

Setting price controls for 2015-20 - business planning expectations

Southern Water's Response



Southern Water's response to Ofwat's consultation on business planning expectations 2015-20

Introduction

We are pleased to provide you with this response to the business planning consultation for the 2015-20 price review.

The key messages from the consultation are clear.

- Company Boards must genuinely own their plans and provide a high degree of assurance of their quality;
- Plans must be accessible to customers and stakeholders, and designed to deliver good outcomes for customers and the environment;
- Companies will be rewarded through lighter touch scrutiny and reputational incentives for producing high quality plans that meet customer and stakeholder expectations.

We support and welcome this approach. In particular, we are pleased that the new approach will give us the freedom and flexibility to deliver a business plan which has a strong focus on delivering the outcomes that customers want. We also feel that the package of incentives is appropriate and will be effective in incentivising the delivery of high-quality business plans.

We also welcome the simplification of the data collection requirements, however we believe there are areas where the data required could be reduced even further, which would also underline company ownership of plans. In particular, we think:-

- Outcomes and associated incentives (Tables W1/W2) should be set out within company plans in the most appropriate format, rather than in a data table, which will force outcome incentives in to a particular form.
- Expenditure by purpose (Table W3/S3) information is not obviously required.
- The weighted average cost of capital should only be required at whole business level, reflecting how companies raise both equity and debt finance. A disaggregated WACC can only ever be theoretical and therefore potentially of limited value.
- Modelling of how risk has been balanced in company plans should be owned by companies rather than specified by Ofwat.

Structure of the response

We set out below our comments on each of the key sections of the document. Responses to the specific consultation questions are included within the relevant section.

A. An Incentive-based price review

We think it is right that companies should have strong incentives to provide robust business plans that are accessible to their customers and stakeholders, and clearly deliver the outcomes that customers want in the most affordable, efficient way. Companies already have strong incentives to produce high quality plans through the normal regulatory challenge process, but we support enhancing these incentives. We think the use of reputational incentives – such as published business plan categorisation – and procedural incentives – in the form of lighter-touch scrutiny and early draft determinations - will provide appropriate and proportionate incentives for companies. To support this there must be a robust and transparent appraisal framework.

We do not think that additional financial incentives, such as enhanced menu rates are appropriate. Given that this is the first time that totex menus have been used, we think it is better to keep their application simple for this review.

Assessing business plan quality

The allocation of company business plans to a category will provide a very strong reputational incentive and we support this.

We do not agree with the proposal to carry out four separate assessments and allocate a company to the lowest category for any element. In particular, in the non-household retail market, competition will ensure that companies who do not have a high-quality business plan will face a penalty through reduced market share, as customers shift to an alternative provider. Therefore, an explicit regulatory assessment – which could affect menu choices for the entire wholesale business - is not appropriate for the non-household retail element.

We also believe the proposal to publish assessments “early in the process” before detailed analysis of plans has been undertaken is premature. Such an assessment should only be published once detailed scrutiny of plans has been completed and plans discussed with companies. We would only support the option of announcing earlier which companies have earned an enhanced categorisation.

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

We think the definition is broadly appropriate. We would suggest adding an additional criterion to cover the extent to which plans are accessible to customers and stakeholders and clearly demonstrate to customers how they have shaped company plans.

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 think the package of reputational and procedural incentives are appropriate and proportionate. We are less convinced that additional financial incentives would be proportionate and deliver benefits to customers. Companies already have strong financial incentives to submit robust high-quality plans that withstand regulatory scrutiny.

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?

As noted above, we broadly support the preferred package of reputational and procedural incentives. However, we think a later decision on resubmissions and early announcement only of those companies that have achieved enhanced standard would be appropriate. Placing a company in a resubmission category will represent a serious step and should not be taken until full and detailed scrutiny of a plan has been undertaken and plans discussed with companies.

Q4. Do you think our proposals will be effective in meeting our objective of handing back ownership of business plans to company Boards?

We feel that the less prescriptive approach to business planning guidance combined with the requirement from company Boards to provide assurance of the quality of business plans will be effective in ensuring ownership is returned to company Boards. We strongly support this.

B. The risk-based review in detail

We support the proposal to take a staged approach to the risk-based review, focusing on the four areas of outcomes, costs, risk and reward, and affordability and financeability. We set out some minor comments on each of the assessment criteria below.

Outcomes test

We generally agree with the assessment criteria for outcomes. For the test for outcome delivery incentives, our work in testing our own published outcomes against the framework set out in the draft methodology suggests that it may not necessarily be appropriate for all types of outcomes. We think the key test should therefore be whether companies have applied a consistent, coherent and proportionate approach to developing incentives and whether these are consistent with customer views, rather than whether the Ofwat framework has been precisely complied with.

Tests for costs

We note that the approach to wholesale costs will use cost corridors or thresholds to establish the appropriate level, but that even if a company's costs fall outside of these guides, Ofwat will look to the strength of the evidence provided by companies. We have consistently supported moving to a totex based approach to cost assessment and recovery, but it is clear that such approaches are in their infancy and model errors may be large. It is therefore right that the onus should be on companies and their Boards to present clear evidence on how they have satisfied themselves that their plans are efficient.

Risk and reward

We agree that it is important that companies clearly demonstrate that they have understood and balanced the risks in their plans. However, we think it would be more in line with genuine Board ownership of plans to allow companies to demonstrate this in the most appropriate way, rather than specifying detailed scenarios to be modelled. The proposed data to support this assessment is new and extensive and it is not clear how Ofwat will use the results, or that there is significant value in collecting this information in a common format.

Affordability and financeability

We support the strong emphasis on testing the affordability of company plans for customers and indeed affordability is one of the six key outcomes that our customers have identified as priorities.

We also welcome the confirmation that, consistent with the principle of separate, binding price controls, Ofwat will test whether each price control allows sufficient returns to be “self-financing over the longer-term”, although it would be helpful to have some clarity over how this relates to Ofwat’s financing duties in practice.

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 that the four high-level groups are the right ones to ensure that companies deliver a business plan which focuses on providing customers with a good quality and affordable services that meet their expectations.

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 broadly support the proposed tests, subject to the minor comments above.

Board business plan assurance

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 believe that the proposed assurance requirement will ensure that Boards will be clearly accountable for the quality of business plans submitted. Our own Board will be fully engaged in the development of the plan, with non-executive directors sponsoring particular workstreams and participating in working groups, and formal Board scrutiny of the entire plan.

C. Delivering focused information requirements

The business plan narrative

We strongly support the proposal to step back from detailed prescriptive business plan guidance. It is right that company Boards should own the business plans and determine the most appropriate way to present their proposals. We are clear that to ensure customer legitimacy, our plan must be accessible to customers and stakeholders; they must be able to clearly see how they have shaped and influenced company plans, and be clear on the linkages to companies’ long-term strategies and outcomes. This is in line with the description of a ‘business plan narrative’ in the consultation and we support such an approach.

There is, however, a risk of conflict between presenting proposals in a way that is accessible to stakeholders and the requirement to set out proposals separately for each price control. Whilst price limits will be set separately, this is not the way in which customers perceive or consume our services, so our

focus will be clearly on presenting an integrated business plan with information to inform individual price limits provided in separate appendices.

Supporting 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 we have not included in the data tables?

We recognise that Ofwat needs a consistent reliable set of core data to set price controls and that where appropriate this data needs to be comparable between companies. The proposed data table represent a huge step away from the amount of information collected at previous reviews and we welcome this. We think there are a number of specific areas where the data could be reduced further. We set out our specific comments on tables in appendix 1.

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 think the data tables are clear, though issues may arise as we begin to populate tables. We note that Ofwat has put in place a clarification process for data tables. We would ask that, as in previous reviews, responses to clarifications are shared with all companies, both for efficiency of process and to ensure that all companies are completing the tables consistently.

Customer challenge group reports

As you know, we are strongly supportive of the introduction of Customer Challenge Groups at this price review, and have appointed a strong independent Chair alongside skilled and experienced members for our Group. The challenge from our CCG has been robust and it is clear that it will lead to a better plan for our customers. It is right that high quality reports from demonstrably independent, experienced and well informed CCGs should play a significant role in the assessment of company business plans within the risk-based review process. We are confident that our CCG will produce a robust, well-evidenced challenge report and we think it is right that Ofwat should not prescribe the format of CCG reports in detail. Nonetheless it is important that the report supports Ofwat's assessment of business plans and we welcome your commitment to continuing to work closely with CCGs throughout the process to achieve that shared goal.

Timetable for setting price controls

We note that Ofwat propose that the submission date should be brought forward to 2 December. We are already working towards the December submission date, and will work closely with our CCG to ensure a high quality plan is ready for submission by this date. It is crucial that Ofwat take the final decision on this point quickly and set out specific dates for the remainder of the milestones. Clearly, the plan that we submit will be based on the best information available at the time, but earlier submission will mean that more of the environmental improvement programme will remain uncertain. It is important that a clear mechanism for incorporating these requirements in to the price limits is set out now.

Conclusions

Ofwat's expectations on companies' business plans differ significantly from what has been expected in previous price reviews by giving companies more freedom to really own their plans. We are strongly supportive of this shift in approach as it will give us more flexibility to produce customer focused business plans.

We are also supportive of the use of incentives to encourage the submission of high quality business plans. We feel that the four high-level groups which will face tests from Ofwat are the correct groups and will ensure that companies take into account the essential aspects of a customer focused business plan.

Appendix 1: table comments

Table W1/W2

The requirement to present outcomes in tabular format, with detailed incremental cost data, may not be compatible with the form of all outcomes or the proposed delivery incentives. Some of our outcomes, especially in the retail area, will be met by behavioural and process changes rather than large incremental investment. We think it would be better for companies to be able to set out this information within their plans, in the form that is most appropriate to the nature of the outcome, rather than all outcomes being presented in a common format.

While it is right that customers should be able to clearly see how costs relate to specific outcomes, it is important that Ofwat recognise that significant allocations of common costs to particular outcomes will be necessary.

Table W3/S3

We are not clear how the information collected on expenditure by purpose (W3/S3) will be used. Our plan is being developed around delivering outcomes and this table appears to require 'conversion' back to a PR09 format. We suggest that this table could be removed.

Table W18/S18

Separate information on the weighted average cost of capital (WACC) for water and wastewater is not something that has been required before. Since neither business unit in isolation raises equity or debt finance, calculating a separate WACC for them would be a theoretical exercise of potentially limited value. We therefore believe this information should be collected only at the appointed business level.

Table R5

In the draft methodology consultation Ofwat made clear that any new capital expenditure within the retail service would be remunerated through the retail margins (we also highlighted in our response the need to ensure that depreciation is included). We note that the table appears to only allow for a margin to cover working capital and risk, but does not include any reference to new capital expenditure.

Table A20

We agree that it is important that companies clearly demonstrate that they have understood and balanced the risks in their plans. However, we think it would be more in line with genuine Board ownership of plans to allow companies to demonstrate this in the most appropriate way, rather than specifying detailed scenarios to be modelled. It is not clear how Ofwat will use this, or that there is significant value in collecting this information in a common format.