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21 May 2013

Dear Stephen,

CONSULTATION ON BUSINESS PLANNING EXPECTATIONS FOR PR14

We welcome the opportunity to comment on the business planning expectations for the PR14 Price Review.

We agree with the principle that companies own their business plans, however we note that Ofwat has raised its expectations of Board assurance for submissions while simultaneously reducing the time available for companies to complete them. It is important that in order for Boards to fully engage with the price review process Ofwat sets out the key dates, both for companies to submit plans and baselines, and when Ofwat will issue key documents such as determinations and baselines. Having firm dates is equally important to enable our Customer Challenge Group to engage effectively.

It will also be important for companies to understand the scale of the financial rewards for achieving an 'enhanced' rated business plan so that they can properly balance the risks and rewards in developing their plan.

We set out the remainder of our response including our responses to Ofwat's questions in the attached annex.

Yours sincerely

Jean Spencer
Regulation Director
Enc.

Annex – our consultation response

An incentives-based price review process

Q1Do you agree with our definition of a high-quality business plan? Is anything missing? Is there anything you think we should change?

The consultation refers to a number of criteria which might be used in assessing business plans hints at a number of different factors that might play a part in Ofwat's assessment, namely:

- outcomes and associated incentives
- costs
- balance of risk and reward
- the existence of fair pain/gain share
- absence of gaming
- affordability
- financeability
- clear well-reasoned evidence, obtained independently
- accessibility
- the level of assurance in relation to the plan, the Boards role in its preparation
- corporate governance and compliance

This seems to be a comprehensive and broadly sensible list. Although we would not expect to know precisely how these criteria will be applied in practice, the consultation and subsequent meetings have fallen short of providing confidence that the assessment process will be objective and balanced. We would welcome more explanation in due course.

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 agree in principle that a package of incentives of the nature set out could provide strong incentives for companies to deliver high-quality plans.

However, whether they will in fact provide such incentives depends on what is known about the potential rewards for companies when decisions about the plan are being made. This is particularly true of financial incentives and we would urge Ofwat to make the broad scale of the likely financial benefits of an "enhanced" plan very soon so that Boards have time to factor it into their considerations. This information will also be of interest to Customer Challenge Groups.

A second concern is the application of a strict "minimum rating" rule (i.e. the overall plan is assessed at the standard of its weakest element). It is more appropriate that the assessment is based on a judgement in the round on the whole of the plan, taking account of the relative importance of each element to customers.

We also believe that a potentially important opportunity to strengthen incentives for "enhanced" companies has been missed by not advancing the date of the Final Determination. Such an incentive would provide a substantial advantage in enabling efficient delivery of investment for these companies. It would seem possible to advance the FD by a number of months. This would require some sort of credible assurance that such companies would not be disadvantaged by subsequent regulatory judgements applicable "standard" and "resubmission" (for example an increase in the allowed rate of return) but this seems feasible to achieve – it is a feature of Ofgem's fast-tracking process.

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?

We think there is some merit in applying the rewards at an element level. Although this will result in a more complex process, it will ensure that rewards are applied appropriately, and that plans where the vast majority of proposals are satisfactory are not unduly penalised if there are minor areas of concern.

We note that the current approach provides asymmetric incentives. This is because the negative effect of companies with one 'resubmission' element is much greater than the positive effect of having one 'enhanced' element. This leads companies to focus effort on ensuring no elements are resubmission, rather than aiming for enhanced status.

We agree there are benefits of using a two-process approach to assessing retail plans, as these areas are likely to be small elements of the overall plan, a simpler approach seems appropriate.

We think there is merit in removing the 'resubmission' category. We think that Ofwat will have sufficient opportunity to gather any additional or revised information required by following the 'standard' process.

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?

As we have previously set out in our response to the consultation on the price setting framework earlier this year, in order to allow Boards and Customer Challenge Groups to engage fully in the process, early sight of key dates is essential. We note that there is no date proposed for the August data submission, and that Ofwat requires companies to provide a Board statement of assurance with that submission. Ofwat has increased expectations of the Board sign off process while reducing the amount of time available to companies to complete submissions. It is important that Ofwat confirms the submission date (and other company submission dates) as soon as possible to allow companies to fully engage their Boards in the process.

We also note the discussion on timetable at the recent Ofwat workshop on 8 May. We remain of the view that Ofwat does not need a significant amount of time to deal with company menu choices before issuing the final determination. This is because companies will have considered all the required adjustments to incentives as part of their menu choice. The implication of a significant gap is that Ofwat is planning to alter other incentives after companies have made their menu choice.

A delayed final determination date of January 2015 was suggested in the workshop. We agree with the comments made in the workshop that this creates a very tight timetable for companies to set its prices under what is a very new process, involving both wholesale and retail prices.

A delayed determination would also exacerbate the issues caused by the cyclical nature of water industry investment. In Defra's recent strategic policy statement to Ofwat (March 2013) the need to reduce the impact of the cyclical nature of water infrastructure investment is articulated under Priority III. Delaying the determination will increase, not reduce, the likelihood of a dip in investment as companies will not commit to expenditure until Ofwat has confirmed price limits.

In any case, we believe that more can be done to alleviate the issue of cyclicality by allowing companies to accelerate the design of schemes and invest in 2014-15 and then simply to allocate the costs to AMP6 schemes when they are subsequently recognised in Ofwat's determination. This leaves ownership (and risk that a scheme is not ultimately included in the determination) with the company.

For these reasons we are strongly against a delayed Final Determination.

Whilst the idea of a “dry run” during 2014 has been discussed, it is not immediately apparent on what basis this could be achieved since it would require separate price controls to be estimated as a starting point. We would also be concerned about the resources needed in companies and Ofwat to achieve it

The risk-based review in detail

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?

These groups of tests appear to be broadly sensible and cover the key aspects of business plans. See comments at Q1 above.

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?

The tests seem broadly appropriate. We note Ofwat's intention to place less weight on a CCG report it had little confidence in, and agree that as these groups are completely independent of companies, this is the right approach to take.

We note that the affordability test is based on whether a company's plan is affordable. It will be important for Ofwat to consider customers' views in coming to its view on whether plans are affordable, as views on what constitutes 'affordable' are likely to vary between companies. Ofwat will also need to consider customers' expectations on service; our customer engagement so far has shown that customers do not wish to see a reduction in bills if there is a corresponding reduction in service levels, and this will be a difficult balance to strike.

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?

We reiterate the need for clear and achievable timetables to be set now, to ensure that both Boards and customer challenge groups can fully engage as envisaged by Ofwat.

We note Ofwat's requirement that companies should prepare their plans independently of other companies and competitors. However, the preparation of plans would be assisted if benchmarking information were available. We can see no reason for Ofwat not to publish, if necessary on an anonymous basis, historic cost and performance information. In addition, we are finding that our costs are increasing signifcantly as a result of having to independently commission economic analysis (not advice) that could be more efficiently approached as 'club projects'.

Delivering focused information requirements

We welcome Ofwat's intention to substantially reduce the data required from companies, but note that the number of data points required does not seem to have reduced significantly when compared to the PR09 data tables.

Q8 Our objective in specifying the data tables (and the August submission) 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 have not included in the data tables?

We have made comments by table, below. It is not possible to comment on whether the tables include all of the information Ofwat requires, as we do not know what assessments Ofwat intends to conduct. For the August submission, one possible omission is total sewerage opex. For the same reason, we cannot comment on whether too much information is being requested.

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 will need to look again at the way we have asked for data to remove any ambiguities in the request?

We have made comments by table, below. In general, the clarity and specification of the data tables is totally inadequate. For lines that resemble former June Return or business plan lines we will assume the same reporting requirements as previously. For the new lines, we are unable to start work until we see detailed reporting requirements.

We challenge the assertion that the information is straightforward to collect, particularly as there are a significant number of lines that have yet to be defined. Some forecasts will be relatively meaningless, for example sewer flooding incidents due to overloaded sewers is a volatile measure highly correlated with rainfall.

We trust that the clarification process that Ofwat used for June Return and business plans will be used and that the responses are published so all companies can work to common definitions.

We have organised our comments by the individual table to which they relate.

W1, 2, S1, 2, R1, 2 Outcomes and incentives
These tables require companies to assign all totex to a measure under an outcome. In order to do this, we would need to have either a very large set of measures covering every aspect of investment, or to arbitrarily group measures up into high level indicators which would have little or no meaning. In either case, the incentive regime would be so complex as to render it ineffective.

As well as requiring a very large number of measures of success, the incentives applied to a company as a whole would also be extremely large. Given that investment must be cost-beneficial, and incentives should be based on value (which exceeds the cost), the total incentives package would necessarily exceed the entire totex required for AMP6 if all expenditure has to relate to a measure of success. We do not believe this would represent a reasonable allocation of risk and reward.

It is not clear why Ofwat requires companies to split enhancement from totex to maintain the current level of service. The requirement for annual milestones for each measure also appears unnecessary and contrary to the view that outcomes should encourage longer term planning.

The tables as proposed would be a significant step backwards towards tightly controlled and monitored output regulation. A central feature of the reforms currently being implemented is that both Ofwat and companies must learn to change their approach. The tables for outcomes as proposed would unnecessarily constrain companies, and take away ownership of their plans which is vital to ensuring the successful adoption of outcome focused business plans.

Companies have been encouraged to own their own plans, and to develop their own approach to outcomes, measures and incentives. We believe that we have developed a strong set of outcomes and measures which will target incentives to change our behaviour and deliver real and lasting benefits to customers in the areas that they value. To do this we are proposing a small set of targeted measures, which cover important aspects of the outcomes they support, but do not necessarily explain all of the investment we will need to make. We firmly believe in the approach that we are taking, and we encourage Ofwat to give us the opportunity to demonstrate the benefits that we can deliver with our approach.

We therefore propose that Ofwat allows companies to submit their measures and incentives in a form which matches their approach, but still enables Ofwat to understand how the proposed incentive schemes are to operate, including how risks and penalties for under-delivery and how any benefits from out-performance would be driven and shared with customers. We would be more than happy to share this with Ofwat in advance of the final submission so that both parties can have confidence that all the information Ofwat needs is being provided.

W3 &S3 Capital expenditure

Block A asks for capital expenditure by purpose. It is unclear why Ofwat needs this information given that expenditure is now to be accounted for by outcome and using totex cost assessments.

W5 & S5 Asset information

It is unclear why Ofwat needs this information, and we do not think that the information allows Ofwat to understand how the size and value of the asset base has changed over time, which is the stated purpose of the table.

W7 AIM
The table asks for information about historic abstractions below the AIM threshold. It is important that Ofwat defines that threshold soon, such that companies can prepare the data required. It will also be helpful to understand on what basis the baseline will be calculated; i.e. whether it is a simple average, or contains some kind of weighting due to weather events or recently delivered schemes, as this would require the provision of additional data.

The table asks for information on the effect of groundwater abstraction on associated surface water sites, after one month. This is information that is firstly based on models rather than actual measurements, and secondly, where it exists, is produced and held by the Environment Agency. We do not think this is necessary or appropriate information for Ofwat to ask companies to provide in order to administer the AIM.

We note that Ofwat requires the data source information to include whether the flow measuring point was an EA or an EA approved monitoring station. The course of action to follow if the measuring point is neither of these is unclear, including who would fund the installation of such a monitoring station.

The table also asks for price review solutions to reducing abstraction below the AIM threshold. It is unclear why Ofwat requires this data in order to set the AIM incentive. Companies will have included schemes within their WRMP to address abstraction causing environmental issues as a result of the EA's RSA programme. If the intention is that Ofwat makes an adjustment to the incentive as a result of schemes proposed to address such abstraction, this removes the effectiveness of the AIM within the period 2015 – 2020 as a means by which environmentally damaging abstraction could be reduced.

We agree that companies should be able to provide local evidence to help calibrate the AIM, and welcome further detail from Ofwat on what it would consider to be suitable evidence.

W9 Wholesale revenue
Line 6 asks for bulk supplies where a contract is to be signed after 1 April 2015, in order to identify revenue that would be subject to the water trading incentive. We note that this would include income from bulk supply agreements signed with future inset appointees.

W10 & S10 Cost Recovery
Our analysis suggests that a reducing balance approach to both run-off and depreciation of post 2015 totex additions is likely to be the most appropriate way of ensuring a sensible profile of depreciation over AMP6 and future AMPs. We assume that the requirement to state an asset life in Block B does not preclude this approach?

W17 & S17 Revenue correction mechanism
Line 10 asks for properties served by a new appointee in supply area as at 1 April 2009. This is not information to which an incumbent has access, as any properties built after the inset is granted are not in the incumbent's supply area, and are not billed by the incumbent. To obtain this data the incumbent must apply to the new appointee. If Ofwat requires this information it should direct

its request to the new appointees to provide it directly to Ofwat, or require them to provide the information to the relevant incumbent.

R3 Household ACTS
Table R3 asks for opex predictions up to 2024-25. We do not think it is reasonable for companies to project 12 years worth of costs given the uncertain economic environment.

Block E asks for marginal costs to serve additional customers in six categories. Please could Ofwat clarify whether there is a specific costing standard that should be applied. For instance, should they be short or long run marginal costs? Should any costs be specifically excluded or included?

R4 Information to set default tariffs
Blocks A to D asks for costs of serving customers “on default tariffs”. We assume, as it appears to be Ofwat’s preference that companies roll over current tariffs in setting defaults, that the relevant level of service against which to cost in each tariff band is our current level of service. This seems to be the only pragmatic way of proceeding.

However, whilst the “default service” is to be interpreted as a level of service that must be offered to every customer in each tariff band. in association with the relevant default tariff, we would understand it will be allowed that non household retailers offer a lower level of service at a lower price than the default tariff, if agreed with customers.

If our interpretation is incorrect and the default level of service is to be viewed as an absolute minimum, then we would like to know as soon as practical, because it will affect the forecast costs reported in this table.

R5 Financeability Assessment Retail Margins
The tables do not specify a line for the element of margin which will be needed to cover new capital expenditure. We intend to include this within the Margin for Working Capital.

A3 Wholesale tax
Ofwat states that it will allocate the brought forward capital allowances pools between wholesale water and wastewater. We would like to know on what basis Ofwat will make this allocation.

There is no request for information on pension payments compared with pensions charged to P&L. As we gain tax relief on the actual payments rather than the P&L charge, excluding this information risks overstating the tax to be paid. Ofwat will need to clarify how pension deficit payments are to be treated in respect of tax.

A5 Defined benefit pensions
We are surprised that Ofwat do not want more detailed information about the historic data for accounting charges.

Block D – we think that the DB scheme deficit should be allocated 100% to wholesale. This is because the deficit costs, for people who have left the business, are unallocatable between wholesale and retail.

A8 Financial Ratios
It would be useful to know at what point Ofwat intends to inform companies of its prescribed financial ratios. It will be essential to know these well in advance so that they can be factored into our financial models.

A13 Other working capital assumptions
Lines 5 and 6 ask for information on income accrual rates. We cannot see any use for this data, and this data does not seem to be forecastable with any degree of accuracy.

A15 Fixed assets (IFRS)
Is the information Ofwat ask for current or historic cost accounting? If current, CCD is not allowed for under IFRS, so how would this be allocated? If historic, it would be difficult to allocate as the costs to assets as they were incurred against assets that are not the same as current assets.

A20 Scenarios
It would be useful to know when Ofwat intends to publish the Ofwat-specified scenario assumptions. In order to properly factor these into our financial models we would like to know these no later than mid July.

Application to small companies

We have no comments on Ofwat's proposals for small companies.