

BUSINESS PLANNING EXPECTATIONS

SOUTH EAST WATER'S RESPONSE

MAY 2013

This paper sets out South East Water's views in response to Ofwat's recent consultation, 'Setting price controls for 2015-20 – business planning expectations'.

1 GENERAL COMMENTS

We are supportive of many of the proposals in the consultation document. We are however very concerned by the lack of clarity and detail in many aspects of the methodology.

Whilst we understand the reluctance to set out more detail on assessment criteria and the decision to not provide threshold details, there is an important distinction to make between companies having sufficient information to understand the process and produce high-quality business plans or providing too little information, which will result in a poor process. For example there is a suggestion that special factors, if submitted, will be considered within the setting of the baseline. In order to develop special factor adjustments we need to understand how the economic models work to establish whether they deal with the relevant cost drivers in an appropriate way. Without visibility of the models we cannot make a robust case for special factors.

We have significant concern around the timetable proposed in the consultation. A January submission date for business plans provided an even balance between time for companies to prepare plans and time for Ofwat to assess plans. The proposal to bring the business plan submission date forward to 2nd December creates an imbalance, with companies bearing more delivery risk. This is in addition to the additional risk and uncertainty from the absence of a final methodology and a number of traditional incentive tools being left to companies to design. In effect, companies are bearing more responsibility for the design of the price review, taking more ownership of their plans, but being given less time to prepare them. The change also has an impact on the governance of the programme:

- Companies have well established programmes of work to develop their business plans which include lengthy customer engagement programmes and important governance steps. These programmes have been built based on previously published submissions dates in quarter 1 of 2014. Importantly Board governance is designed around a January submission date, as indicated in the draft methodology, an earlier submission date requires an unwelcome revision to the established programme.
- The additional complexity of Customer Challenge Groups effectively brings companies delivery date forward even further, if the groups are expected to submit their reports to Ofwat at the same time as business plans.
- Although the previous timetable was not fully lined up with other Regulators timetables, this earlier submission date creates more divergence and we question whether the other regulators can meet this timetable? For example,

the Drinking Water Inspectorate will not confirm the water quality requirements until October and the National Environment Programme will not be confirmed until late this year. With the absence of confirmed requirements in these areas, companies will be carrying greater uncertainty in the plan.

To reduce an element of the uncertainty and allow for effective planning we would urge Ofwat to provide firm dates for all timetable items, company submission dates and Ofwat publication dates. Companies' programmes of work need to be determined based on exact dates, for example it is still unclear whether the August submission is the 1st August or the 31st? Companies require good programme plans to develop high-quality business plans and this is being hindered by a lack of timetabling.

We made a number of points regarding our concerns on timetable and our proposals for dealing with them in our response to the draft methodology and will not reiterate them here. We will however note that should Ofwat adopt the proposal to extend the date of providing the final determination, there is an impact on the price setting process. Price setting for 2015-16 is already a complex process due to the change in price setting and requirement to split prices into retail and wholesale. Whilst we would support this extension of time to improve the robustness of the PR14 process, we would recommend a pilot price setting process is run in spring 2014, to reduce the risk and uncertainty at that time.

On the specifics of the information requirements we would observe that unless the data requirements are clear and unambiguous and that the models used to create financial outcomes and model outcomes are transparent then the time spent following receipt of the draft determination will be wasted on issues of data and model forms rather on the areas where the debate should be focused, in particular on:

- Customer preferences
- Value form money
- Balance of risk and return
- Balance and form of incentives
- Intergenerational assessments

This observation supports our view that careful consideration should be given to the correct balance between plan creation and plan assessment.

2 SPECIFIC CONSULTATION QUESTIONS

More detailed points on specific questions raised in the consultation are provided below.

2.1 INCENTIVE BASED 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 with the definition of a high quality business plan. However the description is very negative. The definition assumes companies submit inflated costs that are not accurate or efficient and seeks to game the regulatory process. This is purely perception and should not be the main feature of whether a business plan is high-quality.

Although the definition includes good outcomes for customers, it does not include whether these are the outcomes customers want. This is a strong feature and cultural change for this price review and we believe this should be reflected in the definition of a high-quality business plan.

In assessing business plan quality there is a criteria for providing the necessary information for Ofwat to complete the risk-based assessment, however there is no visibility, at this time, around the level of evidence Ofwat will be expecting. We agree it should be up to companies to determine the right level of information to provide, that we feel is appropriate to provide evidence and support the plan, it is not appropriate for a company to fall into the resubmission category on this basis. Whilst we accept that it will be up to companies to determine the right level of information to provide, Ofwat should set out some guidelines or expectations. In the absence of any guidelines, there is a risk companies will provide too much information.

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

In principal we agree with the package of incentives. However we have two comments. Firstly, the package could do more to incentivise companies to aim for the enhanced process. The current package has strong incentives for companies to aim at not being in the resubmit category but the incentives for being enhanced are not of an equal strength and companies may perceive the enhanced category to have a 'high bar' for achievement. There is a risk therefore that, companies will aim to be standard.

Further clarity on Ofwat's expectations for high-quality business plans should provide transparency and therefore more companies may strive for enhanced.

Secondly, for the incentives to operative effectively they need to be visible and set out in advance. For example, without sight of the financial incentives companies will not be able to fully understand the implications of having an enhanced, standard or re-submit plan.

We would add that reputational incentives should not be underestimated. We believe the reputational incentives are very strong especially in relation to 5 year business plans, to the extent that there is almost no need for procedural and financial incentives. The inclusion of procedural and financial incentives adds unnecessary complexity.

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 do not agree with the preferred approach to assessing companies overall category as the lowest result of the individual elements. The complexity and impact of a high-quality plan are significantly different for the three elements. Should a company with an enhanced wholesale plan be assessed as re-submit if the non-household plan is assessed as re-submit?

The preferred approach, to score each element individually, will also drive companies to prepare individual plans for each of the price elements, this is not how customers would expect to see or would understand a business plan. From a customer perspective they expect to see a plan which outlines the entire service they will receive and for what price, the breakdown between retail and wholesale is not their concern.

There are alternative options to the four set out in the consultation. One option would be to group the two retail elements into one assessment, therefore providing companies with two overall assessments, one for retail and one for wholesale. This is particularly key when the non-household retail plan will be significantly different in terms of detail than the other two elements because of commercial sensitivities. This would result in more equality between the two assessments.

Alternatively the overall company assessment could be the result of a weighted assessment of the three elements, based on materiality. For example, the non-household retail plan should not carry as much weight as wholesale as the consequence of a poor plan is the loss of customers. This would result in a more complex process but the advantage is a more robust approach.

We would support the alternative option of a two-category approach, an enhanced and standard classification, for the overall plan. We believe there are more advantages to this approach than just simplicity, as outlined in the consultation. This approach provides a strong reputational incentive for companies to achieve the enhanced classification. This would also provide a better balanced package, as per our response to Q2 above. This approach creates a positive incentive rather than one that is penalty focused.

We agree with the approach to change classification mid-way through the review following further scrutiny but this should be symmetrical. If following further scrutiny any concerns or issues that are keeping a company from being enhanced are addressed, the company should be reclassified. Again this forms part of a balanced package of incentives.

We would also encourage Ofwat to adopt a very open and transparent assessment process where if a company is borderline between enhanced and standard, there is dialogue and the Company is given opportunity to address any issues before an assessment is published.

A further consideration in this area is how the preferred approach fits with the CCG report. If the company's business plan is assessed as three separate elements, the CCG report will also need to be broken down into these areas as the CCG report is a crucial part of the risk-based approach. If the CCG report does not highlight which element their challenge relates to, Ofwat will not be able to use it in their risk-based

approach. Guidance in this area is absent and CCG's will need to be made aware of this issue in advance of preparing their report.

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 outlined in our responses in the past, we are committed to owning the business plan and this includes Board ownership. The proposals assume there is a lack of business plan ownership at Board level within companies, we disagree with this view.

However the proposals for an incentive based process which includes some weight to Board sign off, will be effective in meeting the objective.

2.2 OFWAT RISK BASED APPROACH

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.

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?

As we reported in our response to the draft methodology, we have difficulty understanding how the proposed process for assessing wholesale costs, allows for proper consideration of companies future investment. The consultation lacks clarity in the area of wholesale cost tests. The use of ranges (cost corridors) and or thresholds (cost ceilings) needs to be confirmed and explained in more detail before we can establish if they are the right tests.

We support the use of scenarios as a means of testing risk. For the common external risks, we would encourage Ofwat to provide the agreed data sources for scenario assumptions e.g. rainfall data, and scenarios parameters e.g. % household growth boundaries to test, to ensure companies are using consistent assumptions. If Ofwat do not provide this data, there will not be consistency across companies and significant resources will need to be placed to source any data that is not readily available.

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?

See response to question 4. The increased emphasis on Board assurance will be effective in meeting the objective and increase Board ownership, where it is not already present.

We would also re-emphasise the belief that visibility of models, incentives and thresholds would increase ownership of business plans as companies would be in a position to consider all the trade-offs when developing their plans.

3 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 determine whether the objective has been achieved in the absence of the final methodology and models. We will not be able to establish if the proposed data tables contain the right information until we have visibility of the final methodology and associated models.

One area we would highlight as missing is the relationship between the retail and wholesale business plans. It is not clear from the tables how issues such as cross charging approach, between retail and wholesale, will work in the models and how they will need to be presented.

We have some concerns around the information requested for explanatory variables and volumes which will presumably form part of the totex models. For example enhancement expenditure is cyclical and regional and the cost drivers requested would not explain the future requirements e.g. raw water deterioration. In particular, it is important to note that the use of SDB deficit as an explanatory factor does not take into account the feasible options that remain available to the company. For example, a company that has only recently found itself in deficit will have very different options available to them to deliver the water required, lower cost and quicker options like metering and groundwater. A company that has been in deficit for many planning periods will have utilised the low cost options in previous periods and is now looking at more complex and more expensive options like effluent re-use and desalination. Companies invest in developing robust Water Resource Management Plans for the next 25 years, which are available now, and should be used to assess future SDB requirements.

Whilst explanatory factors such as mains replacement and number of sources are a good indication of maintenance investment, this is too simplistic and these simplistic models have been abandoned in the past by Ofwat because they are inaccurate. The explanatory factors should take into account the complexity of the company's assets for example we have a number of groundwater sources that have complex processes associated with them due to the nature of the groundwater, the current explanatory factors would not take this into account. Indeed an adjustment was made at PR09 to reflect this within the model and we would anticipate the same adjustment being made this time but for both operating and capital costs.

Of additional concern is that the models will not cope with changes in future risk. The approach adopted at past reviews and is highly regarded within asset management circles centres capital maintenance investment decisions on risk assessments i.e. the Common Framework. If the baseline is set for maintenance using historical drivers then future generations will not be protected from changes in risk and reverts back to age/condition based maintenance highly criticised by the Competition Commission

following the PR99 review. Ofwat has suggested verbally that companies might want to supplement their business plans with risk based information but has not described the level of proof required likely resulting in an excess of information and therefore inadequate review.

Overall we are concerned that simple models are being used to assess complex drivers and the reported suitability of the modelling is a function of the strength of the explanatory powers of the operating cost drivers supporting the very weak explanatory powers of the capital models. Ofwat should therefore be very cautious in the application of these models in setting baselines for companies.

We recommend an approach to developing the models that incorporates working with companies, as was used by Ofgem, where companies can assist with the development of the model without seeing the costs of other companies. We would be happy to contribute to a working group to develop the models.

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?

The data tables are clear but lack specification and comprehensive reporting requirements. These are critical if the data tables are to be completed consistently across all companies. Some data lines have short guidance notes however there are significant gaps.

We recommend a clarification process is open, similar to previous clarifications processes adopted for June returns and previous price reviews, where companies can raise a query and the response is shared with the industry.

It is not clear from the data tables covering costs whether the costs and margins to be reported are net or gross of the companies' efficiency assumptions. If companies should report gross of efficiency, a specific table for companies assumed efficiency targets is absent. Without this clarity there will be inconsistency in approach by companies.

We have some specific queries relating to the data tables which are set out in sections 3.1 to 3.4 below.

3.1 AUGUST DATA SUBMISSION

We do not have any concerns in our ability to produce these tables by August. However, we would reiterate our request for comprehensive reporting requirements and confirmation of an exact submission date.

3.2 RETAIL TABLES

The definition of household and non-household requires further clarity. Presently the definitions are different between the accounting separation guidance and the Water Act. It is also unclear how mixed use properties should be treated. Once

competition for all non-households is launched, a new legal definition may be in place and this may have an impact on the price limits set for 2015 to 2020.

A data table for retail capital investment is absent. There are tables for including costs of outcomes and retail operating expenditure but where a retail business plan may include investment e.g. a new billing system, it is unclear how this expenditure will be treated. Is this expenditure to be treated as fast money? This is not appropriate and would not pass an audit test.

3.3 WHOLESALE TABLES

Table W10 asks companies to provide one PAYG rate for the AMP period. However PAYG rate may change annually depending on the profile of investment. Whilst we appreciate one rate may reduce price disturbances for customers, it may pose a financeability risk for companies. Companies should be able to enter an annual rate or if they choose, to apply one consistent rate.

3.4 APPOINTED BUSINESS TABLES

Table A1 block A asks for the proposed wholesale limits revenue for year 1 and then the water 'K factor' for years 2 to 5. This is a significant change to how companies may present price changes and there are two specific presentation issues with this. Historically the K factor has been calculated as the five year average and has included the total bill for customers. The K factor in the table is just the price increase from year 2 onwards and only includes the wholesale revenue. The use of 'K factor' may be misleading to customers if they attempted to compare the 2009 K factor and the 2014 K factor. We recommend another terminology.

We note in table A9 the absence of a COPI forecast for 2015-20. We presume based on this RPI will be used for totex. This needs clarification. We also recommend Ofwat publish forecast RPI data for companies to include in their business plan projections. This would ensure consistency in assumptions.

4 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?

We agree with this proposal.

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

We agree with this proposal.

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

No

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

We agree with this proposal.

Q14 New appointees are growing in size. In 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 in approach?

The approach will need to be reviewed over time to ensure it is fit for purpose.