

Northumbrian Water Limited

A response to Ofwat consultation: Setting price controls for 2015-20 – business planning expectations

Introduction and key points

The opportunity to comment on Ofwat's business planning expectations consultation is welcomed. The development of our response has been assisted by the additional insight provided by the workshops held by Ofwat in Birmingham on 7 May and London on 13 May.

We fully support the principle that companies should own and be accountable for the production of customer-focussed, well evidenced and innovative business plans that reflect their particular circumstances. The Board takes its leadership and governance responsibilities extremely seriously regarding regulatory reporting and the PR14 business plan.

Ofwat's intention to implement a risk-based, proportionate review of companies' business plans with a package of incentives for good, customer-focussed business plans is welcomed. We do, however, have some significant reservations about Ofwat's preferred approach for achieving this.

We do not agree that a company's business plan as a whole should be categorised as the lowest result from the assessment of individual business plan elements. This is asymmetrical, it places disproportionate emphasis on the two smaller retail business plan elements and potentially stigmatises a company with a 're-submission' classification when the majority of its business plan may be standard (good) or enhanced (excellent). Our views and suggestions for a more appropriate approach are covered in our response to Ofwat's question number 3.

We broadly agree with the high-level groups of business plan tests set out in the consultation document though further definition is required in some areas before meaningful comment can be made (e.g. tests for wholesale costs are not yet specified at a meaningful level of detail). Our views can be found in our response to Ofwat's question number 6.

The overall business plan data requirement is a reduction on previous reviews but still substantial. The tight August data submission schedule is achievable provided data definitions are provided by Ofwat without delay. Definitions are required to ensure information to be used in comparative assessments is produced by companies on a like for like basis. Without this assurance, any comparative assessment process will lack credibility and be considered unfair. We are currently evaluating the business plan data requirements in detail and will deal with specific queries and comments through the designated Ofwat E Mail address.

Timetable issues

The PR14 timetable is not covered by Ofwat's consultation questions but was discussed at length at the 7 May workshop at Ofwat's offices in Birmingham. We understand Ofwat wishes to extend the period for business plan assessment and determinations to more than a year.

Although bringing the business plan submission date forward to 2 December will compress our programme, we are content to work to this date to accommodate a longer assessment and determination process. To help us meet this date, it is extremely important that Ofwat publishes the final methodology and business planning requirements as soon as possible.

At the workshop it was suggested that the Final Determination (FD) be postponed until January or February 2015. However, this is not a practical proposition – it will not leave sufficient time to develop charges based on the determination and do the billing runs necessary to raise the charges. The November determination is based on a tried and tested format that has been proven to work, to delay this would put the delivery of customer bills at risk.

As well as this, there is the fact that charges will be very different than for previous reviews, with four price controls and some of these in different forms (eg. a default tariff). Ensuring customers are properly charged and communications are clear and appropriate will be very important – this should not be rushed. It is in no parties' interests for there to be problems with charges.

We believe that Ofwat should be able to tailor its methodology and assessment/determination processes to be completed within a year.

Working to achieve a successful price review

We understand Ofwat has to be careful in involving companies in developing its approaches. It is the case though that the approaches adopted will eventually need to work effectively in practice and companies may be able to help ensure there are no significant issues or flaws that may cause problems. As ever, we are happy to work with Ofwat in this respect.

Response to specific consultation questions

An incentives-based price review process

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

We support the move away from the regulatory prescription of past price reviews to the principle that companies should lead and be accountable for the production of customer-focussed, well evidenced and innovative business plans that reflect their particular circumstances. This is entirely in line with our philosophy.

We agree with the definition of a ‘high quality business plan’ as set out on page 20 of the consultation document, with the addition of the requirement for the plan to be financeable. In assessing business plans we agree Ofwat should take account of the governance and assurance processes a company has applied (including independent assurance).

The requirement for companies to submit a business plan that covers each of the four price control ‘elements’ is sensible. It is also our intention to describe our integrated plan (wholesale and retail) for household customers, as this is the total bill and service offering they will be interested in and will experience.

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?

Of the package of incentives proposed we consider the reputational and procedural ones to be the most potent. The financial incentives for good business planning are currently described at too high a level to make any meaningful comment.

We note that incentives for production of good business plans will only be fully effective if they are clear and well understood by companies well before submission.

Whatever incentives are chosen, the process and approach to the assessment of business plan quality is crucial – see our response to Q3 below.

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 agree that for each company, Ofwat should carry out separate assessments for each business plan element (household retail, non-household retail, water wholesale and wastewater wholesale). However, we strongly disagree that the business plan, as a whole, should be categorised as the lowest result from the individual assessments.

Using the lowest result of four is not symmetrical and potentially undervalues a company’s business plan. It means that achieving an enhanced category business plan overall will be extremely difficult as only one element needs to be classified as standard or re-submit to relegate the business plan to that category. This may discourage companies from aiming for an enhanced classification.

The approach also places a disproportionate value on the very much smaller retail elements of the business plan (retail household is circa 9% of total revenue and retail non household is circa 1% of total revenue).

Our preferred approach is for Ofwat to treat the four business plan elements separately in terms of assessment, the subsequent process then followed and the application of incentives. In this way each company receives its due reward, or otherwise, for each element and is not dragged down by the lowest categorisation. Should there be financiability or affordability issues for the overall plan, the cause should be traceable to a business plan element or elements and this would also influence the individual element assessments.

A further benefit of our preferred approach it that it also ensures Water and Sewerage Companies (WaSCs) and Water only Companies (WoCs) are treated equally. A WaSC under Ofwat's preferred approach would have to obtain the enhanced category for both main business plan elements (water and sewerage wholesale) to achieve the enhanced category overall whereas a WoC would only have to achieve enhanced for water wholesale.

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?

Yes, provided the risk-based assessment is seen as fairly and consistently applied and Ofwat are prepared to receive and assess business plans of greatly varying formats.

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?

We agree with these high-level headings.

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 for outcomes appear appropriate.

The tests for wholesale costs are not yet specified in the draft document, except in very general terms. It is, therefore, not possible to comment on Ofwat's proposals in this respect. The lack of definition and understanding of Ofwat's cost assessment approaches is a key area of implementation risk for the periodic review. We are pleased, however, that company's costs will not be automatically rejected if they fall outside the ranges Ofwat establishes using its high-level cost guides. It is important that companies' evidence is taken fully into consideration.

Retail cost tests are adequately covered subject to our comments on the ACTS denominator and ACTS indexation in our response to Ofwat's draft methodology. We would draw Ofwat's attention to the recently published report by First Economics ('Assessing Potential Changes in Retail Costs, 2015 to 2020'), which covers the real cost pressures in retail businesses and offers some options for addressing these when setting retail price controls. This report includes the option we proposed in our response to the draft methodology of including an

ex ante assumption regarding real price movements in the price control. This assumption would be based on analysis of typical retail business costs.

We understand Ofwat's desire to model risk scenarios. However, as currently specified, the approach appears to be overly complex with 36 scenarios to model. In the interests of reducing the regulatory burden, it may be appropriate to confine scenario modelling to a smaller number of higher-priority risk factors. Significantly more information about the objectives and requirements of the scenario modelling is required to ensure the aims for this aspect of business planning are achieved.

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?

Yes. We welcome that governance and assurance arrangements for the 2014 price review have been placed firmly in the hands of company Boards. This is in line with our approach for the annual Risk and Compliance Statement and we have put an innovative, risk-based approach to governance and assurance in place for our PR14 business plan.

Delivering focused information requirements

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 we have not included in the data tables?

It is difficult to answer this question for the August data submission, as it has not yet been determined or communicated which cost assessment models Ofwat intends to use and, therefore, what data is required. The broad coverage of data appears reasonable but the lack of definition on some items is a concern. The overall data requirement for the review is a reduction on previous reviews but still substantial. Some aspects of the data tables are confusing, for instance the requirement for some data only for alternate years.

The August data submission schedule is tight but achievable. Working back from an August submission, this requires Board sign-off in July. Therefore, we require definitions for new data urgently, even if there are subsequent amendments to these once consultation responses have been received.

We understand the August data will be used for comparative purposes and it is essential, therefore, that information is produced by companies on a like for like basis. Clear, unambiguous definitions are necessary for this reason. Companies should be required to indicate where data does not comply with the stated definition.

We are currently evaluating the business plan data requirements and will deal with specific queries and comments through the designated E Mail address. In general terms, we emphasise the need for early and clear definitions, especially for new items of information. We also communicate our confusion regarding the definition and purpose of much of the information in tables W1, W2, S1, S2, R1 and R2 (Outcomes and delivery incentives). More detail is required as soon as possible in this respect.

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?

See our comment to Q8 above.

Application to small companies

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?

No particular comment.

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

No particular comment.

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?

No particular comment.

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

No particular comment.

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?

It is important that new appointees continue to be regulated in a proportional way and one that ensures a level playing field. The situation should be monitored to ensure any circumstances that might put this requirement in jeopardy are identified and appropriate changes to the regulatory approach made.

22 May 2013