



Mr Stephen St. Pier  
Finance and Networks Division  
Ofwat  
Centre City Tower  
7 Hill St  
Birmingham

**23 May 2013**

Dear Stephen,

### **Setting price controls for 2015-20 – business planning expectations A consultation**

We welcome the opportunity to respond to your consultation document, 'Setting price controls for 2015-20 – business planning expectations' and hope you find our response helpful in reaching your final decisions.

We have structured our response into two parts. In the first part we provide some high level comments about the overall approach you have proposed to incentivise high quality plans. The second part of our response, attached as an Appendix, sets out our response to the questions raised in the consultation document.

### **Assessing and incentivising high quality plans**

We remain concerned about the timing and publication of the final price setting methodology. It is vital that this is not delayed so we can have sufficient time to understand and respond to the final design and intended implementation of new incentive mechanisms, including the incentives for high quality plans. Ofwat has yet to confirm specific dates on which key methodological issues will be finalised. We continue to urge you to confirm specific hard deadlines for the remainder of the PR14 programme. This is essential to minimise the potential for delay and to facilitate an effective price review process.

As we set out in our response to your consultation 'Setting price controls for 2015-20 – framework and approach' believe that a 'light touch' review is a strong incentive for companies to challenge the process they follow in developing their final business plan for submission. We are encouraged by the opportunity Ofwat is seeking to give companies. However, we would caution that the incentive design could lead companies to focus on avoiding a 'resubmission' status on any business plan element instead of aiming for 'enhanced' status. This is likely with your current proposal which suggests the element of the business plan with lowest assessment will apply to the whole plan, while achievement of 'enhanced' status requires all business plan elements to be 'enhanced'. The proposals do not explicitly consider the relative weighting of business plan elements. This is

particularly important for water only companies where the contestable retail business plan element is much smaller than the wholesale element.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. Bienfait', with a stylized flourish at the end.

**Richard Bienfait**  
**Chief Executive Officer**

## Appendix: Response to Setting Price Controls 2015-20 – Business Planning Expectations

### **Q1 Do you agree with our definition of a high quality business plan? Is anything missing? Is there anything you think we should cover?**

We think the consultation does identify a number of factors relevant to the quality of a business plan, but the definition of what is meant by a high quality business plan is insufficiently precise and therefore risks creating a misalignment in understanding between Ofwat and water companies. We have no understanding of how Ofwat will determine relative or absolute standards and no visibility of the strength of the incentives Ofwat will implement.

We note that in your 2010 discussion paper 'The role and design of incentives for regulating monopoly water and sewerage services in England and Wales – a discussion paper' you stated that an efficient and effective incentive should be clear and transparent, understood by those affected by it and minimise unintended consequences. We do not consider the incentive for high quality plans to be transparent unless we can be given an understanding of the standards that will be applied in the assessment process.

### **Q2 Do you agree that our preferred package of reputational, procedural and financial incentives will incentivise high-quality business plans? If not, what do you think we should add to the package, or change?**

We believe that a combination of reputational, procedural and financial incentives, can be strong spurs towards high quality business plans

The incentives proposed may lead companies to focus on avoiding a 'resubmission' status on any business plan element instead of aiming for 'enhanced' status. We believe this is very likely with your current proposals as the element of the business plan with lowest assessment applies to the whole plan. However to achieve 'enhanced' status requires all business plan elements to be 'enhanced'. The incentives are not balanced and in addition the proposals do not explicitly consider the relative weighting of business plan elements. This is particularly important for water only companies where the contestable retail business plan element is much smaller than the wholesale element.

This situation is exacerbated for companies as resources expended in business planning can be seen as insurance against the uncertain outcome of regulatory assessment. The outcome is uncertain because companies do not know:

- whether plans will be scored against absolute standards, comparative standards or a combination
- the details of the tests that are to be applied
- the strength of the incentives that will be applied - for example, companies might know a financial incentive, that they have to choose from a more or less attractive menu, but how much more or less attractive?

Ofwat could mitigate these effects by specifying and publishing its assessment standards in advance, give details of the tests it is to apply, and more detail about the different menus that might be used, however we note it has ruled these options out.

**Q3 Which of the options (elements earn procedural and financial rewards; two-category approach; two-process approach for retail; later decisions on resubmissions) do you think we should use, if any? Why?**

Ofwat's basic preferred option - to grade a company as either *enhanced*, *standard* or *resubmission* based on the score of the lowest element of its plan - risks failing to distinguish between companies properly. For example, a company could achieve *enhanced* for 2 elements of its plan and *re-submission* for the third, yet receive the same overall company grading, reputational, procedural and financial penalties as another company that had failed completely across all 3 elements of its plan. The two companies would have achieved markedly different levels of performance, yet would be treated the same.

Therefore of the options consulted, our preference is *Elements earn procedural and financial rewards*. As each element is assessed separately the whole of a company's business plan would not be penalised if just a single element was of lower quality. This approach seems to provide a set of rewards and penalties that most closely reflected plan quality. It could allow elements of the price control to proceed rapidly through to draft determinations if their quality merited that treatment. It would not hold them up because of shortcomings in other elements.

*Two-category approach* – we think the main drawback with only two categories is that companies that miss out marginally on *enhanced* grading are treated exactly the same as those that had failed significantly to produce a quality plan. There is no additional consequence for poor plans so this will have weak incentive effects.

*Two-process approach for retail* – having only two categories for retail suffers the same drawback as the two-category approach above; there is no additional incentive effect and so it would not seem to help Ofwat meet its objectives towards high quality business planning.

*Later decisions on re-submissions* – the advantage of this option is that once the companies with *enhanced* plans have been announced, there is more time to sort the remainder into *standard* or *re-submission* groups, so cutting the risk of subsequent downgrades. However the cost of this option appears to be less certainty because companies will have to wait for longer to find out their score. The knock-on effect is that those who need to re-submit will be doing so against a condensed timetable, when the intention is instead that Ofwat spend more time scrutinising re-submission plans, they being of highest risk. Overall, the benefits do not seem worthwhile in terms of uncertainty costs for *standard* companies. It would not seem to allow Ofwat to carry out its objectives fully for cases of *re-submission*.

**Q4 Do you think that our proposals will be effective in meeting our objective of handing back ownership of the business plans to company Boards?**

The proposals seem to us to confirm that business plan ownership remains the responsibility of company Boards.

**Q5 Do you agree with the four high-level groups of tests (outcomes, costs, risk and reward, affordability and financeability) are the right ones? If not, what do you think we should add or remove?**

Although the consultation says that there are four high-level groups, we think there are actually five, as the final category is performance. We think that there is potential for conflict between tests and we suggest that Ofwat develop an approach that recognises where companies have struck an appropriate balance against the tests. Individual expert teams within Ofwat, studying specific parts of plans, may not be fully aware of the interactions, balancing and trade-offs made by companies in their plans. It would therefore be helpful to the process if companies can be assured that the Ofwat

Board has taken an overall view of company plans to make sure that the final assessment is not simply an aggregation of individual scores and that consideration has been explicitly given to how the plan fits together as a whole.

**Q6 Do you think we have set out the right tests in each group? If not, what do you think we should add or remove?**

We do not understand the purpose of the *Financeability of individual controls* test in Table 8, because the price setting methodology proposes that financeability tests be carried out at company level. It seems wrong to mark down a company's plan for assessing financeability at business plan element level when this not what Ofwat will do when it sets the controls.

In Table 6, Ofwat recognise that companies are *best placed to identify company-specific risks* and should choose themselves whether to prepare additional scenarios. Yet Table 6 also seems to indicate Ofwat might override companies' expert judgements and mark down their plan on the grounds of *insufficient information* if they choose not to prepare scenarios. Elsewhere Table 6 also seems to allow Ofwat to override companies' judgements as being implausible, inappropriate or unacceptable. These tests should be removed as they seem to substitute Ofwat's judgements for the expert judgements of companies.

**Q7 Do you think our proposals for business plan assurance will be effective in meeting our objective of handing back ownership of business plans to company Boards?**

The proposals for business plan assurance seem to us to confirm that business plan assurance remains the responsibility of company Boards.

**Q8 Our objective in specifying the data tables and the August submissions is to ask for all of the information we need, but no more than we need. Do you think that we have achieved this? Is there any information that you think we might not need? Is there any information that you think we will need but we have not included in the data tables?**

We are unable to answer the question with certainty because the final methodology is not yet finalised and we do not understand how you will use this data. We cannot know the full extent of your data requirements and hence whether or not you have all the data you need and no more than you need. In light of this we think it is important to ensure that companies have an opportunity for data correction where it can be demonstrated that genuine errors or misinterpretation of the data specification has occurred.

We plan to complete *Table 2 – Explanatory variables and volume measures for the water service* on the basis of Affinity Water's total area of supply, not on the basis of the three predecessor companies. The exception to this is line 17 "serviceability assessment – infrastructure", where the separate historic assessments for year 2010-11 will need to be given. Further in *Table 7 SIM Legacy* we expect to provide SIM data on a disaggregated basis for the period ended 2012/13.

**Q9 We aim to collect data on a consistent basis from all companies. Are the data tables clear and well specified? Are there any areas where we need to look again at the way we have asked for the data to remove any ambiguities in the request?**

We understand that there are benefits for regulatory simplification resulting from Ofwat not issuing detailed guidelines. However where data items are entirely new, there is scope for companies to interpret what is being asked for differently. We would observe that the simplification of the process

is bought at the cost of a reduction in consistency and comparability. This could matter if the data are to be used for relative comparisons.

In many cases, as we have not attempted to collect the new data before, we cannot necessarily foresee where we may have questions about data. Therefore we welcome the set up of the [business.plantables@ofwat.gsi.gov.uk](mailto:business.plantables@ofwat.gsi.gov.uk) mailbox, which we can use to resolve material questions about data.

**Q10 Do you agree with our proposal to continue to set price limits for new appointees using a relative price control? If not, what alternative do you prefer?**

We think the most sensible approach would be to use a simplified process to calculate allowed revenue and apply relevant price controls, rather as is proposed for Cholderton.

**Q11 Do you agree that we should set Cholderton and District Water its own simplified price control?**

We support this proposal.

**Q12 Do you think that we should develop a new small company service incentive? If so, what form do you think this incentive should take?**

We agree that SIM is not appropriate for small water companies as it would be difficult to obtain reliable and representative contact data because of the small number of customers supplied. Although we do not have a specific proposal for this, we think on principle that a small company who prices relative to the incumbent should not be rewarded unless its service outperforms the incumbent's, and should risk being penalised if it falls below.

**Q13 Do you agree with our proposal that small water companies should not be subject to separate wholesale and retail price limits?**

The consultation says that the main purpose for separating wholesale and retail controls is to facilitate competition for non-household customers. It would seem to follow from this that where small water companies supply large, non-household customers, they should also be subject to separate price limits.

**Q14 New appointees are growing in size. In the future do you think that we might need to adopt a different approach to regulating their prices and service? If so, what circumstances should prompt a change of approach?**

As some of the new appointees now have more customers (up to 2,000), than the smallest incumbent appointee, Cholderton, (700) it seems to follow from this convergence that in future the price setting process should also converge. Setting separate retail and wholesale price controls is necessary to support the proposed national retail market for non-household customers.