Mr Stephen Beddoes
Finance and Networks Division
Ofwat
Centre City Tower
7 Hill St
Birmingham

26 March 2013

Dear Stephen,

Setting price controls for 2015-20 – framework and approach
A consultation

We welcome the opportunity to respond to your consultation document, 'Setting price controls for 2015-20 – framework and approach' and hope you find our response helpful in reaching your final decisions.

We have structured our response into two parts. In the first part we provide some high level comments about the scope and timing of the work necessary to finalise the price setting methodology. The second part of our response sets out our views on a number of the issues that we consider most important. These are the same issues we discussed recently in our meeting with Chris Esslin-Peard on 15 March 2013 but take into account the outcome of that meeting.

Finalising the price setting methodology

First we want to express that we remain concerned, given the time available, about the number of proposed changes you are looking to implement for PR14. We think it is essential that you focus on delivering separated wholesale and retail controls, implementing Totex effectively, robustly and transparently and seeing through the commitment to regulatory outcomes. Any further proposed changes, we believe, should be developed during the next AMP period to ensure sufficient time and effective implementation. For example, we do not see why changes to water trading incentives need to be part of the price setting methodology.

It is essential that publication of the final price setting methodology is not delayed so we can have sufficient time to understand and respond to the final design and intended implementation of new incentive mechanisms. This is particularly important given the need to understand the implications for customers, to ensure we have the time to develop our business plan, engage with customers upon it, provide assurance to our CCG and submit the final plan to you in January 2014. As part of this process it would be very helpful if Ofwat can share its financial model with the industry during this critical time. We believe this could significantly improve companies understanding of how new incentive mechanisms will be implemented and could help reduce the delivery risk of PR14. Finally we urge you to confirm specific hard deadlines for the remainder of the PR14 programme. This is essential to minimise the potential for delay.

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Key consultation issues for Affinity Water

During our recent meeting with Chris Esslin-Peard we discussed a number of key issues arising from the consultation. We have listed these below for ease of reference.

- Totex, baseline, efficiency, menus
- Risk based review
- Cost of capital
- Retail

Totex - Implementation of menus

We continue to be supportive, in principle, to the adoption of Totex and the implementation of a menu that allows companies the final choice of their balance of cost performance risk and reward. We would encourage you to make a firm commitment in your methodology decision document to the use of menus. We understand that there is some uncertainty around whether you will use them for PR14. We believe that the use of menus provides a strong signal that you are committed to 'truth telling' incentives. This should provide you with the confidence to share details of the Totex models you are developing.

Sharing the models and tools you are developing will help all of us use our limited resources more efficiently. For example, understanding the key cost drivers and variables included within the final Totex model for the water service could help eliminate the need for work on special factors that are already accounted for in the modelling. This could be a significant benefit at the industry level.

Totex - Efficiency assessment

Clearly assessing the efficiency of companies and ensuring that an efficiency target is factored into the setting of the baseline will be a significant component of how Totex modelling will work. We are encouraged that you have invested time in developing more robust approaches to efficiency assessment but would, for the reasons set out above, ask that you share this modelling work with us sooner rather than later.

Ofwat have indicated in the consultation document that it intends to continue with the existing opex econometric models as part of the triangulation process. We explained our concern with this approach at our meeting with you last week. We have spent time reviewing the evolution and impact of the past opex econometric models. Evidence shows us clearly that past changes to the Water Distribution and Resources and Treatment models had a disproportionate impact on our opex efficiency assessment at a time when the models themselves were becoming statistically less reliable. We look forward to sharing our analysis with Ofwat in the coming weeks. The work we have carried out shows us that if the existing opex models are to be retained then you should take particular account of how the models distort our efficiency assessment. This will be important in the triangulation assessment in setting our baseline.

We also have some concern that the existing econometric models have in past been used to assess single base year data. If a similar approach is used for PR14, as part of the overall assessment, then our 2012/13 opex costs will be used to assess our comparative opex performance. Since 2010, we have been driving hard operational improvement, improved customer service and expenditure efficiencies. We expect further sustainable efficiencies to be achieved in 2013/14 and we think it is essential that your assessment methodology is able to capture this when establishing an efficiency target for the setting of the baseline.

Another reason why we think a firm commitment to the implementation of menus is important is because of the interaction with the overall assessment of efficiency. We believe that the Totex efficiency assessment you use to set the baseline should be set in relation to the industry average

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(mean) efficiency. This would mirror the approach adopted for capex under the CIS at PR09. This would make it simple to calibrate the mid point of any menu at 100 reflecting industry average efficiency.

We think that using frontier efficiency and skewed menu incentives will only complicate how you introduce Totex. Our concern about the use of the historic opex econometric models would also be partially mitigated by Totex efficiency being assessed in relation to the industry average.

Totex - Baseline setting

From reading the consultation document and following our meeting we understand that you will no longer be carrying out either an AMA type of assessment for capital maintenance or a risk based/cost beneficial type assessment for capital enhancement in setting the baseline. We can see how this approach to Totex modelling can work for a company who has a future investment plan with the same investment drivers as it has had in the past and for whom capital maintenance expenditure has made up the majority of its capital expenditure. We are less certain about how this might work for a company that is expecting to have quite different investment drivers in AMP6 and beyond compared to those in the past.

We are facing a substantial water resources challenge over the coming 25 years, as set out in our forthcoming draft Water Resources Management Plan. We expect our water resources situation to drive a large amount of capital enhancement expenditure in AMP6, when compared to prior periods. It is essential that your approach to Totex modelling is able to capture our changing circumstances if Totex is to work effectively and transparently. We are encouraged that you have built in to your timetable several stages in the process for setting baselines and we are encouraged that you are seeking active dialogue with companies following their final business plan submissions. Nevertheless, we can see that there are good reasons for the possible exclusion of capital enhancement expenditure (where this is different from historic capital enhancement expenditure levels) from the general Totex econometric cost assessment methodology.

Totex – Pay As You Go (PAYG)

It is worth us saying, at this time, as we have previously indicated that we believe we are an outlier relative to the industry average PAYG range. This reflects the importance to date of infrastructure renewals expenditure in our investment programme and the low capital enhancement expenditure in the past. If cost recovery is to be set around the industry average PAYG, there will be revenue effects that might need to be addressed with financeability adjustments to allowed depreciation charges. Financeability tests will be essential to get the PAYG system to work to ensure there is enough cash flow to finance functions.

Risk Based Review

At our meeting last week we discussed Ofwat's risked based review approach. We continue to believe that a 'light touch' review is a strong incentive for companies to challenge the process they follow in developing their final business plan for submission. We are encouraged by the opportunity Ofwat is giving companies. We think this incentive could be further strengthened if there were the possibility for draft determinations to be 'fast tracked' into final determinations allowing companies substantial time to prepare for AMP6 delivery. The incentive for 'fast tracked' companies would come in the form of cost savings and reduced resource requirements to continue to support the price review process but also from potential efficiency savings that could be achieved by reducing the impact of the AMP capital investment cycle.

In putting together our final business plan we will be submitting an overall package of measures, performance levels and assumptions. We remain concerned that about the extent to which Ofwat could 'cherry pick' the assumptions and elements they are happy with while challenging only certain

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aspects of our plan even when the overall package has been consulted upon and has customer support. We have taken some reassurance from our meeting last week and understand the reputational risk that Ofwat would be exposed to in these circumstances. Nevertheless it would be helpful if you could confirm that a risk based review does not imply ‘cherry picking’ and challenging points of relative detail in the overall business plan submission.

Cost of capital

We support the commitment you have made to continuing to allow companies to earn a regulated return on their RCV as part of their wholesale control. You have stated that you will continue to derive the WACC in real terms, and use it for the whole control period, as the RCV and allowed revenues will be indexed to RPI. We agree with this approach.

We believe that a single national WACC and allowances for a small company premium should continue. Our recent experience has shown us that there is a real premium to the cost of raising finance for smaller companies. Ofwat should continue to use notional gearing levels to assess financeability and actual gearing levels for the assessment of tax.

Retail

During the course of developing our draft Water Resource Management Plan, and taking account of Water Resource South East (WRSE) modelling, it is clear that our business plan is likely to include a range of demand side investments to achieve a balanced water resource position. Water efficiency measures will almost certainly form part of the solution and it seems incorrect to us that the funding for this should be through the retail control. We can see the merit of water efficiency as service differentiator for non-household contestable customers but believe strongly that this should be funded through the wholesale business for non-contestable customers.

At our meeting last week we discussed the most appropriate way to deal with the projected costs of retail market implementation that are potentially significant. We remain unclear as to how these costs will be funded but would expect this to be through the non-household retail control. We would welcome your confirmation in the final methodology document. We are convinced that these costs should be identified as a Notified Item at the very least.

Yours sincerely,

Richard Bienfait
Chief Executive Officer

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