

26 March 2013

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Pamela Taylor
Chief Executive

By email to stephen.beddoes@ofwat.gsi.gov.uk

Dear Stephen

Setting price controls for 2015-20 – framework and approach

Water UK welcomes the opportunity to comment on your consultation on 'Setting price controls for 2015-20 – framework and approach' (the 'methodology').

We are not responding to all of the specific questions asked. Our response focuses on a number of key high-level points concerning the methodology and the 2014 price review following discussion with our member companies. Companies will respond individually to the consultation and all the specific questions, reflecting their own circumstances and opinions.

We are content for our response to be published in full on your website.

Ofwat's PR14 ambitions

Water UK supports Ofwat's ambitions for PR14 – based around 'company owned' high-quality business plans that fully reflect the views of customers, focus on longer term outcomes and give companies ownership of the risks they face. In addition, we support the key 'technical' features of your proposed new approach: separate wholesale and retail controls, using the regulatory capital value (RCV) approach for wholesale assets and indexing this to RPI, the use of 'totex', the use of menus, continued use of a WACC approach to remunerating wholesale risks, and the broad approach to assessing financeability.

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Customer views

Companies are ensuring that customers have a key role in the development of their business plans and there has, and continues to be, extensive engagement with customers and constructive challenge through the Customer Challenge Groups. We expect that Ofwat will similarly ensure that it has due regard for customer views, as reflected in company plans, and will show clearly and comprehensively how customers views have informed its decisions in PR14.

We recognise and support Ofwat's wish to avoid companies inadvertently focusing attention on meeting regulatory expectations, rather than customers' expectations, but as the arrangements are new to all of use, we believe it would be helpful if Ofwat could provide further clarity on how the Customer Challenge Group's reports of company business plans will be used. Expectations have been rightly raised about the reflection of customers' opinions in PR14 decisions and it will be helpful for all parties to clearly understand the process ahead of Ofwat's decision making during 2014 to ensure transparency and credibility of the process.

Timescales and scale of the workload

While we are fully committed to Ofwat's objectives for the price review process, we, like many stakeholders, are concerned about the scale of the workload and the very tight timescales for PR14, particularly given the complexity of the proposed new approaches.

There is a significant amount of work already underway on customer engagement and the development of business plans. However, in order to underpin meaningful engagement with customers and to develop robust plans it is essential for companies to fully understand the process and the methodology.

It is essential for the credibility of the price review process, and to help support companies' work to develop their business plans, that there is no delay in publishing the final methodology. We note that Ofwat's proposed forward programme scheduled the final methodology for quarter one (by the end of June) of 2013-14.

Given the concerns about the scale of the work and timescales we believe that it would be very helpful if you could publish a detailed timetable, with key milestones fixed to specific dates, as has been employed by other regulators. This would provide clarity, credibility and support focused planning and delivery by water companies, other stakeholders and Ofwat.

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Financial model

A financial model is an essential tool in the price review. We understand that you will be developing your model and currently plan to share it later this year.

Whilst companies are developing their plans using their own models at the current time, as we have discussed with Ofwat, companies are keen to work with Ofwat on the development of the financial model, given the importance of this in the price review process. This would minimise the risk of variances in the outputs of different models and the difficulties this can then cause. Working together on the development of the model would not detract from the customer facing work in PR14 but would help produce a better understood and more robust financial model as well as fostering better engagement.

Cost assessment models

We are very keen to see Ofwat share its cost assessment models given the importance of these in PR14 and the need for companies to be able to review the robustness of these, alongside the checks that Ofwat will itself be doing to assure itself of their robustness. As a minimum it would be helpful if you could set out when these will be shared. However, there would be more constructive engagement in the price review process if these are shared earlier to enable companies to review these and have a dialogue with Ofwat.

Retail costs

The consultation sets out that you welcome evidence from stakeholders if they consider the retail control does need to allow for uncontrollable input price pressures, and how they meet your criteria. Further to publication of the consultation we have commissioned a study in this area. We expect this to be completed in April and we plan to share it with you then so that you can take it into account in the finalisation of the methodology.

Change protocol

You state that the proposed introduction of outcome delivery incentives will address many of the issues covered by the existing change protocol and therefore it will no longer be required for 2015-20. We would agree that introduction of this incentive should address some aspects of what the change protocol provides for, through providing more flexibility for companies. However, we believe that the change protocol has been a useful tool to address material changes from the assumptions made at a price review, in relation to

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legislative obligations. We consider that a change protocol should remain for 2015-20, albeit potentially adjusted to reflect the interaction with the outcome delivery incentive. This is something that companies would be keen to discuss further with you and, to ensure that there is clarity on the regulatory framework, with other regulators.

Risk and financing

We support the broad approach you are setting out – though more detail is necessary on financing and the proposed use of use of return on regulated equity (RoRE) to calibrate the overall package of incentives.

Further to what you are consulting on, we note that in Jonson Cox's lecture on 5 March 2013 at the Royal Academy of Engineering he set out some further ideas on financing and risk. Whilst he said these were personal views, and not – at the time – Ofwat policy, where they have implications for, or are to be considered as part of, PR14 then it is essential that Ofwat sets out and consults on its formal proposals as soon as possible.

Charging

As part of the wholesale price control Ofwat is proposing to implement a revenue cap with an annual adjustment for differences between actual and planned volumes supplied and meter connections. This is an improvement on the existing revenue correction mechanism to the price cap. However, more detail on charging is required since it is essential to help companies understand the implications of the proposals and their practicality, and take this into account in engagement with customers/Customer Challenge Groups and in preparing their business plans.

Investor survey

As Ofwat is aware, Water UK is currently undertaking a survey of investors (Keith Mason is on the steering group) to explore investors' views of developments in the sector, market reform and Ofwat's approach to PR14. Results of the survey are expected during April and we hope that you will take these into account as you finalise the methodology.

Next steps

Water UK looks forward to seeing the final methodology and working constructively with you during 2013-14.

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Please do not hesitate to contact me if you would like to discuss anything raised in our response.

Yours sincerely

A handwritten signature in black ink that reads "Paul McMahon". The signature is written in a cursive style with a large initial 'P'.

Paul McMahon

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