



Green Lane, Walsall WS2 7PD

23 May 2013

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

Dear Stephen,

**Setting price controls for 2015-20: SST response to consultation on the business planning expectations**

Here is the response from South Staffs Water to the above PR14 consultation. We are content for our response to be published in full on your website. Our response is structured with this covering letter that focuses on our principal issues, followed by specific responses to the 14 questions posed by Ofwat in your consultation document.

There are two issues that are of concern to us. These are the belief of a lack of ownership of plans by Boards and the visibility of the financial modelling.

**Handing ownership back to Boards**

We disagree with the inference that Boards did not own previous Business Plans. For PR09 at South Staffs Water (and also Cambridge Water) the Board was integral to the process and did own the plan. Perhaps in larger companies, with bigger regulation departments, the risk that others in the organisation did not know what was being presented could be a real concern. We appreciate what underpins your comment but do not see that it is necessarily the case that it is relevant for all companies.

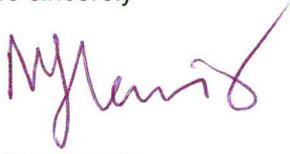
**Financial model**

The sharing of the financial model at price reviews was a huge step forward compared to before. It allowed everyone to concentrate on the issues, rather than the algorithms in the model: the lack of a shared model for PR14 is a backwards step and may easily revert to this unfavourable situation.

*For the sake of clarity, the modelling we are referring to is not the assessment of relative efficiency for TOTEX, rather the model that produces the revenue profile (i.e. what 'Reservoir' was used for at PR09).*

Please let me know if you would wish to discuss any points raised in this response.

Yours sincerely

A handwritten signature in purple ink, appearing to read 'Matthew Lewis', with a stylized flourish at the end.

**Matthew Lewis**  
**Regulation Director**

Enc. Response to 14 questions

## South Staffs Water's response to "Setting price controls for 2015-20 - business planning expectations; a consultation"

### 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 broadly agree with the definition of a high-quality business plan. It would be helpful to add a criterion that the focus of the business plan is proportionate to the issues raised. This will deter long business plans from being encouraged. We do not agree that all estimates should be established independently of other companies. For some complex technical issues it is beneficial to establish a common position that takes account of the industry evidence and this process lowers the costs for companies to prepare for the price review.

**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 are concerned that a business plan that plans that propose flat bills will be rewarded with a better assessment than those with increases, even if the latter is starting from a lower bill position. We hope that the assessment of plans will take current bill levels into account as well as movements. Companies that are already efficient have far less scope to absorb external cost pressures (like rising power prices), A focus on the bill change would be an benefit of inefficient companies that can absorb such cost impacts and the price review process should not be skewed to benefit those companies who are inefficient and/or already have relatively high customer bills.

We would like to clarify if an early determination would change later in the process if some of the key components of the Price Review changed (e.g. the industry cost of capital).

**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 think that the rewards for elements would complicate the process unnecessarily and do not consider it should be progressed.

We would appreciate confirmation whether an 'enhanced menu' for good plans would be simply an increased reward retention rate (i.e. higher possible returns **and** penalties) or if the incentive range would be made more "rewarding" (i.e. higher returns and lower penalties).

We think that the 'resubmission' category could be counterproductive and welcome the two-process category being proposed.

In a similar light to the point above, we agree that a two-process approach for Retail would be appropriate.

We support the proposal to delay publishing which companies have to resubmit (however, note that we believe that the resubmission category is removed).

**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?

Clearly defined dates are required for submissions, in advance, in order for Boards to be able to carry out the assurance that is required of them, but even the August submission does not have a date assigned to it. We would appreciate specific dates for all key events (not just seasons or months), even if some then change later.

### **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 groups proposed and have no changes to propose. We do however note that companies will need to make a judgement on the level of justification to send to Ofwat. Short business plans do not necessarily mean they have poor justification.

**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 welcome the reference to a “company’s track record of delivery in relevant area” as being considered when assessing plans. This is a change to what we had been told previously.

We would support the use of a TOTEX model so long as it can be shown to be statistically valid. Our concern is that the strength of previous OPEX models improves a TOTEX model’s validity, but that it suffers from weak CAPEX modelling. Specifically we are uncertain that spend that would, previously, have been classed as CAPEX Enhancement can be modelled, especially for smaller companies where this spend is more likely to be lumpy. Even taking a company’s outcomes into account, we are unsure of the ability of a model to assess the cost of this type of spend.

We would welcome the TOTEX modelling being shared as early in the process as possible. This would allow companies to internally explain variances between Ofwat’s and their view on costs, which will be a key factor in the company being able to accept a FD and explains variances to their CCGs and other stakeholders.

We believe that the impact of varying levels of debt and collection costs faced by each company should be taken into account in assessing the industry Average Cost To Serve.

We welcome the recent E&Y report that stated that the allocation of costs between Wholesale and Retail was broadly comparable across the industry. This will give greater confidence in the ACTS.

We believe that scenario modelling would be far more consistent across the industry if there were an Ofwat model to do this in (see separate comment at end of this list).

We welcome the use of RORE to assess the range of returns for companies.

We have concerns about the ability for companies to set plans based on:

- PAYG ratios that differ from the actual split of OPEX/CAPEX that is incurred &
- different asset lives to those which are actually capitalised.

Whilst the Price Review may focus on TOTEX, the world outside of Ofwat will only consider OPEX & CAPEX. We feel that the two areas above should be closely scrutinised. We propose that the default assumption on this is that the PAYG ratio and average lives would be those actually expected to be incurred, and any deviation from these would require robust justification.

We believe that affordability is more than just average household bills and hope that the assessment of financeability is more detailed than seems to be proposed.

We agree with comparing bill impacts across the industry, but are aware that companies can't do that when preparing our plans. Also, we feel that absolute bill levels should be taken into account.

**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 agree that ownership has been handed back to Boards.

However, some of the decisions (lack of financial model, weak definition of submission dates, reliance on TOTEX modelling, etc.) have also resulted in a backward step and further work for companies to consider in a tighter timetable, which is to the detriment of the Price Review process overall.

### **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?

Specific comments on individual lines will be fed back through the email process that has been set up.

We do have concerns on Table W7 (AIM) in particular. Despite having been informed by Ofwat that the EA has the data required to complete the table and operate our network in a manner that allows us to control the AIM penalties, our experience is that they do not. Whilst we know the sites where abstraction impacts on band 3 water bodies, we do not have:

- the rates to apply to abstractions (i.e. 1 MI abstracted from borehole A causes a reduction of x MI/d from a nearby river) &
- the real-time data that would allow us to either:
  - determine historic abstractions at times of low flow
  - or make decisions in the future about which sites to operate.

If the AIM is to be used then this lack of data must be addressed: this should come from the EA. If we are expected to fund both the installation of real-time flow monitoring equipment and assess the relationship between abstraction and flows, then this must be stated explicitly and a cost benefit analysis carried out by Ofwat to ensure that it is a good investment of their money. This decision must be made soon so that companies can factor it into their Business Plans.

We hope that the final set of tables will make use of formulae for totals to improve the data collection process and to enhance the likelihood of Ofwat receiving the data they need.

We believe that the reference to W5 that companies should “carry out a 2012-13 valuation of their assets in line with their regulatory accounts” refers simply to an indexation by RPI and not a re-valuation (like that carried out at PR09). Clarification on this would be appreciated.

Table W10 only allows for a single run off rate, asset life and PAYG ratio. Some lumpy CAEPX may result in odd bill impacts unless we are able to include year-specific figures.

We would appreciate knowing the date of the publication of the “notional’ capital structure” required to complete table W18. This will assist in our financial modelling.

The tables collect neither retail capex nor retail tax. Table R2 only collects retail opex. The treatment of retail capex, especially in light of business competition from 2017, needs to be clarified.

**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 must have detailed definitions for all table lines. For the imminent August submission, the new lines do not have definitions and these are needed urgently. Whilst we understand the concept of allowing companies the freedom to produce a Business Plan free from the constraints of specific structural requirements, this cannot be the same for data tables. We welcome the process for submitting and circulating questions on the tables and hope that this is augmented with detailed data definitions.

#### **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 have no view on the approach for small companies.

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

Whilst we have no view on the approach for small companies generally, it would be wrong to make Cholderton & District Water go through the same process that larger companies must follow.

**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?

We have no view on the approach for small companies.

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

We have no view on the approach for small companies.

**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?

We agree that there should be a threshold above which NAVs would be deemed to no longer be “small”, but we do not have a specific level in mind.

### **Additional comments**

The lack of a Financial Model is increasing the burden on companies of the Price Review. The requirement for us to determine bill impacts of various options and to model scenarios requires us to have a financial model, and in the absence of the official Ofwat one we must invest time, effort and money in our own ones. We fear that 2014 will be taken up with reconciling the output of our model with Ofwat's, rather than focussing on the areas that matter to customers.

Given the new approach to setting prices (the replacement of Principal Statements) that will need to be taken between final determinations and tariff approval, we would welcome the opportunity to test-run this aspect of the price setting process prior to FD publication. Specifically we have difficulty envisaging how the default NHH tariffs will operate in the context of other tariffs. Due to this important milestone, since we must get customer billing done smoothly and correctly, any thoughts on delaying the Final Determination would not be welcomed.