South East Water's Response to: Setting price controls for 2015-20 – framework and approach

March 2013

1 GENERAL COMMENTS ON THE FRAMEWORK AND APPROACH

Our previous responses have focused on our view of the effectiveness of the proposed reform and highlighted the reforms we support e.g. outcome incentives and explained our reasons in the areas where we believe the benefits attributed to the reform do not exceed the risks or the implementation costs e.g. totex. This response does not reiterate these points but concentrates on the methodology itself. Our biggest concern remains one of deliverability as there appears to have been no reduction to the scope of proposed reform and there remain areas where considerable work needs to be undertaken by companies and Ofwat alike.

Overall there has been shift of responsibility and effort from Ofwat to companies with a considerable number of the traditional incentive tools being left to companies to design. In some areas this is appropriate to achieve greater ownership of plans by companies e.g. outcome incentives; however there are other areas where we believe it is less appropriate and key decisions should, for now, be left within the remit of the economic regulator, namely:

- The method of assessing the depreciation rate
- The ratio between fast and slow money
- The scale of the outcome incentives
- Household and non-household retail margins

This shift proposed by Ofwat represents a considerable new regulatory burden and adds to the considerable work already required to produce an effective business plan that delivers for customers and stakeholders. Many of these areas represent items that we would be willing to adopt and incorporate into our plan in the medium term but we feel that the current timing allowed may well lead to less than robust and inconsistent approaches across the industry.

Whilst there is still an opportunity Ofwat needs to review the deliverability of its reform agenda and put in place contingency should the programme not unfold in the way hoped.

What should also be recognised is that this reform and the proposed approach represent an increase in both implementation and financial risk. Without sufficient time or indeed the usual building blocks of a successful approach i.e. a shared financial model, shared, visible efficiency models and a well understood, defined methodology, there is considerable risk in both the setting of revenues and the implementation of plans. This risk is enhanced due to the inability at this late stage in the process for companies to understand the trade-offs they are making within their plans as all the incentive mechanisms are yet to be fully defined or shared.

There are a number of potential ways of dealing with the implementation risks and we would suggest two possible options:

1. Increase the time to prepare by rolling over the existing price control for another year to allow a reduction in implementation risk
2. For this price review reflect the increased risk in the WACC and in the household retail margin.

We are committed to owning the business plan and will take care when balancing risks and incentives between our stakeholders and customers. However this is difficult to do when the strength of all the incentives are not known in particular the strength of cost performance incentives. The absence of these will likely lead in some plans to a more conservative approach than might have been evident if complete incentive visibility were available.

It is also our strong belief that visibility of models and incentives would reduce gaming as visibility allows the plan to consider all the trade-offs and this increases the feeling of ownership of the plan. We disagree that transparency increases gaming as seems to be Ofwat's suggestion.

A key issue for us is that the methodology is silent on a number of areas where Ofwat have in the past asked for and scrutinised a large amount of information. If this information is no longer required then companies should be informed sooner rather than later to reduce the regulatory burden. Elements of this information are clearly required for our business plan but we need to understand the level of detail and format Ofwat will require, if any.

Key to us would be clarity on the need for:

- A cost base submission
- A supporting pensions return
- A maintenance plan that is written to allow assessment using the AMA approach
- A MEA assessment

In addition to enable balanced incentives to be proposed we need to understand whether the approach to serviceability and shortfalling and the associated penalties will be retained and how to include new costs in particular the costs associated with market opening.

More detailed points on specific methodology issues have been incorporated into the answers to the questions below.

2 ANSWERS TO SPECIFIC CONSULTATION QUESTIONS:

2.1 DELIVERING WHAT MATTERS – AN OUTCOMES-FOCUSED APPROACH

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

We agree with the framework proposed. We would suggest, however, that there is an additional step that considers whether other incentives already exist that relate to that outcome and the form that these take. For example an outcome that focuses on interruptions has a serviceability financial incentive associated with it and therefore there is the option to have no further incentives or to add a reputational incentive.

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?

The preference to consider delivery incentives for the next 5 years only is driven from a belief that consistent measurement may not be possible or that the outcomes contain sufficient flexibility to be able to track changes in deliverability and / or customer preferences over time. This may be the case for some forms of outcomes and incentives, in particular those with delivery incentives set at the level of outputs. Outcomes set at a higher level should be long term outcomes and tracked in the longer term, each period whether annual or 5 yearly should be a measure along the journey that has been predefined at the outset. To illustrate the table below relates to an outcome defined as "customers consider their water supply to be reliable". This is assessed annually using an outcomes survey of customers and is applicable for the longer term as outcomes should be.

Year	2013 (current perf)	2015	2016	2017	2018	2019	2020 (h'pipe ban year)	Period position
Satisfaction score	4.5	4.4	4.0	4.7	4.9	4.5	4.1	4.4
Variability tolerance	+/- 0.2	+/- 0.2	+/- 0.2	+/- 0.2	+/- 0.2	+/- 0.2	+/- 0.5	
Penalty/ reward	NA	None	P	R	R	None	None	Net reward
WTP derived value	NA	0%	0.2% revenue	0.1% revenue	0.2% (capped via WTP)	0%	0%	
Total penalty / reward	NA	£0m	-£4.0m	£2.0m	£4.0m	£0m	£0m	£2.0m
Min service level	Stable service	Stable service	Stable service	Stable service	Stable service	Stable service	Stable service	Stable service

We would suggest in this case the assessment would be performed annually, the incentive would be applied at the end of the period and the outcome is valid and should be valid for this and all periods. The factors that might change relate to the tolerance placed on the measure, influenced by the sensitivity of the measure to external factors and the tools the company use to achieve the outcome.

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?

Consistent performance commitments do not sit comfortably with company specific outcomes. Companies are already generating their outcomes, incentives and the plans that support them and it would not be reasonable or practical, post the submission of plans, to attempt to create a comparison unless the commitments and incentives were industry wide, consistent and well flagged.

Areas suited to consistency are those where there are less customer driven regional differences or there are already set compliance performance objectives. We would suggest that the latter have sufficient performance commitments already associated with them. Therefore we would suggest that the only candidate would be the measures of customer contact satisfaction and complaint volumes. These we would suggest be retained in the form of the SIM incentive.

2.2 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 remain of the view that water efficiency is predominantly a tool for the wholesaler particularly where the area served is in a water stressed area and the companies rely on water efficiency to meet the supply demand balance. However the proposal which we understand following the recent workshop to mean that the cost of water efficiency will not be included in the ACTS but will still remain within the retail price control is acceptable as long as they reflect companies actual water efficiency costs which will vary widely between companies. This does however create unnecessary complications within this calculation which would be better remedied by leaving water efficiency activity and cost within the wholesale business.

We do not have significant issues with customer side leaks and developer services being part of the retail price control.

2.3 SETTING WHOLESALE CONTROLS

2.3.1 FOR CONTROLLING WHOLESALE REVENUES

Q5. Do you agree with our proposed scope for the wholesale water and wastewater controls, given the proposed scope of the retail business we have defined in chapter 3? Are there any revenues of the regulated wholesale business you think should be excluded from this scope – if so, please give your reasons?

We agree to separate water and sewerage wholesale controls.

The driver for changing infrastructure charges from being treated as a capital contribution as at present to being treated as revenue is not clear. As long as the revenue matches the forecast cost then this will not present an issue but our preference is to continue to treat these revenues as a capital contribution.

We would support the wider contributions for on-site developments and reinforcement being treated as capital contributions within totex and if this is the case then it seems more sensible to also include connection charges in the same way.

In addition connection charges are contestable so if a third party undertakes the connection it is not clear how this be reflected 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?

The adjustment mechanisms appear superficially straightforward and a more immediate adjustment than the RCM is welcomed.
We do not support an adjustment for cost differences associated with demand changes within the wholesale control as proposed. Our assessment is that costs are unlikely to be materially different year to year and the relationship with demand is not linear or simple. For example in a dryer year we are forced to use more expensive sources than a normal year and this pattern will depend on the type of dry year as different source types are affected in different ways. For example prolonged dry periods deplete groundwater and we therefore have to opt to use more expensive surface water sources and critical peak periods require maximisation of all sources

This is a clear case where the complexity of the solution outweighs the materiality of the issue being solved.

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?

NA

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 believe an incentive is necessary as accurate demand forecasting is key to the operation of a water company whether as a wholesaler or as a retailer.

2.3.2 FOR COST ASSESSMENT

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

We have difficulty understanding how the proposed process allows for proper consideration of companies future investment needs. The suggestion seems to be that econometric models will be used to assess future efficient costs. Whilst in some areas we can see this might be appropriate there are other areas where this approach is not credible. We use the traditional divisions of cost below and comment on the applicability of such an approach against each of these:

Expenditure	Econometric applicability	Comment	Our proposed approach
Operating costs	Medium	Models exist for assessing efficiency of current spend. Poor at forecasting changes to future costs e.g. power, pensions and business rates	Use models for setting the current efficient position but include robust adjustment for future costs
Base maintenance	Medium	Relies on companies being in steady state and offering comparable levels of service. Key drivers not included however in the current totex assessment i.e. treatment complexity and asset condition. The model will also need to be able to adapt to customer driven changes in service levels as a result of the outcome based approach.	Models may be used but the drivers for investment need to be refined and not constrained to the data that is already available i.e. do not replace accuracy with simplicity. Companies need to be allowed to make a case for future risks as adjustments to the model as would have been allowed in previous assessment under AMA and the Common Framework approach.
Enhancements – water resources	Low	If water deficit is used as an explanatory factor then the model is likely to be more accurate but there will still be a reliance on history being a good indicator for future costs. Our experience is that this is unlikely as sources of new water are progressively more expensive. This approach will also ignore the considerable cost and effort companies have undertaken to derive	Use the output of the WRMP process, challenged via cost base

Expenditure	Econometric applicability	Comment	Our proposed approach
		the best value solutions via the WRMP process.	
Enhancements – water quality	Low	This spend is highly company specific and driven by externalities including changes to the raw water environment and legislation. It is not feasible that history in this area in any way helps predict the future.	Use information directly from company plans, challenged via cost base This approach best fits the prior approval process of both the DWI for quality schemes and the Secretary of State for the Water Resource Plan
Enhancements – customer driven	Low	Again history will be a poor indicator and solutions and service levels will be bespoke. For example extra mains relining to reduce customer complaints.	Use information directly from company plans, challenged via cost base

Perversely the proposed approach is driving ownership away from companies as the baseline will be made largely independently of plans. Whilst it seems there may be opportunities to amend the plans and proposals our expectation is that there could be a significant difference between plans and the baseline driven by a number of factors including:

- The fundamental differences in approach between modelling and bottom up forecasting
- The lack of transparency of the modelling
- The inability of history to predict future investment in most areas
- The lack of consideration of customer preferences within the modelling

To enable the totex models to have some form of predictive power then they need to consider explanatory factors not currently included within the CEPA paper for example:

- Current assets – complexity of treatment (surface and groundwater is not an adequate proxy), age of infrastructure, consequence of failure i.e. interconnectivity, historic replacement rates, susceptibility to temperature changes for mains, ground types.

- Water resources – size of deficit, future cost per Ml of meeting the deficit, sustainability reductions, leakage targets and customer driven service level changes.

- Water quality – changes to raw water quality, customers' preferences for change, new regulatory impacts.

It would also be helpful if Ofwat were to make it clear what evidence it would need on the operating cost items such as pensions and power costs.

It is difficult to comment further in the absence of an explanation of the models that Ofwat intend to use. It is hoped that Ofwat will share their models in time for companies to be able to adequately review and understand them. It should not be under-estimated how important it is to achieve accurate baselines both for the credibility of the process but also for future operational risk.

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?

See above

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?

As mentioned above in our preferred approach the factors that need to be considered relate to risks and service changes that individual companies face including:

- Changes to service levels via outcomes and customer preferences
- Whether assets are operating in a steady state
- Risks posed to water quality via externalities
- Input cost changes e.g. business rates (There is a specific issue relating to business rates as the next revaluation has been delayed from 2015 to 2017 hence Ofwat will not be able to include the actual valuation outputs in cost forecasts for AMP6)
- Proposed changes to metering assumptions
- The consideration of key drivers to maintenance expenditure
- Companies derived best value water resource plans

2.3.3 FOR COST PERFORMANCE INCENTIVES

Q12. Do you agree with our criteria for excluding costs from the general cost performance incentive framework? What types of costs should we exclude from the general framework? Please explain how these meet the cost exclusion criteria and how we should incentivise cost performance for these costs.

Notwithstanding comments above on the ability of econometric models to explain all costs, the criteria you suggest for exclusion are the important ones, you do suggest however that there might not be many costs that fulfil this criteria. There are two main ones in our view, business rates and power costs both of which have significant forecast increases driven by factors outside of management control. Evidence on these can be found from previous reviews where there was an acceptance that these costs fulfil the criteria proposed.

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

31st March 2013 seems sensible although not an issue for SEW

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

The issue of simplification needs to be considered from the perspective of both Ofwat and the companies. Many of the areas of Ofwat's proposed "simplification" presuppose that, to arrive at an aggregated figure, all the work undertaken to produce a more granular number will not be required. This is without exception not the case: companies need to provide to their Boards a process and a result that gives them confidence that the position included in the Business Plan represents the true position of the company and is an assessment that allows for possible further scrutiny and challenge. None of this can be achieved without a bottom up approach.

This applies to tax as much as to any other measure and we will need to calculate the impact on the separate tax pools to arrive at the average capital allowance figure. Indeed, with the uncertainties surrounding the impact of introducing totex and the added complexity of companies moving to IFRS, which is likely to increase tax payable and customers' bills, we would contend that it would be wise to not introduce any "simplification" of the tax calculation process in the PR14 process.

2.4 RETAIL CONTROLS FOR HOUSEHOLD CUSTOMERS

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

The ACTS assessment should either include forecast costs or take actual costs and include a robust forecast of future costs. An alternative would be to allow a suitable form of indexation to the actual cost.

Forecast costs clearly provide an opportunity for gaming and by their nature are less uncertain. However, robustly challenged forecast costs with the luxury of relatively simple cross industry comparisons of these increases should enable Ofwat to gain comfort that these costs are robust. From this position forecast ACTS can be used to set revenues.

The current proposal seems to be to allow historic costs, no indexation and only future forecast for the impact of metering.

Our strongly held view is that for the retail price cap to have the desired effect and focus incentives on the retail business then there is the need to separate the impacts of inflation from efficiency. To not do so would dilute and create opaqueness around the efficiency challenge both set and achieved. This is not in the companies or Ofwat's interest as there will undoubtedly be significant interest in the effectiveness of the reform before future reforms are allowed to progress.

This should be achievable by indexing the costs with RPI or another suitable alternative such as wages indexes, as they represent the bulk of the retail costs. The efficiency challenge would then be applied via the ACTS moving to a frontier approach as the methodology develops.

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?

Metering is the only suitable adjustment as it has a real impact on costs and to not do so would create a disincentive to meter. Should water efficiency be included in the ACTS then a company specific adjustment should also be made for the same reasons as metering. South East Water's water efficiency programme is likely to be significant going forward as the cost of alternative solutions are increasing, ACTS should not produce a disincentive to efficient water resource planning.

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

Yes we strongly support this and it is essential that ACTS reflects this, again to ensure it does not act as a disincentive to efficient water resource planning.

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 should be used at the rate an efficient company would be able to reduce its costs. This can be assessed using historic cost assessment for customer service and retail provided over recent years.

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

The answer to the question really depends on the intended longer term use of the ACTS mechanism to set future retail revenues. To set those companies below the average, a cost to serve equivalent to their current costs provides no incentive to reduce costs. To set it at the ACTS in the short term creates an incidence effect to those customers served by these companies but does ensure the industry ACTS is likely to be lower next period as all companies are incentivised to outperform their funded level.

Q20. Do you think we should use a net margin to remunerate household retail invested capital and risk over the period 2015-20? How can we avoid over-recovery of returns and take into account any implicit margin that exists in the difference between efficient retail costs and the retail price?

A net margin approach seems to be a sensible approach.

If the aim of the incentive regime is to encourage companies to behave as if in a retail market and potentially to prepare them for that prospect, then the retail business must be allowed to attract a margin. This margin serves a purpose other than to provide a return on physical assets - it should act as a buffer for risk, allow for appropriate working capital management and ultimately provide the reason for the retailer's existence.

There is an argument that retail should not be allowed to double recover on retail assets already assigned to the RCV within the margin. The materiality of this double recovery has not yet been demonstrated and in any event the assets in question have a short life typically 5 years or less. To allow for a retail margin the better approach might be to adjust the wholesale returns in the early years until the assets are materially depreciated.

In the absence of information on true inefficiency the difference between efficient costs and price is difficult to ascertain and this assessment may have to be reflected in future reviews when more evidence exists.

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 strongly agree - this incentive, and particularly the reputational aspects of the incentive, has been powerful in the reform of how the industry interacts with its customers.

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

As mentioned earlier this seems sensible as these tools are largely wholesaler tools, what is important is that the company specific costs are reflected properly within both price controls and that no disincentives to undertake water efficiency are generated and that the process and adjustments are simple.

2.5 RETAIL CONTROLS FOR NON-HOUSEHOLD CUSTOMERS

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

Key to the success of this reform is the confidence of the customers this reform is designed to protect. We should avoid introducing changes that produce incidence effects for non-household customers. Equally we would wish to ensure that the customers are not initially faced with confusing changes to their tariff structures. For these reasons we would advocate maintaining the existing tariff structure.

The gross margin has both fixed and variable elements, e.g. bad debt is volume related whereas billing and mater reading costs are of a fixed nature so retail tariffs will need to be structured to reflect this.

We assume that rolling over the existing tariffs and setting default tariffs for the retail element means that Ofwat intend to set tariffs at the same volumetric bands as our current tariffs. e.g. our inter saver tariff at 10-50k m^3 and 50-250k m^3 and our saver tariff at 250+ m^3?

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

An important point is that when a customer switches the wholesale tariff will need to be billed and collected, hence there will still be billing costs related to customers who switch, which will need to be recovered in either the retail revenue or wholesale revenue. Such costs may not be recovered if average default revenues are just set for retail customers when customers switch.

Setting average retail revenue per customer by customer type ignores the fact that not all costs in the retail business are variable with customer numbers. It is likely that some customers will be the more attractive to retailers looking for customers to switch, for example those with lower perceived bad debt risk such as public service organisations or large blue chip companies. Initial default tariffs will not reflect such differences if retail default tariffs are averaged.

It is important to ensure that costs that will still be incurred in billing, debt management and retailer interface once a customer switches are within the retail margin.

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?

Operating costs for non-household retail controls need to reflect changes in input prices. The two main drivers of retail costs are labour costs and bad debt costs. Both are likely to be related to RPI. Therefore either historical costs indexed for RPI or forward looking costs that reflect specific input price changes would probably be an acceptable starting point. Forward looking costs could also identify potential changes in the cost base from the historic costs although it is accepted that there is a degree of subjectivity about these and it is likely that the best measure of input price change for the retail business will be RPI.

An additional consideration is that if costs are not adequately inflated then this will result in a margin squeeze over time possibly to the point that even efficient entry to the market by a third party is not possible.

One additional cost area that needs to be understood is the additional costs associated with the introduction of competition and costs related to customers switching.

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?

It is hard to understand how retail competition can function without recognition that organisations operating in this market will be able to earn a net margin. Without building a net margin into the default tariffs it is highly unlikely that retail competition will be successful as the only incentive for companies to enter the market will be if they are confident that they can do so at lower cost levels than incumbents.

Retail organisations will need to invest in capital equipment after 2015 whether it is vehicles for meter readers or new computer systems and such investment will require funding. Allowing a net margin in the default tariff seems the most reasonable way to fund such expenditure.

Over- recovery of returns by allowing greater returns in the wholesale and retail operations of the business than would have been allowed in the combined business could be prevented by reducing the allowed return in the wholesale business through an explicit transfer of return from the wholesale business to the retail business equal to the appropriate net margin for the retail business. This is in fact tantamount to a slight reduction in the allowed rate of return in the wholesale business recognising that the existing return allowed through return on the RCV includes an element for the risk associated with the retail business. It is likely that for SEW that the retail net margin would be less than 0.1% of the return on RCV. (in 2007/8 prices 0.1% of RCV of £902m in 2014/15 would be £902k). Hence a margin transfer between wholesale and retail is probably more appropriate than a reduction in the allowed rate of return.

The potential of over recovery is a transitional issue and should only be material in the period 2015-20 so a phased out element within the wholesale return would seem an appropriate mechanism for dealing with this.

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?

Constraints should only be in place to protect customers. Smaller non-household properties are less likely to benefit significantly from switching and therefore may need protection from their prices being increased at the expense of larger customers who are more likely to switch. One possible form of protection might be for customers below a certain threshold, say 500 m^3. not to be charged any more than household customers using the same volume or having a similar RV.

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?

Firstly it is not clear why it is considered that only uncontrollable increases costs should be included within the price control. Many costs are subject to increases which may be controllable in the short-term but which in the medium term are cumulative and inevitable. Retail businesses face controllable and uncontrollable cost pressures constantly, they manage these to varying degrees and the result is an increase or decrease in prices to customers which in turn contributes to the RPI. Limiting retail cost increases to uncontrollable cost increase and not inflating costs with an appropriate index is putting pressure on the water retailer that does not exist in the wider retail market. It will inevitably result in a margin squeeze over time which may be seen as anticompetitive.

Payroll is a significant part of the retail cost base. Generally payroll costs broadly follow inflation. Bad debt costs are likely to be related to RPI as the wholesale costs are likely to reflect RPI.

There will be billing, debt collection and account management costs associated with customers that switch. It is not clear whether these will be part of the wholesale cost base. It is likely that they will be incurred by the retail business as the company billing systems and relevant staff will be part of the retail organisation. It may be that these costs associated with wholesale supply are then cross charged to the wholesale business.

Additionally, the introduction of retail competition is likely to incur set up costs. If competition results in a significant number of customers changing supplier it is likely that a central market management system will need to be introduced which will require funding. It is not clear how the costs of market opening will be recovered within this price setting process.

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

The use of existing GSS standards to set the minimum service levels for default tariffs is a sensible approach. These standards however do not cover the frequency of meter reading or billing which is one of the major variations in service level and cost to our customers. It is therefore a simplified service level but given the intended use of the default tariff and the complication of using other measures of service within the default tariff it seems a pragmatic solution.

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

A SIM based approach for non-households would seem appropriate.

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?

The use of a non-household ACTS approach with the appropriate adjustments would seem a reasonable approach.

2.6 MAKING BETTER USE OF WATER RESOURCES

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

We are strong advocates of enhancing the incentives around water trading and support any reform that achieves this. However we are also committed to the principle of value reflectivity within incentives. Therefore the incentives should relate to the benefit customers will realise from the increase in water trading the incentives generate. We believe this is Ofwat's intended approach and we therefore welcome it. We support, at least initially, incentives on both importers and exporters to improve the likelihood of new trades occurring Indeed we have spent considerable resource in assessing the best value regional options that are acceptable to a wide range of stakeholders via our highly successful Environmental Focus Group forum, and this work needs to be properly reflected in the process to avoid loss of credibility for the process.

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.

Evidence is difficult in the areas of retained profit as it is difficult to predict the size of incentive required to increase trading and whether the size of that benefit is likely to exceed the cost of the incentive. We would recommend an approach that evolves over time but that seeks to ensure the incentive is spread evenly over the life of the agreement to ensure agreements are not generated to realise the incentive and then withdrawn.

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

The import incentive is in many ways already in built into the WRMP procedures once the exporter has raised the potential availability of the water. It might also be argued that once a number of imports have occurred that the import incentive is no longer required, as the implementation risk is reduced and there is greater familiarity with regard to contract negotiation and procedure.

However to ensure that trading is kick started a higher initial import incentive might be advantageous and again this incentive should reflect the long term benefits of trading.

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 agree with the proposal although Ofwat should examine if the natural cap and collar associated with the abstraction licence one end and zero abstraction the other is already sufficient protection. It is difficult to imagine that inefficient trades are likely to occur, firstly each trade has occurred as a result of the consideration of all alternatives such that it is the best value scheme and the in perpetuity benefits of increased trading both tangible e.g. cost and less tangible e.g. operational flexibility.

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

We agree the approach seems sensible although we remain convinced that the ability of companies to alter its abstraction patterns is crucial to ensuring this incentive is effect and consistent. The degree of flexibility is directly related to companies' surplus water volume. Therefore we would propose either this is factored into the assessment of the AIM flow threshold or into the size of the incentive that is applied.

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

The scope of the AIM should be decided on the consideration of the regulatory burden versus the environmental benefit. As both parts of this assessment have yet to be completed it is difficult to come to a conclusion at this time.

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

The AIM should be calibrated in the way you propose although we encourage that the baseline is set using data of 10 years or more to reflect service level return periods and ensure expected but extreme events are captured.

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

We agree with the approach, although a two year phased in approach would seem more appropriate as the initial year will likely concentrate on data and implementation issues and provide little opportunity to understand the real impact of abstraction changes.

2.7 OVERALL INCENTIVES, RISK AND FINANCEABILITY

Q40. Do you agree we should develop the balance of our proposed incentives using initial quantitative analysis of notional companies, and refine the calibration of incentives to reflect individual companies' business plan proposals?

We agree this approach seems sensible as long as the refinement is sufficiently robust.

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

We think this is important for the future of market reform. It would seem to be counterproductive to spend considerable effort in attempting to gain the benefits attributed to separate price controls via targeted incentives etc. but then assessing the overall risks at a higher level.

In built into this should be the inclusion of implementation risk via an independent assessment.

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?

Subject to our comments on the issue of double counting of retail assets mentioned earlier we agree with the approach proposed.

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?

This question is difficult to answer without understanding how the risks in the retail business will be dealt with. We believe it is likely in the early periods that the risk to the combined retail and wholesale elements will be higher than the risk under the previous arrangement. These risks relate largely to uncertainty and deliverability of reform.

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 believe the approach is acceptable given the current proposed price limits but should be reviewed should market opening have an effect on the financeability of the whole.

2.8 ASSESSING PERFORMANCE DURING 2010-15

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

We agree that this seems the most sensible approach and support your rationale for doing so.

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

Clearly there are two main considerations, impact on customers' bills and the impact on financeability. As this is often a difficult balance a case by case process seems sensible.

2.9 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?

You have set down previously the objectives for the process and we believe these remain valid, however caution should be used when assessing the baseline and any penalties associated. The strength of these should reflect the evolutionary state of the reform and the time that companies have been allowed to create compliant balanced plans. We do note however that Ofwat's Chairman has proposed some additional criteria for light touch review and it would be helpful if these were also included within the consultation on assessing business plans.

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

A key factor in risk based review is the risk register; this needs to put the appropriate weighting on areas that are material and those that are less so. We would expect to see a demonstration of the different components of risk and their weighting to be included within the business planning expectations in the summer of 2013.

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?

As mentioned earlier with a fixed Final Determination date any rearranging of the timetable is simply a reallocation of risk rather than a reduction in risk i.e. to bring the business plan deadline forward increases the risk of less than robust plans but reduces the risk that Ofwat have insufficient time to assess the plans. We therefore, as a starting point would expect the risk between companies and Ofwat to be balanced. This in our view cannot and should not be achieved by bringing the business plan submission date forward especially at this relatively late stage in the process when governance arrangements have already been made.

The timetable contains significant elements of risk with much still to do to reduce this risk. We consider the risks to its deliverability to be very significant and growing. We consider it would be sensible and practical to either significantly scale down the areas of methodology change for this price review or to defer the determinations by a year to realise the benefits of the new approach and to reduce the implementation risk significantly.

There might be ways to reduce the risk such as earlier publication of requirements, reduction of the scope i.e. delaying of the AIM and other less material reform issues. However it is our view that the bulk of the risk lies within the key building blocks of the wholesale and retail price setting and this is compounded by the absence of a financial model.

2.10 BUILDING FOR PRICE REVIEWS IN 2019 AND BEYOND

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

Yes, we would urge Ofwat to focus on the key building blocks of the wholesale and retail price control and reallocate resource and defer activity in this area.

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

Yes

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

Yes

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

Yes

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?

See previous detailed information and framework supplied by SEW on this question

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

We do not believe financial incentives are necessary