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22 May 2013

Dear Sonia

Further to my letter of 7 May 2013 and your response on the 9th May I now have pleasure in enclosing a fuller response to your consultation – business planning expectations.

You will recognise many of our key themes from the previous letter.

I hope that you find this additional detail helpful. In particular, and to clarify my previous letter, we are not seeking a tick-box approach to plan assessment and understand why you will not wish to publish in advance detailed criteria underpinning the assessment. Our proposed changes to the process are instead designed to help ensure that good quality plans and plan elements have a reasonable chance of being assessed as enhanced, without resorting to this tick-box style approach.

As ever, if we can be of any further assistance please do get in touch.

Yours sincerely

Best regards,
Andy

Andy Pymer
Director of Customer & Retail Services



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7 May 2013

Dear Sonia

Thank you for the opportunity to respond to your consultation, PR14 Business Planning Expectations.

I thought it would be helpful to set out our key responses in an early letter and then provide more detail on the specific consultation questions subsequently.

We understand and support your aim of encouraging companies to prepare good business plans that are customer focused and provide good value for money. We consider we are well placed to deliver this:

- Our business plan submissions at previous reviews exhibit many of the characteristics that you attribute to an enhanced plan. They were holistic, did not stick to the rigid structures of the regulator, sought to balance customer affordability and statutory requirements and offered up mechanisms by which pain and gain could be shared between companies and customers. We had anticipated taking the same approach for PR14.
- We continuously engage with customers and other stakeholders; our PR14 focused engagement has been a natural extension to processes that we already had in place and so we are confident that our plan will reflect customers' priorities
- Our planning process is also business as usual; our business planning team have wider management roles within both retail and wholesale directorates and therefore are well placed to deliver a submission that meets customers' and other stakeholder needs. We do not treat a business plan submission as simply a series of technical tables to fill in or a set of regulatory questions to answer.
- Our single unified Board has been fully engaged with the development of our plan and with the wider regulatory and political reforms within the sector.

Continued



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This is not to say that we are complacent or confident that our plan will meet your requirements for being assessed as enhanced. We understand why you may wish to avoid setting out in advance the requirements in detail for such an assessment, but it is in the interests of customers that as many companies as possible submit good quality plans that have the potential to be assessed as enhanced.

We must also ensure that within your plan assessment there remains room for legitimate debate and disagreement on the best way to approach what are some new issues for the industry – or to propose new approaches, as we did at PR09 when we proposed separating retail and wholesale controls and a pain/gain sharing mechanism on power costs.

With these issues in mind we propose the following:

- There should be a short period of high-level engagement between the business plan submissions and Ofwat's initial assessment of them. This will allow Ofwat to ensure it understands areas of companies' plans where companies have proposed innovative, alternative and perhaps unexpected approaches to particular issues within the price control.
- Quality assessments should be performed only at the level of each element of the business plan, rather than having a further assessment at an overall company level. Then, for each element of companies' business plans, Ofwat would publish the assessments and apply financial incentives, rather than these applying at the overall company level. This has two main advantages:
 - First, if there are overall affordability or financeability problems, it enables Ofwat to identify which element(s) of a plan are causing these and mark those as standard or resubmission and thus subject them to more scrutiny. (Under the current proposals, all elements could be assessed as enhanced and therefore need to be accepted in the round while the overall plan is (say) on the margins of affordability and assessed as standard, leaving no scope for Ofwat to adjust that plan to make it more affordable).
 - And second it creates greater incentives on companies because, even if a company felt it was inefficient in one element of its plan and wouldn't be able to reach enhanced status for that element over AMP6, it would still challenge itself to submit the very best plan it could to gain as many enhanced elements as possible.
- Ofwat should publish in advance its cost assessment models and wider efficiency modelling approach, so companies can assess where there are areas of their plan that may require a greater burden of proof before their submission.
- Ofwat should give an indication of the scale of the financial rewards available to enhanced companies so that companies can take their impact into account when assessing the overall affordability of their plan.

Continued

We will send a more detailed response to your consultation questions in due course. I hope that you find this summary of what we consider to be the key points useful.

Yours sincerely

Best regards

A handwritten signature in blue ink that reads "Andy". The signature is written in a cursive style with a long, sweeping underline that extends to the right.

Andy Pymer
Director of Customer and Retail Services

Wessex Water's response to the Business Planning Expectations Consultation

This response should be read alongside our letter to Sonia Brown of 7th May 2013 and also our covering letter dated 21st May 2013.

Summary of our Response

We understand and support your aim of encouraging companies to prepare good business plans that are customer focused and provide good value for money.

We consider we are well placed to deliver this:

- Our business plan submissions at previous reviews exhibited many of the characteristics that you attribute to an enhanced plan. They were holistic, did not stick to the rigid structures of the regulator, sought to balance customer affordability and statutory requirements and offered up mechanisms by which pain and gain could be shared between companies and customers. We anticipate taking the same approach for PR14.
- We continuously engage with customers and other stakeholders; our PR14 focused engagement has been a natural extension to processes that we already had in place and so we are confident that our plan will reflect customers' priorities.
- Our planning process is also business as usual; our business planning team have wider management roles within both retail and wholesale directorates and therefore are well placed to deliver a submission that meets customers' and other stakeholder needs. We do not treat a business plan submission as simply a series of technical tables to fill in or a set of regulatory questions to answer.
- Our single unified Board has been fully engaged with the development of our plan and with the wider regulatory and political reforms within the sector.

This is not to say that we are complacent or confident that our plan will meet your requirements for being assessed as enhanced. We understand why it may be appropriate to avoid setting out in advance the requirements in detail for such an assessment, (and we do not want a tick-box style of assessment), but it is in the interests of customers that as many companies as possible submit good quality plans that have the potential to be assessed as enhanced.

We must also ensure that within your plan assessment there remains room for legitimate debate and disagreement on the best way to approach what are some new issues for the industry - or to propose new approaches, as we did at PR09 when we proposed separating retail and wholesale controls and a pain/gain sharing mechanism on power costs.

So with these issues in mind we propose the following:

- There should be a short period of high-level engagement between the business plan submissions and Ofwat's initial assessment of them. This will allow Ofwat to ensure it understands areas of companies' plans where companies have proposed innovative, alternative and perhaps unexpected approaches to particular issues within the price control.
- Quality assessments should be performed only at the level of each element of the business

plan rather than having a further assessment at an overall company level. Ofwat would publish the assessments and apply incentives for each, rather than these applying at the overall company level. This allows Ofwat to better identify if any element(s) of a plan is causing an overall affordability/financeability issue and subject them to more scrutiny. It also gives greater incentives for companies that feel they are inefficient in one element of their plan to reach enhanced status in the other elements.

- Ofwat should publish in advance its cost assessment models and wider efficiency modelling approach, so companies can assess where there are areas of their plan that may require a greater burden of proof before their submission.
- Ofwat should give an indication of the scale of the financial rewards available to enhanced companies so that they can take their impact into account when assessing the overall affordability of their plan.
- In the absence of a shared financial model, Ofwat should publish further details at a technical/modelling level on its intended approach to avoid simple mistakes of interpretation from companies, in particular:
 - opex roller (including enhanced),
 - SIM performance rewards/penalties,
 - ACTS calculation,
 - notional gearing assumption,
 - payment terms for retailers,
 - and potentially a range for the cost of equity.
- Assessing plan elements as either enhanced or standard, would in our view be more likely to achieve your overall objectives than enhanced, standard or resubmission. The threat of penalties may drive a more risk averse approach from companies, rather than encourage them to challenge themselves to achieve uncertain rewards.
- We continue to be flexible in our approach and while the timetable is challenging we are willing to accept an earlier submission date so that OFWAT has more time to scrutinise our plan. The implicit transfer of process risk from Ofwat to us should be formally acknowledged by Ofwat.
- Continued Board level engagement in the plan at the level that OFWAT desires is dependent in part now on obtaining sufficient certainty on the remainder of Ofwat's programme for PR14 – this must now include committed and delivered dates for all the further steps on the PR14 process.

Wessex Water: Responses to Individual Questions

Please note that we have repeated elements of our summary response where appropriate in the following question responses.

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 are working hard to ensure that our business plan will meet this definition.

We think it important that the business plan assessment should be based in the round, rather than being reduced to a box-ticking exercise that is both inefficient and does not deliver for customers. We therefore understand why you would not publish detailed requirements for an enhanced plan.

At PR09, we proposed a number of new and/or innovative approaches such as pain/gain sharing mechanisms and separate retail price controls. These did not gain acceptance at the time but are now standard practice; and we expect to be proposing similar approaches in our business plan at PR14. We hope that our plan will not be judged detrimentally if Ofwat decides that certain elements should not be taken forward until later price reviews.

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?

The assessment process must allow legitimate debate around the key issues, and not stifle opportunities for adopting innovative and new approaches to deliver outcomes. It will be counterproductive if companies fear penalty under the incentives to produce high-quality plans or there is a risk they will adopt a more conservative and less innovative approach.

For this reason assessing plan elements as either enhanced or standard, would in our view be more likely to achieve your overall objectives than enhanced, standard or resubmission. The threat of penalties may drive a more risk averse approach from companies, rather than encourage them to challenge themselves to achieve uncertain rewards.

So with this in mind we suggest the following:

- There should be a short period of high-level engagement between the business plan submissions and Ofwat's initial assessment of them. This will allow Ofwat to ensure it understands areas of companies' plans where companies have proposed innovative, alternative and perhaps unexpected approaches to particular issues within the price control.
- Plan assessments should be performed only at the level of each element of the business plan, rather than having a further assessment at an overall company level. Then, for each element of companies' business plans, Ofwat would publish the assessments and apply financial incentives, rather than these applying at the overall company level. This has two main advantages:

First, if there are overall affordability or financeability problems, it enables Ofwat to

identify which element(s) of a plan are causing these and mark those as standard or resubmission and thus subject them to more scrutiny. (Under the current proposals, all elements could be assessed as enhanced and therefore need to be accepted in the round while the overall plan is (say) on the margins of affordability and assessed as standard, leaving no scope for Ofwat to adjust that plan to make it more affordable).

And second it creates greater incentives on companies because, even if a company felt it was inefficient in one element of its plan and wouldn't be able to reach enhanced status for that element over AMP6, it would still challenge itself to submit the very best plan it could to gain as many enhanced elements as possible.

- Plan elements should be assessed as either enhanced or standard: the availability of rewards (reputational, procedural and possibly financial) will tend to promote the behaviour change you are seeking from companies' plans. The existence of the resubmission "penalty" category will however tend to make companies more risk averse in their approach in order to avoid the penalties associated with this assessment – this effect will be more pronounced because Ofwat has historically tended to wield a comparatively larger stick than it has offered in carrots.
- On a practical level the likely scope of any financial rewards should be published well in advance so that companies can take them into account in their own assessments of plan affordability.

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?

Our single unified board has been fully engaged with the development of our plan and with the wider regulatory and political reforms within the sector.

While we have been putting together our plan, consistent with our business as usual approach, the Board clearly needs to understand Ofwat's detailed approach to price setting in more detail than is currently available before it can approve the final plan.

Continued and full Board engagement with the plan would therefore be facilitated by Ofwat publishing specific and committed dates immediately for the rest of the PR14 process. This will enable us to plan in advance the appropriate number of Board and audit committee meetings at the appropriate times, allow adequate assurance to be given and to ensure that the views of the CCG can continue to be heard at Board level.

We are prepared to accept an earlier submission date to allow Ofwat more time to make its plan assessments, although this has made our own internal processes more challenging.

The implicit transfer of process risk from regulator to the company that this flexibility implies should be recognised formally by Ofwat. It is now essential for a successful price control that Ofwat provides committed and fixed dates for the remainder of the process.

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?

The record of past delivery should also be taken into account for each test when assessing the quality of the plan and the company's likely ability to deliver the performance commitments it has offered up.

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 agree in general with the tests for each group. It is critical that the tests observe the five principles of better regulation, and contribute to a fair and transparent process.

Quality assessments should be performed only at the level of each element of the business plan, rather than having a further assessment at an overall company level. Then, for each element of companies' business plans, Ofwat would publish the assessments and apply financial incentives, rather than these applying at the overall company level.

While we do not want a tick-box list of criteria to meet there are technical areas of the plans that would benefit from additional clarification well in advance so that we can avoid an area of a plan failing an assessment purely because of a mistaken interpretation of the regulatory mechanism. This is all the more important if, as seems likely, Ofwat will not be sharing a common price setting model with the industry in advance of submissions. The following areas are ones that we believe fall into this category:

- Sharing of a model for AMP5 opex roller (standard and enhanced) calculations, in particular the companies eligible for the enhanced roller, the treatment of pensions costs on a cash basis and any other adjustments Ofwat expects companies to make to ensure comparisons with the PR09 determination are fair.
- Draft rewards/penalties for SIM performance based on the results achieved in 2011-12 and 2012-13.
- Publication in advance of key common financial assumptions such as the notional gearing assumption, payment terms between retailers and wholesalers, and potentially a range for the cost of equity which we believe would help avoid gaming on the cost of capital.
- A detailed methodology and/or model for calculating the adjusted average cost to serve in the household retail control.

Our comments on the proposals for the specific groups of tests are as follows:

Tests for outcomes

- We understand Ofwat's need to have confidence in the outputs from the CCG. We think that Ofwat should be slightly more prescriptive for its requirements in this area. The CCG is a new process and much effort has been made to ensure that the group adds value to the overall planning approach. It would represent a real lost opportunity if the influence of these groups was diminished purely because the outputs from them inadvertently did not meet Ofwat's expectations

- Alongside this we think that it would be of benefit for CCGs or other stakeholders to have the ability to respond to Ofwat's determination if it considers any areas of customers' interests have not been taken into account.

Tests for costs

- Ofwat should publish in advance its cost assessment models and wider efficiency modelling approach, so companies can assess where there are areas of their plan that may require a greater burden of proof before their submission
- Any ranges and thresholds Ofwat applies should be grounded in evidence and transparently applied
- We agree with the proposals for retail costs and stress again the need for an accurate assessment of the ACTS that reflects real efficiencies. We would expect our outturn ACTS to be extremely similar to Bristol Water's due to our combined retail company sharing the vast majority of costs

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?

Please see our response to question 4.

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 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?

At present Ofwat has not set out its detailed process and so it is too early to confidently assess whether the data requests are the correct specification and magnitude. We attach an analysis with our comments where we feel further clarity is required, or requesting the inclusion of additional parameters which we hope will be helpful.

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?

In order to achieve consistent data from all companies, a complete set of standard definitions will be required. This is especially important for data that previously was not part of the June Return.

The tables concerning outcomes (W1-2, S1-2 and R1-2) are complex, as are their relevant descriptions. In addition many of our planned investments deliver multiple outcomes (for example the completion of our integrated grid that delivers resilience, water quality and an improved environment) and it would be helpful for Ofwat to set out the principles by which the costs of such investments should be allocated across outcomes.

The tables do not appear to allow companies to explain multi-AMP (overlap) projects spanning AMP6 and AMP7. We expect to be beginning work on a number of projects in AMP6 that will continue into AMP7 and enable outcome delivery to be sustained over the longer term. This is consistent with the delivery of outcomes over a longer time frame and will contribute to a smoothing of the investment profile between AMP periods.

Applications to small companies

Q10 – Q14

Customers should be protected from inefficient monopoly behaviour whatever the size of their supplier. Whilst we recognise that some measure of proportionality will apply to smaller companies and inset appointments, they should be subject to appropriate scrutiny in the interests of customers.

A specific area that would benefit from further consideration relates to affordability; in particular customers served by small companies who experience affordability issues have access to the same level of assistance as is provided by the incumbent company to which their customers' charges are tied.