Setting price controls for 2015-2020 – framework and approach
A consultation

Southern Water's Response

Southern Water's response to Ofwat's consultation on setting price controls for 2015-2020

Introduction
We are pleased to provide you with our response to the consultation on setting price controls for 2015-2020.

Ofwat's priorities for the forthcoming price review are clear – namely ensuring companies:
- really own the development of their business plans
- produce real world plans that deliver for customers and stakeholders
- face performance incentives clearly linked to how well they deliver for their customers

This set of objectives for the regulatory framework represent a significant step forward.

It is clear that Ofwat has listened to and responded to many of the issues raised in previous consultations and during engagement with the industry. As a company, we feel that the framework gives us sufficient information to engage meaningfully with our customers and for us to develop a plan to deliver the outcomes they seek.

Structure of our response
In this main section of our response, we discuss a number of the key issues discussed in the consultation document, including outcomes, totex cost assessment and recovery, the retail control, water trading and financing and risk.

That is followed by a number of more detailed responses on key issues arising from the consultation:-

I. Further evidence for adjustments to the average cost to serve for metering and bill size
II. A discussion of retail profit margins, including payment terms and indexation of retail controls
III. The impact on Southern Water's customers of the proposed re-allocation of RCV using MEAV data rather than relying on the values currently in the financial model and used to set indicative K factors.

Finally, we provide answers to the consultation questions not addressed elsewhere in our response.

Overall framework
We are supportive of the overall framework and intent to place responsibility for development of business plans that deliver the outcomes that customers want to see, firmly with company boards.

To reinforce company ownership and responsibility for development of business plans, it is important that the forthcoming consultation on business plan expectations allows the flexibility for individual companies to address their own customers' needs and develop a genuinely customer-focused, commercial business plan.

We are absolutely committed to building our plan around customer priorities. We have been engaging with customers and stakeholders extensively in the development of our long-term strategy and will shortly complete publication of our strategy document setting out the future challenges that we see, and the outcomes we expect to deliver for customers. This document has been published in a staged approach over the last few months allowing customers maximum opportunity to contribute to the development of the strategy. As part of this engagement process we have also established a dedicated website www.swhaveyoursay.co.uk to ensure that all customers have a chance to contribute to and influence the development of our plans.

We have set up a strong Customer Challenge Group (CCG), with an independent Chair and the group is providing significant value for customers by robustly challenging and advising on the development of our customer engagement and business plan development. We are publishing all advice received from the CCG, and our response, as well as minutes of CCG meetings, on the Group's dedicated website www.swccg.org.uk.

Outcomes

As we have made clear in our previous consultation responses, we strongly support the move from a tightly defined outputs-based regime, to one based on delivering long-term outcomes, which reflect customer and stakeholder priorities. We have now published our initial customer outcomes in part two of our Strategic Statement, 'What matters to you?' (http://swhaveyoursay.co.uk/long-term-strategy/part-2), and are now thinking hard about the associated incentives, to ensure we have a fair balance of risk in our plan.

In our response to last year's wholesale incentives consultation we highlighted the diversity of these outcomes and the need to have flexible incentive mechanisms to ensure these were appropriate for each type of outcome. We suggested that rather than a one-size-fits-all mechanism, Ofwat should develop a set of proportionate, transparent and consistent principles for the setting of incentives. We therefore welcome the preliminary framework outlined in the consultation. We will be testing our own customer outcomes against this framework over the coming weeks. We would be pleased to share and discuss that work with you to help in finalising the framework.

We share your views about the practicality and potential complexity of setting outcome incentives spanning more than one regulatory period. So we support the proposal to allow companies to pilot multi-period incentives in the next regulatory control period. We will be testing whether it would be possible to define longer-term incentives for any of the outcomes included in our strategy statement. Again we would welcome the chance to discuss this with you.

One area where we think the framework could be more flexible is in allowing greater scope for trade-offs between outcomes, consistent with the latest customer preferences and subject to sensible constraints around funding levels. We prefer an approach that identifies unacceptable trade-offs in advance but leaves open the possibility to trade-off others, subject to consultation with our customers. There should be an ongoing, mature dialogue between Ofwat, the company and CCG about whether the package of measures actually delivered is consistent with customer priorities and delivery of the outcome commitments overall.

Cost assessment, incentives and recovery

We continue to support the proposals to move to a totex-based wholesale price control, to address any of the perceived biases built-in to the current regulatory regime.

On cost incentives, it is clear that setting a robust baseline will not be possible without a clear view of the outcomes in companies' business plans. As you note, that means that the timetable for making menu choices, post draft-determination, is extremely constrained. However, we think post draft-determination choice is the right approach and, on this basis, we support your preferred approach of continuing with a menus approach. In our view, the key to a successful outcome we think is to ensure that there is extensive dialogue between companies and Ofwat in advance of the submission of the business plan in January 2014. Following the discussion at Ofwat's wholesale workshop, we set out some initial views on timetable issues in Appendix D.

In calibrating the menu it is important that the incentive strength reflects both the robustness of the models used to determine the baseline and the degree to which the process allows companies to make a genuine menu choice. If it is possible to develop the baseline setting process to allow companies to choose an incentive strength, or review their own plans where challenged, then that would point to a menu with higher-powered incentives. Similarly, if the totex models are robust and the degree of judgement necessary in interpreting the results from the models is minimal, then this would be compatible with a menu of high-powered incentives, but less robust models would not.

There may be a case for excluding certain costs, such as pension deficit payments, from the totex menu, where Ofwat wishes to incentivise particular behaviour. In the case of pensions we think it is right that companies that best responded to the incentives put in place at PR09 to manage pension liabilities are recognised. If this can not be achieved within the totex framework then it may be appropriate to treat these costs separately.

The proposed more flexible approach to run-off rates, with the removal of the mechanistic caps and collars approach is consistent with a totex framework that allows companies' to address the long term outcomes their customers' need. It is right that the onus should be on companies to manage the trade-off between financeability and customer bills and this gives us an important tool to manage that balance.

In last year's wholesale incentives consultation Ofwat committed to ensuring any cost assessment models were easily replicable to ensure transparency for all stakeholders. The proposed triangulation approach now being proposed to setting efficiency targets will necessarily require regulatory judgements to be made. It is therefore essential that these are made within a clear framework, with clear visibility of the models used to inform these judgements.

Retail controls

We support the proposal for a separate, focused control for non-contestable retail activities, which we think can deliver benefits for customers, if set properly. We are pleased to see that Ofwat has adopted the approach that we proposed to setting the Average Cost to Serve (ACTS) using a unique customer denominator. We also support the proposed glidepath, as a more proportionate way of imposing the ACTS efficiency challenge.

We discuss a number of other issues associated with the Retail Control in appendix A, including evidence on the additional costs associated with metered customers and why we believe allowed debt costs should be based on average collection efficiency, adjusted for bill size. In appendix B we also discuss our views on setting the allowed margin for retail and present evidence showing why retail controls should be indexed to RPI.

Water trading incentives

We remain supportive of the proposals on water trading and welcome the recognition that incentives for both importers and exporters are likely to be necessary in the short-term to ensure that trades are maximised. Clear signalling of the intention to change the regulatory incentives in this area has already led to greater discussion with our neighbouring companies on the potential for trades, in the context of the development of water resource management plans.

Financing and risk

We note your view that the overall PR14 methodology proposals do not result in a significant change in the overall systematic risk or financeability of the sector for investors. It is difficult as a company to make that judgement before specific details of incentives, especially around totex are developed. It is critical that Ofwat views the risk profile of the price control in its entirety and considers the returns of both equity and debt investors. We have been considering using something like the RORE (Return on Regulated Equity) mechanism to understand the overall balance of risk in our plan, so we would welcome a dialogue on this particular issue with you.

The annual revenue control, to replace the current five year true-up of revenues through the Revenue Correction Mechanism, provides a stronger incentive for companies to control demand, removes some uncertainty, and is better value for customers. Our experience of a revenue shortfall in this AMP, and the upward pressure that it may place on customer bills in the next regulatory period, convinces us that an annual revenue reconciliation is very much in customers' interests.

In that respect, we are concerned that the consultation paper proposes only to test the financeability of the retail and overall price control package, but not the wholesale plan. If the purpose of individual price controls is partly to send the right price signals about the cost of providing wholesale services then it is essential that these reflect the full costs of providing these services, including any financing constraints.

Summary

We welcome the general direction of travel in the methodology consultation. We look forward to the opportunity of engaging further with you as the methodology develops. In particular, we would like to continue our productive dialogue with you about the case for an adjustment to ACTS for customer bill size and the evidence that we have on the additional costs to serve metered compared with unmetered customers. We would also welcome the opportunity to share with you the work we will be undertaking to test our customer outcomes against the incentive delivery framework and our latest thinking on understanding the balance of risk within our plan.

Appendix A: Further evidence for adjustments to the average cost to serve for metering and bill size

KEY POINTS:
We think only two adjustments to the average cost to serve are necessary. These are for metering and bad debt. We present here, evidence on the size of the metering adjustment. We also suggest a simple adjustment to the ACTS, to reflect the impact of bill size, using average collection efficiency.

Introduction
We understand and support the proposed 'light-touch' approach to regulation of household retail costs through an Average Cost to Serve (ACTS) allowance. We agree that it is important not to over-complicate the assessment, by making multiple adjustments to the average, for company-specific factors. All companies will, to some degree, face a unique set of circumstances, but in most cases there will be offsetting benefits and costs, such that any differences are not material.

We think there are only two material areas where an adjustment should be made. In this appendix we present evidence to support the size of the proposed adjustment for metered customers and present a proposal for an alternative approach to setting the allowed costs for doubtful debts within the ACTS.

A1. Additional costs of serving a metered customer
- We support the proposed approach to making an adjustment to the ACTS for the additional costs of serving metered customers
- Our assessment is that the additional costs associated with Southern Water's metered customers are [redacted] per customer (opex only). We assume that meter depreciation is included in the wholesale control.
- These comprise [redacted] relating to meter reading; [redacted] for billing and meter data management; and [redacted] for additional customer contact
- Water and sewerage customers cost on average, [redacted] more to serve. Water only customers cost an additional [redacted] and wastewater only customers an additional [redacted]

The issue
It has been recognised for some time that companies necessarily incur higher retail costs to serve metered customers than unmetered customers. Ofwat has historically recognised and made allowance for, some of these differences in setting the tariff differential between metered and unmetered charges.

These additional costs include, (i) the direct costs of acquiring the meter reading - either directly or by purchasing meter readings, in the case of our sewerage-only customers; (ii) the indirect costs of managing this dynamic billing data, compared with static Rateable Value information; and (iii) the higher contact rate for metered customers, reflecting the level of billing queries relating to consumption.

We show below, the level of these costs, based on our own data, as a contribution to the building of the evidence base for setting this allowance. These comprise a blended mix of costs of serving our pre-AMP5 metered customers and those customers metered to date under the Universal Metering Programme. Our costs do suggest that there are material differences between single and dual service customers, with higher costs incurred for dual service customers for meter reading and customer contact.

(i) Additional direct costs of metered customers

The most significant item is meter reading, which is shown on the face of Accounting Separation Table, ST2. For Southern Water, this comprises both the costs of reading meters ourselves and the cost of acquiring meter readings for more than 420,000 wastewater only customers, whose meters are read by one of nine water suppliers in our region. Additional payments to water only companies in respect of meter data maintenance are included within the billing costs.

We agree with Ofwat's proposed treatment of these costs, which is to remove these costs before calculating the ACTS and then making an additional allowance, based on the average meter reading costs. Total meter reading costs from table ST2 are [redacted] which equates to [redacted] per unique metered customer.

We assume that the proposal to set a separate allowance for water only, water and sewerage and wastewater only customers is intended to reflect the sharing of meter reading costs for customers who are served by more than one provider. This should be distinguished from water only customers who may have a private drainage arrangement, for whom the meter reading costs will be the same as for a dual service customer.

Our average meter reading costs of [redacted] per customer, break down to [redacted] for water only and water and sewerage customers whose meters are read by Southern Water and [redacted] for wastewater only customers whose meter readings are purchased from their water supplier.

Also shown on the face of table ST2 is the cost for meter installation non-capex, which we assume will be reflected in the wholesale control.

Additional metering costs (£/customer)

	Waste only	Water only	Dual Service	**Average**
Meter Reading	[redacted]	[redacted]	[redacted]	[redacted]

(ii) Additional indirect costs of metered customers

As well as the direct costs of meter reading which are shown separately in the Regulatory Accounts supplementary tables, there are a number of other additional costs which are not reported separately. Below we describe why these costs are incurred and provide our initial estimate of their size.

Billing

There are three categories of additional cost that are incurred under the billing line.

First, there are the additional costs associated with providing more detailed information to metered customers, to enable them to manage their consumption. We believe this is part of the basic service that metered customers expect.

Second, metered customers also receive on average more bills, due to the correction of estimated bills following customer readings and the fact that meters are all read at least twice a year. We also believe that more frequent billing is a service that metered customers will increasingly value to help them manage consumption and bills. In contrast an unmetered customer with a payment plan will only receive a single bill at the start of the year. As a result, our data shows that on average, a metered customer receives 2.6 bills per customer compared with 1.5 for an unmetered customer. These two factors mean that a water only and a water and sewerage customer incur an additional [redacted] per annum compared with an unmeasured customer.

Third, included within the billing line is a portion of the costs that we pay to water only companies for data management (in excess of the pure meter read data which is included elsewhere). These costs are captured within the Billing and Payment Handling lines of table ST2 and mean that the total additional billing costs for a wastewater only metered customer are [redacted]

Additional billing costs (£/customer)

	Waste only	Water only	Dual Service	Average
Billing	[redacted]	[redacted]	[redacted]	[redacted]

Enquiries and complaints

The level of contact from metered customers is significantly higher than for unmetered customers. This is predominantly non-network contacts, for which the contact rate from metered customers is more than double that for unmetered. The rate of contact for network enquiries is broadly similar, which is as we would expect.

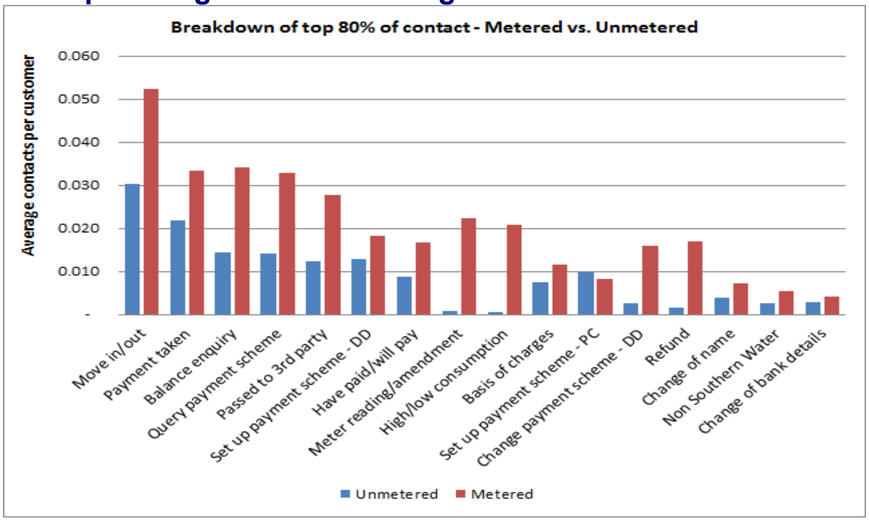
Contacts per customer

Contact type	Metered	Unmetered
Non-network	[redacted]	[redacted]
Network		
Total		

This additional contact can arise for a wide range of reasons, but the largest differences relate to consumption and meter reading queries, which do not arise at all for unmetered customers and enquiries relating to payment schemes, direct debits, refunds etc which, by their nature, are more variable for metered than unmetered customers. This contact, where it promotes greater customer understanding about consumption and changes in behaviour and water use should be encouraged.

The chart below shows the breakdown of our incoming contact volumes across both metered and unmetered customers. This clearly shows that across all categories of contact, with the sole exception of payment card set ups, the contact rate is higher for metered customers than for unmetered.

Principal categories of incoming customer contact



Within this, dual service customers also incur much higher costs than wastewater only customers. This arises because customers will usually query a meter read or register change of details only with their water provider, who then passes the information on to us (as part of the service they supply under the billing line). Our data also shows that the costs for water only customers are significantly lower than for dual service customers. However, there are no obvious reasons for this marked difference which may reflect the fact that this is a relatively small group of customers.

Additional customer contact costs (£/customer)

	Waste only	Water only	Dual Service	Average
Non-network contacts	[redacted]	[redacted]	[redacted]	[redacted]

Summary

As well as differences in the level of direct costs for reading meters, there are differences in indirect costs included within the billing, payment handling and complaints and enquiries lines of Table ST2. Based on analysis of Southern Water data, we estimate that the total difference between the costs of serving a metered and unmetered customer is in the region of [redacted] excluding any capital maintenance. There are also material differences between water only, wastewater only and dual service customers. This is shown in the table below.

Additional metered customer costs (£/customer)

	Waste only	Water only	Dual Service	**Average**
Meter Reading	[redacted]	[redacted]	[redacted]	[redacted]
Billing	[redacted]	[redacted]	[redacted]	[redacted]
Non-network contacts	[redacted]	[redacted]	[redacted]	[redacted]
TOTAL	[redacted]	[redacted]	[redacted]	[redacted]

Applying the adjustment

Excluding the direct, separately reported, meter reading costs from calculation of the ACTS is straightforward and we support Ofwat's proposed method for doing this. Adjusting for costs that are embedded within other reported data is a more complex process. We therefore suggest that the ACTS is calculated in the normal way, after removing direct meter reading costs. An additional uplift could then be applied, on a per customer basis, based on the additional costs associated with meter reading, billing and customer contact at a suitable rate per customer for each of water only, wastewater only and dual service customers.

A2. An alternative approach to setting the allowance for doubtful debts within the ACTS

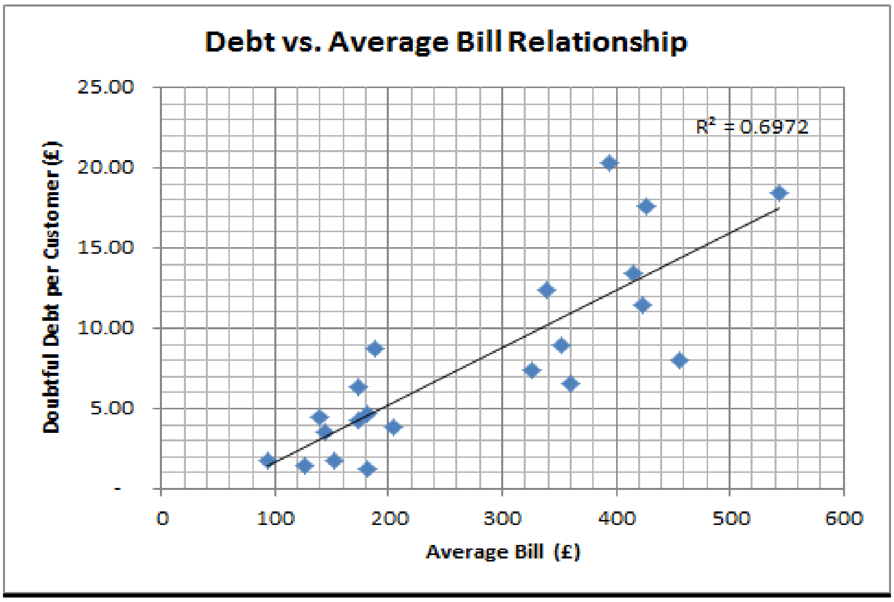
- On average, doubtful debts make up almost a third of the total ACTS for all companies
- The single biggest driver of differences in debt costs is the size of average bill
- We propose that a separate allowance for bad debt is made, based on average collection efficiency
- The Ofwat criteria for an adjustment are met in this case – the differences in costs are material, beyond management control and impact different companies in materially different ways

The issue

Doubtful debt is the single biggest item within the ACTS, accounting for almost a third of the total. Ensuring the correct treatment of this item is therefore highly material to the outcome of the retail price control. The current approach, which allows a fixed amount per billed customer, unfairly rewards companies with a low average bill and unfairly penalises those with a high average bill.

Our analysis clearly shows that the single biggest driver of reported average debt per customer is the size of the average bill. This is shown in the chart below. We do not believe there is any evidence that differences in the efficiency of companies' debt collection practices can on its own explain this relationship.

Relationship between average bill and doubtful debt

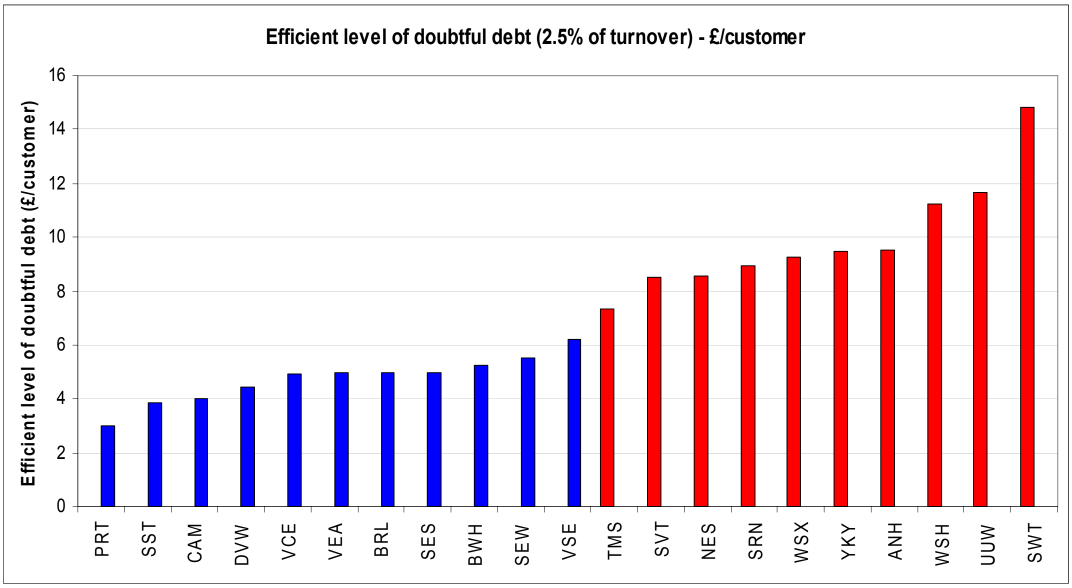


On the other hand, it is clear that all else being equal, a company with a larger average bill will incur a higher doubtful debt charge. The issue can be illustrated most clearly by looking at the implied differences for the companies with the highest and lowest average bills, South West Water and Portsmouth Water.

Under the current proposed method, both will receive exactly the same allowance of £7.89 for doubtful debt. For South West Water, that represents just 1.6% of the average bill of £499 (in 2013-14), whereas for Portsmouth Water it represents 8.2% of the average bill of £96. What that means is that South West Water would need to be more than five times more efficient than Portsmouth Water to achieve the allowed rate of £7.89.

Two companies with identical rates of collection efficiency should, logically, receive the same efficiency challenge through the ACTS. The chart below shows the allowance at a consistent rate of collection efficiency.

Doubtful debt allowance at average collection efficiency



An alternative approach

We recognise that Ofwat wishes to keep the retail price control simple, to minimise regulatory intervention and ensure that the incentives are clear and transparent to company management. We believe there is a fairer alternative, which remains simple, and consistent with the principle of setting an efficiency challenge based on the average level of efficiency.

The ACTS should properly reflect the doubtful debt charge that an averagely efficient company would incur. Therefore, it is simple to calculate the average collection efficiency, on either a weighted or unweighted basis, by dividing the debt charge by the relevant turnover and then using this average rate to calculate the ACTS allowance for doubtful debt. So the allowance becomes:

ACTS debt allowance = average non-collection rate * relevant turnover

This simple method allows us to account for the most material difference in ACTS, requires no further data to be collected from companies, and ensures that the allowance better represents the costs that a company with average collection efficiency would incur. Without such an adjustment the single allowance will unfairly penalise companies with higher bills.

Other issues

The approach outlined above does not, of course, take account of any other factors that might impact on collection efficiency, such as local income deprivation. Analysis of data from our own debt portfolio, strongly suggests that there are other factors that are related to the size of the bill that are not captured in the above approach.

For example, there is clear evidence from our customer base – which is largely homogenous - that those customers with the largest bill size are most likely to fall in to debt. And evidence from our debt collection agencies strongly shows that the ability to collect debt from customers who fall in to debt is strongly related to the size of that debt, which in turn is driven by bill size.

It would be possible to take these additional factors in to account in setting the ACTS, but we are satisfied that our proposed approach deals with the most material differences and does not require further complex analysis or additional data. If Ofwat were to move away from a simple approach, we think it would be necessary to take these additional effects into account through a further adjustment mechanism.

Appendix B: Retail profit margins, payment terms and indexation

KEY POINTS:

We set out here our understanding of the key components of a retail margin and highlight the importance of clarity on the regulatory objectives for the margin and its components. We argue that that a ‘single margin’ rule is not consistent with meaningful retail price controls and honouring the commitment to retaining the RCV in wholesale. We also review the options for allowing for unexpected cost pressures within the retail control and conclude that RPI indexation provides the simplest and most effective option.

Introduction

Calculating and setting the ACTS for retail is a relatively straightforward exercise. But to ensure that the retail price controls are financeable in their own right – which is important if they are to be meaningful and send the correct price signals to the market – requires the setting of a retail profit margin, which is a more complex exercise.

Any margin will need to reflect the proposed actual payment terms in the competitive non-household segment and make an assumption about the notional payment terms for household customers. Given the size of working capital balances associated with customer billing in the sector this is a highly material issue.

It is also necessary to consider what, if any allowance should be made for retail cost escalation. We present here further evidence, and our views, on each of these issues.

B1. Retail margins and payment terms

- Clarity over regulatory objectives for the separate price controls and the functions that the retail margins are designed to meet is essential to setting the margins at an appropriate level
- Decisions on payment terms are critical to this – we calculate that requiring pre-payment from retailers, could add around 1.5% to the retail margin
- Margins need to provide both for a return on and return of new capital invested – the consultation paper is silent on funding of depreciation
- There are a number of clear precedents available for informing the level of the margin, but care needs to be taken to adjust for differences
- A full margin should be allowed without adjustment - a single margin rule would be incompatible with the regulatory objective of meaningful retail price controls and retaining the whole RCV in wholesale

The issue

PR14 will be the first time that explicit retail margins have been set for the England & Wales water sector and this represents a significant challenge for this review. While there are precedents from other sectors, it is important to be clear what the specific arrangements, risks and capital requirements in each sector are before reading across from these precedents.

It is also crucial that there is clarity on the regulatory objectives of the price control, as these will influence the appropriate level of margin. For instance, in the competitive non-household control, it is important that the margins reflect those that would be incurred by a standalone new entrant, so that new entrants are not squeezed out of the market.

Our reading of the consultation suggests that the retail margin needs to perform four distinct roles:-

(i) Providing a return on new investment in the retail business
(ii) Providing for the return of new capital employed in the retail business (the ACTS does not appear to include depreciation of retail assets)
(iii) Financing working capital balances, depending on payment terms
(iv) Compensating for risk within the retail business

The consultation rightly notes that most retail assets are short-lived (typically IT systems have a five-year asset life) and will need to be replaced or upgraded in AMP6. We think the level of new investment in the retail business could be significant over AMP6, as the retail control focuses companies' efforts and customer demands increase. In setting the retail margin Ofwat will need to forecast the level of investment likely to be required and make clear the assumptions they have made for each company.

There is no explicit discussion in the consultation of how depreciation of new retail assets will be provided for. It does not appear to be included within the ACTS calculations that we have seen, so therefore allowance will need to be made within the net margin for depreciation of retail assets. As above this will need to be based on a forecast of new investment for each company.

If payment terms are the same as in Scotland, where 45 days pre-payment is required, then we calculate that the implied margin would be around 1.5%, for this item alone. (Our calculations assume an indicative pre-tax WACC for a retailer of 8-10%.) In contrast, if these working capital balances were financed within the wholesale business at a lower WACC, by allowing payment in arrears, the costs to customers would be reduced. We think, for that reason, using the same model as is applied to the smaller non-household only market in Scotland would not be in customers' interests.

The key risk within the retail business relates to bad debts and unexpected cost changes. While an allowance for bad debt costs is included within the ACTS, in our case the retail business will be responsible for collecting revenues of around £4-5bn over the control period. So small changes in collection rates, which can be affected by factors outside of the control of the retailer, can have a significant impact on a retailers return. Where we see such volatility in the returns of other retail businesses these are reflected in the margins earned.

Without any allowance for indexation of retail price controls (see below), it will also be necessary to allow for unexpected cost movements in the retail margin.

Relevant precedents

We show below what we think are the most relevant comparators for setting a margin for water retailing services. For each we highlight whether the business is relatively asset-intensive (which relates to the first two factors identified above), what the payment and working capital arrangements are and the degree of debt risk carried by the retailer.

The combination of these factors leads to a view on the expected margin in each of these sectors. This provides a useful framework for considering the most appropriate margins for a water retailer.

Key comparator characteristics

	Water in Scotland	Energy	Rail	Post	Telecoms
Fixed assets	Low	Low	Lowest	Highest	Medium
Working capital requirements	Positive and higher than energy	Positive on average	Negative on average	Negative on average	Negative on average
Bad debt risk	Medium/high exposure	Medium exposure	Lowest exposure	Low exposure	Highest exposure
Expected margin	Medium	Low/medium	Lowest	Medium/high	Medium/high

Based on this framework, we think that an England & Wales water retailer is likely to have low/medium level of fixed assets (based on net book values). The return on (and of) these assets will need to be remunerated through the margin. The working capital arrangements are to be determined, but as we highlight above, if we adopt the Scottish pre-payment model these are likely to be relatively high. Given the size of turnover and collection restrictions in the household market, bad debt risk is also likely to be high.

Single Margin rule

The consultation paper highlights that because all retail assets have been left in the RCV, there will be an element of double-counting of the return on these assets within the retail margin. Ofwat suggest that they could include a ‘single margin’ rule, so that either the retail or wholesale returns are adjusted to remove the double-count.

We do not think that either of these is desirable. As Ofwat note, if the retail controls are to be meaningful, then they need to reflect the full costs of those activities. Similarly, if an adjustment is made to the wholesale control, such that an element of the RCV will earn no return, then the commitment to leaving the RCV intact is effectively meaningless, as it will de facto have been transferred to retail.

We think therefore that allowing full recovery of net margins for the retail household price control, without taking account of recovery of retail assets in the wholesale control is the only option that both honours the commitment to leave the RCV intact and meets the regulatory objectives of a meaningful price control.

While this would entail an element of double-counting of returns (and potentially depreciation) it is important to reflect on the size of the issue. For Southern Water, the retail assets (excluding meters) at 31 March 2012 had a net MEAV of £116.5m, out of total assets of £34.2bn. So they represent just 0.3% of the assets employed. By extension, just 0.3% of the RCV, or £14m (at 31 March 2012), is notionally comprised of retail assets. The return on this notional RCV is very small and not material to the overall price controls.

B2. Indexation of the retail control

- Setting the retail controls on a nominal basis, with or without an explicit forecast of input cost pressures, means companies would carry more risk from unexpected input price changes. That risk would need to be reflected in the retail margins, raising prices to customers
- If cost pressures were greater than those allowed for in the nominal price limits, companies would not recover efficiently incurred costs in the household sector and default tariffs would not reflect the true cost of service provision, potentially distorting the market (and exposing companies to the risk of a margin squeeze challenge)
- Based on our examination of a number of possible mechanisms for allowing for input cost pressures, we have concluded that some form of indexation is appropriate and that RPI remains the best of the indices examined

The issue

Ofwat says in the consultation that it does "not consider that RPI indexation would be an appropriate mechanism for reflecting uncertain and uncontrollable input price rises" in the context of retail price controls. It therefore proposes not to include an allowance for uncertain input price increases unless it receives evidence that these costs are beyond the control of companies' management. The consultation does not make clear what Ofwat does consider would be an appropriate mechanism for reflecting these factors, but we assume that Ofwat would set prices on a nominal basis and include a forecast of input cost pressures.

In this section we examine (i) the rationale for providing some protection against uncontrollable input price pressures; (ii) the main cost categories for retail and the cost risks; and, based on that analysis, (iii) what the options for providing such protection are.

The evidence presented in this section is summarised from a longer paper prepared for Southern Water by Reckon LLP. We would be happy to discuss the more detailed findings of that paper with Ofwat.

(i) The importance of protection against input cost pressures

We assume that Ofwat intends to set allowed revenue over the length of the price control period in nominal terms, on the basis of the assessment of costs that it will make at the start of that period. Inevitably, Ofwat will face uncertainty in its assessment of companies' costs over the five year period.

Things may turn out very different from what it expects in 2014. There is a risk that the assessment of costs carried out in 2014, and thereby the level of the average cost to serve or of the default tariff set in 2014, turns out to be wide of the mark, in either direction.

The impact of unexpected changes in the economy-wide level of prices is something that is largely outside the control of a water company, and is something with a material impact on the level of operating costs of businesses in the UK, including those of water companies. Companies that are not subject to price control can react to this by changing the price for their goods or services. That is not an option available to regulated water retail companies. Indexation of allowed revenue can provide protection against this without undermining incentives to control costs.

Reducing the financial risks that companies face can contribute to lower financing costs, which can feed through to benefit consumers. Indexation mechanisms can also provide protection to customers against the level of multi-year price controls turning out to be too high in the light of lower than expected outturn costs.

It is not the role of an indexation mechanism to capture the *expected* industry-wide changes in costs. Ofwat can take account of how it expects input prices to vary over the price control period, without introducing an indexation mechanism. The purpose of the mechanism is to address the risk of unexpected changes. In this context, it is important to think separately about:

> (a) The analysis and judgement needed at the price control review on the likely evolution of retail costs over the five-year price control, taking account of expected changes over time in input prices (e.g. debt levels, wages, energy) and potential productivity growth or efficiency improvement.
> (b) The potential use of indexation mechanisms during the price control period to potentially provide *some* protection — not full protection — to companies and consumers against the risks of input price changes over the five-year period being much higher or lower than had been expected when setting cost allowances at the price control review.

Ofwat's choice of indexation to address bullet point (b) affects the nature of the forecast of future costs that it would carry out under bullet point (a). If Ofwat were to choose to have no indexation, then it would need to set, at the start of the price control, a nominal value for the allowed costs for each year of the price control.

Furthermore, it is not just about unexpected changes to input prices. In the context of retail services, the cost associated with bad debt must also be considered. Water companies face the risk of unexpected changes in the level of bad debt during the price control period. As with the risk of unexpected changes in input prices, indexation may provide some protection against the risk of unexpected changes in the level of bad debt, which would otherwise need to be reflected in the retail margin.

(ii) The composition of retail costs and potential cost risks

In the two tables below we show the main cost categories for our direct retail costs and the key input price risks associated with the largest of the cost categories.

Main categories of retail costs

Categories	Detail	Percentage
Bad debt		46%
Employee gross pay	Relates to basic salary, bonuses, overtime, NI & Pension costs	18%
Employee other	Includes costs relating to travel expenses, recruitment costs, mobile phone costs, agency costs	2%
Hired and contractors	Relates to various contracts; offshore and onshore	21%
General office	Contains costs relating to stationary, books & publications, postage, microfilming etc	2%
Rates and licences	Relates to water only company payments	3%
Vehicles	Relates to costs of vehicles, car repairs etc	0%
Materials and equipment	Hardware accessories, consumables etc	0%
Other costs		8%
Total		100%

Key input price risks for retail

Element of retail cost	Risk
Bad debt	There is a risk of unexpected changes in customers' ability to pay for their bills, possibly related to changing economic circumstances.
	Wholesale costs make up for the bulk of water charges. Because wholesale charges will be linked to RPI, there is a risk that, in the face of unexpected and significant changes to RPI, retail tariffs will increase significantly. This would have a knock-on effect on the nominal value of bad debt, assuming that at least a similar share of consumers would be unable to pay their bills.
Employment costs	Water companies compete in the labour market to attract employees and so are exposed to wage movements in the wider economy. There is a risk of unexpected changes in the economy-wide labour costs, which would have an impact on water companies' employment costs. There is also a risk that changes in the economy-wide labour costs will have an impact on the value of new contracts with contractors, as we expect employment costs to account for a material share of the price quoted by contractors.
Other input costs	There is a risk of an unexpected increase (or fall) in general economy wide inflation, with an impact on prices across range of inputs. Water companies compete in relevant market for those inputs and so will be exposed to relevant price movements in the wider economy, and may be constrained in their ability to control the impact of those price changes by changing practices and processes.

(iii) Options for reflecting unexpected input price changes in the retail control

Based on the identification of the main cost categories above, we have considered five alternative ways in which Ofwat may mitigate the risk of unexpected changes in input prices or the risk of unexpected changes in the level of bad debt. These are:

(a) indexing allowed revenue to the retail price index (RPI)
(b) indexing allowed revenue to a published index on unit labour costs
(c) indexing allowed revenue to a composite input price index, e.g. an average of the RPI and of an index of unit labour costs
(d) setting allowed revenue for one year and recalculating it each year on the basis of an assessment of previous year's costs
(e) including a premium within allowed revenue to cover the risk of escalating cost pressures

Assessment of the options

Each of the options set out above was assessed against the following criteria:

(a) **Risk protection**. To what extent does the mechanism protect companies against the risk of uncontrollable and unexpected changes in input price, or in the level of bad debt over the price control period?
(b) **Efficiency incentives**. To what extent does the mechanism encourage a company to take actions that are not aligned with long-term efficiency in the performance of its functions (or the delivery of agreed outcomes)?
(c) **Competition**. To what extent does the mechanism risk distorting competition or deterring entry in the retail market for non-households?
(d) **Regulatory burden**. How does the implementation of the mechanism add to the costs and effort needed from Ofwat, regulated companies and other stakeholders as part of the regulatory framework?

The candidate mechanisms examined can all help address the risk that, over the price control period, things — input prices and other uncontrollable factors contributing to costs — do not turn out as Ofwat expected when setting allowed revenues at the time of the price control review. And all of the different options can be introduced without dampening companies' incentives to control costs and manage risk.

The option of including a risk premium within allowed revenue to reflect the risk of higher than expected uncontrollable costs is not appealing. It provides protection from unexpected increases in uncontrollable costs only up to the level corresponding to the premium set by Ofwat. This option also relies on there being sufficient competitive pressure to ensure that companies do not make a windfall gain in the event that outturn costs turn out to be lower than had been expected. Consequently, this option is only suitable for the contestable segment, and if adopted it would necessitate a different approach for the non-contestable segment. Such a dual-solution approach would not be desirable in itself.

Using RPI to index allowed revenue, rather than an index of labour costs or a composite index, has the benefit of being familiar to Ofwat and to stakeholders, including investors. Ofwat has used RPI indexation in past price controls, and intends to use it for the wholesale controls for 2010–2015. Examination of alternatives did not show that indices of labour costs provide a noticeably better tracking of retail costs.

Ofwat would be able to adjust allowed revenue to track more closely changes in retail costs if it were to recalculate allowed revenues on an annual basis, each time using the most recent cost data to set allowed revenues for the subsequent year. This is feasible and would provide for customers to realise the benefits of any reduced costs or absorb additional cost pressures with only a small lag. However, under this option there may be a weaker efficiency incentive for companies, as they would potentially retain less of any efficiency saving they realised in period as it fed in to a lower ACTS.

We do not see that the costs and effort needed to implement the various options would be significantly different from those that would be incurred in a setting where none of the options are taken up. This said, the option of recalculating the industry average costs each year is likely to impose a higher on-going regulatory burden over the price control period than any of the other options, where virtually all effort would be done up front.

Ofwat's criteria for indexation

We note Ofwat's requirement that the evidence presented for indexation would need to meet the criteria that it impacts the company in a materially different way to other companies. However, we do not see that this is relevant to the case for indexation, which is based on the view that it is desirable to protect against the risk that input costs, or other uncontrollable factors affecting costs, turn out to be very different from what had been expected.

Conclusions

We think it is important that retail price controls properly allow for the risks associated with uncontrollable input price pressures. If price controls are set on a nominal basis, using only a forecast of input prices, then companies will bear more financial risk in the retail control (and more than they currently bear under the single RPI-linked price control). That will need to be reflected in the retail margin that is allowed. While it would be perfectly reasonable to conclude that companies are best placed to carry this risk of unexpected cost pressures, there is equally no opportunity for customers to benefit if cost pressures are overestimated. We have concluded that on the whole, it would be more appropriate to share these risks between customers and companies through some form of adjustment mechanism.

Re-setting the ACTS on an annual basis has some appeal, but would require significantly more regulatory intervention and an ongoing 'policing' of cost allocation and reporting throughout the period. We do not think this is consistent with a lighter-touch regulatory regime, and may have the unintended consequence of weakening the incentive for companies to seek efficiencies.

We therefore conclude that some form of indexation is appropriate. We looked at a number of candidate indices, but our analysis suggested that neither of the alternative indices we examined provided a noticeably better reflection of retail cost pressures than RPI. On the basis that the RPI mechanism will continue to be used for the wholesale controls and is a familiar, well-understood and straightforward mechanism we believe it remains the most appropriate way of allowing for unexpected cost pressures in the retail price control.

Appendix C: Allocation of the RCV to water and sewerage

KEY POINTS:

The proposed splitting of the RCV between water and wastewater using MEA values, rather than the service-specific RCVs that have been used to set indicative Ks previously, will lead to material changes in our customers' bills. This arises because the MEA values are not proportional to the split RCVs, so in our case there will be a transfer of RCV from the sewerage service to water. This will increase bills for water customers and reduce bills for sewerage customers. We suggest instead that companies should be required to propose the most appropriate RCV split in their business plans to avoid these types of incidence effects.

Introduction

- We support the proposal to set separate wholesale price controls for water and wastewater, which requires the RCV to be split
- The two methods set out in the consultation paper would have a potentially significant one-off impact on customers' bills of between £6 and £17, due to the difference between the unpublished service-specific RCVs in the financial model and the MEA values
- Because our water and sewerage customer bases are quite distinct, there would be a net overall reduction in the bills of 1 million wastewater only customers and a net increase in the bills of our dual service customers
- We propose that companies should be asked to propose, in their business plans, the most appropriate split of the RCV in order to avoid any material one-off bill impacts

The issue

Ofwat are proposing to set separate price controls for water and wastewater wholesale services from 2015. To do this requires all costs to be clearly apportioned between the two services. As approximately one-third of all costs reflect the allowed return on the RCV, it is also necessary to split the RCV between the two services.

Two proposed methods are set out in the consultation paper for making this adjustment, both of which use the Modern Equivalent Asset Valuations updated at the last price review, as described below.

(i) the re-valued current cost fixed asset net book values in the reported regulatory accounts for 1 April 2010; or

(ii) that value updated for subsequent additions and depreciation – for example, the net book value at 31 March 2013.

The effect of using either of these methods for apportioning the RCV would, in our case, move between £345m (method (i)) and £119m (method (ii) using 2012 as a proxy) from the wastewater service to the water service. (The significant difference between the two reflects the addition of a valuation for private sewers within method (ii)).

The effect of moving RCV between the water and wastewater service would be to immediately increase bills for our water customers by between £6 (method (i)) and £17 (method (ii)). The compensating reduction in sewerage bills is around half of this level, due to our significantly larger sewerage customer base. This is shown in the table below.

Apportionment of RCV using MEA values

	Water	Wastewater	Total
RCV per financial model (£m)*	557	2,960	3,517
Method (i)			
MEAV at 1 April 2010 (£m)	5,984	17,338	23,321
Implied RCV at 2015 (£m)*	902	2,615	3,517
Change (£m)*	345	(345)	n/a
Bill impact (£/customer)	17	(10)	n/a
Method (ii)			
MEAV at 31 March 2012 (£m)	6,555	27,542	34,097
Implied RCV at 2015 (£m)*	676	2,841	3,517
Change (£m)*	119	(119)	n/a
Bill impact (£/customer)	6	(3)	n/a

* 2007-08 price base

The change is entirely neutral from a company point of view as the total RCV remains unchanged. But, because our water and sewerage customer bases are very different, this approach would deliver a net benefit of between £3 and £10 to our wastewater only customers and a net increase in bills of between £3 and £7 for our water and sewerage customers.

The impact on bills arises because the MEA values do not align with the separate water and wastewater RCVs that are contained within the price review financial model and which have been used as the basis for setting indicative K factors and hence charges over the last several AMPs. This reflects the balance of recent expenditure between the two services, with most enhancement expenditure taking place in the sewerage service, leading to an RCV that is proportionately larger than the MEAV.

An alternative approach

We understand that, despite the existence within the Ofwat financial model of separate water and sewerage RCVs, these split RCVs have never been published and hence any split based on these values risks appearing arbitrary to stakeholders. We recognise that the Ofwat proposal is designed to provide a means to split the RCV in a way that is transparent to all stakeholders.

However, we do not think it is right that customers should see potentially significant changes in their bills to reflect what would amount to a re-allocation of the RCV between water and wastewater. Our suggestion, therefore, is that companies should be asked in their business plans to propose the most appropriate split of the RCV between water and sewerage. This would give companies the opportunity to ensure that bills to customers do not experience any significant changes to their bills as a result of the split.

For some companies, adopting Ofwat's preferred method of using the MEAV at a point in time may make no difference to customers' bills and they would be free to adopt that method. Alternatively, for companies with a homogenous water and wastewater customer base, any change may beneficially offset other bill pressures in a particular service. But for companies like us, where the water and wastewater customer bases are quite distinct and there is a risk of significant changes to bills, these could be appropriately managed by adopting a split that reflects the current RCV split within indicative price limits.

Appendix D: Timetable

KEY POINTS:

Ofwat has expressed concern about the tightness of the timetable for making determinations in 2014. We do not support the suggestion of bringing forward submission of business plans to December 2013 which we think will compromise quality. Meaningful dialogue on draft totex plans at the end of 2013 is our preferred approach with options for pushing back menu choices, or in extremis, the final determination.

The issue

At Ofwat's wholesale workshop there was extensive discussion on the pressures on the timetable for 2014 and a suggestion from Ofwat that companies might submit business plans one month earlier at the start of December 2013. We do not support moving the submission date, which companies have been working to for over twelve months and which is itself, a challenging timetable for companies given the uncertainty about the approach to the price review prior to this consultation. Earlier submission would, in our view, reduce the quality of plans and in particular compromise the clear intent for company board's to 'own' their plans.

We believe many of the challenges of the timetable could be addressed by an open dialogue between companies around their totex plans in late 2013, prior to submission of final plans. Given the removal of the draft business plans, we should all be aiming for a 'no surprises' plan in January. Early provision of draft data on plans in this period would allow Ofwat to begin analysis and review – with feedback to companies prior to submission of their final proposals as part of the business plan in mid-January. We think regardless of the timetable pressures, these sorts of discussions should be an integral part of the price review timetable anyway.

The alternative is to reduce the time between company final menu choices being made in mid-October and Final Determinations in early December. It is not immediately clear that six weeks is required in this period, as long as Ofwat has good processes in place to incorporate the menu choices in to the determination. In extremis, if further time was required between menu choices and Final Determinations, it would be possible to delay the Determinations to early January with prices for 2015-16 being set on the basis of the draft determination. Any differences between the draft and final determinations could be picked up in the annual true up which is part of the new revenue controls.

We do not support the suggestion made at the workshop to delay the making of the determination by a year, as provided for in the licence.

Appendix E: Answers to consultation questions not addressed elsewhere in our response

In this appendix, we provide answers to the consultation questions not addressed elsewhere in our response.

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 definition of retail. Splitting developer services between retail and wholesale will require some degree of cost allocation, but we understand the logic of separating customer-facing elements and the need for the sector as a whole to take a more customer-focused approach to dealing with developers.

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 with the proposed scope.

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 are not convinced of the case for an adjustment to allowed revenues to reflect water volumes. This cost risk is currently borne by companies and we have not seen any evidence of a strong case for passing this risk to customers.

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 believe that sewerage costs vary materially with customer consumption. We therefore agree that there should be no adjustment for volumes.

Q8. How do you suggest we incentivise companies to prepare and update accurate demand assumptions to apply our proposed forms of wholesale control?
We think companies already have good incentive to prepare accurate demand forecasts for water supply planning purposes. Where Ofwat had concerns it would be able to apply closer scrutiny to companies' forecasts.

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?

Without sight of the full models that will be used for cost assessment, it is difficult for us to identify 'special factors' that are not adequately accounted for in the models. We think it is important that the models are shared with companies prior to any submission on 'special factors'. Without this, companies will be simply be incentivised to submit large volumes of special factor information, which may not be necessary.

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

We think there is some benefit, from Ofwat's point of view, to simplifying the approach and there are no obvious obstacles to this. Companies will still need to prepare detailed tax forecasts and aggregate these for the business plan. Ofwat will need to recognise that under this approach the average writing-down rates will, just like depreciation and asset lives, legitimately vary between companies.

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

We think historic costs are most appropriate, because comparability of cost allocation - between retail and wholesale and between household and non-household - can be more easily assured.

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?

Yes we agree with the criteria. We set out our views on metering and bill size in appendix A.

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

Yes. Any adjustment needs to reflect the full additional costs of metering, including higher levels of customer contact and billing costs.

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?

Implicit in the duty to ensure that companies can finance their functions is the need to ensure that any assumed efficiency gains are reasonable and achievable. (Indeed in the postal sector, the regulator's duty to promote efficiency is explicitly linked to a concept of a reasonable rate of improvement.) It is important that in setting price limits, regulators take care not to assume an unrealistic rate of change in company costs. For this reason, we support the use of a glide path, which reduces the allowed cost to serve to the average over the life of the price control.

Q19. How should we set a forward-looking efficiency challenge for those companies below the industry ACTS?
If costs are set on the basis of actual costs then we do not think that an additional efficiency challenge is appropriate.

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 are not clear how capital invested in retail in the next AMP will be remunerated. No allowance for depreciation of retail assets appears to be included within the ACTS. We therefore assume that it will be recovered through the margin. In setting the net margin, the key issue is to ensure clarity over what it is intended to remunerate. We discuss this in appendix B.

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 think SIM should be used as a backstop only, where companies do not themselves include sufficiently stretching outcomes that relate to customer satisfaction. Where companies have an outcome that relates to the same services then, consistent with companies' owning their own plans, this should take precedence.

Q22. Do you agree with our preferred option of funding additional water efficiency services and customer-side leaks through the wholesale control?
We agree that this is a sensible approach. There is a need for clarity on the level of demand-side water efficiency services that will be delivered through the retailer, as compared with those that will be funded through the wholesale control.

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

Q24. What are your views on our approach to customer churn under the proposed form of control for default tariffs?
Yes. We think the proposed approach is sensible. But, Ofwat should recognise that customers who remain on the default tariff are likely to be those with a higher than average cost to serve. To default tariff should be set to avoid these additional costs effectively falling on ineligible customers.

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?
Due to allocation of costs the approach needs to be consistent with that adopted in household market. The proposal to use 2015-16 costs in non-household control may have implications for the household market control.

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

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.
Q34. What evidence should we take into account in setting incentive rates for importers (buyers) of water?
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 that importer incentives should be set as a percentage of the import costs rather than case-by-case comparison with the next best alternative, which would be overly burdensome. Given that importers will already have an incentive to reduce costs via the totex menu, we think these incentives should be relatively small to maximise the benefits to customers.

We note that at the wholesale workshop, Ofwat proposed an alternative method for ensuring trades were efficient, based on ‘profits’ from trades. The method presented was rather complex and relied on being able easily and objectively to identify the ‘profit’ associated with a particular trade. We think this needs some further consideration. A mechanism based on sharing of revenue from trades, which are more easily identifiable and less open to judgements about the allocation of shared costs, may be preferable. We think there would be merit in a small group of companies working with Ofwat to develop the thinking further on this issue; we would be happy to help with this.

Q36. Do you agree with our preferred option for implementing the AIM?
Q37. Do you agree with our preferred limit to the scope of the AIM?
We support the proposed scope of the AIM.

Q38. What evidence should we take into account in calibrating the AIM?
Q39. What are your views on our proposed phased implementation of the AIM?
We agree that it is sensible to have a shadow year, where only reputational incentives apply. It is important that the incentives do not simply impose unavoidable penalties. Any incentives need to have genuine scope to change behaviour.

Given the amount of work still to be done on the core elements of the wholesale price control, we would support the proposal, raised at the Ofwat workshop, to set out in the Determination only the intention to implement AIM and the scale of the incentives that will apply. Details of implementation could then be finalised after the Final Determination. The application of any penalties and rewards would not be until price controls were set in 2019 and would be open to appeal as part of those price controls.

Q45. Do you agree with our preferred option of implementing adjustments for legacy tools through wholesale controls?
Yes. We strongly support this proposal.

Q46. What factors should we take into account when determining whether to spread adjustments over the price control period?
Ofwat should share details of the proposed adjustments in advance of companies' business plan submissions wherever possible. Companies should propose the recovery profile in their business plans.

Q47. What are your views on our emerging criteria for identifying high-quality business plans? Are there other criteria we need to consider?
Q48. What factors should we take into account in further developing our process for a risk-based review?
We broadly support most of the emerging criteria, which seem reasonable. The key question will be how much weight is placed on each of the criteria and ensuring that the process for assessing the quality of business plans is objective and transparent.

Q50. Do you agree with our preferred scope for network plus?
Q51. Do you agree with our preferred option to implementing network plus?
We think it is right to defer introduction of a network plus sub-limit until after the price review. That will enable more time for an open debate about what the controls are trying to achieve and the costs and benefits associated with their implementation.

Q52 Do you agree with our preferred scope for network management?
Q53 Do you agree with our preferred approach to implementing network management?
We remain largely unclear what Ofwat is trying to achieve with the network management incentive so find it difficult to comment on the proposed scope. We do not think that the first tranche of information should be included within business plans. Rather, the data collection should commence after the Final Determinations, to ensure that companies and Ofwat are focused on the challenges of delivering the core elements of this price control, rather than preparatory work for a 2019 price review.

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?
We do not think that this information should be included in business plans, which should be focused on how we will deliver the outcomes customers have told us they want.

Q55 Do you agree with our preferred approach to financial incentives for network information reporting?
We do not think that a financial incentive, beyond the reasonable costs of providing information should be necessary. Ofwat should be using its information gathering powers if it believes this data is necessary to effectively regulate the sector.