SEVERN
TRENT
WATER

Setting price controls for 2015-20 – framework and approach

Severn Trent Water response to the consultation

26 March 2103

Our response to the consultation on the framework for PR14

We welcome the opportunity to comment on Ofwat's consultation on the framework for the price control. We support the overall approach, which has the potential to create a more innovative and customer-focused industry, better equipped to meet future challenges.

Our main concerns are in the following areas:

- The split of Regulatory Capital Value between water and sewerage services.
- The calculation of retail average cost to serve.
- The approach to cost assessment.
- Ensuring sustainable financing.

In each of these areas we have put forward changes which we think are needed for the framework to be successful. We have also included with our response a spreadsheet which illustrates a potential approach to setting the totex "menu", incorporating incentive rates.

We are concerned at the slippage in the timetable, and the resulting risk that the effectiveness of the framework will be reduced by rushed implementation. We would be happy to help to resolve outstanding issues in any areas where it would be useful.

In the meantime, if there is anything in this response that you would like to discuss, please do not hesitate to contact me.

Dr Tony Ballance
Director of Strategy and Regulation
Severn Trent Water

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Summary

- We believe that the overall approach has the potential to create a more innovative and customer-focused industry, better equipped to meet future challenges.
- We support the approach to outcomes and incentives, and to encouraging better use of water resources.
- If the approach is to work effectively, then submission of a balanced plan, supported by stakeholders, with efficient costs, must be encouraged.
- There are a number of areas where we feel that changes are essential for the approach to work effectively. We have set out alternatives in this response. The key areas are:

  Regulatory Capital Value (RCV): the existing RCV split between water and sewerage should be used. The proposed switch to using RCV based on current asset values would lead to large changes in customer charges and will inhibit competition.

  Retail average cost to serve: the calculation needs to allow for higher costs where both water and sewerage services are provided, particularly bad debt and network call costs. Allowance should be made for inflation in retail costs – not doing so will inhibit competition.

  Cost assessment: We think that there should be an initial overall assessment of a company's plan, based on whether:

  - It is acceptable to customers and stakeholders.
  - There is an appropriate package of incentives and benefit sharing, and challenging efficiency targets.
  - There is an appropriate approach to financing, and benefit sharing for any financing outperformance.
  - The company has a good track record, in terms of submission of robust plans and sharing of benefits.
  - There is an appropriate approach to assurance of costs.

  Only if these criteria are not met should significant weight be put on the results from a modelling approach in assessing a company's costs.

  Financing: There are increasing concerns about the risks and high returns to equity associated with highly-geared structures, and whether such structures are sustainable in the long term. We think that it is time to consider sharing with customers the high returns to equity in these structures.

  Timetable: We are concerned by the continual fluidity and slippage in the timetable - there is a risk that the overall approach will be undermined by rushed implementation. Effective engagement with Customer Challenge Groups requires a timetable to be set and adhered to. We would be happy to help to resolve outstanding issues in any areas where it would be useful.

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Our detailed response to the issues raised in the consultation is set out below, indicating which of the questions raised by Ofwat are being addressed.

The response is structured as follows:

1. Outcomes and Incentives
2. Defining retail and wholesale services
3. Controlling wholesale revenues
4. Cost assessment
5. Regulatory Capital Value: water – sewerage split
6. Simplifying the approach to tax
7. Retail – average cost to serve
8. Retail costs for non-household customers
9. Making better use of water resources
10. Financing
11. Assessing performance during 2010-15
12. Totex and menus
13. Timetable
14. Building for future price controls

1. Outcomes and incentives (Q1 to Q3)

We support the proposed approach to setting incentives.

We have already had extensive discussions with our Water Forum (our Customer Challenge Group) and developed a set of measures of success which we will be consulting on in April. If the customer engagement process is to be effective, then it is important that Ofwat does not overwrite the proposed measures of success where it can be shown that these are supported by stakeholders, and that there has been an appropriate level of challenge to companies' proposals.

We support the proposed approach to setting incentives for measures of success, and we will apply the framework in developing our incentives. We will be developing our proposals over the next few months, and discussing them with our Water Forum (our Customer Challenge Group). Once we have developed our initial proposals, we will discuss them with Ofwat, before submission of the business plan.

We agree that it is not feasible at this stage to consider incentives beyond a five-year period, and that other aspects of the framework will ensure that companies take a long-term view.

We do not think it is necessary to set consistent performance incentives across companies, except, as suggested, for the Abstraction Incentive Mechanism and Service Incentive Mechanism. Incentives should be developed to reflect customer and stakeholder engagement on priorities and should, therefore, differ between companies. In the case of leakage, we agree that there could be a consistent framework for setting incentives, but the scale of the incentive needs to reflect the local supply-demand position.

2. Defining retail and wholesale services (Q4)

Network calls

Including network calls in retail activities could create duplication and complexity in managing the functional separation between retail and wholesale. It will also create a barrier to entry. As Scottish Water Business Stream highlighted, it will oblige new entrants to provide a 24-hour response that would not be required if they dealt with billing queries alone. In other utilities and services it is commonplace for companies to provide different numbers for different purposes; if a customer calls the wrong one it is simple to redirect them, and a new entrant could provide an automated response stating the number to call for out of hours emergencies.

If the proposed allocation is implemented, the activity – and the associated cost within the accounting separation tables - will need to be defined appropriately. Although at first the operations will be performed by two different parts of the same company, the arrangements have to be set up on the basis that the incumbent retailer could be replaced by a competitor. An independent retailer would not be able to function in the way that our network calls centre does at present.

An independent retailer would only be able to receive the initial customer call, record their details and the general nature of the issue before passing it on to the wholesaler. They could not operate in the way that our operational call centre does at present because they would not have access to our asset information systems, and would not be able to direct wholesale staff.

Consequently, some operations and costs that we currently include within this line would need to be transferred to wholesale. These include:

- Reviewing asset data and telemetry systems
- Inspections
- Directing operational teams to incidents

There will be some double-handling of calls, and the sum of the new costs in retail and wholesale will be greater than when they were combined.

Water efficiency, supply pipe leakage and developer services

We agree that water efficiency and supply pipe leakage should be retail activities. We address how the activities should be financed in Section 7 of this response. We also support the proposed approach to developer services, with customer-facing activities in retail, and provision of connections in wholesale.

3. Controlling wholesale revenues (Q5 to Q8)

Scope of control (Q5)

In our view, including wholesale charges for large users within the scope of the revenue control is a sensible step. This reduces complexity and reflects the reality of where a competitive market currently exists.

We have some concerns about the proposal to treat connection charges as part of wholesale income. At present we, and most of the industry, treat these charges as capital contributions. If they are treated as turnover for the purpose of the revenue requirement, there would be a number of consequences:

- In the short term, there could be a reduction in charges to other customers – for example, household bills. But this would only be a timing issue. In the long run, adding a higher value of gross capital to the RCV would drive customer bills up – unless this was offset by a corresponding change in Pay As You Go rates.
- There could be a mismatch between what is considered as turnover in the final determination and our statutory accounts. External observers, such as the credit rating agencies, start from the statutory accounts. They would see this as a reduction in the return on capital, and in cashflow - which could affect our credit metrics.
- If the statutory treatment was aligned with this new approach, then HMRC would treat the income as taxable. It is currently taxed as it is released to the P&L – which, as it relates to long-life assets, is over a long period. An increase in tax payments would (partially) offset any benefit to customers in period.

While there are some attractions to simplifying the arrangements around all charges that the wholesale business makes, this is an area where we think that all potential consequences of the change need to be fully considered. In view of the limited time remaining, it might be better to leave the current treatment unchanged.

Form of wholesale control (Q6 to Q8)

The proposal to move from a price control to a revenue control could help to simplify the regulatory framework (since the current Principal Statement is extremely data-intensive) and should also be consistent with the approach on retail control. It also transfers more responsibility for charging policy to companies. Therefore we support this move.

The proposal to make annual corrections to bills risks creating instability in prices. The current Revenue Correction Mechanism provides greater price stability than a revenue control, because it smoothes corrections over five years. However, we believe that we can avoid excessive changes from one year to the next, provided that Ofwat adopts the following approach:

- A residual correction mechanism between periods is implemented, with over or under-recovery from one period carried forward to the next. If it is only an option for Ofwat, as suggested in the consultation, a company will not be certain that Ofwat will allow for

under-recovery. This would create an incentive for companies to over-charge in order to ensure that they at least recover their allowed revenue, which is not desirable.

- The adjustments should take account of present value. If they do not, then there is an incentive for companies to load revenues into the early part of a control period.

Corrections for metering and volume (Q6 and Q7)

A unit cost-based correction for metered customers is reasonable. For meter *switchers*, limiting this to the water service alone is appropriate. But if connection charges are brought into the revenue control, it will also have to be varied for the number of new connections, at a different unit rate. Connecting new metered customers drives significantly higher cost than changing existing customers to a meter, particularly with larger developments which require the construction of new assets. This second correction would also need to apply to wastewater (since infrastructure charges are collected for both water and sewerage at present).

The current Revenue Correction Mechanism approach removes the incentive for companies to sell more water. Companies collect the same revenue regardless of volume. This feature was welcomed by all stakeholders at Ofwat's workshops on leakage and water efficiency. Adjusting income for any increase or reduction in volume could undermine the objective of removing the incentive for companies to sell more water. Therefore, we think that it should be set only at the short-run marginal cost of water production, so that there is no impact on profitability.

The short-run marginal cost of water *and* wastewater is very low (though the latter is lower). Therefore annual corrections based on cost could be very small – looking at the historic variation in water delivered, the average correction for us under such an approach would be only about +/- £1.5m per year. This leads us to question whether the adjustment is required at all. However, if Ofwat consider it necessary to do this for water then it should probably be done for wastewater as well, albeit that it is less material.

4. Cost assessment (Q9 to Q12)

The methodology consultation sets out a relatively mechanistic approach to setting company's baselines – involving use of models, with adjustment for costs not adequately covered by modelling. It suggests that "whether the business plan's costs fall within cost corridors identified by our cost assessment models" will be one of the criteria for an initial assessment of company's plans.

We recognise that Ofwat needs a way to assess a company's costs, where it is not satisfied that a company has put forward an efficient plan – and an approach using modelling may be the best way. We support the move to totex modelling, which should remove the impact of different approaches to cost allocation, and discourage a bias towards capex. We support the use of multiple forms of the model to triangulate a result rather than relying on a single form of model.

However, modelling inevitably has its limitations. We are not certain that it is possible to develop a satisfactory model that includes enhancement capex. In any event, modelling cannot adequately incorporate some aspects of expenditure, where past levels of expenditure provide no guide to future needs, such as:

- River quality improvements for the sewerage service.
- Resilience improvements for the water service.

Adjustments would need to be made for these costs. We consider that identifying these costs is more important than making adjustments for "special factors". In these areas, companies' costs should be assessed in terms of whether reasonable efficiency targets have been included and whether the company has obtained appropriate external assurance on the scope and price of work. After review, these costs should be included in the menu and incentive framework.

We think that there should be an initial overall assessment of a company's plan, based on whether:

- It is supported by customers and the Customer Challenge Group, and there is evidence of sufficient CCG challenge.
- The overall change in bills is reasonable.
- There is an appropriate package of incentives and benefit sharing.
- There are challenging efficiency targets incorporated in the plan.
- There is an appropriate approach to financing, and benefit sharing for any financing outperformance.
- The company has a good track record, in terms of submission of robust plans and sharing of benefits.
- There is an appropriate approach to assurance of costs.

Only if these criteria are not met should significant weight be put on the results from a modelling approach.

We recognise the need for data for models but the requirement should be minimised. There were good reasons for bringing the June Return submission to an end, and data requirements for the Business Plan should not reinstate it.

Some of the June Return data is still readily available because we use them in the normal course of our business. However, we do not collect the data formerly used in the sewerage opex models. We have reorganised in this area and with reduced staff numbers we cannot readily reinstate the provision of data. Therefore information requirements should be limited to those clearly needed for the models, and as much as notice as possible given of the requirements. It may not be possible to reinstate fully the level of assurance that was provided with previous data submissions.

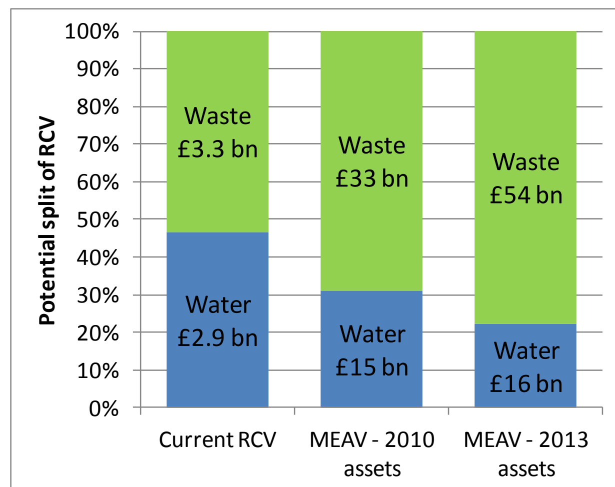
5. Regulatory Capital Value: Water – Sewerage split (Q13)

We think that this is one of the most material issues in the consultation, and that Ofwat should use the existing waste-water split of RCV. The proposed change in approach is illogical, would not be understood by or be good for customers, does not make economic sense, and could inhibit water competition

The existing split of RCV between water and waste was based on a split of the value in 1989 using initial MEAVs. Subsequent capex in each service has been included at cost and then inflated.

This is consistent with the overall approach to calculation of RCV, and accurately reflects the fact that post-privatisation capex is included at full value, so is in principle the best approach.

Reallocating the RCV based on MEAV, as proposed by Ofwat, would transfer around 15% to 25% of our capital value from water to waste, as shown in the graph on the right (depending on whether it is based on the 2010 or 2013 asset split – the 2013 asset split includes the transferred private sewers). The approach would create a marked difference in the recovery of the cost of past investment between water-only companies and water and sewerage companies.



Changing the approach to splitting RCV would cause significant incidence effects. For Severn Trent:

- Sewerage bills would be around £11 to £17 higher.
- Water bills would be around £12 to £20 lower.
- Customers who receive water from water-only companies (such as South Staffs) would face an increase in sewerage bills but not receive the offsetting reduction in their water bill.
- Many business customers do not have an even split of their bills between water and sewerage, so some would face significant increases.

It would be very difficult to justify the increases to customers affected.

There has been significant attention given to water prices not reflecting marginal costs, which gives difficulties in promoting efficient water use and setting the framework for competition. The proposed RCV split would exacerbate this problem by discounting water prices further.

There would be negative consequence for future market reform if such an adjustment was made:

- It could create an uneven playing field for water trading. Water and sewerage companies seeking to trade water off an existing network may be able to do so at lower cost than a water-only company with a similar marginal cost structure, due to potentially lower access prices arising from use of the network.
- A split of the RCV for sludge assets using Ofwat's proposal would inhibit competition, because only a small proportion of RCV would be allocated to sludge. This would be contrary to the proposed remedies for Ofwat to consider raised in the OFT's study on organic waste. A split using the same principles as for the existing water-sewerage RCV split would promote it. We have presented our detailed analysis on this in our February 2012 consultation response1.

6. Simplifying the approach to tax (Q14)

We support the proposal to simplify the approach to tax, in line with the overall objective of reducing complexity, and encouraging focus on the material issues in the price review. To achieve the benefits of this, companies and Ofwat will need to avoid debate and raising queries on matters which are not material.

7. Retail – average cost to serve (Q15 to Q19)

The average cost to serve needs to make allowance for the additional costs of providing both water and sewerage services.

We agree with the proposal to determine an Average Cost to Serve (ACTS) for setting retail price limits. However, we propose that the approach to its calculation be revised.

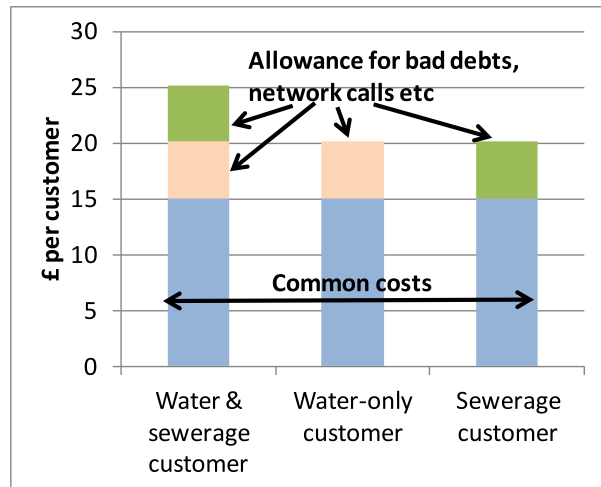
The proposed approach gives the same weight to a customer receiving both water and sewerage services as one receiving only one service. Some aspects of customer service, such as billing or meter reading, may not vary significantly with provision of both services. But some costs are clearly higher if both services are provided:

- Bad debts are related to the level of income. If the bill is twice the size then the bill outstanding will be twice as large.
- Charitable donations are an extension of companies' approach to dealing with debt.
- Network calls clearly relate to water and waste – for example, we would not get calls about blockages if we did not provide a sewerage service.

Elsewhere, the framework does recognise that the cost of serving single and dual service customers *is* different, because it proposes to allow a different unit cost revenue adjustment for each one in annual price-setting. This is inconsistent with the assumption for ACTS that the differences are marginal.

[1] Future price limits - a consultation on the framework: Severn Trent water response, February 2012

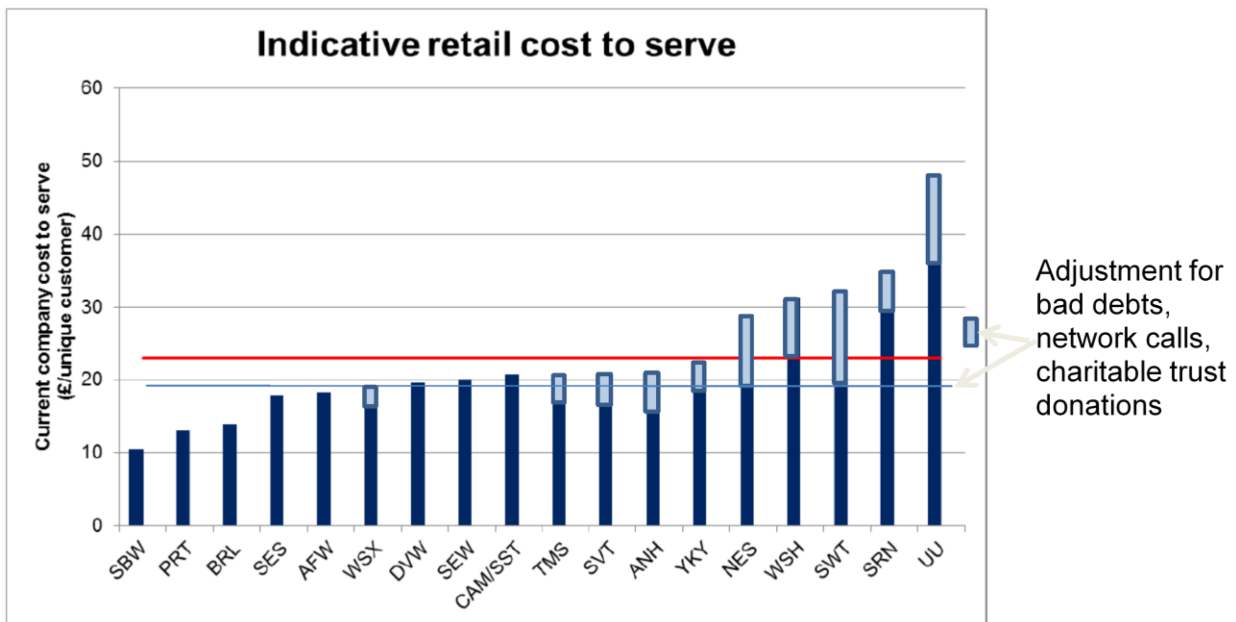
If this approach to price-setting were to be followed through into charges, then customers receiving water and sewerage services from separate companies will be facing significant increases in charges. In practice, doubling-up of costs can be avoided by companies working together – South Staffordshire bills for sewerage for the customers in its area.



We propose that:

- Average cost to serve be calculated separately for WASCs and water-only companies; and / or
- An additional allowance be made for costs which are higher where two services are provided – in particular bad debts and network calls, as illustrated in the graph above.

The proposed approach favours water-only companies, and WASCs with a high proportion of sewage-only customers. Adjustments for costs which are clearly higher when both water and sewerage services are provided give a more balanced result, as illustrated in the graph below.



If the aim is simplicity, then a simple modification to the ACTS **for WASCs** could be:

Billed services costs = bad debts + charitable trust donations + network calls

Unique customer costs = other retail costs

$$\text{ACTS} = \frac{\text{Unique customer costs}}{\text{Unique customers}} + \frac{\text{Billed service costs}}{\text{Services billed}}$$

Average cost to serve – adjustments (Q16 and Q17)

We think that an adjustment for serving metered customers is appropriate. This could be based on companies' target differential for measured charges, but excluding some elements that do not relate to retail costs - such as supply pipe leakage and cashflow effects. In our view, the impact on retail should comprise meter reading and the incremental billing cost.

In principle, we think that other retail costs should be similar between companies as the activities involved are the same wherever the company is located. Therefore, we agree with that companies should have to demonstrate that other costs affect them in a different way to other companies, and there should be few such adjustments.

Average cost to serve and default tariffs – indexation (Q15 and Q19)

We consider this to be a material issue in the consultation, and we propose that retail charges should be indexed, as cost increases will reflect inflation in the economy as a whole.

The framework proposes that average cost to serve, and default tariffs for non-household customers, should not be indexed with RPI. The grounds for this are that retail costs are largely controllable. This does not, however, mean that retailers are immune from inflationary pressures. If wages generally are rising in the economy, then it is unlikely that a retailer could keep pay rates constant. On average, the service sector increases its prices faster than RPI.

This does not mean that tariffs need to be increased fully in line with RPI – an "RPI-X" allowance can be set if it is felt that retail costs do not rise fully in line with RPI. Providing that indexation is included, then the average cost should be based on historic rather than forecast figures.

As suggested in the consultation, an efficiency target could be included. This could be based on past trends in retail costs. At PR09, Ofwat commissioned work to understand the scope for productivity growth in the water sector. Overall, this concluded that frontier efficiency growth in the whole of the value chain would be no higher than the rest of the economy (as reflected in the RPI). We think that Ofwat should commission work to understand whether the scope for efficiency in retail is any greater than wholesale.

Household retail margin (Q20)

We support Ofwat's proposed approach on the single margin rule, to avoid a double return on the retail assets in the RCV. But we think this adjustment should only be applied at PR14.

Now that meters have been allocated to wholesale, we estimate that our residual retail assets will represent only 0.2% of the RCV. As these are usually short life, the value that is not written off by the end of AMP6 should not be material.

Form of the retail control

We agree with most elements of the proposed control. However, the form proposed acknowledges that there are different costs for combined customers, when the ACTS does not. It only allows for differences in the cost of new, metered, water and sewerage customers. We think the factors which make a combined customer more costly to serve, such as bad debts, are the same for existing and new customers.

In our view, the basic form of the control should be modified as follows:

Annual allowed retail household revenue			
	Unmeasured single service customers for water	x	Rate for unmeasured single-service (Uw)
+	Unmeasured single service customers for sewerage	x	Rate for unmeasured single-service (Us)
+	Unmeasured combined service customers	x	Rate for combined service (Uws)

The other aspects of the retail control could remain as proposed (i.e. the separate allowances for metered water, metered sewerage and metered combined service).

Service Incentive Mechanism (Q21)

We support continued use of the Service Incentive Mechanism, and putting it into the household retail control. It is affected by wholesale performance, but this does not create any significant issues with both wholesale and household retail services being under the same ownership for the foreseeable future.

Funding additional water efficiency services and customer-side leaks (Q22)

We consider that the best option would be for these activities to be included in retail services, but all costs for provision of these services to households to be financed by the wholesale function. If, however, retail is to finance the current level of activity, then we agree that wholesale should finance any increase.

8. Retail controls for non-household customers (Q23 to Q29)

We agree that:

- Existing tariff structures should be used as the basis for default tariffs, as this will minimise incidence effects.
- Default tariffs should not be adjusted for changes in customer numbers in the period.

- A gross margin basis should be used, to avoid changing the default tariffs if the level or structure of wholesale charges changes.
- The default minimum service level should be based on Guaranteed Service Standards.

We think that a net margin allowance should be added to operating costs to provide a sufficient return for an efficient stand-alone retailer. Otherwise the default tariffs could be anti-competitive. This margin could be based on margins in other sectors. It should not, however, be set as a proportion of total revenue by company, or margins will be higher where bills are higher. An average margin per customer (based on the size of customer) would be appropriate.

We think that that the margin calculation should be based on the retailer paying in advance. Otherwise a new bad debts risk is created for the wholesaler, of the retailer defaulting, which would need to be allowed for in price limits.

Once an average margin and assumed recoverable costs have been set, companies can set the detail of default tariffs. Competition law and the possibility of scrutiny by Ofwat will ensure that companies adopt a reasonable approach.

As with household retail charges, we consider that the default tariff should be indexed with RPI. Failing to index default tariffs with RPI will squeeze out competition, by squeezing profit margins. If this is done, then there is no need for further consideration of potential increases in input prices. This model has worked successfully in Scotland with the evidence suggesting that most customers are paying below the default tariff.

9. Making better use of water resources

Water trading (Q32 to Q35)

We agree that incentives should be provided to both exporters and importers. Our preferred approach would be that both importers and exporters' incentives would be based on a share of the gains from trading. Care would be needed in setting the incentive rate that it does not absorb all the exporter's gains for high-cost trades.

We agree that under the current system, exporters have limited incentive to trade water. The introduction of an export incentive would help to address the situation. But the system adopted needs to be straightforward, transparent and easy to administer. Whilst setting a target level of 50% of the export profits sounds simple to do, in practice this is difficult to administer, largely due to the differing lengths that water trades may entail. We are party to a number of water trades with over 20% of our distribution input being provided through these contracts. Some water trades have contract lengths of up to 100 years. Our analysis of the economics show that most water trades requiring new infrastructure are uneconomic if the costs are recovered in less than 30 years.

Duration of water trade (years)	Years to recover 50% of the profit @ 4.5% real return	Years to recover 50% of the profit @ 7.0% real return
20	7	6
30	10	8
50	13	9
100	15	10

We would propose to adopt a simple method for retaining profits by allowing the exporter to keep all profits for the first 10 years, followed by an offset of the revenues received against costs thereafter. Whilst in theory, short duration trades could be seen to benefit, our analysis shows that short duration trades, that require new assets to create interconnection, are uneconomic given the long asset lives of interconnector pipes and the need to amortise costs over a long period. Adopting a case by case approach to meet a prescribed 50% share of gains would need Ofwat to commit to an incentive being kept for different time periods.

Every year, companies report the revenues and average prices for each of their bulk imports and exports in Ofwat's Special Agreement Register. This register would need to identify new bulk supplies agreed from AMP6 onwards. The register should also separately list (but excluded from the importer incentive) bulk supplies made to new appointments (insets) as these are akin to new connections to large users, rather than water trades between existing undertakers.

Water trading – importer incentive (Q34)

Our preference for import incentives would be a flat percentage of the agreed price. A case-by-case analysis of the profits made the trade is problematic as the underlying costs of supplying the trade are not straightforward and move over time. For example, if a trade occurs where the exporter sells water from their integrated grid, the costs of that supply are unclear and would be difficult to establish with a degree of certainty. They would be difficulties establishing the costs consistently due to differences between:

- Current v. future costs.
- Marginal cost of the specific point of supply vs marginal cost of the integrated network point of supply.
- Whether future costs are over the life of the contract, over the period of the AMP or over the WRMP planning cycle.

Water trading – procurement code (Q35)

We do not agree that there is a need to create a trading and procurement code; this would create unneeded bureaucracy. In Ofwat's own work on identifying potential trades, around 20 trades were identified over a 20 year period. A simpler approach in order to qualify for the export and import incentive would be for exporters to provide assurance through an independent third party report which would validate the benefits to customers of the contract.

Abstraction Incentive Mechanism (Q36 to Q39)

We support the proposed approach to implementing the Abstraction Incentive Mechanism. Remaining details can be addressed as part of the current UKWIR project in this area.

10. Financing (Q40 to Q44)

Approaches to financing (Q42 to Q44)

We think that it is time to consider sharing with customers the high returns to equity in highly-geared structures.

In our joint report with National Grid "Changing course through sustainable financing" we raised concerns about:

- The potential risks of increasingly high gearing.
- Whether highly-geared structures are suitable for the direction in which the industry is heading.

Jonson Cox also raised in his recent speech "Observations on the regulation of the water sector" the risks of high gearing, and how the gains from high gearing might be shared.

The methodology consultation notes these potential risks and refers to potential sharing of outperformance of regulatory capital financing assumptions.

We think that it is time to consider sharing with customers the high returns to equity in highly-geared structures. The increase in the cost of equity which the CAPM approach indicates is excessive in a regulated environment, where some of the risks of high gearing are transferred to customers. We think that this can be addressed by:

- Companies setting out in their business plans their approach to financing for the next five years.
- Where companies' plans involve a return to equity (or distribution to shareholders) outside a certain range, then part of this gain should be allocated to customers.
- Introducing stress tests to ensure that companies' financing structures can withstand external shocks, and limiting gains where they cannot.

The extent of sharing may need to be limited in the next five year period, to allow time for a transition – but sending a signal that a new approach will be adopted at PR19 would encourage sustainable finance through the formation of new equity in the sector.

Risk assessment (Q40 to Q41)

We agree with the approach outlined to assessing the overall balance of incentives and risks. There is a forthcoming UKWIR project in this area and we would welcome Ofwat's participation.

11. Assessing performance during 2010-15 (Q45 to Q46)

The majority of the legacy incentives relate almost exclusively to wholesale. For example:

- The Revenue Correction Mechanism is concerned with changes in volume – an issue for wholesale rather than retail
- The Efficient Billing Incentive, though it sounds like a retail incentive, is actually compensating the business for revenue gains from billing additional properties that would otherwise be stripped away by the RCM. Therefore if the RCM is wholesale, the EBI must be too.
- The CIS relates to investment, which is concentrated in wholesale.
- The majority of opex also resides in wholesale and therefore it seems right to allocate it the opex incentive allowance (if any).

The SIM is the one area where there is some debate as it relates to performance in both wholesale and retail. If the existing or future SIM, based on whole-business revenue was allocated to retail in its entirety it would swamp any normal margin for that business. Therefore this would not be tenable. But since we presume that SIM will be an uplift or penalty of +/- 0.5% we see no reason why the same percentage cannot be applied to the revenues of both (in the case of retail, the ACTS including any margin). This approach could continue to apply beyond 2014.

No SIM adjustment should apply to the gross margin for default tariffs in the contestable market. Doing so could distort competition (a negative SIM adjustment could squeeze margins and represent a barrier to entry).

Legacy adjustments should be spread over the period of the price control. And, given that Ofwat changed its approach to financeability at PR09, we think that the concern over incentive adjustments that are made before and after financeability is no longer relevant. All should be added to the company's revenue requirement – which presents an opportunity to simplify the price control.

In the past, incentives were added to revenue after the financeability test because there was a concern that a company should not be given extra revenue to offset penalties that were the result of past failure. But at PR09 no extra revenue was given – the only tool used was equity injections. At PR14 if the tools available to address financeability issues – such as varying PAYG and depreciation rates - are used, the difference to the company will only be one of timing; it will not be NPV positive. Therefore, there is no reason why the additional stage in the price-setting process should be required.

Including incentives with the revenue requirement does not mean that they will be subsumed within the allowed rate of return – the target rate can be adjusted for incentive allowances as it is at present. But making this change will also enable some consistency in tax arrangements. For example, at PR09 the opex incentive allowance was reduced by the effective tax rate to remove this benefit from companies – then moved to be a post-

financeability adjustment. Consequently, the benefit to companies was reduced twice (as companies bear the tax consequences of revenue allowed after financeability)

12. Totex and menus (Q47 to Q49)

The consultation proposes that there be a menu approach, with Ofwat setting a baseline. It refers to the challenges of the timescale, and the possibility of a more traditional business plan challenge process.

We support the use of a menu approach. However, it does not eliminate the need for a challenge process where a company's plan and Ofwat's baseline differ markedly. In order to enable this to happen, as many issues as possible should be resolved before business plan submission. We have identified issues where we want to have discussions with Ofwat.

In addition, a significant number of companies will need to be subject to a lower level of scrutiny. Therefore the criteria for determining a low level of scrutiny, and the way in which these criteria are applied, will be crucial. We have set out our proposals for criteria in Section 4 above.

If total expenditure is assessed over only five years, it will encourage companies to take a short-term view rather than reducing whole life cost, as we showed in our report, *Designing Incentive Packages*. We set out in our report how this problem could be removed.

It is also important that there is an NPV-neutral correction for cost differences, so that the incentive rate that companies get for any given level of performance is the one that they can see in the menu. (The true-up for the PR09 Capital Incentive Scheme is not NPV neutral).

The consultation does not set out the design of the menu or the incentive rate available. Incorporating opex into the menu approach means that, without an increase in the incentive rate available for the menu, there would be a very significant, and undesirable, reduction in companies' incentives to innovate and improve efficiency.

In terms of how performance is measured and expenditure added to the RCV, we assume that COPI as a measure of inflation for capex will be dropped – this would be in line with the aim of removing the distinction between opex and capex in order to correct perceived capex bias. This should be confirmed in the Business Plan consultation.

The menu design at PR09 did not make best use of the properties of the menu, in terms of encouraging accurate business plans, because companies were not allowed a choice. We are therefore pleased that the framework will allow companies to exercise a choice when they have seen the final baseline. However, where companies submit a plan which is efficient and supported by customers, and therefore only needs a low level of scrutiny, the baseline should be set at the company's plan and there is no need for a company choice.

The PR09 approach was to set Ofwat's baseline as the central point of the menu. This led to most companies having CIS ratios above 100, and lower rates of incentives. This was because of differences between companies and Ofwat on the scope of investment. We think it is better if the menu centres at the average difference between business plans and the

baseline, so that there is an appropriate spread of companies between those having lower rates of incentive and those having higher rates.

We have attached to this response a spreadsheet setting out a proposal for a menu, incorporating incentive rates, and would be happy to discuss this further.

13. Timetable (Q49)

We are concerned by the continual fluidity and slippage in the timetable - there is a risk that the overall approach will be undermined by rushed implementation. Even the timing of Business Plan submission has not yet been set.

The timetable is now very tight and there is still a lot which remains to be determined. The focus now should entirely be on issues which need to be resolved for PR14. Issues such as the network information incentive should be put to one side. We would be happy to help with development of the proposals in any areas where Ofwat would find it useful.

There needs to be sufficient time for thorough internal scrutiny of our plans, and review by our Water Forum – any further slippage in the timetable, or information requirements which have not previously been signalled, will jeopardise this. Arranging meetings when our Water Forum members can attend, and ensuring that they can be fully informed of the key aspects of the process, has to be planned well in advance. This is proving difficult with price review timings not being fixed.

We are well advanced in our planning cycle and could adjust to meet early December submission – but the decision on submission date needs to be finalised rapidly.

14. Building for future price controls (Q50 to Q55)

The process for PR14 is running very late. All efforts should be focussed on getting a satisfactory framework in place for PR14. We do not consider this is an appropriate time to divert company or regulatory efforts to the issues raised in these questions.

Appendix – CIS True-up

The CIS True-up model which was issued with the framework consultation is not NPV-neutral. This is a key requirement if the menu is to deliver the correct incentive rate for company choices. There are two key issues with the adjustment at present.

Financing adjustment

The indexation that has been applied for the purpose of the financing adjustment has the effect of clawing back part of the difference between the RPI assumptions that Ofwat made at PR09 and what has happened since. It is possible to demonstrate this as follows:

- Set company spend, in nominal terms, to be exactly the same as Ofwat assumed in the Final Determination (Allowance capex * assumed COPI), so that there is no adjustment to the RCV.

- Set actual COPI to be equal to the FD assumption (or vice versa)

The result is that the company suffers a financing adjustment, which is supposed to claw back the benefit of spending less capex than Ofwat assumed. But it has not done this – the calculation is clawing back the difference in RPI.

At present the calculation deflates FD nominal by the assumed RPI and actual expenditure by real RPI. Both allowance capex and actual should be deflated by the same index.

Gross adjustment to RCV

If there is no adjustment to reflect the over / under allowance for capital charges then there will not be a PV-neutral adjustment to reflect the difference between actual and assumed capital costs. Including a gross adjustment to RCV distorts the menu incentive rates and undermines the objective of reducing capex bias.

It might be possible to make a compensating adjustment to future depreciation in some way, but we cannot see where this has been done in the current approach. We think any such mechanism would probably be more complicated than adjusting for differences in capital charges, as Ofwat has in the past. Indeed, the simplification of regulatory depreciation would make this work much better in future: there could be a much better match between allowed depreciation and the adjustment.

We would welcome the opportunity to discuss this further with you, along with our other proposals concerning menu design.