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26 March 2013

Dear Stephen,

Setting price controls for 2015-2020

Thank you for the opportunity to respond to the consultation on the framework and approach for setting price controls for 2015-2020. The framework of separate price controls for retail and wholesale activities has been well signalled in the previous "*Future Price Limits"* consultations and the s.13 licence change process. We believe it is now appropriate to focus on the methodology that supports this framework as we approach the business plan submission and decision phases of PR14.

We have given some thought to the detailed questions posed in the consultation and set out our responses in an Appendix to this letter. These have been considered in the context of the potential stakeholder impacts summarised here.

Our response focuses on the key areas of the consultation, but with the emphasis on potential impacts to customers, the environment and investors.

A new framework and methodology necessarily requires thorough review and consideration to ensure that there are no unintended consequences and that the overall framework and methodology is coherent. Whilst we are responding to the consultation in the timescales required, as noted by Ofwat in the consultation, there are a number of areas that are still being developed and we will be coordinating and consolidating evidential analysis to support emerging points arising from the continuing methodology development which we will share with Ofwat.

Turning to the impacts of the methodology on stakeholders, we outline below specific points we believe are important considerations for Ofwat in finalising the methodology.

Customer impacts

We are supportive of a number of the approaches outlined in the methodology which we believe will improve the outcome for customers. In particular;

- We fully support the principle in the methodology that business plans should be owned by companies and reflective of customer priorities. We believe the use of independent Customer Challenge Groups (CCGs) to review and challenge company plans will result in a positive outcome for customers. Through the development of the South West Water (SWW) 25 year Future Outlook, the CCG reviewed and challenged the approach taken for customer engagement and translation of emerging priorities into an overall plan. The

CCG endorsed the approach taken and has written to Ofwat on this matter

- The introduction of the Service Incentive Mechanism (SIM) during 2010-2015 has been beneficial for customers and has encouraged focused reporting of improved service delivery from companies. We welcome its retention. Moving to an outcomes rather than an inputs and outputs approach for delivery will allow companies to flex their plans to align more closely to customer priorities over time.

Whilst there are areas we welcome in the methodology, outlined below are impacts arising from the methodology which we believe could have a detrimental impact on customers;

- We believe the detailed methodology presumes principles of unwinding existing cost allocations that will result in changes to customer charges between groups of customers without the customer evidence to support it. For example, legislation protects household customers and does not allow for household customers to be disconnected from supply despite bills for the service not being paid. Since the legislation was passed in 1999, debt outstanding from this customer grouping has increased, the consequential costs of which are borne by all customers (as it is legislatively driven). The methodology implies a shift in approach for cost recovery; costs previously applied universally will now apply to specific customer groups. This will result in bill differences arising which are not due to changes in company service but due to price control methodology changes. Where changes in the methodology result in bill changes (without a specific change in Government policy to signal this), we believe this should only be enacted if there is evidential support from customers for the change

- The methodology suggests an annual revenue correction mechanism with implications for customer bills accordingly. The potential for customer tariff and bill volatility as demand changes is unlikely to be welcomed by customers, given previous customer research on this issue. We are concerned that legitimacy and public trust in the industry may not be maintained by an approach which requires year on year bill adjustments for demand fluctuations. This may lead customers to form the view that “when it rains we have to pay more”, or “what I pay depends on the weather”. An Ofwat report in 2007 came to the same conclusion, and resulted in five yearly reconciliations. We believe the Regulator should support flexible approaches to applying revenue controls to customer bills which are reviewed on a longer term rolling or five year basis

- We note the outlined approach to calculating an industry average retail cost to serve which will be assumed as an allowance in companies cost base. The approach needs to guard against potential unintended consequences. For example, customers of water only and sewerage only companies effectively paying twice or significantly more for ‘retail’ costs, or customers currently benefiting from debt support initiatives that could cease if not recognised in the cost base. We believe these issues can be addressed in the approach to the calculation

- We note that this consultation focuses on the price setting methodology, but we believe it is important to consider the development of end customer tariffs and bills in parallel (especially as there is a potential for creating customer confusion because of the many price controls). Whilst not explicitly covered in this consultation, how price controls map through to customer charges and tariffs will be an important consideration. Customers will want to be billed for services received, and not prices arising from a ‘retail’ and ‘wholesale’ split. SWW has initiated a programme of work to look at this, and we are happy to share emerging thoughts

- We note the reference to (risk) and reward and sharing of (underperformance) outperformance of the regulatory settlement. We believe the continuation of a regulatory model which maintains as a principle the sharing of outperformance with customers is important. Under the existing regulatory mechanism, where operating outperformance has arisen, customers share in the benefits and have this passed back to them at the next regulatory price review. In the meantime many companies share benefits sooner from re-investing in the asset base and direct customer initiatives. In this regulatory period alone SWW has re-invested in the asset base and in customer initiatives. It should be noted however, that where risks manifest themselves, these are currently borne by the company and its investors for the regulatory period (unless they are significant enough to trigger other interim regulatory mechanisms). Any change in regulatory mechanism that moved this approach to a shorter period could move the risk allocation towards customers, with arising cost pressures not being mitigated by the company. In finalising the business plan, SWW will propose an overall incentive package which offers a balance between risk and (shared) reward that will still ensure innovation and the stable flow of capital.

Environmental impacts

We are supportive of the changes in methodology in this area namely;

- We agree that the Abstraction Incentive Mechanism will benefit the environment and is proportionate in the proposed approach to implementation. The approach provides an incentive to consider the sustainability of abstraction when short term drought issues arise

- The approach to Water Trading incentives for both importers and exporters ensures that the PR14 methodology does encourage increased cross-border supplies and is proportionate, given that resolution of other barriers to water trading are outside of Ofwat's remit

- The outcomes approach allows companies to reflect customer views on wider environmental impacts in measures that they target. Government priorities such as catchment management can be reflected in the outcomes framework with customer research and engagement providing clear support for the proposed approach

- The phased approach to incentivising network management and optimisation has the potential for long term environmental benefits. Our experience suggests that coordinated planning of both clean and waste networks and resources allows for improved customer service, lower costs and significant environmental benefits, including carbon reduction.

Investor impacts

We firmly believe that retaining investor confidence in the framework and methodology is paramount to securing long term efficient finance for the business. We believe the following areas in the methodology will assist in retaining this;

- The outcomes incentives approach and the financeability approach will provide an industry regulatory framework that is attractive to gaining and retaining lower cost investment. The suggested approach to incentives calibration is a technique SWW uses in developing our own plans as it provides a clear way of demonstrating the sensitivity of outcomes to critical assumptions

- The methodology simplifications such as "Pay As You Go" and the recognition of the importance that companies consider the balance of their own plan should be a welcome shift for investors.

We do believe however that a key risk borne by investors is the outcome of Ofwat's cost assessment.

- The impact of the regulatory assessment of a company's cost base is ultimately borne by investors. The shift in emphasis of a cost assessment methodology which has as its basis an arithmetic industry averaging approach needs to be applied with caution. As historically recognised by Ofwat, there may be valid reasons why companies may not have industry average levels of costs arising from legacy customer, environmental or geographic reasons. In particular we note the approach taken for assessing the retail average cost to serve. We have previously expressed concern on an approach that would fail to recognise company specific factors that drive higher operating costs, and factors that are outside of the control of management. This could drive perverse incentives. We welcome the acknowledgment that certain cost drivers like metering levels have impacts, and we welcome the opportunity to work constructively on assessing the drivers of customer debt costs. We believe that adjusting for company factors which are not mitigated by company efficiency or effectiveness is important in retaining legitimacy

- We note that Ofwat is also considering other costs that may vary from company to company. Historically, Ofwat has recognised a small number of cost areas; energy, pensions and rates which have been assessed separately due to their materiality, atypical and company specific nature. We would urge Ofwat to look at these areas again to refine the final methodology. Without recognition of these at a company specific level, the impact and volatility created would affect investor's decisions and discourage investment in headline below 'average' companies. If the factors concerned are customer or environmental driven, this will not be in their or customers interests.

We do not believe the issues highlighted are insurmountable, and we have outlined some pragmatic suggestions for how the approach can be implemented that would avoid the unintended consequences for customer and investors we have raised.

PR14 process and timetable

There is a balance to be struck between the time available for high quality company plans to be submitted, the amount of CCG engagement in advance of this and Ofwat's subsequent reviews and determinations (including the possibility for a fast track acceptance of plans).

The process needs to be credible for parties concerned and practically robust. We note that subsequent methodology workshops have suggested that the date of business plan submission may be accelerated to accommodate the 'fast track' process.

Clarity and certainty on the process and timetable are needed for companies to deliver plans on a tight timescale. This ensures appropriate engagement with company Boards and CCGs.

To assist companies with the timetable, we think it would be useful to identify if conclusions on some of the options presented in the methodology consultation can be finalised in advance of publishing the final methodology statement. Our own view is that with a few amendments as noted above the proposed framework will meet the objectives for the new regulatory approach.

Whilst recognising there is still much to confirm for the new methodology, we believe delivery can be accommodated in the timescales required as long as outstanding decisions are made in a timely manner.

We have welcomed the constructive engagement we have had to date with Ofwat on the development of the methodology and would welcome further opportunities to share our analysis and plan development.

Please contact me if you would like to discuss any aspects of our response in more detail.

Yours sincerely,

Susan Davy
Finance & Regulatory Director

APPENDIX – DETAILED CONSULTATION RESPONSE

In the section below we provide a summary of our overall response to the specific questions in the consultation (where the question requires a specific answer on what is proposed in the consultation).

	Q1	Q2	Q4	Q5	Q6	Q7	Q9	Q12
	Outcomes process	**Outcomes for 5 years**	**Definition of retail**	**Scope of wholesale controls**	**Water revenue/revenue yield**	**Simple revenue control for waste water**	**Draft process for developing baselines**	**Criteria for cost performance exclusions**
Summary of SWW views	Agree	Agree	Agree in part	Agree	Agree in part	Merits further consideration	Merits further consideration	Agree in part

Q4. Agree with water efficiency and customer side leaks in retail. Less sure on developer services and network calls where other than an initial contact all costs fall within wholesale. Forcing retailers to provide these services will affect the ability of new entrants to compete in the market, so we would suggest on balance that wholesale allocation should be preferred (particularly considering developer pricing changes and upstream markets for the future).

Q5. Subject to understanding in more detail how developer charging will work within this price control

Q6. Although in principle the approach has attractions, we are not convinced that it will smooth customer bills in practice, compared to the current RPI+K control with an end of period Revenue Correction Mechanism. The revenue yield approach may more complex than necessary

Q7. As for Q6, however changes in metering and new connections also affect sewerage costs (e..g meters on boreholes for sewerage only customers)

Q9. Cannot assess process due to lack of detail about what is involved. How will forecast data be considered? The approach that companies will make submissions where forecast data is not reflected in the CEPA variables does not feel practical.

Q12. Criteria need to consider link to the outcome incentives companies have chosen and the link to interim determination mechanisms that deal with uncertainty

	Q13	Q14	Q15	Q16	Q17	Q18	Q19	Q20	Q21
	MEAV value split	**Approach to simplifying tax**	**Average cost to serve costs**	**Criteria for adjustments to ACTS**	**Industry wide metering adjustment**	**ACTS glidepath**	**ACTS forward looking efficiency challenge**	**Net Margin for household retail**	**Retain modified SIM**
Summary of SWW views	Merits further consideration	Agree	Future costs	Agree	Agree	Agree	Merits further consideration	Agree	Agree

Q13. Should continue to use existing notional RCV split

Q14. Agree in principle, but would need to consider on what basis existing tax pools should be split between water and sewerage

Q15. Also need to consider carefully how capex is dealt with

Q17. Also need to amend the unique customer approach and consider how bad debt adjusted in the retail cost approach.

Q19. No forward looking challenge should be included given the purpose of the incentive framework

	Q22	Q23	Q25	Q26	Q29	Q32	Q35	Q36	Q37
	Additional water efficiency and customer leaks through wholesale	Roll forward existing non-household tariff structures	Historic or forward looking non-household costs?	Net margins for non household retail	Linking non-household default service to GSS	Water trading incentives approach	Securing efficiency water trades	Approach to implementation of AIM	Limit to scope of AIM
Summary of SWW views	Agree	Agree	Forward looking	Agree	Merits further consideration	Agree	Agree	Agree	Agree
Q29. A specific set of standards should be developed as GSS largely reflects wholesale service levels									
Q32. Agree with the approach, although some simplification of the importer incentive may be beneficial.									
Q35. As per Q32.									

	Q40	Q41	Q42	Q44	Q45	Q47	Q49
	Calibration of incentives	Evaluate overall risks in assessing the allowed returns	Approach to WACC for wholesale services	Approach to assessing financeability	Approach to adjustments for legacy tools	Criteria for assessing high quality business plans	Is the menu timetable feasible?
Summary of SWW views	Agree in part	Agree	Agree	Agree	Agree	Agree in part	Need more details
Q40. Important to retain an industry average cost of capital. If incentives are skewed for a particular company, then the first option should be to change the incentives rather than the expected rate of return.							
Q47. Criteria need to be more specific and focus on costs, financing and areas where there is the most risk to the primary duties of consumer protection and financing functions							
Q49. More details is needed on the data requirements for the cost models in order to test the timetable							

	Q50	Q51	Q52	Q53	Q55
	Proposed scope for network plus	Preferred option for implementing network plus	Preferred scope for network management	Preferred approach to implementing network management	Financial incentives for network management
Summary of SWW views	Agree	Need more details	Agree	Agree	Merits further consideration
Q51. We believe that non-financial incentives should be used, but the scope and intention is not clear					
Q52. We agree that a network management incentive has benefits. We remain of the view it should be defined as part of serviceability					
Q55. Although we agree on network management we are not sure that the scope is defined enough for financial incentives at this stage.					

Delivering what matters – an outcomes-focussed approach

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

We believe the Outcome process set out in the consultation has the potential to be an effective part of the regulatory regime. For initiatives that have a large influence on the outcomes that are identified by a company in consultation with customers and stakeholders, then the process is appropriate.

However, where initiatives only affect the measures in a minor way or indirectly, but it is still in customers interests for there to be delivery consequences built into the regulatory regime, there are benefits from considering an alternative approach. Cost based rather than value based incentives may be appropriate for some activities that are more difficult to link to outcomes. In particular, the treatment of supply demand and metering expenditure (both new connections and meter optants) which is largely customer demand driven and varies year to year will need to be considered. These initiatives are unlikely to have a significant value that can be derived across the whole customer base, but individual customers and developers and wider economic development are affected.

There are likely to be other aspects of performance where outcomes may meet the criteria for financial consequences, but incentives are already included in the regulatory framework (such as GSS compensation payments).

We will be carrying out research in order to understand customer views to inform our design of the outcomes incentives and how we will address these in our plan.

Where initiatives are uncertain, the role of interim determination mechanisms also needs to be considered in determining the type of outcome financial or non-financial incentive that may be appropriate. As an example, private sewers during PR09 has an outcome of effective and efficient adoption from a stakeholder and customer perspective, even though the costs were excluded from initial price limits due to uncertainty prior to adoption.

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

We agree that in most cases outcome delivery incentives should cover the 2015-2020 period, but companies should have flexibility to identify longer term delivery outcome incentives and propose these in their plan.

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

We believe that consistent performance commitments and incentives should apply across all companies where there are industry standard measures, in particular where there are specific government targets that apply across the industry. Therefore consistent incentives are appropriate for leakage, AIM, SIM, and potentially water efficiency/ consumption given Government policy guidance in this area.

For other aspects of incentives, delivery incentives are generally company specific even where there are industry standard performance commitments. An existing example is a consistent performance requirement to maintain stable serviceability using a standard set of KPIs, but the level of the KPI targeted and the performance consequence is largely company specific.

The methodology consultation did not directly consider the role of serviceability indicators in regulation. In an outcomes framework where the objective is for the measures to be customer focused (particularly for the 5 year period), there remains a role for longer term asset indicators that provide an indication that the approach taken is protecting the long term performance of the asset base, well in advance of it necessarily impacting the performance in terms of the services that customers receive.

We see a role for a consistent set of industry KPIs for asset performance to continue to be defined and monitored, but companies would identify the level of performance and propose delivery consequences alongside their outcomes framework. This consistent set of KPIs would also seem to be necessary for any network management reporting incentive. Ofwat may want to consider whether there should be any consistent delivery consequences and it is appropriate for Ofwat to undertake risk based scrutiny on the serviceability performance measures. However Ofwat should be cautious about applying consistent financial incentives even where there are industry standard asset KPIs being monitored, given the objective in the outcomes framework that targets should be set based on an economic level of service wherever the evidence is available to support this.

Defining retail (and wholesale services)

***Q4** Do you agree with our definition of retail? Specifically, do you agree with our preferred option for demand-side water efficiency services, customer-side leaks and developer services?*

Our views have not changed from the previous retail consultation – we agree with water efficiency and customer-side leaks being included in retail.

We believe developer services is substantially a wholesale activity – the initial customer contact and communication can be through the retailer but all of the discussions on connections and information on requirements naturally sit within wholesale. The customer service levels should be defined within wholesale as both retailers and end customers will need to be able discuss details directly with the wholesaler. Retailers could choose to provide developer services liaison on behalf of customers, but as in other sectors (e.g. telecoms, electricity etc) customers should have the option to go direct to wholesale providers. For instance, how does the developer of a mixed use housing and commercial development know which retailer to contact – the retailer is the choice of the eventual commercial customer? It may be better for the market for this to remain a wholesale activity to avoid new entrant retailers being required to gain sufficient expertise to deal with development and planning issues in order to enter the market.

For developer services and network calls, other than an initial contact all costs fall within wholesale activities. For network calls, we retain the view that although retailers may ask customers to route all calls through them, direct contact with the wholesaler during emergency situations is both desirable and unavoidable. Forcing retailers to provide these services will affect the ability of new entrants to compete in the market, so we would suggest on balance that wholesale allocation should be preferred (particularly considering developer pricing changes and upstream markets where the future design is yet to be established).

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

We generally agree with the proposed scope of wholesale water and wastewater controls. If Ofwat do choose to move from the current tariff price controls to a revenue based price control, given the planned market reforms, it is sensible for the two wholesale price controls to include all wholesale customer revenues, specifically large user customers using more than 50Ml that are currently outside of the tariff basket.

There was not sufficient information on the approach to developer connection charges to reach a conclusion on including these revenues within the wholesale revenue control. Although in principle we agree that this might be sensible, we need to understand what pricing approach will be assumed within the methodology (for instance for price setting will the current charges with their annual link to RPI be used as an initial default). The scope beyond infrastructure charges to other developer contributions and connection charges also needs to be considered, given the potential reforms that may be implemented for all developer contributions.

We assume that even if developer services are allocated to retail, the prices charged and developer contributions will be a matter for the wholesale business. We also raise related points in our response with regard to the outcomes framework and how developer demand led activity (for instance costs associated with new connections) should be adjusted as they change in the cost side of price limits in order to match the control of revenue. Therefore we need further clarification on these related points before we can finalise an opinion on the scope of the wholesale controls.

As we highlighted in the retail controls consultation, we identified that the key issues related to whether a sustainable business model would emerge from the decisions that were being considered as part of the consultation, and what impact this would have on household customers who had no choice of supplier and non-household customers who had choice of retailer.

First, setting separate price controls between retail and wholesale, and for retail differentiating these controls between household and non-household customers, implies a number of impacts for individual and groups of customers compared to now:

NOW	FUTURE HOUSEHOLDS	FUTURE NON-HOUSEHOLDS
A single price control recovering costs	Wholesale cost + Retail “average cost to serve” price control	Wholesale cost + Retail market price
Households and non households pay the same tariffs (except for the largest users)	Household tariff price control	A proxy price control based on a default tariff
Social protection costs (debt, vulnerable customer support) recovered over whole customer base	Household debt costs recovered from household customers.	Individual customer risk in market price – no social tariff cross subsidy (**unless this was reflected in the wholesale price**)
Cross subsidies inherent in framework unless physical service different (e.g. service and volume) – regional averaging of prices	Cross subsidies within household customers only	No retail cross subsidies between customers – wholesale cross subsidy pressure from retailers (e.g. water efficiency)

As highlighted in the table above, a key aspect that we identified from our analysis was that even if the same definition of retail services was used between households and non-households (which we agree with Ofwat should be the case), there would still remain a number of drivers as to why wholesale as well as retail tariffs could vary between the different customer groups. We agree with Ofwat’s suggested approach to assume a single wholesale revenue control and tariff for most household and non-household customers, as this will help to avoid tariff incidence impacts on individual customers. Revenue rebalancing over the whole customer base will continue to need to be reflected in any pass through of wholesale charges to non-household charges if this was not to result in an increase in bills to household customers.

However, setting separate retail price controls between households and non-households will result in some degree of tariff change, particularly for retail costs such as bad debt where higher household costs are currently recovered over customers as a whole (as most customers currently pay the same tariffs). This impact will vary by region, but will be greater where wholesale costs are higher and more revenue rebalancing for services such as social tariffs are required.

There are a number of drivers of why both wholesale and retail elements of tariffs (and potentially services associated with the price) are likely to change compared to the current position for both household and non-household bills:

- retail tariff separation (debt and social tariff costs)
- differences in the nature of retail services (more account management to provide price and service differences – including for wholesale and their arrangements with retailers)
- differences required as part of competition market codes (e.g. if the market rules included a strict rule required for a “level playing field” of no leak allowances for non-households, then this would result in a difference wholesale price between households and non-households to reflect the revenue recovery difference)

- wholesale services to retailers (e.g. for meter reading services, compensation for customer GSS events)
- legislative service differences (e,g. only households have a right to a free meter option – the past cost is within a wholesale price charged to both sectors as well as the potential to need to split wholesale prices for future meter optant costs)
- cost of market / Central Market Authority.

We believe these issues are at the core of the market and price control design and therefore needed to be explicitly exposed and addressed through the consultations. Currently households and non-households generally pay the same tariffs except for social tariffs that benefit households and lower tariffs for larger volume non-household users (reflecting the fixed costs involved in much of wholesale supply).

The PR14 consultation appears to make the general assumption that past regulatory reporting data collected as to numbers of household and non-household customers will match the future retail market customer eligibility. However, this is not the case. Many customers that are identified as non-household in regulatory data are mixed use premises that may not be eligible in the retail non-household market, in particular where they merely resell to domestic consumers (such as park homes, flats and sheltered housing). With the form of separate price control and tariffs that Ofwat envisage, these issues will need to be resolved in advance of setting prices. The simpler approach of setting a total household price control that would also act as the default tariff in the non-household market was suggested by us previously to avoid these issues and we believe it has significant merits.

Q6 Do you agree with our proposal for a mixed revenue and revenue yield form of water wholesale control, including our proposed adjustment mechanisms to smooth allowed revenues within the control period? Are there any adjustments you would suggest?

The new forms of the price controls will be very different for customers and investors in practice. From a customer perspective, there will be much less certainty about what the bills will be once price limits have been set. Ofwat has an objective that the form of price control will lead to a smoother change in price limits. Ofwat suggest that companies can improve demand forecasting in order to assist this, but in practice given weather and metering demand uncertainty it is very difficult to achieve this on an annual basis. We are of the view that it is important to retain the option for companies to balance revenue changes between price review periods, utilising an RCM at the following review for any revenue variation not amended by the company within the period (perhaps on a 5 year rolling basis).

We see the potential for more dramatic changes in prices with this methodology, particularly if demand appears to be fluctuating outside of determined levels at the start of a price review period. The final demand position for a year will not be able to be reflected in tariffs until two years after the year in which this occurs (as tariffs have to be set before the conclusion of the previous year). Based on calculations of demand changes experienced to date in AMP5 since PR09 (with meter optants and new connections also affecting this impact), we identify that there could have been annual tariff swings of up to +/- 10% under the proposed revenue controls compared to the current tariff controls, even where revenue across the whole 5 year period remains in line with that originally determined.

Tariff changes based on fluctuating demand could be smoothed out, but this would only be known with a large degree of hindsight and companies would require regulator support to retain flexibility to smooth tariff changes, particularly if demands were initially higher than expected. A key consideration is the customer perception and understanding of price changes that are based on forecasts of demand, rather than being fixed directly to an RPI+K tariff basket with a very clear link to a regulatory determination. It is important that Ofwat considers, before finalising the wholesale revenue control approach, how it will deal with the communication of such changes in annual charges where there could be dramatic fluctuations arising from the methodology that are not linked to the original determination.

We have a number of practical points that have arisen from our analysis which results in us reaching this conclusion:

- from a customer and stakeholder perspective – we do not think that explaining on an annual basis that charges are changing because of short term changes in demand and meter optants will generally be easily understood or accepted
- customers prefer smooth changes in prices (evidenced by research carried out at previous price reviews, including for SWW by YouGov at PR09). There is a degree of certainty with tariff controls. Turnover and profit variability could also be greater than currently with a wholesale revenue control, which will affect financial ratios and investor perceptions
- although the methodology for the revenue control allows companies to smooth out prices within the revenue control, the timescale for setting tariffs for a particular year means that only revenues two years previously will have been finalised at that point.

The DotEcon report for Ofwat in 2007 "Forms of price control for the water industry" included an in depth study using worked examples of different forms of price control using the tariff basket. This report included the conclusions:

"*Fixed revenue controls may be beneficial for ensuring the companies bear little revenue risk, though only in cases where costs are relatively flat (i.e. economies of scale are present). However, fixed revenue controls will not generally be seen to promote bill stability"*

The report also appeared to identify the options that Ofwat are currently considering for the mixed revenue yield for the water service:

"Dynamic controls with specified volume drivers, including for example in the case of new builds, may be particularly relevant for the case of water. Revenue drivers, such as water billed, may also be employed."

However the report also highlighted significant consumer issues with fixed and dynamic revenue controls:

"Fixed revenue caps do not perform particularly well against consumer issues criteria. The flexibility granted to firms may induce greater price volatility, particularly if demand is uncertain, transferring risk from firms to customers (Beesley (1997), Costello (1996), Littlechild (1986)). Revenue caps may also be less transparent for consumers (Beesley (1997)), and may therefore be less likely to meet Ofwat's criterion of consistency of bill movements with the price control."

With respect to tariff controls:

"Tariff baskets may fare better than fixed revenue controls where flexibility for the firms is limited between products being regulated, thus providing greater pricing stability. In addition, where weights are tied to previous year outturns then customers are likely to see stable bills. However, concerns may still remain on prices as across price controls and the extent to which significant price changes are experienced at the start of the next control."

The Revenue Correction Mechanism at PR09 was considered to be the best fit for the challenges highlighted above. If there is to be a revenue control then it will need to give companies freedom to smooth out changes in prices as far as possible across the five years. We would propose that companies should have flexibility to smooth out tariff changes, with an equivalent of the Revenue Correction Mechanism at the following review for any residual revenue differences. The examples shown in the consultation document do not include adjustments for the revenue differences in previous years or what the regulatory rules may be for adjusting for these. We think company flexibility will minimise the need to define detailed rules on how annual residual revenue differences should be adjusted.

In principle changing the revenue allowance for the cost of metering, new connections and demand has attractions. However, the additional cost of metering and new connections may be offset by the cost savings from the lower volume as customers on a meter save water. It is not yet clear whether this additional complication to price controls will be material enough, or whether a simpler approach is sufficient.

An additional issue with the wholesale revenue control arises from how the additional costs for the change in metering and water volumes will be determined. Incremental water costs are unlikely to be easy to ascertain (and there is no industry methodology for this currently, taking into account differences between company cost bases, peak demand patterns and how demands change over time). With developer contributions within the revenue control this may be complicated to apply in practice as numbers of new connections change (the incremental costs may vary over time depending on the nature of the new developments, both in terms of size and location). An additional question to consider is the relationship between the adjustments to revenue yield allowances and the wholesale cost assessment approach, in particular the link between forecast costs allowed for metering and new connections and the incremental allowances in the revenue yield, including whether these are industry averages or company specific costs.

A second issue arises from having separate price controls between wholesale and retail. Customers will not understand charges for ‘wholesale’ and ‘retail’ and therefore flexibility needs to be given to companies to allow appropriate charging categories to be developed for end customers. SWW is developing a charging approach, and is happy to share this with Ofwat.

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?*

Although sewerage volume related costs do generally vary much less than water costs for changes in customer usage, the variation of cost for the other factors within the water wholesale revenue yield also apply to the sewerage service. However, more detailed analysis on sewerage volumes may show that for certain customer groups (particularly where trade effluent is involved), then there is a much clearer link between changes in customer volumes and costs.

Meter costs in customer charges are currently split between the water and waste water service, as are new connection costs. If these charges continue to be split between water and sewerage (which is appropriate given the existence of water and sewerage only customers), then adjustments to the sewerage wholesale revenue control for these elements should be consistent with the water wholesale approach.

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

Companies will continue to have an incentive to prepare and update accurate demand assumptions irrespective of the form of the wholesale revenue control, as internal operating cost and investment planning relies on good demand forecasts to allow efficiencies to be optimised. There is also external scrutiny on demand forecasts through the Water Resource Management Plan process. However, short term changes in demand from one year to another will continue to be linked to uncontrollable events such as weather conditions, particularly as metering increases as a method of charging.

The current charging framework requires companies to prepare an annual assurance statement and this process will remain appropriate for 2015-2020. Ofwat can continue to undertake risk based scrutiny of the charges that companies apply. However, although companies can estimate long term demand trends, no incentives to predict short term demand changes are likely to be appropriate, as they would effectively amount to a disincentive to increase metering (and an ability to predict the weather!). A residual Revenue Correction Mechanism also ensures that a company will need to explain their approach to the revenue control in its annual assurance statement.

If Ofwat are concerned that the risks associated with the revenue control approach are such that detailed controls and incentives on demand forecast are required, it may be better to implement wholesale price limits rather than revenue controls.

Cost assessment

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

It was difficult for us to assess this process for developing wholesale baselines from the information provided in the consultation. This process relies on "triangulation" between a set of as yet unspecific cost models. Experience suggests that it has taken several years of reviewing cost drivers and potential models through a structured and transparent consultation process to develop the cost models that have previously been used in the industry. Whether "triangulation" will be appropriate between the cost models depends on the nature of the models and whether the results can be compared. Clearly any model has a degree of estimation within it, but this does not mean that multiple models can be combined in order to produce a cost baseline that is a reasonable estimate of efficiency. There was not enough detail in the CEPA report that accompanied the consultation on the approach or specifics on the type of models to know whether the process will be successful, but given the very tight timescales we have significant concerns.

Companies can prepare plans without reference to these baselines. However, in the absence of specific information, there could be greater differences in Ofwat's views on baselines and efficiency from company assumptions than at PR09. The process will need to be carefully approached and it will be useful for companies to be able to comment on the nature of the models and provide feedback and comments on the appropriateness of their intended use before cost assessments are published as a formal stage of the price review process. Given the timeframe, companies need to have the opportunity to review the baseline information, check the models and understand the implications for their plan, outcomes, investments and financing for there to be clarity about the price review process for customers and stakeholders when the baselines are placed in the public domain.

With a number of other companies we have engaged OXERA to consider how companies should consider wholesale cost assessment in company plans in advance of cost baselines being published, in particular so we can demonstrate the impact on the overall plan balance of incentive, investment, bills and financing from the cost assessment when this detail is available following our plan submission. We expect the results of this work to be available soon to inform the cost assessment approach and that it should also help to inform the forthcoming business planning consultation. Our preferred process would be to work with Ofwat to identify what costs in our plan fall outside of the scope of the potential cost models and for the business planning requirements to reflect that additional information will need to be collected. From a practical perspective, we think this will be easier with a set of initial models rather than from a longer list of variables from the CEPA report. We also think that an industry study on the overall scope of efficiency would help with the calibration of wholesale (and retail) cost and efficiency assumptions.

Even without publication of any cost assessment models in advance of submitting our plan, there are a number of additional areas of clarification needed in the PR14 methodology:

- the timing of publication for cost assessment and detail that will be available to companies
- the timetable for review of the baseline, comparison to company plans and clarifications being raised before draft publication
- the process for amending plans and outcome incentives in light of the baseline
- when the menus and incentive rates will be published – clarity could potentially be provided on this in advance of the baseline itself
- clarity that the final menu choice will allow companies to choose their position on the menu based on a final baseline and totex menu
- the approach to the use of corridors for cost assessment as suggested in the CEPA report
- how boundary issues between where company cost assumptions are used in price setting and where Ofwat will apply the results of the cost models
- how triangulation will take into account of issues where different models have technical inconsistencies that mean that the results cannot readily be combined
- the process by which company specific factors will be considered, particularly where they only apply to some of the cost models being triangulated.

Although we have not undertaken a full critique of the CEPA report, we have a number of concerns based on the limited information that it contained. The report appears to suggest that measures of service failure (e.g. leakage, interruptions and flooding) may explain higher costs. The report also refers to the additional costs that companies would incur in order to deliver stable serviceability. We do not believe that these are factors that can easily be interpreted within cost assessment models. For instance, serviceability is a company specific level of performance that reflects a long term standard of asset performance that have arisen from past improvements in service that customers continue to pay for in their bills. The CEPA report appears to assume that companies have enhancement expenditure in order to get from less than stable serviceability to a stable position. In reality this should not be enhancement expenditure, rather there could be additional operating or maintenance costs of recovering from less than stable serviceability.

Similarly, within the CEPA report (and in the outcomes section of the methodology consultation) a general assumption is made that enhancement expenditure results in service changes (or improving customer outcomes). Whilst this is true for compulsory legislative improvements and supply demand / developer infrastructure expenditure, most recent customer service improvements have been delivered through measures that change operating and maintenance costs (wherever possible alongside efficiency improvements that have reduced customer bills). This was a central part of our PR09 business plan approach, particularly through the move towards automating network management associated with our PUROS project.

We are not surprised that is proving to be more difficult to identify suitable cost drivers for the sewerage service total expenditure models compared to the water network. From experience volumes of waste water tends to be a very poor driver for explaining differences in wastewater wholesale cost to serve. A combination of factors including properties served, pipe length and capacity, numbers and size of works, treatment process spare capacity, load strength, treatment complexity such as UV disinfection, areas served, numbers of pumping stations and CSOs and non-resident (holiday) population will all be significant drivers of wastewater wholesale cost that vary in significant between companies. For the water service, water softness is an additional cost driver not mentioned in the CEPA report.

Past approaches have taken special factors into account, but these have taken several years to develop and test once the nature of the cost models has been revealed. None of this necessary detail is currently available. At the wholesale workshop it was suggested that companies could identify in their plan, or in advance of this, which of their own costs would not be picked up by the cost drivers listed in the CEPA report (in particular where the future is different from the past, including capital enhancement). Without knowing which variables will be included in the proposed models, we have concerns about the practicalities involved. For sewerage, where models are based on volumes are suggested, a company plan would need to specify all other drivers of costs (for instance future power cost changes linked to more intense rainfall volumes as well as forecast increases in future power prices).

This suggests that a very large amount of detail of uncertain value may need to be included in company plans, as we do not know what variables will be included in the final TOTEX models and what the sign of these variables (i.e. are these indicators of higher or lower costs). Experience from past modelling suggests that the same variable could indicate higher opex cost and lower capital cost, therefore we cannot predict the sign or explanatory significance of the CEPA report variables and whether this is relevant against the future costs in our own plans.

In our plan we expect to consider a number of alternative ways of delivering the same outcome. Some of these approaches will have impacts across a number of outcomes (both water and sewerage service related) and these will be compared to more traditional "single output" solutions. Catchment management approaches are a good example of this. There are long term benefits to both tap water quality, water resource availability, risk to bathing water compliance, flooding and wider benefits such as carbon. Cost benefit analysis allows these innovative approaches to be considered against traditional solutions that may be contained within the cost models (e.g. an end of pipe sewage treatment works solution that may be more certain in the short term, but ultimately would appear to be more expensive). We are concerned that the cost assessment approach may mitigate against such innovative approaches in company plans, or that post company plan submission the process will result in detailed scrutiny of very detailed options appraisal within company plans.

Another aspect of that needs to be considered in the baseline process is the treatment of forecast cost data for totex. This is an area of uncertainty and the validity of cost models based on historic data may be at risk once company specific forecast data is introduced.

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

There are some costs that should be passed through on a company specific basis. These are largely areas that are consistent with previous methodologies, or where there may be significant uncertainty as to the future impact, either across the industry or on a company specific basis:

- EA Service Charges
- Local Authority rates
- Competition preparation set up costs
- Pension deficit recovery costs
- Future energy cost changes
- Any other significant company specific costs identified by the company

Generally costs can be excluded from a general cost assessment approach when there is little short term ability for a company to materially affect or amend allocation of historic costs once the decision for the exclusion from general cost assessment has been announced. Ofwat should undertake risk based scrutiny on these costs – although no specific challenge should be necessary for EA Service Charges and Local Authority Rates. Cost allowances based on standard industry assumptions could be made for competition preparation set up costs, particularly for central settlement costs where notified item protection for cost variation should also be considered.

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?*

Special factors are unlikely to change significantly from those considered at previous reviews. However this will depend entirely on the cost assessment models used (and the cost drivers included or excluded from them) as to whether the factors should be adjusted for or not. Therefore we cannot be definitive as to what special factors will be appropriate in the absence of specific cost models. However for SWW it is unlikely that special factors should change significantly and the ones considered at previous reviews will still be just as relevant.

Based on the model variables in the CEPA report and the work undertaken by OXERA we believe that all enhancements driven by quality regulator legislative drivers and sewerage costs not linked to volumes are all likely to be special factors. As an example, if the cost models include leakage as an explanatory variable of higher TOTEX costs, the SWW would require a special factor for having low leakage per km of main and would also require an adjustment for any proposals that customer support for reducing leakage further.

Clean water special factors in the South West are likely to include peak holiday visitor population, pump storage water resource operations, impact of soft water area on discoloured water and additional chemical costs due to regional location.

On the sewerage service, as highlighted above that simpler cost models based on volumes is likely to result in a large number of special factors being required. In the SWW region, peak holiday population, scale of works, number of works, UV treatment processes, tight consents, coastal and bathing water discharge costs, no of CSOs, number of pumping stations, rural area with low population density compared to network length and topography that requires pumping, sludge treatment and disposal approaches appropriate for environmentally sensitive areas and rainfall volume and intensity are all key drivers of sewerage service costs that may well require special factors.

Ultimately the criteria will be a judgement on the overall case presented as to whether the factors are sufficiently significant to require an adjustment as part of the cost assessment process. In part, a special factor process depends requires data to be available that Ofwat may collect during 2013 in order to allow such comparisons to be made, wherever possible on a consistent basis across the industry.

Cost performance incentives

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

Within the methodology consultation there are a number of areas where industry averages and assumptions will be used to test company plans. Ultimately a key test for the final methodology will be to understand:

- how it adjusts for valid differences between companies
- how to do this whilst delivering a simpler, better regulatory process
- can the impact be predicted– as it could have a big impact on bills and customers views on investment options
- does it reflect the degree of management control over the cost

When the methodology relies on industry averages, it is more likely that some company specific or industry costs will need to be excluded from the general cost performance incentive framework.

Excluding costs from the cost performance incentive framework for uncertainty depends on the wider regulatory framework. If costs, timing and outputs are uncertain, but the costs qualify for interim determination adjustments that protect both company finances and customers from changes, then performance incentives can be retained as part of the framework (as with CIS).

Materiality of the excluded cost and the degree of control management have over incurring them are similar judgements to those used within the existing interim determination criteria currently. Therefore the criteria set out in the consultation are likely to be relevant.

It may be appropriate for Ofwat to link the exclusion of costs from the cost assessment framework with the cost performance incentive decision. Where cost performance criteria related to uncertainty or risk associated with the investment result in costs being excluded from the incentive performance framework, then it is likely that input cost or output delivery incentives are likely to be appropriate rather than through outcome measures with value-based performance incentives. This would be consistent with the outcome incentive decision making process that Ofwat set out in the consultation. This would allow uncertain costs / outputs to still be included in the general cost performance incentive framework with logging up/logging down.

For cost recovery

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

We are not sure why a revised RCV split to set wholesale price controls is necessary, using either 2010 or 2013 MEA Values. There is an existing notional RCV split between water and wastewater which has been used to set indicative K values between the two services, which reflects service specific additions and depreciation in the RCV since privatisation.

The choice of MEAV date of a revised RCV split will be impacted by the impact of private sewers (and pumping station) adoption and how companies have reflected this in the MEAV as at 31.03.13. Therefore we think it is appropriate for the water/sewerage split to continue to evolve over time with new additions, rather than being reset for the current MEAV. This avoids immediate customer bill impacts for those receiving only one service which would arise from what we estimate would be a c. 8% shift (c. £12 per customer) in total RCV from water to sewerage, changing the balance of wholesale tariffs with associated individual customer impacts.

Given that with PAYG and RCV run off approaches there will be a divergence of price setting assumptions with future MEAV calculations in any case, we would question the value in using MEAVs to reset the RCV between water and sewerage. This would be a difficult price change to explain to sewerage only customers which arises from a regulatory methodology.

It is not clear from the consultation what future value there is to MEAV and CCD calculations to the regulatory process. Given the proposed PR14 methodology, it would be helpful for Ofwat to reach a conclusion about whether this will be required for regulatory accounts or other purposes post PR14 as it does not appear to be needed by Ofwat for price setting.

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

In theory we agree that this is a workable simplification to the price setting process, although we are not sure how the existing capital allowance pools could be readily split between water and sewerage. Ofwat therefore have the option to leave this entirely to companies to decide on how to split capital allowance pools, or to provide guidance with the final methodology publication.

Setting retail controls for household customers

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

We believe that the Average Cost to Serve (ACTS) should be reflect both historic and forecast cost changes evidence – given Ofwat's stated intention for the retail revenue controls not to be linked to RPI. No retail business would plan its prices and activities without taking into account expected forecast cost data when making a decision about whether to operate in the market and how to serve it.

There are a number of issues of methodology that we have raised in response to earlier consultations that need to be considered before the ACTS can be calculated. The methodology does not appear to provide guidance as to how it is intended to deal with retail capital expenditure and how shared system costs and overhead allocation (particularly for future costs) will be adjusted for.

We have carried out some research on the evidence as to whether retail businesses can avoid input price inflation and future incremental cost increases through efficiencies. Our research concludes that retail input inflation is currently lower than it was at PR09 and potentially below RPI, but is not as low as zero. There are two factors that mean that it may be significantly higher than RPI in the near future. For household retail this is customer bad debt (of particularly concern are recent benefit changes in rented accommodation) and for non-household retail this is the cost of set up and maintenance of a competitive retail market. We think that this area is worthy of a more comprehensive industry study to inform the final price control decisions and we include our initial research with our consultation response.

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

We broadly agree with the proposed criteria for assessing other adjustments to ACTS other than metering. However, the criteria are not absolute or thresholds that should be met in their entirety. For instance, no costs are likely to be completely beyond management control, but it is the degree to which it is material to price setting judgements to assume that costs can be controlled when over the price control period this is unlikely to be materially the case that should be the relevant criteria.

There are two other criteria that we believe Ofwat need to consider. First, a criteria is required where not making an adjustment would create a perverse cost incentive to not deliver outcomes that customers or stakeholders want. Ofwat effectively consider this within aspects of the methodology such as allowing costs for additional water efficiency within wholesale rather than retail price controls. We believe it should be specifically considered in the ACTS criteria.

Second, as we describe in Q17 below, adjustments may be required where the cost of serving a customer who receives one service is not the same as a customer who receives both water and sewerage services. This criteria is consistent with Ofwat's stated approach of using the unique number of customers in calculating the ACTS.

Following on from our previous reports on this subject, we have worked with Plymouth Business School to explore the drivers of bad debt costs across the industry. This report clearly demonstrates that increasing bad debt is a specific matter for the water industry because of the unique legislative framework of a ban on disconnection, the impact on debt varying across the country because of matters outside of direct company control (wholesale bill levels, insolvency rates and proportion of tenancies). The report summarises past research on this subject and provides new evidence that household bad debt should be considered separately from the average cost to serve. A copy of the Plymouth Business School report is included with this consultation response and we look forward to discussing this new evidence to support the final PR14 methodology decisions.

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

We agree with the incremental cost approach for metered water and wastewater metered customers as the ACTS adjustment for metering. However, this appears to not be inconsistent with the "number of unique customers" approach which assumes that retail costs are the same for serving a water customer as a waste water customer.

Although Ofwat do not specifically address the unique customers approach as a question in the consultation, we believe that whilst it is generally true that it costs the same to retail to one service to a customer as two services (as sewerage calls form only c.10% of the total received by water and sewerage companies and most of the costs, particularly if network calls were allocated to wholesale, fall within the wholesale price control), this only applies if the ACTS adjustment adjusts for costs which vary between the services received.

For metering, an adjustment is required due to the potential for measured customer billing queries arising from metering for water separately from sewerage services. For bad debt, a customer receiving only one service will have a lower bad debt cost to that company than a company that supplies both services, because water and sewerage bills will be higher than the individual service bills. Companies with a significant number of customers who receive only one service will appear to have lower bad debt charges using the unique customer approach. A bad debt adjustment will correct for this and allow the unique customer approach to be used for cost assessment purposes. Without a bad debt adjustment, the unique customer approach is not appropriate as it does not reflect an accurate comparison of companies cost to serve on a like for like basis, even if you assumed that bad debt charges did not link to wholesale turnover or other factors that were sufficiently outside of management control to justify an adjustment.

However, even if the number of unique customers reflects cost drivers for the purposes of cost assessment, this is not sufficient for the approach to be used for revenue controls. A customer of a WOC who receives a sewerage service from a WASC could pay twice as much for retail services as a customer who receives both services from a WASC, with the potential for a noticeable impact on individual customer bills. We would suggest one simple approach could be to calculate the retail average cost to serve separately for water only customers as well as water and sewerage customers, with any average difference between WASCs and WOCs applied to the retail sewerage service. This would require a separate calculation for bad debt (linked to turnover) in order to ensure that sewerage only customers contributed their retail 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?*

We believe that a glide path approach should be applied and this should be applied smoothly over a price control period to allow companies time to respond to this retail cost incentive, whilst also providing a smooth change in customer prices that is generally preferred where possible.

Whether it is appropriate to assume that companies will reach the ACTS or a proportion of the difference between their actual costs and the ACTS should also be considered in the final approach. These decisions should be considered as part of the overall incentive calibration that Ofwat have set out in the methodology.

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

For companies below the industry ACTS, a forward looking efficiency challenge could only be set with a specific incentive mechanism or by considering the retail efficiency potential across the whole industry. Given the need to focus on other aspects of the methodology, for PR14 we would suggest limiting this challenge to risk based scrutiny of forecast cost changes projected by company in the business plan, which would apply to companies both above and below the industry ACTS (as this may need to be based mostly on historic costs with future costs being considered on a company specific basis).

An alternative approach can also be considered in combination with how input price inflation is dealt with. Ofwat could allow an element of input price inflation based on the most efficient company (on a per customer basis). This would provide all companies with some input price inflation allowance (within the price control rather than necessarily as annual indexation), whilst also ensuring that all companies both above and below the ACTS had an incentive to cut their costs further (to form the frontier at a future review). This approach would be compatible with a separate bad debt adjustment calculation and would be relatively simple.

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?

If a single price control is being set for wholesale prices (separately for water and sewerage), then Ofwat need to make the same assumption of retail payment terms between retailers and wholesalers for both households and non-household retail tariffs. This suggests that the same net margin may be appropriate between household and non-household retail. Given this, we do not think that there is an obvious methodology for assessing across the industry how household retail capital investment that may be being renumerated in wholesale prices should be adjusted in the household net margin. If a methodology could be identified, then it is unlikely to be material to the overall prices that customers are expected to pay, because the level of assets (with meters allocated to retail) is unlikely to be significant and will in any case vary by company, something that for households cannot easily be adjusted given the household retail average cost to serve is not using company specific retail costs in the price control.

Therefore we suggest that a simple approach to setting net margins is taken for the industry as a whole (as a proportion of wholesale turnover) and that over-recovery of returns, should this indeed arise, be considered as part of the overall RORE and incentive calibration / financeability process.

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

SIM should be retained as an industry standard KPI. However we believe that some modification needs to be considered so that it can be accommodated within the outcome process. For instance, Ofwat should consider modifying SIM so that it focuses on the wider customer satisfaction surveys rather than measuring “outputs” of unwanted customer contact activity. Although SIM may exist as a standard KPI, Ofwat may wish to consider whether the rewards or penalties for SIM performance should be established from company specific customer WTP surveys alongside other outcomes, rather than requiring Ofwat to establish the incentive range.

Industry standard SIM incentive rewards and penalties may limit the potential benefits from the outcomes approach (where improvements are best measured through how they impact customer satisfaction), because of the risk of double counting. Ofwat could consider the final approach to whether consistent SIM rewards and penalties across the industry are required after reviewing how companies have addressed outcomes in their final plans.

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

It is clear in the consultation that the arguments in this area were fairly balanced in arriving at this preferred option. We agree that there are points to be made both in favour and against this option. On the one hand, water efficiency and customer side leaks are allocated to retail services, but there is then a clear disincentive with the ACTS for the retailer to fund increases in demand side measures that are the most efficient way of delivering the water resource requirements that have contributed to a balanced wholesale plan and price control.

Although we recognise the pragmatism of the proposed solution, there are practical issues that Ofwat will need to address as how this would work in practice with accounting separation rules, although it may work depending on how outcome incentives are set. Given Government priorities for water efficiency, this may be a matter that is suitable for industry standard incentives. Equally it is clear that there needs to be some method for wholesale demand side measures that are needed across both households and non-households (as the benefits apply to both) to be included in wholesale price limits. Therefore we agree that the approach is probably sensible, although Ofwat will need to be clear about the accounting separation treatment of the increased costs to allow this to work.

An alternative approach that may be more consistent with ongoing accounting separation reporting would be to build into price setting an approach where the wholesaler pays the retailer for the demand side change to water efficiency measures, leaving an incentive for the retailer to deliver this cheaper within the appropriate retail price control. The price from the wholesaler would be subject to cost assessment challenge as part of wholesale price limits, with the additional cost "passed through" into household retail prices in addition to the ACTS on a company specific basis.

Setting retail controls for non-household customers

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

We agree that setting default tariffs on a company specific basis by rolling over existing tariff structures provides the most practical solution for implementing default tariffs, as we highlighted in our response to the previous retail price controls consultation. However, where companies identify in their plans that they wish to significantly change non-household tariff structures because of the move to separate price controls, it may not in practice be easy to roll over existing tariff structures (which are not separated between household and non-household customer except for the largest volume commercial customers). Flexibility may be required in this area.

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

There was not sufficient information in the consultation about how a non-household average revenue control would operate in practice (such as a worked example) in order to be able to answer this question. This has the potential to become very complex – when Ofwat refer to an average revenue control being applied per customer by each customer type, does this effectively mean a profile for the revenue for each default tariff would need to be established as part of the determination and then monitored in practice.

We assume that this approach only applies to the non-household retail element of the default tariff, with wholesale revenue controls reflecting the appropriate wholesale charge. Therefore a key question not covered in the consultation is whether the retail element of the default tariff will be set on a fixed or both fixed and variable amount. The consultation refers only to non-household customer numbers being considered within the average revenue control. However, we believe that forecast volumes will also need to be considered. Reflecting working capital in the margin with this link to wholesale charge levels suggests that the net margin for non-household retail tariffs should contain both a fixed and a variable element that will be applied to fixed and variable wholesale charges. Note that the separate decision in the consultation concerning meter costs being allocated to wholesale means that wholesale charges will need to be split between fixed and variable elements where standing charges currently vary by meter size. Not translating current charges between wholesale and retail elements in this way will prevent existing tariff structures being rolled over to a default tariff basis as Ofwat suggest.

Therefore we think that the average revenue control for non-household retail may not a practical approach, and would make it very difficult for companies to change tariff structures, something that would prevent innovation and may restrict the benefits of the competitive retail market. For instance, we have separate large user tariff thresholds for both water and sewerage, and in some cases there are very few customers on those individual tariffs. Customers already choose which tariff to be on and therefore they can and do switch. The average revenue control may result in the company having a revenue control for a single individual customer.

We understand that the once customers move away from the default tariff, the average revenue control no longer applies, in which case the tariff innovation point made above becomes less relevant. However, we were not completely clear on this point after the workshops.

Our preferred solution would be to have a single default tariff, which reflects a maximum price for non-household customers which for regulatory simplification purposes would be set at the total household regulated price until full market opening. The non-household retail revenue control would provide for an annual limit based on forecast numbers and volumes for non-household customers based on the gross margin included in the single default tariff which acted as a maximum price in terms of a fixed and variable element for retail charges (split water and sewerage customers as appropriate). There would be a single annual non-household revenue control for all non-households, irrespective of the tariff structure.

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?*

The costs included in the non-household retail control should be forward looking and company specific, including an allowance for input price inflation. A retail business would take into account both its actual costs and input price inflation in the prices it set, even if these are not indexed link. For market prices to be linked to default tariffs it is important that these are based on actual company costs. We do not think that it will be possible to adjust retail prices based on actual service levels based on GSS as most of these service requirements are based on wholesale costs. Therefore we would suggest making a simple assumption that it is the action of new entrant retailers and customer choice that will provide the future challenge to non-household retail costs and service levels.

It will be difficult to establish what the additional costs of service levels in addition to GSS are as these are embedded within company practices (and if efficiently delivered better retail service may well not result in additional cost to serve). A single retail default tariff (split fixed and variable) and linked to household retail price controls may be a simple solution.

The non-household retail costs will need to make an allowance for company specific capital costs, rather than assuming this forms part of an industry wide net margin. Retail investment decisions (including outsourcing and “cloud computing” rental rather than purchasing of retail systems) mean that specific allowances for both opex and capex costs are needed in order to avoid the non-household retail price control incentivising particular procurement approaches.

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

Ofwat have the option of only allowing the recovery of net margins in tariffs once the market is established. However, this may not be easily understood by customers as to why prices were increasing because of the opening up of a market competition. Therefore it may be better to accept that the net margin will be established for the whole period within the price control. There will be cost risks and uncertainty involved in setting up the market so it is likely that it will be appropriate to assume a net margin from 2015 in any case, and Ofwat can consider this matter as part of the overall risk and incentive balance in setting price controls. We would therefore suggest that a simple approach is taken rather than attempting to calculate how returns may vary between efficient retail costs and those used to set default tariffs, given that this would require a methodology and analysis which has yet to be identified.

Q27 *What constraints, if any, should we place on companies' ability to set the gross margin levels for individual default tariffs for non-household customers?*

What was not clear from the consultation is whether Ofwat will provide advice on net margin assumptions to be used as standard across the industry (e.g. taking into account payment terms) or whether companies will need to establish this for themselves. Ofwat appear to suggest in the consultation that companies should be able to estimate what margin a new entrant would need, but in practice we are unsure how to do this.

Tariff corridors for default tariffs risk additional complications – ultimately the default tariff should be set by the company based on a wholesale charging structure from the wholesale revenue control plus a gross retail margin that has been determined at price setting. Customers must be able to choose higher or lower service levels than this gross retail margin and move away from the default tariff. The choice is about how to regulate this in advance of the market – the most obvious approach appears to be a default tariff control (rather than revenue control) until the market is established.

Ultimately the approach that Ofwat set out appears to require revenue separation between wholesale and retail and then potentially different lines for these charges on a customer's bill. Customers may find this to be complex and not easy to understand. It may also entail expensive billing system changes.

Before companies can consider what gross retail margin is required (and before Ofwat can consider appropriate tariff corridors), a decision is needed on what payment terms should be assumed. For the default tariff to protect the end customer for the current level of service, the payment terms from retailer to wholesaler need to reflect existing terms. However, if the tariff corridors are designed to judge whether new entrant retailers have sufficient margin (or companies are proposing too high a margin) for the retail market, then the retailer to wholesaler payment terms for the market (which may be payment in advance as standard if this is a retailer market option) would need to be included in the gross margin. Our preferred approach would be to focus price setting on the default tariff protection for customers rather than attempting to reflect directly as the new entrant retail margin, which should for price setting purposes be set as a percentage of the wholesale non-household revenue to be added to the company specific wholesale costs. The regulatory regime could consider a Notified Item protection for recalculation of margins to allow for efficient entry once market design and pricing requirements were sufficiently clear for companies to consider what margins were appropriate to offer to new entrants.

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

Any retail business would anticipate in its prices that there will be general input inflation. Therefore this should be reflected in the forward projection of prices. Whether input price changes are difficult to predict is in itself unpredictable and uncertain; the past is not necessarily a good guide to the future. We would suggest that an appropriate solution would be to reflect an element of the gross margin that is variable (and linked to wholesale price changes), which will include therefore an element of forecast indexation within the non-household retail revenue control.

We include our analysis on the evidence for input price adjustments for retail services with this consultation response.

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

A specific set of standards for default tariffs need to be developed (including payment term assumptions). GSS largely reflects wholesale rather than retail aspects of service. As we highlighted in our retail price controls consultation response, there is the potential for incidence effects on customers which would not reflect Government policy – in particular on recovery of household bad debt across both services where customers currently receive the same level of service and same tariffs between households and non-households. An additional issue not covered by the consultation concerns which customers that are currently considered non-households for regulatory reporting is not the same definition as used for GSS and services standards and is also different from the current definition for eligibility in the competitive market. For instance household GSS and service standards apply to consumers who are re-sold water through what are currently counted as non-household customers, but because of the end user customers the non-household Reseller may not be eligible for retail competition in the market.

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

No opinion

Q31 *Are there other options for setting an efficiency challenge for non-household retailers in Wales we have not considered? If so, what are they? Which approach do you think best meets our objectives?*

No opinion

Making better use of water resources

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

We agree with the overall option for implementing water trading incentives. A worked example of water trading incentives would help with understanding the detailed aspects of the proposal. We are not convinced that the exporter should be penalised if the importer makes a decision that proves to have higher costs, as this is unlikely to encourage trading. It is also not clear how it would be identified that the trade was inefficient. All water resource decisions are based on social and environmental impacts (including the risks of availability in drought periods). Imported water may appear to be more expensive because it carries a different risk to the alternative options.

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.*

We support the aim of the proposed approach, although we think that in practice the proposed mechanism may become complex and discourage water trading. In the absence of a specific example from our experience we cannot comment what share of export profits should be shared with customers. In theory, it is important that any sharing considers the potential cost risks over the lifetime of the trade and that the amount of short term benefit that is shared with customers should vary with this risk. This could be simplified with an incentive rate that increases the amount shared with customers up to 50% based on the proportion of the cost to the exporter as a proportion of the total value of the bulk supply. The bigger the margin of profit over cost from the trade, the greater the proportion that is shared in practice. A stepped approach would avoid disincentivising more marginal trades that have the potential to be more worthwhile in the long run.

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

The approach should be as simple as possible, and preferably consistent with the export incentive approach. Where there are risks that additional costs may arise for the importer, the sharing incentive rate should vary to encourage trading and with a bigger share to customers built in for less marginal trades.

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 are not convinced that the approach will encourage significant new trades, but it is appropriate given the other barriers to water trading that are outside of Ofwat's remit. Ofwat need to balance the long term potential gains from water trading (including in the short term the evidence gathered as a result of early trades) with the potential for incentives to initially increase customer bills.

The most significant barrier to water trading is the need for quality regulator approval for each trade, with abstraction licence volumes reduced where these are traded or water is traded between catchments. This is a matter for Government policy rather than for Ofwat. However to encourage water trading Ofwat and the EA could co-ordinate scrutiny of draft Water Resource Management Plans and undertake risk bask challenge where companies do not appear to have fully considered import options to resolve any water resource needs.

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

A worked example of the AIM proposal would help with our review of the options. Groundwater AIM sites and the incentive options will require further development as part of establishing AIM. However, based on the description in the methodology, we agree with the approach set out by Ofwat of applying AIM to the most environmentally sensitive sites, with a specific over-abstraction volume that AIM is targeting for that site.

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

We agree that AIM should be limited in scope to sites where the EA has high confidence that abstractions are damaging Good Ecological Status (e..g WFD Band 3 sites). Any expansion of scope would require more complexity that Ofwat's preferred implementation option and would require site specific environmental costs and benefits to be considered within the AIM incentive.

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

Companies need to be able to demonstrate why AIM should not apply to a site as it would provide perverse incentives. In some cases the abstraction licence conditions at the site may contain evidence that the abstraction is being balanced in a way that contradicts the AIM incentive (e.g. if water is released from a reservoir for the abstraction, which would not benefit the river if abstraction was disincentivised during dry periods).

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

We think it is sensible to keep the phasing of AIM implementation under review. The incentive needs to be trialled in order to allow for calibration and we cannot prejudge what time period may be required for this.

Overall incentives, risk and financeability

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

The approach to developing outcomes, allowing companies to make balanced risk/reward cost incentive menu choices, calibrating incentive effects and testing the overall financial balance through a Return on Regulated Equity (RORE) approach are all parts of the PR14 methodology that we support. Indeed, this type of approach is one that we have included in business plans and determination responses at previous price reviews. Considering the uncertainty and risk involved in a suite of decisions and assumptions, such as testing the link between incentives, the value of investments, financeability and the cost of financing using decision support techniques such as Monte Carlo simulation helps us to identifying the outcome that we believe best balances customer, stakeholder and investor needs.

We think our approach has value for calibrating incentives and we are keen to work with Ofwat to consider its role at PR14. One key aspect of our approach is that it considers cost and financial risk alongside outcome delivery risks, allowing a direct link to be made between the key factors impacting customer bills and the value to services that they receive. For instance, the profile of investment over time is considered against the customer priority for how quickly different improvements should be delivered and preferred profiles for changes in prices.

To allow us to carry out this analysis in developing our PR14 plan, there are a number of areas where we would appreciate the detail on the approach in the methodology being clarified as soon as possible. For instance, cost assessment and how different types of cost changes are to be treated can have major impacts on the short term bill profile. In order to reflect customer views in our plan we will need to be able to predict bill impacts with a reasonable degree of certainty. Sufficient details of the wider approach to costs needs to be confirmed in advance of plans being submitted in order for balanced five year plan choices to be realistic. If this cannot be accommodated in the timetable then the potential for plan amendments following publication of draft baselines would be a very important step in the process.

It is important that an industry cost of capital and rate of return remains. However, where the incentives package may be skewed for a company because of the incentives package (e.g. perhaps because cost assessment does not include factors affecting a company plan), then the best approach is to adjust the cause of the skew (e.g. allowing for company specific factors). The second approach is then to adjust the industry incentive calibration (e.g. breakeven point or incentive rate on the menu). Only after this should company specific calibration be considered, due to the iteration with financeability support that this requires.

One aspect where further details of the price review process is required, is to understand what dialogue between companies and Ofwat will be required and when this will occur. In calibrating the incentives, it will be necessary to understand how Ofwat assumptions and judgements in a determination compare with the plan that the company considered was balanced when it was submitted.

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

We agree that the overall risks in assessing whether allowed returns are sufficient should be evaluated. This is a process we have always considered as a company in developing what we considered (through discussions and research) to be a balanced plan. Examples of such decisions at previous price reviews include the scope for smoothing out investment requirements to balance service improvements with customers' WTP and whether to smooth out changes in price controls to reflect customers' preferences for bill profiles.

A single clear methodology does not exist for evaluating overall plan risks. This is an area where our past business plan submissions provide an example approach that we would be interested in working with Ofwat to develop further as an approach for risk evaluation.

One key issue not subject to one of the specific consultation questions arises from the impact on the profile of profits that arises from a combination of the revenue controls approach and the use of Pay As You Go (PAYG) and RCV run off ratios for capital charges. The latter is a regulatory simplification, but can result in a different profit profile in actual company accounts from that assumed at price setting. PAYG and RCV run off ratios do have the benefit of allowing companies to balance price setting financing and investment decisions in presenting their plan as Ofwat intend, there is the potential for the unwanted consequence of making actual financial performance less certain, particularly if Ofwat challenge and scrutinise the company proposal based on industry averages.

This also shows a potential limitation with Ofwat's RORE approach, including using PAYG ratios to deal with financeability issues. Ofwat must ensure that the process is not perceived by investors as using the discretion that the regulator has in applying these regulatory tools by risking equity returns to deliver a short term decrease in customer bills.

The PAYG ratio was seen by Ofwat as helping to reduce a perceived capex bias. However, in the scenario of declining profit, the company would have to focus on reducing operating costs to offset this price setting turnover impact and to deliver the stable profit profile that would normally be taken by investors as a sign of a business performing in line with its plan and incentives framework. This has the potential to have the opposite impact to that intended by creating a material capex bias (an issue which has only arisen in practice from the low incentive for capital savings once the PR09 CIS ratio had been set – particularly as Ofwat intend to make an additional revenue adjustment at PR14 for the financing benefit obtained from any underspends against the RCV during AMP5, meaning that CIS outperformance is likely to result in total in a negative revenue adjustment at PR14 and vice versa for underperformance). This may mean that increased incentives for capital efficiency compared to opex were required, a solution to the capex bias concerns that UKWIR reports on cost assessment and recovery identified as a potential solution. Our preferred approach would be for companies to be able to propose an annual profile for the PAYG rate and RCV run off rate (rather than a 5 year flat rate) to help avoid these issues arising within the overall TOTEX incentive menu framework.

Q42 *Do you agree with our broad approach to setting the WACC for wholesale services, given our proposals for the remuneration of retail services in chapters 5 and 6?*

We agree that Ofwat should, consider market evidence for the WACC and rate of return on RCV using a number of techniques and then consider the overall risk balance in order to inform the assumption used for wholesale price control calculations.

Q43 In setting the WACC are there specific considerations we should bear in mind taking account of the profile of relevant risks to wholesale service provision?

The considerations of the WACC will be similar to those at previous reviews. Factors that will be significant are, as Ofwat identify, the overall incentives and risk package of assumptions used in setting price limits. Part of the consideration includes the degree of licence protection for unexpected events and uncertain costs through interim determination mechanisms. The degree of risk mitigation that is provided by index linking (including RPI for wholesale, COPI for capital cost elements of TOTEX and the use of forecast input costs within retail) will also be significant considerations as to the appropriate WACC. Evidence of any regulatory or market risk arising from competition will also be relevant to the WACC, mitigated by the price control and licence framework.

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

We agree with the broad approach to assessing financeability. As well as considering the regulatory risk and incentives framework, Ofwat will need to consider what impact the competition and market framework may have. How the cost of introducing competition is taken into account will be one factor that may affect the financeability risk. Greater uncertainty in the regulatory and market framework has the potential to increase the financial ratios that are consistent with investment grade ratings, as a bigger margin on financial indicators may be required if ratings agencies consider that there is greater uncertainty in the industry than in the past. The short term time horizon for any uncertainty may also mean that financial ratios need to demonstrate financeability over a shorter time period than in the past, where a glidepath of improving ratios over a price review period was sufficient to be considered financeable.

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

From a practical perspective we agree with this preferred option.

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

In the first instance it is for the company to consider the balance of financing and customer preferences for smooth changes in prices to inform how adjustments are applied. Ofwat can consider whether they agree with the company view as part of the price review process.

Delivering price controls in 2014

Q47 *What are your views on our emerging criteria for identifying high-quality business plans? Are there other criteria we need to consider?*

The key purpose of the criteria should be for Ofwat only to scrutinise in detail elements that are materially likely to affect the consumer protection and financing duties if price controls were set without scrutinising that detail.

The criteria therefore need to be more specific. As currently drafted the criteria could be interpreted as four separate stages with scrutiny at each stage if some criteria are triggered. Such a process would not necessarily assess company plans as a whole, in the way that companies are challenged to consider them. We would suggest a process that instead starts with the acceptability of the overall plan in terms of prices and customer/stakeholder support for the outcomes, and then if necessary scrutinises the costs and specific risk/reward approach that the company proposes.

The initial criteria that Ofwat apply should be related to the key economic regulator judgements on cost and financing. With the outcomes framework, it is not clear how Ofwat would be able to link a track record of delivery with the proposed commitments. The financial incentive in outcomes should be sufficient in theory to reflect this. However if the outcome incentive presents a risk in terms of delivery track record then other forms of delivery incentive (e.g. output or input regulation) may be required. To do this Ofwat will need to consider cost challenges and delivery incentives together. Therefore clarity on cost challenges and how these link to incentives and financing is the first stage of any regulator challenge to company plans.

Ofwat should be mindful of the risk of applying cost corridors when this information is not available to companies prior to preparing the plan, particularly if this results in step changes in challenge (from zero to the level of the corridor once it is reached).

The PAYG approach is an example of where specific criteria will need to be developed. Without objective measures for risk based scrutiny, we are not sure on what basis company PAYG proposals would be challenged. We would propose that dialogue is required, with the opportunity for companies to respond to any challenges with Ofwat before baselines and determinations are placed in the public domain. CCGs should be included in this advanced process. This will ensure that the challenge is understood and the context in the process set out from a stakeholders point of view.

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

There should be a high bar for Ofwat before unpicking in detail linked outcome and investment proposals that have been developed in company plans. Where detailed scrutiny for risk based challenges alters the company proposals, it will then be difficult to understand the overall cost assessment and incentive calibration judgements that Ofwat may consider applying to a plan. Ofwat need to distinguish between the criteria for redefining through regulatory judgement what outcomes and investments that have been developed from what is the efficient cost and appropriate price control for that set of outcomes and investments that companies have developed with stakeholders and CCGs.

There is a difference between the traditional output judgements Ofwat made at previous price review determinations (e.g. specific scope and cost challenges or removing whole tranches of investment from price limits through comparative analysis) and the outcomes approach, where customer and stakeholder views should remain central to a coherent package of investment and bill impacts. This change in regulatory approach is needed in order for the full benefits from the outcomes approach to be realised in practice.

Q49 *Is the timetable we propose for introducing menus feasible? How could we improve it? What can we and the companies do to address the challenges of the timetable to allow companies to make a real effective menu choice?*

The price review timetable needs to balance a number of objectives, with menu choice being one of the final aspects of the review process. There is a balance to be struck between the time available for high quality company plans to be submitted, the amount of CCG engagement in advance of this and Ofwat's subsequent reviews and determinations (including the possibility for a fast track acceptance of plans).

The process needs to be credible for the parties concerned and practically robust. At the workshops on the methodology consultation, revised timetables for the price review were presented as options. This included company final plan submission at the beginning of December 2013 rather than January 2014, to allow for more time for Ofwat plan scrutiny and representations on determinations. Whilst it may be possible for us to submit our plan earlier (although this would depend on the extent of the business planning requirements yet to be published and the final methodology), we do need to balance this with need for customer and stakeholder engagement.

Clarity and certainty on the process and timetable are needed for companies to deliver plans on a tight timescale. This ensures appropriate engagement with company Boards and CCGs. To assist companies with the timetable, we think it would be useful to identify if conclusions on some of the options presented in the methodology consultation can be finalised in advance of publishing the final methodology statement. Our own view is that with a few amendments as noted above the proposed framework will meet the objectives for the new regulatory approach.

Whilst recognising there is still much to confirm for the new methodology, we believe delivery can be accommodated in the timescales required as long as outstanding decisions are made in a timely manner.

Should Ofwat identify following plan submission that detailed scrutiny questions are required, significant plan amendments and hence more time for incentive and menu choice representations to be completed, then contingency plans can be available. There are a number of options for this, which depending on the final methodology could include company menu choices after the final determination and only reflected in prices after 2015/16. Simplifying the approach to cost assessment and retail tariffs may also help with any timetable issues.

We need more details on the data requirements and approach to developing the cost models in order to judge whether the menus timetable will be feasible. However, we believe that the timetable needs to include a final menu choice for companies between final menu publication and final determinations in order for the PR14 price review methodology to achieve the full benefits that it is designed to deliver. We recognise that this will be within the boundaries of the overall incentive calibration that Ofwat establish and that this is likely to influence the menus choice timetable.

If the timetable were such that a real effective menu choice was not available, then the process effectively reverts to that at previous price reviews where Ofwat replace company views on cost and investment needs with regulatory judgements. Ofwat would have to provide sufficient information on the assessment of costs and views on outcome incentives in advance of company plans being submitted, or allow substantial revisions to company plans with time for the views of customers and stakeholders about these changes to be understood.

There are a number of steps that Ofwat and companies can take to work within the proposed timetable. For companies, they must carry out their own assessment of cost risk and ranges and through this expose the assumptions on which they have based their plans. A key step is for Ofwat to finalise the approach as soon as possible with as much certainty as the regulator believes appropriate. In particular, cost assessment based on model industry averages allows a menu incentive framework to be published in advance of plan submission, whilst using a frontier efficiency approach would then require menus to be re-calibrated to industry average position on the menu before menu choices could be made. The choice between these approaches should not make a significant difference to price controls across the industry as a whole, but will affect the timetable.

Another option is for different menus to apply to “fast tracked” plans and those subject to more detailed scrutiny, or to only allow a menu choice to “fast tracked” plans. However we would not support such an approach as it may not reflect one of the key objectives of the totex menus approach which is allow companies to choose the risk and outcomes balance that matches the service they believe is in the interest of their customers, rather than regulator comparative cost judgements dominating price setting decisions.

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

We agree that water resources and sludge are the two activities that could be considered to be outside of a network plus sub-price limit scope.

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

The purpose of the network plus incentive has been discussed previously in the Future Price Limits consultations, but we do not currently have a clear understanding of the precise role and objectives for it.

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

We agree in principle that a network management incentive approach has the potential for long term environmental benefits. From our own perspective, the ability to manage the network is a fundamental part of the wholesale business and cost effectively delivering stable service and asset performance for customers. What information may be useful as best practice or to potential market entrants has not been defined and is likely to be company specific.

We note that recently the regulatory framework has moved away from standard industry reporting and KPI measures. We have questioned the role of serviceability targets within the regulatory framework elsewhere in our consultation response and as stated in earlier consultation and believe it is worth exploring if this existing approach could be developed into network management – the understanding of how services and asset performance are optimised and planned that is needed to inform potential upstream markets in the future.

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

The phased approach proposed appears to us to be, given that further work to define the scope is required. This depends on understanding what type or reporting is needed and useful.

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?*

If the objectives is to understand how the overall management of integrated water and sewerage network businesses has been balanced then understanding how companies had developed their asset management and investment plans as part of their PR14 submission would be the first stage. The level of information in the business plan requirements will depend on what information Ofwat need for risk based scrutiny of the plans, including from the perspective of future reporting.

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

It is difficult at this stage to identify how the cost of reporting will be identified without a definition of what the objectives and requirements are. We anticipate that there are investments that will continue to contribute to improvements in network management, building on our PUROS investment at PR09. There are gains possible in sewerage network management that will benefit from the development of network optimisation techniques in the water network where the largest gains from such approaches are initially apparent.

Cost based financial incentives for network management however do not appear to sit easily with the outcomes framework. Investments in improved network management should be determined by the benefit to customers and the environment. Using the criteria for outcome incentives therefore, given the uncertainty around the objectives and whether network management can be measured, this would suggest that non-financial incentives or no incentives are appropriate.