Our response to the consultation on business planning expectations

We support the overall approach set out in this consultation. Our comments are suggestions as to how the process could be operated, and views on the options put forward by Ofwat, rather than proposing any significant change to the approach.

Our response to each of the questions raised by Ofwat is attached. The issues which we have raised include the following:

- The process will work most effectively if there are opportunities for companies to discuss their plans with Ofwat before submission.
- The assessment process should recognise that the nature of assessment of retail elements of the plan will be different from that for wholesale because:
  - Strategy for non-household retail will be determined by the competitive market, rather than the business planning process.
  - The average cost to serve approach for retail household will mean that the approach to reviewing costs will differ from that for wholesale.

We have made some suggestions for changes to the tables, which provide broadly the same information but are intended to simplify the presentation and make the data more meaningful. The most significant proposal for change relates to the “Pay as you go” ratio. We consider that this should vary from year to year, rather than being fixed for the five years, or fluctuations from year to year in the capital programme will lead to undesirable instability in bills (or in returns if the bill profile is smoothed).

We have also included as an appendix our proposals for modifying the denominator for calculating retail “average cost to serve, which we have already shared with Ofwat.

Please contact me if you would like to discuss any of these issues further.

Dr Tony Ballance
Director of Strategy and Regulation
Severn Trent Water

Severn Trent Water
Response to Ofwat consultation on business planning expectations

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 fully support the proposed definition.

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?

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 proposed package and agree that the thresholds and tests should not be set out in advance.

We agree that the plan should be considered as a whole. Therefore applying rewards should be based on the assessment of the overall plan rather than individual parts. However, this needs to be linked to a proportionate approach, so that minor shortcomings in one part of the plan do not prevent overall enhanced status being achieved.

Keeping the plan down to a reasonable size means that not all the available evidence can be provided. The plan will need to summarise all the key evidence, and state what additional evidence is available. This may mean that Ofwat will require additional information to be submitted, and we welcome the indication from Ofwat at the workshop on 7th May that this will not prevent enhanced status being achieved. We recognise that the scale of this additional information would need to be limited, given the short timescale for making judgements on enhanced status.

Given the limited time for assessment of plans, for the process is to work effectively we think that Ofwat needs to discuss the key issues in companies' plans before submission. We hope that opportunities will be made for companies to do this.

If a company is going to have to resubmit, then presumably a substantial amount of additional work would be required, so we do not support later decisions on this.

Given that prices for the retail plan will be set on an industry cost-to-serve basis, there is only limited scope for companies to deviate from this level of costs, as opposed to wholesale elements of the plan where companies have a wide scope for material changes to customer prices. Therefore, given the limited information needed and cost impact of the retail plan, we support a move to drop the resubmission category for retail, and for Ofwat to consider whether there is a need to assess non-household retail plans on an enhanced/standard basis at all. We see the non-household retail submission as relating to regulatory aspects such as default tariffs. The strategy on serving non-household customers will develop through the competitive process, rather than through the price review.

An area of the retail plan that may need some harmonisation and alignment across companies after FD submission relates to wholesale/retail tariff setting. There is still considerable uncertainty regarding the setting of wholesale/retail tariffs, including the interaction with WSL access prices. We consider any amendments to the retail plan for tariff setting purposes should be considered independently to the quality and substance of the retail plan.

For an enhanced plan, the proposed process suggests that an enhanced plan would have menu choices. We do not think this would normally be applicable, as a company should not need to revise a plan which has customer and stakeholder support. However, where there have been changes since a plan has been submitted, such as new information on costs, it may be appropriate for a menu choice to be available.

Q4 / Q7 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 the objective of handing back ownership of business plans to company Boards. We believe that removing prescription on format, giving ownership of assurance to Boards, and requiring support of the whole Board for the plan, will achieve this. In terms of signing off the plan, we expect that the Chairman will do this on behalf of the Board, but indicating that the plan has the support of the whole Board.

The risk-based review in detail

Q5 Do you agree 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 these are the right four tests.

In relation to the non-household plan, we see the submission as being primarily about the regulatory elements of the plan, including the split of costs between household and non-household and between retail and wholesale, and the setting of default tariffs. Information about future costs and service provision should be limited as this is part of competitive strategy. Therefore Ofwat should consider a framework that only considers the regulatory elements of the plan (and not outcomes, costs, risk and reward, affordability and financeability). Ofwat should consider WICS' approach for the information required from Business Stream in its upcoming price review.

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?

Wholesale costs: We recognise that Ofwat needs to have a way of assessing company cost projections, and that econometrics has some role in this. But we think that models should be only be deployed as a check after a business plan has been assessed in an holistic way; the result from a model should not be seen as the "answer" that companies have to disprove. This could lead to undesired behaviour – for example, companies bringing forward excessive detail in order to rebut the results and special pleading for factors not controlled by the models.

We have not seen the models that Ofwat has developed but from what we have seen, we observe that, with totex models:

- The residual values (which are intended to give an indication of "inefficiency") grow very large even compared with previous opex models, and may reflect model limitations rather than real efficiency differences.
- Results vary greatly depending on the years observed.
- The specification of the model (i.e. the explanatory variables selected) sometimes appears to be more important than changes in costs in determining the assessment of relative efficiency.

Therefore, we agree that Ofwat should triangulate using a wide range of techniques, but also use other tests to consider whether the results are reasonable – for example, a company's track record in terms of spending against the proposals in its PR09 Final Determination; previous assessments of efficiency, and relative operational performance; and financial performance and risk-reward sharing over AMP5.

Retail costs: We support the "Average Cost To Serve" approach because we think that, in general, retail activities and costs should be very similar between companies. Any adjustments for special company circumstances, beyond metering, should require robust evidence. As set out in our response to the Framework consultation, we think that:

- Indexation of historic costs (less efficiency) is the simplest and most effective way of dealing with changes in retail costs.
- "Unique customers" is not an appropriate denominator for ACTS because of the additional costs of providing both water and waste services.

We have done further work on our simple, pragmatic alternative to unique customers, which we have shared with Joe Sunderland. We have attached it as an appendix to this response.

Risk and reward: We think that more of the risk scenarios should be defined by companies and perhaps fewer by Ofwat. Additionally for the scenarios to be meaningful, they should stress test the company's ability to perform under plausible, high impact scenarios. Some of the proposed scenarios – for example, more or less rainfall – could require significant effort if they are modelled in detail, but may not actually represent a significant risk to the company in terms of the level of additional expenditure involved.

There should be more scope for companies to define the risks that are most significant to them and companies should explain how they are aligned with existing Enterprise Risk Management processes.

We agree that Ofwat should consider whether the returns that companies are asking for are commensurate with the risks that they are bearing. If more of these are company-defined, part of Ofwat's assessment should be whether companies have chosen suitably challenging risks and their approach to dealing with them.

Financeability: We note that the diagram on page 51 still envisages a two-stage approach, with financeability being assessed *before* the application of rewards and penalties. We think this division should be reconsidered for three reasons:

1. The original reason for adopting the two-stage approach is no longer relevant. At PR99 and PR04 this was done to ensure that companies did not have money taken away for poor performance only to have it given back in order to meet financial ratios. At PR09, Ofwat did not give companies any extra money – the solution was equity injections. At PR14, another option may be to increase PAYG or depreciation rates. Neither of these adjustments will be NPV-positive; they only affect timing. Therefore there is no question of removing penalties or rewards.

2. It is not appropriate to consider some incentive effects outside the financeability assessment. For example, CIS rewards and penalties are a replacement for the effect of the "RCV roller". This would previously have affected the return in the building blocks of the revenue requirement.

3. Moving incentives from the revenue requirement to post-financeability at PR09 created inconsistency in the treatment of incentives for opex and capex outperformance, and issues with the treatment of tax, for example:

Incentive	Treatment	Tax effect	
Capex outperformance from AMP4	Implemented through RCV roller, within revenue requirement	Customer received tax benefit (lower return within revenue requirement)	✓
Opex outperformance from AMP4	Adjusted downwards by effective rate of tax, then removed from revenue requirement and added after financeability	Added to turnover, therefore benefit to company reduced **twice** for tax.	✗

In our view, the legacy "incentives" can be considered in three categories: service, cost and the revenue control:

- **Customer service:** The only legacy reward / penalty that should be considered after financeability is the SIM adjustment. This is a reflection of the service that customers have received, and therefore it is right that customers should see a short-term change in their bills to reflect their experience.

- **Cost outperformance:** In our view, the roll-out of CIS and opex rewards should be done before financeability. These are part of the way in which the regulatory framework shares past efficiency between companies and customers. But whichever way they are implemented, it should be done consistently. They should only be adjusted for tax if they are within the revenue requirement (and therefore the customers bear the tax consequences). Any adjustment should also be at the *headline* rate (not an effective rate) since the incentives will be changes to revenue, not cost.

- **Revenue Correction Mechanism:** It would be wholly inappropriate to adjust for the RCM after financeability. The RCM is, in effect, the delayed implementation of a revenue cap and therefore not really an incentive at all. Although the Efficient Billing element of this has incentive properties, the manner in which it has been implemented means that it is - at least in part - a correction to the RCM (it prevents companies from gaining revenue when customers are lost). Doing so would also be at odds with the future approach to the revenue cap, where corrections will be done on an annual basis and therefore will not be part of financeability considerations.

Future outcome incentives – These should be implemented within period, on an annual basis. This would send the strongest possible signal about the impact of performance to existing management. Given the turnover in ownership and employees, delaying the consequences of performance to a future review could mean that the consequences of company actions will affect different employees and different investors.

Investment in retail: We think that it is important that companies are able to invest in improvements to retail provision. We had understood that new capital investment (such as IT and telephony systems) would be remunerated through the retail margin, but the retail tables do not appear to make allowance for this. We have proposed an amendment to this (and some other tables) in our appendix.

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?

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 have submitted comments and suggestions for table amendments to the "Business Plantables" email address. The most significant suggested changes are:

- **Outcomes, performance measures and expenditure:** Specifying an excessive number of measures of success should be avoided as it undermines the move to an Outcomes based plan. Therefore not all expenditure will have a measure of success attributable to it. In addition, the split of existing expenditure between measures of success is often not meaningful. We propose that expenditure to maintain current service be provided at an outcome level, with expenditure to deliver improvements being provided at measure of success level.
- **Incentives:** we have proposed a reworking of the table to make the proposed incentives clearer.
- **Cost recovery:** we suggest that the "Pay as you go" ratio should vary from year to year, rather than being fixed for the five years, or fluctuations from year to year in the capital programme will lead to undesirable instability in bills. This more accurately reflects the underlying spend profile of the company. Comparisons between companies could still be made on a 5-year average basis.

- **Retail margins:** As noted above, there needs to be provision in the margin to cover financing of capex, e.g. for IT or property costs, and we suggest this should be an additional line in the table.

Some of the June Return data for the August submission is still readily available because we use them in the normal course of our business. However, we do not collect the data formerly used in the sewerage opex models. The data for these tables will inevitably be less accurate than some of the other data. For this information on sewage treatment costs we will need to apply the current RAG 4.04 guidelines, as used for the accounting separation tables, rather than the old RAG 4.01 guidelines indicated in the line definition.

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?

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?

As these smaller companies increase in size, it is going to become unacceptable that these monopoly companies may be in a position to make returns which are not proportionate to the risks which they face. Until now, Ofwat has deemed that simplified price limits are appropriate for a company the size of Cholderton. We see no reason why a different approach should be adopted with new entrants. If they grow significantly larger the size of Cholderton, then a conventional price review approach will be needed.

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

We agree that Cholderton & District Water should have a 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?

The costs of developing a service incentive could be disproportionate to the benfits until companies reach a certain size. If a mechanism is to be implemented, we agree that the qualitative research approach in the SIM would be disproportionate. Given the number of customers involved, quantitative measures might be misleading (for less than a thousand customers there could be no complaints one year and a large increase the next year if there was an incident). Therefore a survey approach, less costly than the SIM survey, would be the most appropriate.

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

We agree that separation is disproportionate for smaller companies.

Average Cost to Serve

May 2013

Unique customers as a denominator is unfair to WaSCs – but, more importantly, to customers

The "company-centric" view

- Providing 2 services rather than 1 does not drive double the cost
- This is a "company-centric" view – is the company providing its services efficiently, given the make-up of its customer base
- To some extent, this is beyond the company's control; there are restrictions which prevent WOCs and WaSCs from merging
  - But it is possible for companies to bill for each others' services; billing and meter-reading on an agency basis are more efficient
  - Benefits of scale are thus available to all
  - Issue: some companies treat commission as negative opex, others as non-appointed income

The "customer-centric" view

- Why should a customer pay 2 retail charges to 2 companies, receive 2 bills and have 2 meter readings when the activity could be combined (and is elsewhere)?
- Surely this is just inefficient?

ACTS serves as a measure of efficiency and as a revenue allowance

These two functions need to be considered separately

- In our consultation response, we suggested a simple alternative for efficiency, which takes account of the costs that are driven by the services billed
- We do not support a bad debt adjustment based on the size of the bill alone (as suggested by Southern in the retail workshop)
- Such an approach favours:
  - Companies with high bills
  - Companies with more single-service customers (WOCs and WaSCs which have few customers for water)
  - Companies in affluent areas (where high billing collection rates should be expected)
- It does not consider whether the retail operation is structured in the right way:
  - i.e. is it sensible and efficient for water and sewerage companies to bill separately?

We agree that ACTS needs to be adjusted for the level of metering

We suggested that the tariff differential should be the starting point for differentiating the cost of service for metered customers, so we are broadly happy with this approach

- Ofwat's method for adjusting ACTS is:
  - Household Retail Costs, adjusted for costs now excluded from retail
    - Meter maintenance - clear
    - Meter capital charges (?) – agree but not clear how this has been done
    - Other adjustments (?)
  - Less metering costs
    - Principal statement values (£/prop) x the proportion of the property base that is metered
    - This approach is fine in in principle but:
      - Financing benefit should be excluded (not part of opex)
      - In the differential, the total cost of metering is split 50/50 between water and sewerage
    - Therefore, when recombined for dual service customers, the total cost should be water + waste, not water plus a fraction of waste

As a measure of efficiency, the calculation needs some amendment

Issues with the calculation

	Retail costs	PS Costs per prop	Unique Custom -ers	CTS per prop	Issues
Household retail costs	£97.1m		÷ 4,036k	£24.06	Unique customers; Ofwat adjustments to retail costs (which are not transparent)
Cost to meter water only customer		£7.43 Prop	x 4% of customers	-£0.33	Use of differential components from principal statement – these include financing costs which are not part of opex
Cost to meter sewerage only customer		£7.03 Prop	x 10% of customers	-£0.67	Is there any need for a separate sewerage meter reading? Surely this is just inefficient duplication
Cost to meter water and sewerage customer		£9.71 prop	x 21% of customers	-£2.02	Excludes sewerage meter-reading and billing costs from the differential – when these are a 50/50 apportionment of total cost
Company ACTS with 0% metered customers				£21.03	

How we think the principal statement data should be used

Severn Trent differential values 2011/12

Differential (£ per property)	Standard Differential	For ACTS efficiency	For billing allowance
a. Meter reading	1.45	**2.91**	2.91
b. Billing and account management	3.31	3.31	3.31
c. Cash flow benefit	2.68	NA	2.68
d. Water only customer	**7.43**	**4.76**	**7.43**
e. Meter reading	1.45	1.45	1.45
f. Billing and account management	3.31	3.31	3.31
g. Cash flow benefit	2.27	NA	2.27
h. Sewerage only customer	**7.03**	**4.76**	**7.03**
Combined customer - Ofwat ACTS	9.71 (d+g)		
Actual differential for combined customer	**14.47 (d+h)**	**9.52**	**14.47**

- We think that it is not appropriate to adjust opex for cashflow benefits
- When assessing efficiency, these costs should be excluded (as per column 2)

- They should be brought back in when considering the amount that is should be billed to metered customers (column 3)

Our main concern relates to the use of unique customers as the denominator for all costs

Stakeholders - including Ofwat and WOCs (the beneficiaries) - agree that a weighting of 1 for a combined customer is not correct, but differ on the solution

- **Option 1:** adjust the bad debt charge for the size of the bill
  - ✓ Simple solution, as proposed by SRN at the Ofwat's retail workshop
  - ✓ Measure of "billing efficiency" – bad debt as a % of revenue
  - ✗ By itself does not recognise that providing 2 services is more costly than 1
  - ✗ Favours companies with high bills in affluent areas
- **Option 2:** adjust for size of bill and affordability
  - ✓ Takes account of customers ability to pay (e.g. proportion of customers who spend >5% of income on water bills)
  - ✗ Could be complicated – particularly if taking account of sub-regional data (e.g. pockets of deprivation)
- **Option 3:** split costs between "unique" and "billed service" drivers
  - ✓ Simple, and only approach that differentiates dual service provision properly
  - ✓ Acknowledges differences in costs other than bad debts (e.g. network calls)
  - ✓ Could be combined with approach 1 or 2

We think costs can be divided between “unique customer” and “billed services drivers

A simple and fairer alternative – for WaSCs*

	Retail costs	PS costs prop	Denominator	CTS	Notes
Bad debt and network calls	£36.1m		÷ 6,705k	£5.38	Bad debt element **could** be adjusted for billing efficiency / affordability
Other retail	£61.0m		÷ 4,036k	£15.11	Unique customers
Cost to Serve				**£20.50**	**Before adjustment**
Meter water only customer		£4.76 Prop	x 4% Props	-£0.21	Allocates all metering and billing costs to water but excludes financing costs
Meter sewerage only customer		£0.00	x 10% props	-£0.46	No opex for metering –agency fees for metered are deminimis
Cost to meter water and sewerage customer		£4.76 Prop	x 21% props	-£1.98	Same as for water-only metering
Company ACTS with 0% metered				**£17.85**	
Unique costs with 0%				£12.47	Excluding bad debt & network calls

* We do not think that the “company-centric” view should be applied when comparing WaSCs against WOCs

Revenue allowed for each type of charge should differ from this base

This offers a simple way to build up charges for different types of domestic customers

Allowed ACTS for:	Base ACTS – unique costs £	Service adjustment[1] £	Metering adjustment (for billing)[2] £	Total £
Each unmetered water-only customer	12.47	5.38		17.85
Each metered water-only customer		5.38	7.43	25.28
Each unmetered sewerage customer		5.38	-	17.85
Each metered sewerage customer		5.38	7.03	24.88
Each unmetered water and sewerage customer		10.77		23.23
Each metered water and sewerage customer		10.77	14.47	37.70

1. The service adjustment, relates to costs that exist regardless of whether the property is metered and is therefore the same for metered and unmetered. It is doubled for customers receiving both services (£5.38 x 2)
2. Metering charges here **include** the cashflow benefit from the differential because this reflects the charge (not an adjustment to opex)
3. The costs here do not include any margin to allow for capex or working capital in general – only the difference in the benefit to metered customers as per the differential

The unique customer measure, which assigns a weight of 1 to combined service

Our proposal, for Severn Trent, equates to a weight of 1.3x

- This would differ between companies, depending on the scale of their bad debts and network calls
- The approach could be combined with an adjustment for the size of the bill, and / or affordability – though this would be more complex
- We also think that there are other differences between the retail costs of WaSCs and WOCs
  - particularly billing commissions and whether they are treated as income or contributions to opex
- This means that comparisons between the two types of companies on retail activities are not like for like and it would be better to calculate the ACTS for each separately
- We remain of the view that the customer angle should be considered
  - It is difficult to explain why customers of WOCs should pay 2 retail charges for the same service