legitimacy process.

Without it there is a significant risk of the aims of the engagement approach, namely customer focus, innovation and legitimacy will be undermined. This is likely to have a lasting effect on the reputation of the industry with customers and other stakeholders.

### **Opacity of the process**

The process is opaque and Ofwat is reluctant or currently unable to share information with companies. This is creating further challenges for companies, who are already under pressure from timetable slippage.

Examples include baseline setting; uncertainty surrounding which approaches that are being carried forward from PR09 and the evaluation thresholds for 'acceptable' plans in the risk-based review process.

- In the case of baseline setting it is very difficult for companies to make informed comments and decisions on many aspects of the price setting process; despite Ofwat requesting their input and assistance. This is undermining the quality and efficacy of the current consultation process.
- Companies are unsure what data may be needed if the risk-based review process does not rate their plan 'acceptable'. This places risk on companies of either doing unnecessary work in case of challenge; or being unable to provide data at very short notice due to timetable constraints.
- Finally Ofwat risks placing additional data burden on itself if companies over-compensate in their plans as a result of being unable to judge appropriate information levels to provide to satisfy risk-based reviews.

Providing too little will result in Ofwat requiring more information; providing too much will be a data burden to both the company and Ofwat. Either way unnecessary work will be created for both parties. Ofwat must work to avoid this wherever it can.

All parties acknowledge the timetable difficulties and it would be helpful to all if Ofwat therefore reviewed its approach and shared more information which will help companies make considered and meaningful comment and ultimately focused and appropriate business plan inputs.

## **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 welcome Ofwat's proposed framework for outcome incentives on the basis that it will create transparency in the outcome development process, and in turn reduce risk.

However the process remains complex, and made more so by the proposal for outcomes to be value-based. Whilst we agree in principal this step should be taken in the next price control.

As a first step cost-based approach will allow outcomes to be more objectively and clearly assessed than a more subjective value-based assessment unless of course a company can demonstrate that there is a clear justification for a value-based incentive.

The proposals for trade-offs are too restrictive for this first iteration of outcome incentives. To encourage learning and innovation in incentive design companies should be given more scope. To reduce risk this could be an option of trade-offs outside the constraint of the consultation proposal, but with an associated cap on incentive rates.

**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?*

- To avoid further complexity and possible unintended consequences we agree that it is sensible to restrict delivery incentives to 5 years.
- We agree with the proposal for pilot schemes with companies that can clearly demonstrate the value in a longer-term incentive. A company should not be disadvantaged by a reduced incentive within a pilot target.

**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?*

- The retention of a household SIM for comparative purposes is reasonable and will continue to drive customer service excellence.

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## 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 split of activities falling within Ofwat's 'confirmed direction' of retail definition.
- Customer side leak repairs logically sit within retail due to their customer-facing nature and the fact that the pipework concerned belongs to the customer.

However we do not understand how Ofwat foresees the issue of leakage allowances and how retailers (in particular new entrants) will be expected to either bear the cost or attempt to recoup the cost from wholesalers.

- Demand management activity should sit within the wholesale control. Ofwat's rationale is understandable but does not recognise that the greater driver is water resources management planning and therefore within wholesale.

Regardless of wholesalers deciding the 'efficient level of activity', if it is placed in retail cost pressures may lead retailers to cut back on household activities. We do not agree with Ofwat's suggestion that retailers would not view a saving of up to 8% of retail costs (by scaling back water efficiency and customer-side leak repairs) as something they would choose not to achieve, in particular if above the retail ACTS.

Neither do we agree with the proposal that wholesalers remunerate retailers for any activities above those funded in the ACTS as this adds unnecessary additional complexity.

Placing activities in wholesale which would then effectively outsource to retailers (or another organisation offering a superior service) is the better option.

## Setting wholesale controls

### General

There are many aspects of the wholesale control that are very complex and could cause volatility in customers' bills and we challenge Ofwat to consider whether even it could explain the regulatory process to customers in a succinct and easy-to-understand way. If it cannot then it should not expect companies, when challenged, to have to try to explain.

If Ofwat wishes customers to understand how companies are regulated it must make its regulatory regime simpler, in particular its approach to wholesale controls and, for non-household customers, default tariff setting.

### ***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?*

- As stated in our response to question 4, and in previous consultation responses, we believe that household water efficiency activities should reside in wholesale. This will permit wholesalers to effectively outsource activities to the customer-facing retailer.

This will avoid perverse incentives to retailers funded by an ACTS to cut back on activities that directly impact wholesale. We do not agree with Ofwat's suggestion that retailers would not view a saving of up to 8% of retail costs (by scaling back water efficiency and customer-side leak repairs) as something they would choose not to achieve, in particular if above the retail ACTS.

The alternative would be to create service level agreements between business units but this would introduce further unnecessary complexity to an already complex price control period.

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

- We do not have any suggestion.

**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 understand the logic of the proposal, therefore cannot say whether we agree or not.

The variable cost of water production is small therefore, for example, if water use is low the average cost per unit will rise. The revenue yield approach suggests it will stop this occurring.

We do not see how the two will interact to offer companies more freedom and flexibility.

- The approach appears overly complex and in need of simplification and we challenge:
  - what added value the proposal brings, and
  - whether there is evidence there is a problem to solve.

**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 do not understand why it is appropriate to use this simple approach for wastewater. Where at least 50% of a customer's bill is for the wastewater service we do not see why the two services should not be treated in the same way.

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

- We do not have any comment.

### **For cost assessment**

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

- We are very concerned at the proposal to include enhancement expenditure in the process. Ofwat intends to use forward-looking projections from companies' business plans to inform it but it is unclear whether any changes to baselines will be based on company-specific data or industry information.

All companies will have significant differences in future spend profiles and these differences must be incorporated in to the modelling.

- Even if companies provide the 'clear and compelling evidence' Ofwat requires to underpin future spend proposals, we are not convinced that due to timetable constraints Ofwat will have the time and resource to fairly assess this evidence.

We are also very unclear about how Ofwat intends to evaluate this evidence and how it will apply it. Clarification would help companies to focus on what Ofwat really wants to know.

- We are reasonably comfortable with proposals for capital maintenance but once again have concerns over the opacity of the process and exactly how the consideration of forward-looking data will work in practice.

- We are not clear on where efficiency is proposed to lie. Before companies submit their plans at the end of 2013 Ofwat needs to make clear how and where it plans to impose efficiency. For example will average or frontier cost be used for baseline setting?

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

- We would prefer that enhancement expenditure is removed from the process.
- Business rates, abstraction charges and any other cost that is a direct pass through and out of companies' control should also be removed.

Future unavoidable costs such as pension auto-enrolment pension costs, changes to National Insurance and the cost of competition should also be treated in isolation.

*How should we assess these costs?*

- Ofwat's requirement for 'clear and compelling' evidence should be enough for companies to provide what Ofwat needs for assessment, however we repeat our concerns above; that timetable constraints will mean that Ofwat will not have the time or resource to make fair assessments.

**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?*

The costs of metering should be weighted for individual levels of meter penetration.

- It is very difficult to comment on SBW-specific factors until Ofwat reveals its approach to companies.
- In the absence of information to the contrary at this stage there should be no change to previous SBW applications.

### ***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?*

- Due to the lack of clarity in the baseline setting process we are unable to provide any comment on this area.

*Please explain how these meet the cost exclusion criteria and how we should incentivise cost performance for these costs.*

- Please see previous comment above.

### ***For cost recovery***

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

- Ofwat must ensure that there will not be any significant incidence effect on the sewerage bills of water-only company customers.

By this we mean that for WASC customers the proposed split will simply mean a potential rebalance of water and sewerage elements of the total service bill.

Conversely customers paying a WOC for the water service and a WASC for the sewerage service could potentially see their sewerage bill increase (or decrease) with no corresponding effect on the water element.

This has implications for bad debt and ultimately business planning for both the affected WOC and WASC.

- We have no comment to make on selected 'point'.

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

- We agree, so long as:
  - companies are granted autonomy
  - are free to set appropriate periods to smooth effects of, for example, lower capital allowances and lumpy spend patterns, both of which tend to affect WOCs
  - Ofwat will accept the numbers in good faith.

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## Retail controls for household customers

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

- If no input cost allowance is made, in particular on salaries and pensions then forecast data should be used.

However, if input inflation factors are used then historic cost should be used, the benefit being their certainty.

**Q16** *Do you agree with our proposed criteria for assessing other adjustments to the ACTS?*

- 'Material' must be considered in the context of retail costs only, and not in the context of the whole price control.
- Any factor that can be shown to '*impact the company in a materially different way to other companies*' suggests that in certain circumstances company costs could be very different to the industry efficient cost; meaning that in these cases adjustments should be made at actual rather than the efficient cost.
- Potentially disproportionate squeezes should not be put on a company. Adjustments could be made on the basis of the efficient cost unless a company can provide compelling evidence that it should be adjusted at its actual cost.

*Are there other factors we should take into account, and (if so) how?*

- A company does not have control over underlying salary inflation. This cannot be argued-away as other retailers will be similarly affected.
- Ofwat cannot draw a straight comparison with retailers who are able to drive cost down by benefitting from the cheap production cost of imported overseas products. Efficiency gained this way cannot be compared with UK staff cost.

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

- We agree. Stripping out the industry metering costs and then reapplying an adjustment based on meter penetration and the average cost of providing retail metering services seems a reasonable and transparent way of approaching the adjustment.

**Q18** *How do you think we should apply the ACTS for those above the industry ACTS?*

- By glidepath, to avoid a potential step-reduction in the ability to provide good customer service.

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*Do you think that we should use a glide path and (if so) of what form?*

- As stated above, yes; but the form and level is subjective and we make no comment.

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

- This is dependent upon the level of service improvement expectations. Comparison should not be made against productivity with those organisations operating on a worldwide base which can benefit from cheap labour and production cost. Any considerations should be against the UK-based service sector.
- To encourage companies already below the ACTS to adopt positive behaviour in Ofwat could consider incentivising a frontier-approach where the company at the frontier received financial recognition for its contribution to driving down the industry's average cost to serve, and in turn customers' bills.

To maintain transparency and therefore avoid added complexity any such incentive should involve few adjustments, if any, to establish frontier performance.

**Q20** *Do you think we should use a net margin to remunerate household retail invested capital and risk over the period 2015-20?*

- Ofwat must be mindful that exit for any incumbent retailer is not an option, therefore must ensure margins at least equal the service sector average.

The proportion of retail assets that will lie within wholesale is very small and will be shortlived with, say, an average remaining life 2½ years. Any potential issue will be transient.

We question whether:

- Ofwat has conducted any work to quantify the extent of any potential issue, and
- whether actions to mitigate any over-recovery may outweigh the problem, perceived or not.

*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?*

- Glidepath approaches should alleviate some of the concerns.

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

- Yes; we support the retention of the SIM.

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

- No, we do not agree. As we have previously stated we strongly believe that all water efficiency services activity should lie within the wholesale control, outsourced to retailers if deemed appropriate.

In line our response to question 4 we remain unclear how retailers will reconcile the leak allowance process when wholesalers have provided the wasted water retailers have compensated their customers for.

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## Retail controls for non-household customers

### General

- Retail costs and any margin is a very small part of the overall bill, but for a customer provides a significant part of their overall experience.

Ofwat needs to avoid complicating the non-household retail control in order to try and minimise this cost and margins because in doing so it will constrain companies and alienate customers. Over-complication will result in low value for customers at a high-risk to the desired outcome of an active market.

- As suppliers of last resort (SLRs) for non-household/contestable retail customers, companies will always need underwriting and regulating. Ofwat must ensure that these SLRs are able to fulfil their functions.

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

- We agree with the proposal to roll over existing structures however it is important that tariffs will also remain recognisable to customers.

The transition to default tariffs must be transparent and involve certainty for customers. It should also not result in incidence effects.

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

- There needs to be recognition that for suppliers of last resort (SLRs) there is a fixed and variable element to customer provision. Adjustments should therefore take this in to account.
- For suppliers of last resort the cost of churn needs also to be recognised. The main cost driver in the power industry is the cost of churn, where the cost to lose a customer is significantly lower than acquiring new customers. This cost is currently not built in to default tariffs.

**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?*

- If no input cost allowance is made, in particular on salaries and pensions then forecast data should be used.

However, if input inflation factors are used then historic cost should be used, the benefit being their certainty.

**Q26** *Do you think we should use a net margin to remunerate non-household retail capital employed and risk over the period 2015-20?*

- Ofwat must be mindful that exit for any incumbent retailer is not an option, therefore must ensure margins at least equal the service sector average.

The proportion of retail assets that will lie within wholesale is very small and will be shortlived with, say, an average remaining life 2½ years. We question whether actions to mitigate this may outweigh the issue.

*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 we previously have stated in our response to question 20 Ofwat should quantify the level of perceived issue and evaluate whether the actions to mitigate any over-recovery may outweigh the problem, perceived or not.

**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?*

- None. Competition must be allowed to do its work and Ofwat must avoid attempting to regulate it.

**Q28** *Is there evidence that demonstrates that the costs of providing retail services to nonhousehold 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?***

- Salaries and pensions are outside a retailer's control, however in the competitive market competition should be left to take its effect.

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

- We agree.

To encourage market activity retailers need flexibility and setting a minimum level of service will provide them with the option to enhance levels of service to serve customers as they deem appropriate.

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

- We do not have any comment on this question.

**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 do not have any comment on this question.

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## Making better use of water resources

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

- The preferred option does not go far enough. We support full deregulation as this is the option that will deliver optimal benefits.

We remain concerned that regulatory influence and control over the process will continue to stifle water trading.

- However in the absence of deregulation we support the introduction of incentives for importers as this option introduces a degree of market characteristics.

**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.*

- An incentive of 50% of the lifetime profits from exporting water is simple, transparent and easily understandable to all stakeholders.

To retain transparency it should also replicate, as near as possible, a deregulated environment. Companies should be allowed to retain revenues from exports for more than one price control period rather than the alternative proposal of adjustments to cost performance rates which will serve to cloud the matter.

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

- It is unclear why a temporary import incentive will break down existing behavioural and cultural barriers. Knowing that it will only be short-lived importers may still look to quantify returns over the longer-term and be incentivised to select a capital approach.
- An incentive should replicate the net benefit of an import over a capital solution and, as with exporter incentive, should be allowed over more than one price period to replicate the benefits of deregulation.

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

- As stated in our response to question 34 it is unclear why a temporary import incentive will break down existing barriers. We do not therefore agree with an import incentive cap, if there is clearly a net benefit of an import or imports over capital spend.
- We support the concept of efficient trading levels and the fact that they should in theory self-regulate.

- Reporting against a trading and procurement code should not create an additional regulatory burden to companies. Either reporting against a code should be introduced, or the notion of efficient trading levels should be permitted to replicate market conditions. Both are not required.

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

**General comments on AIM**

- We do not currently foresee that we will be affected by AIM therefore make the following high level comments:
  - We agree with the proposed scope. AIM should apply only to circumstances where there is a high confidence that it can incentivise behaviour that could reduce companies' impact on already environmentally vulnerable sites
  - A phased introduction is a pragmatic option for increasing understanding and reducing risk. We support the proposal.

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

Please see question 36 above.

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

Please see question 36 above.

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

Please see question 36 above.

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## 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?*

- In principle this seems a reasonable approach, in particular if the analysis is conducted for a range of companies (both WASCs and WOCs) of different sizes and structures, as suggested in the consultation text.
- However we retain our concerns over the proposed use of RoRE. These were laid down in our recent response to Ofwat's consultation on measuring and reporting its performance (January 2013).

We have a number of concerns:

- A focus on rate of return will encourage companies to hold back on innovation and cost reduction in order to not be seen as over performing.
- Equity-funded innovation by smaller companies may be further stifled if the associated risk is judged to outweigh a capped benefit.
- Appropriate returns may only be accurately assessed using company-specific business plan data.

It is not clear from the consultation document whether Ofwat intends to apply a one-size-fits all approach, or take a more considered approach. Because of the lack of clarity we are not convinced that the use of the metric for assessing incentive calibration will result in appropriate or realistic analyses.

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

- No, we do not agree.

Each separate control should be evaluated separately to avoid cross-subsidies, in particular for non-household retail.

**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 will only agree if the small company premium is preserved as there is no allowance for scale elsewhere.

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**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?*

- Splitting the price controls has also removed the synergy of a vertically integrated business and further increased the risk to wholesale by moving to outcomes-based regulation.

In the eyes of investors outcomes-based regulation is riskier than outputs-based regulation. This will increase the cost of equity, if not the cost of debt too.

**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 do not agree that financeability should be assessed at the whole business level.
- Retail should be assessed as financeable in its own right, as new entrants would be.
- Assessment across the business will also stifle innovation if a high probability of a return in the short-term is not foreseeable.

## Assessing performance during 2010-15

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

- Yes, we agree.

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

- The dynamics in individual companies' cases will differ so blanket factors are difficult to cite.

We agree that any adjustment should be revenue neutral, depend on the individual circumstances of the company and mindful of the effect on customers.

In the context of these constraints companies are best-placed to recommend to Ofwat within their business plans how any adjustments should be applied. Recommendations should be challenged only if poorly evidenced or not have the support of the relevant CCG.

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## 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 understand the rationale of deflecting focus from the regulatory regime by not revealing precise details of the evaluation process.

However for a transparent process and proportionate approaches companies must have enough information to make reasoned decisions on their business plan submissions.

Ofwat risks placing additional data burden on itself if companies over-compensate in their plans as a result of being unable to judge appropriate information levels to satisfy risk-based reviews. Providing too little will result in Ofwat requiring more information; providing too much will be a data burden to both the company and Ofwat. Either way unnecessary work will be created for both parties. Ofwat must work to avoid this wherever it can.

All parties acknowledge the timetable difficulties and it would be helpful to all if Ofwat therefore reviewed its approach and shared more information which will help companies make considered and meaningful comment and ultimately focused and appropriate business plan inputs.

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

- Ofwat must be mindful that in the absence of guidance and the slippage of the timetable companies have had to forge forward with developing their plans.

Imposing criteria that companies should have known about months ago and that may not be in line with the assumptions they have made may not be workable and must be factored-in.

**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 have significant concerns about the timetable in general. Please pages 1 and 2 where we lay down our comments and suggestions to mitigate the issues.

We repeat here our specific comment regarding menus:

We do not object to moving menu choices to the end of the process and combining them with the final determination but we are unclear how this would work in practice. Ofwat must very clearly state in advance of any decision to adopt this approach how it will deal with any changes companies may make to their own plans in light of the final determination. If all parties are willing to take this risk as a trade-off to other timetable risks the underpinning rules should be absolutely clear.

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## Building for price reviews in 2019 and beyond

### General comment

We have no specific comment to questions 50-55 but make the following general observations:

- Ofwat must be clear when specifying its expectations of the data submissions; including the breadth and depth of information. Clarity will enable more accurate assessment of resource requirements and in turn reduce the risk of inappropriate or incorrect remuneration.
- To reduce the impact on customers' bills companies should be remunerated only for the additional resource requirement needed to produce the required information to the specified standard.
- To further reduce the cost to customers the information required and the process by which remuneration is settled should be proportionate to the expected benefit. Keeping the process and its requirements simple will help this.

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

- Please see general comment above.

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

- Please see general comment above.

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

- Please see general comment above.

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

- Please see general comment above.

**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?*

- Please see general comment above.

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

- Please see general comment above.

*Sembcorp Bournemouth Water  
March 2013*