

Our ref: Ofwat130524/LS



Your ref:

24 May 2012

Stephen StPier
Finance and Networks Division
Ofwat
City Centre Tower
7 Hill Street
Birmingham
B5 4UA

BY EMAIL ONLY

Dear Stephen

**Setting Price Controls for 2015-20 – Business Planning Expectations
Consultation Response**

Please find attached our response to the above consultation.

I confirm that it is our intention to submit a high-quality business plan, fully supported, approved, and owned by our Board. In general we are in agreement with the principles and approaches set out in your consultation document. We have tried to set out in our response some changes to Ofwat's proposals which should result in a better outcome for all parties involved. We have also indicated where some additional guidance could help.

A summary of some of the key points from our response follows:

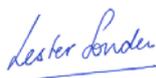
- We agree that a high quality business plan should deliver good outcomes for customers and the environment. We will want to deliver what we consider to be the best outcome for customers and the environment taking into account willingness to pay and affordability, and the views of other stakeholders. This will however probably require us to make compromises between different measures of success. However well our plan is written, it is possible there will be misunderstandings. We therefore think that Ofwat should be prepared to enter into dialogue before assessing a plan to help rule out misunderstandings, and to satisfy itself that a company's plan is not a bid, or an attempt at gaming the regulatory system.
- We are at the start of a new era of regulation, and we are sure that all companies will be doing their best to submit the best plans they possibly can. We are of the opinion therefore, that incentives should not be so blunt as to discourage companies from aiming for 'exceptional' because they are so concerned about not being assessed as 'resubmission'. We suggest therefore that incentives for submission of a high-quality plan should be reputational only, and that Ofwat should give themselves more flexibility in how they assess plans. Again, dialogue with companies before assessment is important.
- We suggest that rather than the three category approach suggested that Ofwat adopt a four category approach. Details are set out in our response to Ofwat's questions (attached).
- We would encourage Ofwat to enter into dialogue with companies before submission of Final Business Plans. Pre-consultation would give companies comfort that they were

heading in the right direction. This can be done without compromising or prejudicing Ofwat's position.

- We would like to reach early agreement on how 'affordability' is to be measured.
- We have concerns about proposed Business Plan tables W1, W2, R1 and R2. Our concerns are set out in our response to Ofwat's questions (attached). In particular, we consider it a high priority for Ofwat to explain how they propose to use this information so that allocations can be made on an informed basis. We would also like to see some additional guidance to help companies understand the link (or interaction) between incentives related to outcomes, and incentives associated with the totex menu.
- We would appreciate some further guidance on how short-falling will work inside and outside the totex menu.

In our response we have aimed to be constructive, either in suggesting alternative approaches that could be adopted, or advising where we consider additional guidance would be helpful. Should you wish to discuss any of the issues raised in our response please don't hesitate to contact me.

Yours sincerely

A handwritten signature in blue ink that reads "Lester Sonden". The signature is written in a cursive style and is underlined.

Lester Sonden
Engineering Director

encl.

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|---|---|
| <p>An incentives-based price review process</p> | |
| <p>Q1 Do you agree with our definition of a high-quality business plan? Is anything missing? Is there anything you think we should change?</p> | <p>At a high level, we agree with the four bullet points which you have used to describe a “high-quality” business plan. However, because there is little detail to say how these points will be interpreted and judged, it is difficult to fully support your definition.</p> <p>Our thoughts on each of the bullets follows:</p> <ul style="list-style-type: none"> <p><i>Designed to deliver good outcomes for customers and the environment and ensure companies meet their statutory obligations;</i></p> <p>How will a “good outcome” be defined? A good outcome for customers may be interpreted as delivering everything they ask for at the price they are willing to pay – however this may not be possible.</p> <p>Customers could have conflicting “good outcomes”. For example they may be willing to pay £10 for reducing leakage by 5 MI/d. But for the same money they could actually get 20 MI/d of new water. So for £5 they could have lower bills and more water and greater resilience (a Government priority) but not reduced leakage.</p> <p>A good outcome for the environment is perhaps easier to define but success may not be so easy to measure. In some areas, the company may have to make a compromise between what is good for its customers and what is good for the environment. Customers may not be willing to pay anything towards the environment.</p> <p>The definition does not include other stakeholders</p> <p>We acknowledge that it will be up to each company to make a good and clear case for its preferred plan and explain why it considers it delivers a good outcome for customers and the environment, but because it is subjective, Ofwat and other stakeholders may not agree. <u>We propose therefore that Ofwat will need to commit sufficient resource to liaise with a company after submission, but before marking its plan, to ensure that there are no misunderstandings. In particular this should apply if Ofwat is considering assessing a plan as “resubmission”.</u></p> <p>We agree the plan should set out how each company will meet its statutory obligations.</p> <p><i>Contains accurate and efficient projections and estimates without inflated costs</i></p> <p>Agreed, but the phrase “without inflated costs” is not required if projections and estimates are accurate.</p> |

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|--|--|
| | <p><u>By efficient projections and estimates do you mean projections and estimates that demonstrate that the company's activities will be carried out efficiently?</u></p> <ul style="list-style-type: none"> <i>Is not a 'bid' and does not seek to game the regulatory process</i> <p>Agreed, but again, because it is a subjective measure, we believe it will be important for Ofwat to ensure it can commit sufficient resource to be able to liaise with a company before marking the company's plan. For example, what Ofwat may interpret as gaming may be considered by the company to be a legitimate estimate made for uncertainty.</p> <ul style="list-style-type: none"> <i>contains fair proposals to share 'pain and gain' with customers</i> <p>We agree with the idea expressed here, but it is quite difficult to see where customers will accept the concept of shared pain. Perhaps this could apply where two sided incentives are part of a basket in which under-performance is balanced with over-performance.</p> |
| <p>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?</p> | <p>All companies will want to submit high-quality business plans, but not all will succeed in Ofwat's opinion. Is it right that Ofwat is setting itself up as judge and jury? Because there are no draft plans, companies will be striving to get it right first time without a full knowledge of the rules, or the criteria by which their plan will be judged.</p> <p>No company will want to have its plan assessed as 'resubmission', but a company is going to have to make a judgement as to whether it is worth making the additional investment needed to get its plan into the 'exceptional' bracket.</p> <p>We think it is right to encourage companies to do more than the minimum that is required through incentives, but if there is to be a financial incentive then it is important that the criteria for judgement and the scale of the incentive are clear so that a company can judge whether it is worth making the additional investment required to gain the reward. Some companies will find it much easier to achieve a plan that will be assessed as 'exceptional' as a consequence of their geographical location, water resource position, or historic investment. Is this fair on the companies that have more difficult investment decisions to make and more difficult plans to write?</p> <p><u>Perhaps therefore, for PR2014, the reward for producing an 'exceptional' plan should not be financial.</u></p> <p>We also think it is important that Ofwat gives itself more flexibility for dealing with a company that has tried hard but has maybe failed in one small area, or in just one element of its plan. We do not agree that one element classified as 'resubmission' is sufficient to classify all elements of the plan as 'resubmission'. Would it be reasonable for example if one element of the plan was assessed as</p> |

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|---|---|
| | <p>'resubmission, but the other elements were assessed as exceptional, that the whole plan was assessed as 'resubmission'?</p> <p>We do not agree that a resubmitted plan that meets Ofwat's tests should continue to be classed as 'resubmission – <u>like the Water Resources Management Plan process, a company should have the right to submit a statement of response which deals with Ofwat's queries and objections and allows the status of its plan to be upgraded.</u> The company would already have been sufficiently penalised through a reputational incentive having been assessed as 'resubmission' and by the additional investment it will have to make to get its plan upgraded.</p> <p><u>Generally we consider that Ofwat should be more flexible in their proposed approach and there needs to be more dialogue before submission, and before publishing assessments.</u></p> |
| <p>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?</p> | <p>Our thoughts on each of the options follows:</p> <ul style="list-style-type: none"> • <i>elements earn procedural and financial rewards</i> We would strongly support an option in which elements are individually assessed and incentivised. • <i>two-category approach</i> <u>We propose a four category approach for each element as follows:</u> <ul style="list-style-type: none"> - Exceptional (or enhanced) - Good (or standard) – further improvement required to reach exceptional status - Acceptable (but further information required) – should be able to achieve good, but unlikely to achieve exceptional - Unacceptable (or resubmission) – only required where a submission is totally inadequate • <i>two process approach for retail</i> Don't see any advantage in this – just need to assume that most of these elements will fall into Acceptable or Good • <i>later decisions on resubmissions</i> <u>Agree with this which could fit in with the four category approach described above.</u> <p>If a company can satisfy Ofwat on resubmission or following receipt of additional information, without causing the regulator significant additional work, then it should be entitled to the available incentives for the final category into which the plan element is placed.</p> |

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|--|--|
| | We consider that Ofwat should carefully consider the idea explained above especially because this is the first review being carried out using this new approach. |
| <p>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?</p> | <p>Our Board has always taken ownership of our Business Plan submissions.</p> <p>Our Board does however welcome Ofwat’s direction of travel with the introduction of outcomes and the greater involvement of customers, whilst trying to reduce the regulatory burden.</p> |

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|--|--|
| The risk-based review in detail | |
| <p>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?</p> | <p>Our view is that the high-level groups you have selected are the correct ones to focus on. <u>We suggest however that some early engagement with companies is required to discuss their proposals.</u> It would look a bit silly, for example, if Ofwat assessed a company's plan as 'resubmission' in January 2014 on the basis that it disagreed with the company's proposed outcomes.</p> <p>Our comments on each of the groups are as follows:</p> <ul style="list-style-type: none"> • <i>outcomes</i> <p>We agree that Ofwat's proposed tests for outcomes should look at what companies are proposing to deliver for customers and the environment in the periodic review period, including proposed rewards for delivery and penalties for non-delivery. The tests also need to look beyond the five year period to see how the proposed measures dovetail into a longer term outcome – a good example of this would be resilience based schemes that might produce little or no measurable benefit in the short term.</p> <p>We note and agree in principle with the key assessment criteria for the risk-based review tests for outcomes. <u>Is it Ofwat's intention to give some further guidance on these criteria?</u></p> <p>We agree that the CCG's report should be taken into consideration as part of Ofwat's tests.</p> • <i>costs (wholesale)</i> <p>It is difficult to comment on Ofwat's tests for wholesale costs without knowing how they are going to work. Clearly analysis of historic and forecast costs are an essential part of any model. <u>With regards to comparative cost information, does Ofwat anticipate requiring information additional to what has been asked for in the tables issued as part of this consultation?</u></p> • <i>costs (retail)</i> <p>We agree with the proposed risk-based review tests for retail costs, however, despite the assurances regarding robustness and comparability given by Ernst and Young at the wholesale workshop on 7 May 2013, we remain concerned about the wide range of ACTS that appear to exist and how Ofwat proposes to deal with this issue.</p> • <i>risk and reward</i> <p>We acknowledge, and accept in principle, the risk based review tests for risk and reward.</p> |

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|---|---|
| | <ul style="list-style-type: none"> • <i>affordability</i> We would like to understand how Ofwat proposes to assess affordability. There should be a common agreed test across the industry. <u>One approach may be to look at the number of customers that are in “water poverty” and how a company’s proposals are likely to impact that figure.</u> • <i>financeability</i> We agree in principle with the proposed risk-based review tests for financeability. • <i>performance in 2010-2015</i> We agree in principle with the proposed risk-based review tests for performance. |
| <p>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?</p> | <p>Our comments on the tests for each group are given above in our response to Q5.</p> |
| <p>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?</p> | <p>Our Board has always taken ownership of our Business Plan submissions.</p> <p>Our Board does however welcome Ofwat’s direction of travel with the introduction of outcomes and the greater involvement of customers, whilst trying to reduce the regulatory burden.</p> <p>As part of its statement the Board will be keen to assure Ofwat that it owns and is accountable for the Company’s plan. It will set out why it considers it has submitted a ‘high-quality’ business plan, and will also set out how the Board and Company are operating transparently, with good Board leadership, and in compliance with appropriate codes and licence conditions.</p> |

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|--|--|
| <p>Delivering focused information requirements</p> | |
| <p>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?</p> | <p>In general we are content with the information required by the proposed data tables although as we start to fill them in there may be some questions about definitions.</p> <p>We have specific comments on some of the tables as follows:</p> <ul style="list-style-type: none"> <p><i>Table W1</i></p> <p>Table W1 asks companies to relate total expenditure (totex) to the individual performance measures associated with each outcome. For each measure the table asks for the amount of totex to achieve the current level of performance and the incremental totex required to meet the outcome commitment (target).</p> <p>We have concerns relating to this information request. Assigning 2014/15 totex across different performance measures will be an allocation exercise which will involve a degree of arbitrary assessment. For example, much of the current wholesale expenditure on R&T and distribution is to deliver a range of outcomes for customers (e.g. water quality elements (safe to drink, taste, odour and discolouration), few interruptions and security of supply). Allocating this expenditure to different outcomes (let alone individual measures) will require a degree of judgement. Judgements will be poorly based if the way in which the allocations are to be used is not clear.</p> <p><u>We consider that a higher level allocation of totex would be appropriate and also that more detailed guidance should be provided on how the figures will be used and the degree of evidence required to support the allocations.</u></p> <p>The assessment of incremental totex should be more straightforward though even then it is likely that incremental totex may be associated with more than one performance measure and therefore needed to be allocated.</p> <p><i>Table W2</i></p> <p>Table W2 asks for information relating to the design of appropriate outcome incentives. We consider that the table may not fully capture the range of information needed to assess incentive design. It does not easily allow for cost or benefit values that change with the level of the outcome. For example, the benefit per unit may decline as the performance increases beyond the commitment level.</p> |

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|---|---|
| | <p>We are not proposing that the table be expanded, as it appears unlikely that a useful table could be set-up to capture all of the circumstances that companies may face. However, we consider that this table will represent, at best, a summary that allows some cross-checks and high-level appraisal to be undertaken. The main evidence for a proposed incentive design will form part of the business plan submission and relate to the specific views and evidence from the company and its customers. It will be hard to capture this in a single table.</p> <p><u>Some guidance is required to help companies understand the link (or interaction) between incentives related to outcomes (and associated ‘measures of success’), and incentives associated with the totex menu.</u></p> <ul style="list-style-type: none"> • <i>Table W8</i> Our views on the AIM were made clear in our response to Ofwat’s methodology consultation. Whilst the table itself should be straightforward to complete (subject to the Environment Agency’s cooperation), further guidance is required as to where the costs and incentive are supposed to be captured, and the relationship between tables W1, 2, and 3. • <i>Table W14</i> We assume that Table 14 will only apply to schemes that were specifically identified as part of the ‘overlap programme’ in PR09. If not some further guidance is required. • <i>Tables R1 and R2</i> Similar comments to those on tables W1 and W2 apply to tables R1 and R2. |
| <p>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?</p> | <p>Some further guidance will be required as outlined above.</p> |

Sutton and East Surrey Water Setting price controls for 2015-20 – business planning expectations

| OFWAT consultation question | SESW Response |
|---|--|
| Application to small companies | |
| <p>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?</p> | <p>We have no comment to make on Ofwat's proposals concerning Cholderton & District Water, or other small companies.</p> |
| <p>Q11 Do you agree that we should set Cholderton & District Water its own simplified price control?</p> | |
| <p>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?</p> | |
| <p>Q13 Do you agree with our proposal that small water companies should not be subject to separate wholesale and retail price limits?</p> | |
| <p>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?</p> | |