United Utilities Water

Response to “Setting price controls for 2015-20 – business planning expectations”

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1. INTRODUCTION

UUW is pleased to respond to the questions posed by Ofwat in its consultation document "Setting price controls for 2015-20 – business planning expectations".

We welcome the clarity on assessment methodology that this document provides and are supportive of Ofwat's overall approach to business plan assessment. We support the principle of customer focussed plans that are owned by company Boards and welcome the flexibility to choose the best way to present our proposals.

It is right that companies – and company Boards – should own their business plans. We consider that the scope to do this could be enhanced if Ofwat assesses plans independent of test criteria which require compliance or consistency with industry wide incentives or cost assessment methods. This is because companies should not be disincentivised from owning and articulating their own plans merely because the result might differ from that implied by the regulator's cost assessment.

We welcome the publication of the business plan data tables and will be providing specific feedback through the dedicated email address provided. We would strongly support Ofwat in providing full disclosure of all company queries, and Ofwat responses. This will reduce the volume of repeat questions, and give all companies equal access to business plan table clarifications. This approach was taken at PR09 and was widely supported by companies.

Ofwat's new timetable requires submission of the business plan on 2 December 2013. This presents a significant challenge for us and for the CCG to fully assess our business plans and write their own report, given the scale of reforms to the price review and business plan assessment process. As we set out in our response to the *framework and approach* consultation in March, we believe that a more appropriate timetable would have been to retain submission in January 2014 by delaying determinations into January 2015. If we and our CCG are to meet the new timetable, it is vital that Ofwat provide clarity on detailed requirements, and the finalised methodology, as soon as possible.

It would help inform our planning expectations if Ofwat can fix firm dates going forwardrather than continue to work on broad or seasonal timings. In particular, it would be helpful to state the date on which it expects to publish a finalised methodology and business plan requirements (or the last possible date on which this could be expected).

2. 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 agree that Ofwat's proposed definition incorporates many of the key elements of a high quality business plan. Ofwat's proposed description of a high quality business plan, that it:

- is designed to deliver good outcomes for customers and the environment and ensures companies meet their statutory obligations;
- contains accurate and efficient projections and estimates without inflated costs;
- is not a 'bid' and does not seek to game the regulatory process; and
- contains fair proposals to share 'pain and gain' with customers;

is broadly aligned with the proposals made in our response to *framework and approach*.

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 with the principle of providing incentives for high quality business plans and suggest two amendments to Ofwat's proposals.

First of all, we believe that it would be prudent to publish assessments of company business plans following an initial discussion with the company to explore the basis for Ofwat's initial assessment. This would ensure that Ofwat would be able to publish its assessment in the knowledge that the company has had an opportunity to make representations where it considered the assessment was based on a factual error or misunderstanding. Accordingly, the risk that an inappropriate external perception is created would be reduced and confidence in the published assessments would be increased.

Secondly, we consider that compliance and consistency with the predictions of Ofwat's totex models should not – in and of itself – be used as a criteria for assessing the quality of company business plans. This is because companies should be focussed on taking ownership of their plans, placing less reliance on prescriptive requirements and seeking to deliver a plan which reflects customers' interests. This would be constrained if companies were instead concerned about the certainty of a penalty due to inconsistencies with the results of Ofwat's predicted cost assessment.

We believe that the risk based review should be focussed on whether plans which are outside Ofwat's cost assessment are adequately justified, rather than merely on whether they are above or below the predicted level. We agree that unjustified or inflated expenditures should attract penalties, and believe that this can be applied through Ofwat's use of menus. In 2009 this approach was applied to capital expenditure and is an approach which we supported.

At this stage, we have no expectation that our business plan would fall materially outside of the predictions from Ofwat's totex models. In this context, we note that in the 2009 price review, our submitted plan was broadly in line with Ofwat's assessed capex baseline. We are committed to delivering a high quality, great value business plan based on customer-driven outcomes. We believe that Ofwat's assessment of our forthcoming business plan should be based on the full range of evidence provided by the company.

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 support the implementation of three of the proposed options.

- **Procedural and financial rewards should be applied at the element level.** Ofwat's base approach results in a clear asymmetry by only providing enhanced incentives where all plan elements are assessed as enhanced, whilst resubmission status only requires a single element to be classed as resubmission. Element level procedural and financial rewards would provide a better balance of incentives.
- **There should be a two-process approach for retail.** We agree that the retail elements of company plans will be less complex than wholesale and that a two-process approach is appropriate. Further, we note that one of the primary consequences of the resubmission category is that the company would have less favourable treatment under the totex menu process. The totex menu process only applies to wholesale controls, and not to retail.
- **Later decisions on resubmissions**. As set out in our response to Question 2, we believe that Ofwat should discuss any elements classified as resubmission with companies before this is publicised, in order to ensure that a resubmission assessment is not based on an error of fact or misunderstanding.

We believe that Ofwat should retain the resubmission category for the wholesale elements. In addition to maintaining an effective incentive for companies to submit high quality business plans, a requirement to resubmit plans may be a necessary risk mitigation measure. This is in view of the scale of reforms to the price review and business plan assessment process and the constrained timetable between publication of final price review methodology and completion of company plans in time for CCG engagement ahead of the revised submission deadline.

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?

We support Ofwat's view that plans should be owned by companies and their Boards, and welcome Ofwat's proposals to reduce the level of prescription to be imposed on company plans.

Throughout our price control preparations, we have recognised the importance of governance and accountability, and ensured that our preparations have been subject to appropriate levels of scrutiny and approval, including comprehensive governance arrangements for our price review preparations. We have also refocused our business into three areas with separate accountability for wholesale, domestic retail and business retail, in alignment with the clear direction of water industry reforms.

The UUW Board has been engaged with the development of our business plan, and our main price review "Strategy Steering Group" is chaired by our CEO, and consists of all executive members of the UUW Board, as well as the senior leaders that have operational responsibility for our price review preparations. This group has already actively reviewed and approved all elements of our price review documentation to date, including the approach to consultation responses, CCG engagement and customer research. Preparations for each business plan element are steered by executive-led steering committees, reporting up to the overarching Strategy Steering Group and a formal three stage approval process for each element of our business plan submission is in place.

As a result of this, we are confident that the ownership of our business plan submission sits with the Board. As noted in our response to Question 2, company ownership of business plans would be enhanced if it were clear that their plans were not being judged by Ofwat based on consistency with the outputs from Ofwat's cost assessment tools.

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3. 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 the four high level groups of tests that form Ofwat's proposed risk based review, and support Ofwat's overall approach to assessing company business plans.

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 agree with the overall approach to assessing company business plans.

We also agree with the proposed tests, except for those which may be contrary to the aim of company Boards taking greater ownership of business plans. There are three particular tests where this issue arises:

- **Assessment of outcomes** – Ofwat's proposed tests for Outcomes include *"Are the company's proposed commitments consistent with requirements specified in our methodology, including in relation to SIM, AIM and leakage?"* We are not seeking to challenge whether or not Ofwat should apply industry wide outcome incentives in some areas, but we disagree that it should be a requirement of company business plans that they must follow Ofwat's intended approach, rather than being free to propose outcomes that are owned by company Boards having been developed through customer engagement.

- **Wholesale cost assessment** – Ofwat proposes tests in this area, including *"Are the company's proposed costs consistent with the outputs of our cost assessment analysis?"* Again, it is difficult to see how company Boards can be expected to fully own their cost proposals if Ofwat impose a requirement for the company's cost proposals to second guess the result of Ofwat's cost assessment methodology. Ofwat's stated reasoning for not sharing its totex models with the industry is that companies should not be focussed on Ofwat's approach to cost assessment.

- **Retail cost assessment** – Included in Ofwat's tests for household retail is *"Is the company's proposed household retail cost to serve consistent with the industry ACTS?"* Application of this test would appear to rule out the opportunity for companies to propose plans which do not conform to a closely defined metric which is substantially exogenous to the company. Accordingly this would limit the extent to which company Boards could own their plans, as Ofwat's expectation is that company cost forecasts should conform to an industry average, and not the company's own cost forecast. The existence of adjustment factors only enables the identification of exogenous impacts on costs relative to this average – it does not enable company boards to make their own proposals for retail costs.

For clarity, UUW is highly likely to propose outcome incentives in line with Ofwat's methodology for SIM, AIM, and leakage, assuming that these industry wide incentives are confirmed and published in more detail as part of Ofwat's methodology statement in the summer. Our concern is that the requirement to comply with Ofwat's methodology constrains company plans to conform, and leaves Boards unable to make their own case for their own plans, as is Ofwat's stated intention.

We would suggest that the tests in these areas should simply relate to how well companies have evidenced their plans and demonstrated, in the case of cost proposals, that they are derived from sufficiently robust plans which embrace efficiency and innovation. For determinations, we expect that Ofwat's final methodology will be the default tool for assessing costs, and this assessment will be informed by company plans. This process can only be effective if the business plan assessment process is independent of any requirement to conform to Ofwat's industry-wide price review methodologies.

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 are fully supportive of Ofwat's statement that plans should be owned by company Boards.

We consider that our price control preparations and recent changes to our company structure are consistent with this aim.

However, as set out in our response to Question 6, we believe that there are some aspects of the business plan risk based review that are inconsistent with Ofwat's intention that business plans are owned by company boards, particularly tests that require compliance or consistency with industry-wide assessments being utilised Ofwat's to inform price determinations.

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4. 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?

We believe that the data tables will require further development in some areas. It is also difficult to ascertain whether or not the information requirements currently specified are adequate in the absence of clear line definitions, and prior to the publication of the final methodology. We have sought to separate our comments below into the five key areas of August Submission, Outcomes, Costs, Risk/Reward, and Financeability.

We are happy to support Ofwat fully ensuring that any issues or ambiguities arising from any of the following areas are resolved.

<u>August Submission</u>

Our main concern in this area is the absence of a request for "cost-base" information, similar to that collected at previous price reviews.

Ofwat's methodology consultation stated that baselines predicted by Ofwat's totex models would be triangulated against "previous Ofwat approaches" and that, given the problems with "estimating capex spent on both new sewerage assets, and on maintaining and enhancing sewage treatment assets", Ofwat proposed to use "models [which] are similar to the methods we used in previous price reviews"

These previous utilised approaches were (i) opex efficiency models – a combination of econometric and unit cost models – and (ii) capex cost base – a comparison of a basket of standard costs relating to a list of specified generic projects.

There are understandable difficulties with assessing sewerage expenditure. There are two main services being provided, collection of foul and surface water, and wastewater treatment and subsequent sludge disposal, which have different scale variables (volume in the case of surface water, and biological load in the case of wastewater treatment). These services are also subject to significant issues:

- Surface water volumes are not easy to measure. They are not metered and exhibit significant variability as they relate to weather patterns. As such, there are significant problems associated with identifying and measuring a suitable exogenous cost driver for the scale of required company expenditure.

- The costs associated with wastewater treatment are also variable. This is because they are substantially dependent on (a) the quality of influent (which can be very variable, depending on the nature of trade waste from local industry), and the sensitivity of receiving waters and habitats that treatment works discharge to.

- Geography and demographics within the company's region also drive cost variations. Sewerage networks are (largely) gravity based drainage systems. This means that the costs required to operate and maintain them will be highly dependent on the combined impact of the location of population centres and the topology of the local environment.

The use of a cost-base assessment seeks to separate out unit-price related efficiency from volume related cost impacts, as volume related effects (for the reasons outlined above) are substantially more problematic to assess, and does not lend themselves to simple econometric assessment.

If Ofwat chooses not to perform a cost-base assessment, we do not currently understand how it proposes to assess wastewater total expenditure. In anticipation that Ofwat would require cost-based information – and as supporting evidence which we may use in our business plan submission - we have nearly completed our own cost-base information exercise. We would welcome clarity from Ofwat as soon as possible whether or not cost-base information will be required, either in August, or along with the business plan submission – and if not, what approach it intends to take to assessing capex costs which are not covered by its totex models.

Outcomes

The tables indicate that the form of incentive (e.g. penalty only) is set at the outcome level, with individual disaggregated measures attracting their own benefit values and incentives. The table implies that the incentives within each of these measures is of the same form as the overall outcome – this may not be the case, as we may have individual sub-measures with different incentive forms, e.g. a measure with a reputational incentive and a measure with a financial incentive both within the same outcome. We would be happy to work with Ofwat to develop the format of the table to ensure that companies can properly represent the outcomes, measures, benefits and incentives that we will be discussing with our CCG.

We also note that tables W2 and S2 require specific identification of outcomes as “trade-off”. We do not agree that these should be specified in advance of the final determination - rather that any trade-offs should be justified and applied ex-post. The purpose of trade-offs should in part be to account for marginal over/under delivery in a sensible and efficient manner, by not forcing higher costs (in order to deliver to every individual performance measure) to the detriment of customers

Costs

There are a number of areas where requirements to provide information on costs appear to be missing, or requiring specific details that we believe are unnecessary:

- **Totex** – there appears to be some duplication of cost information between tables A6 and tables W3 & S3, which both require costs by cost driver. It is also difficult to ascertain whether the cost lines relate solely to enhancements by each cost driver, or the total costs, i.e. including maintenance. Also, the form of tables W3 & S3 seems inconsistent with Ofwat’s proposed totex approach, as the table relates solely to capex, with Opex information confined to a total on a single line.

- **Wholesale Cost Drivers** – the explanatory tables W4 & S4 are also not split by maintenance and enhancement. This may limit Ofwat’s ability to develop sufficiently robust totex models, particularly given the known difficulties with developing totex models for enhancement activities.

- **Retail capex** – the retail tables do not contain any requirements to provide capital expenditure relating to retail. This would seem to be an important addition in order to ensure that retail costs can be fully reflected in company plans.

- **Marginal household retail cost to serve** – table R3 includes marginal costs to serve for different types of customer. We are concerned that Ofwat's requirement to provide this information is indicative of the on-going misconception regarding the denominator that the primary issue is the existence (or otherwise) of economies of scope when retailing for more than one service. We covered this issue in detail in our response to Ofwat's *framework and approach* consultation.

- **Efficiency** – we note that the data tables do not include any information relating to efficiencies being proposed over the period. In any case, we would incorporate analysis of this within our business plan, but wonder whether it would be beneficial for Ofwat if this information is be collated on a consistent basis. This may particularly be the case if these costs are to be used to populate Ofwat's totex models.

Risk/Reward

The new requirement to provide information on scenarios indicates that this area has been sufficiently accounted for in the data tables. As noted in response to the following question, we would welcome clarity on the detailed specifications on the common scenarios at the nearest possible opportunity.

Financeability

We agree that Ofwat are seeking all the information that is needed.

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 are separately using the email query process to raise specific detailed queries on individual tables.

We strongly support Ofwat in providing full disclosure of all company queries, and Ofwat responses. This will reduce the number of questions that Ofwat receive and ensure that all companies have equal access to Ofwat clarifications. This approach was taken at PR09 and was widely supported by companies.

We would also like to raise a number of suggestions below that are more generic in nature.

- **Line definitions** – many of the tables do not currently have line definitions. We note that at its recent workshop Ofwat indicated that it intends to provide these, and this is welcome. We would also suggest that further clarity is required on the precise nature of each input, i.e. (i) price base, (ii) units, (iii) signage, (iv) inclusions / exclusions (e.g. gross or net of income or efficiency), (v) totex, opex or capex, (vi) total or partial (e.g. just maintenance or just enhancement) (vii) accounting basis, and (viii) any expected calculation rules (if applicable, e.g. annualised costs on table W2 and S2).

It is also worth noting that in previous reviews Ofwat shared its full financial model with industry. From a practical perspective, this provided a valuable cross check to reporting definitions to ensure that numbers filled into business plan tables are in accordance with how they are utilised within the financial model (this could be as simple as whether numbers are assumed to have the same sign). Such cross checks have in the past identified numerous inconsistencies between line definitions and their use within the financial model. If the financial model is not to be shared for this price review, then the need for clarity on the precise nature of each data input is emphasised.

- **Default tariffs** – table R4 contains very detailed structural requirements for default tariffs. Whilst we are content to comply with the requirement, it raises a number of important issues:

    - The methodology for the preparation of default tariff remains unclear, and we would welcome further clarification in Ofwat's final methodology. For example, we assume that there will need to be some complementarity between the structure of default tariffs and the structure of wholesale charges. Given that the issue of wholesale charging structure is yet to be addressed, we wonder whether it will be possible for companies to provide such a detailed structure for their default tariffs, rather than simply allocating a level of gross margin to each customer group.

    - Given the criticality of charge separation both for business plan preparation in relation to default tariffs, and for company implementation of price controls following final determinations, we believe that Ofwat should commence work now with the industry to review these issues, and in particular to establish an implementation workstream to pilot charge separation prior to final determinations. We consider the transition risk to be significant at this stage, particularly in the event that Ofwat seeks to defer final determinations.

    - With such prescription required for default tariffs, this raises the issue of within-period changes to charging structures. As such, we suggest that a change process for default tariffs will be required, else this risks stifling tariff innovation post determination.

- **Scenarios** – As part of our business plan submission, we were intending to perform some high level risk modelling. We therefore support this new requirement which will formalise the stress testing of company plans in a manner that enables Ofwat to perform a more consistent risk assessment across the industry. Given the constraints of the business plan timetable, we encourage Ofwat to provide the specification of the common scenarios as soon as possible.

- **Financial tables and PAYG ratios / RCV run rates** – we note that the appointed business tables (e.g. the income statement table A10) include depreciation. It is unclear whether Ofwat intend for financial statements to be prepared consistently under normal financial accounting rules (i.e. with opex and capex treated as such, and depreciation calculated in full), or whether Ofwat intend that these tables reflect the company's proposed PAYG ratio, and depreciation consistent with company assumptions for the RCV run rate. We would suggest that the former would be most appropriate, but note that the data tables would not provide Ofwat with the data required to produce its own financial tables; this is because companies are only required to provide an RCV run rate, not a full forecast of base depreciation. We also assume that the financial tables are to be completed on an IFRS Historic Cost basis, and not Current Cost. Clarification of this as soon as possible would be welcome.

5. 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?

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

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?

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

The price control process should not confer undue advantage or disadvantage to companies, based on either their size or status. We agree that it is justified to recognise and raise these potential issues now.

It is clear that decisions made on the appropriate treatment of small companies will play an increasingly significant role in future outcomes for the sector as a whole. Whilst historic arrangements appear to remain tenable for the current review, it is likely that market developments will warrant further consideration of this issue ahead of the next price control in 2019.