SETTING PRICE CONTROLS FOR 2015-20 – FRAMEWORK AND APPROACH
RESPONSE FROM DEE VALLEY WATER

1. INTRODUCTION

We welcome the opportunity to respond to Ofwat's consultation on the framework and approach for setting price limits for 2015-20. We were also grateful for the one-to-one meeting with Chris Esslin-Peard and Dave Russell, which clarified some aspects of the consultation document that were unclear. The workshops have also proved useful.

We fully support the principle that companies should take ownership of their plans and be responsible for delivering outcomes that customers and society value. However, it is not clear how this can be achieved when there is significant uncertainty and lack of detail on how prices will be determined for customers at such a late stage in the periodic review process.

We are generally supportive of the outcomes approach but the amount of time involved in defining and agreeing the outcomes, measures of success and the incentive package should not be under-estimated. We foresee that sharing of companies outcomes incentive packages with the Customer Challenge Panels could lead to additional delays as there may be difficulties in comparing outcomes between companies. In the absence of knowing the specific circumstances for each company it will be difficult to explain the differences in the overall incentive packages and this could result in further challenges by the Panels which can only result in delays in the PR14 process.

Generally, we have concerns about the overall approach but particularly that there is still a large amount of uncertainty about deadlines for submitting information and the information requirements in regard to the framework to setting prices. For a business plan to be ready by the end of 2013 and allowing for the considerable requirements of customer engagement, the timetable is extremely challenging for all stakeholders. Definitive dates for methodology papers and submission of key documents would add clarity and assist in efficient programming and coordinating of the array of activities.

As it is now clear that the threshold between contestable and non-contestable customers will be different between English and Welsh companies, which will undoubtedly lead to confusion for eligible non-household English customers supplied from a company wholly or mainly in Wales, it is important that DVW is not disadvantaged when developing the different approach for non-household retailers in Wales. We are concerned at the possibility that DVW could be disadvantaged by the incentive mechanisms if they are not calibrated appropriately.

The theory of a totex approach is good as it would overcome the complexity and conflicts of the separate capex and opex incentives. Again, the difficulty will be in its practical application. The challenges of such an approach appear considerable and an early indication of acceptable bands for the PAYG ratio would assist companies in formulating their plans.

We have significant concerns regarding the latest cost assessment models and understand that, due to the size of DVW, some of the cost assessment models do not work well with our data. We noted during PR09 that DVW's position in the ranking tables could vary largely depending on the econometric models Ofwat used. We would therefore caution against a one-size fits all approach to the cost assessment and raise the point that company-specific factors for DVW are taken into account in any assessment of costs that an efficient company of DVW's size would require.

On the financeability assessment we feel it important to emphasize the need to include a small company premium for DVW in the overall assessment of WACC. We have made the point at the last Periodic Review that DVW is the only listed water-only company and therefore has a particularly strong case for the inclusion of a small company equity premium in the overall assessment of cost of capital.

One final general point worth noting is that is not clear how the Customer Challenge Panel process is managed over the Business Plan submission and the following year when the Customer Challenge Panel may not know what it is signing up for.

We have responded to the majority of the questions in the consultation document and our responses are provided below.

2. DVW RESPONSE TO CONSULTATION QUESTIONS

OUTCOMES FOCUSED APPROACH

Q1 Given the limited number of outcomes that we, as a small company, are likely to propose in our business plan, the framework outlined in section 2.3.2 would appear to be sufficient in deciding on the nature of the incentives. This view is tempered by the lack of detail or examples which could have shown how the outcome incentives will be valued, monitored and enforced.

Q2 In view of the uncertainty about the business planning methodology and the significant changes already proposed we agree that the outcome delivery incentives should be for no longer than five years (2015-20). The success or otherwise of the new framework can then be considered during AMP6 and a longer-term view taken if deemed appropriate.

Q3 Consistent performance incentives should be applied in circumstances when there is a need to compare companies. Of the proposed new incentives, the modified SIM is likely to be the only incentive that is comparable across the industry. DVW is unlikely to be subject to the Abstraction Incentive Mechanism or the Water Trading Incentive and as a result a consistent performance incentive would not be applicable. In terms of the modified SIM we note Ofwat's intention to introduce an additional performance incentive for companies operating wholly or mainly in Wales. We would wish to be reassured that DVW would not be disadvantaged by this measure.

DEFINING RETAIL (AND WHOLESALE) SERVICES

Q4 We noted from the Retail workshop on 1 March 2013 that the definition of retail aligns with the Scottish Model but is dissimilar to the gas and electricity models, i.e. developer services are treated differently. It would seem to us that developer services are more closely associated with the network operation than a retail provider and so developer services would be better aligned with the wholesale activity. This would potentially avoid a developer having to deal with a middle man and therefore provide an efficient service to the customer. Also, the link between new mains activity and water quality risk should not be under-estimated.

SETTING WHOLESALE CONTROLS

Q5 The calculation and inclusion of infrastructure charges in revenue collected may need to change to reflect the fact that the current infrastructure charges are not sufficiently transparent. They should revert to a company specific infrastructure charge.

Q6 The proposal for a mixed revenue and revenue yield form of water wholesale control would seem to be an improvement on the current system, providing flexibility for companies to moderate bills according to variations in demand. However, it needs to be noted that there could be a two year lag year to revenue adjustments with the possibility of confusing customers. It is also worth considering how the changes in bills will be communicated as there will no longer be a direct link to the K Factor.

Q8 The variables in demand forecasting make it difficult to foresee how there could be an appropriate incentive that could take account of all the possible extenuating factors that would need to be considered when comparing the actual demand to the forecast. The key to accurate demand forecasting is methodology and data. This is where the effort should be rather than incentives.

Q9 For a small company, such as DVW, the baseline setting should be relatively straight-forward and is unlikely to require the sophistication of the econometric models presented in the CEPA report. It will be necessary to take account of the lumpy nature of our investment programme when applying our data to the econometric models.

Q10 - Q12 It was stated during our one-to-one meeting that DVW data would probably not fit well in the econometric models. We would therefore caution the use of them in assessing the efficient costs for DVW. As noted above it will be necessary to consider separately the exceptional items such as rebuilding the Legacy treatment works when applying the cost models to our investment programme. Companies' historic appetite for risk and the link to historic asset investment levels and bills to customers should be considered. There needs to be an acknowledgement that historic level of expenditure is not necessarily a guide to future requirements.

RETAIL CONTROLS FOR HOUSEHOLD CUSTOMERS

Q15 As Ofwat has already identified that there is scope for regulatory gaming if forecast cost data is used our preference would be to use historic cost data.

Q16 – Q17 Yes, the proposed criteria and preferred option seem appropriate.

Q18 It does not seem sensible or realistic to expect companies above the industry ACTS to reduce their costs in a single year. A glide path over the course of the AMP (or longer if necessary) would seem appropriate depending on any particular factors.

Q19 For companies below the industry ACTS, company specific factors would again need to be considered when setting a forward-looking efficiency challenge. A better understanding of variability between companies' ACTS is needed before the setting of any meaningful efficiency challenge can be considered.

RETAIL CONTROL FOR NON-HOUSEHOLD CUSTOMERS

Q30 During interviews with non-household customers, as part of the market research for PR14, it has been noted that some non-household customers would be willing, potentially, to pay more for additional services, such as enhanced supply resilience or additional leakage detection services. It would be difficult to define an incentive for these aspects of service.

Water efficiency advice and similar connected services are a possible aspect of service that could be linked to an incentive mechanism but it is clear that the incentives would need to be carefully calibrated to ensure that companies operating wholly or mainly in Wales would not be penalised by the incentive.

Q31 In setting the efficiency challenge for companies operating mainly in Wales it would seem appropriate to set it based on the performance of non-household retailers in England. In this way the efficiency challenge would be based on real data rather than arbitrarily applying the efficiency challenge placed on household retailers. It would also address the odd possibility of an efficiency challenge leading to lower prices in Wales than in England if competition does not drive charges down as expected.

MAKING BETTER USE OF WATER RESOURCES

Q32 – Q35 We stated in our response to the *Wholesale Incentives Consultation* that water trading incentives seem wholly sensible in a water-stressed region where it may be necessary to incentivise companies to import water rather than build their own resources. We remain of this view.

Q36 – Q39 Whilst the preferred option put forward is an improvement on the previous consultation in that it simplifies the mechanism there is little information to describe how the mechanism will work in reality, eg how will flows and abstraction be monitored, which presumably would have to be in real-time and how will the penalties be calculated? The consultation also gives no clarity on how the mechanism will account for rivers where there are several companies abstracting from it and the abstraction from one causes the low flow. In this example the other water companies would be penalised through no fault of their own, and could actually deter conjunctive use of resources.

The proposed limit to the scope of the AIM to only include Water Framework Directive 'Band 3' sites could be considered too simplistic an approach to a complex problem as there will often be many variables to consider in determining whether an abstraction is having a detrimental impact on the river. As the mechanism evolves, during the shadow period for example, we foresee that it will be necessary to develop river specific measures which are likely to add to the complexity of calibrating the AIM.

OVERALL INCENTIVES, RISK AND FINANCEABILITY

Q40 - Q44 We continue to maintain that a small company premium for DVW is justified and should be included in all components of the WACC. There is merit in linking a company's risk appetite to its allowed return but how this can be done would be a challenge.

ASSESSING PERFORMANCE DURING 2010-15

Q45 The uncertainty surrounding the application of legacy tools leads to the conclusion that the decisions to spread the adjustments across the price control period will have to be made on a case-by-case basis. Furthermore, it would seem inequitable to apply a one-size fits all approach when there could, as seems likely, be potential tensions between the new tools and the legacy tools.

Q46 One factor that will probably need considering is the materiality of any adjustment and the impact this has on the financeability assessment and thus on overall price limits. The effect on customer bills, customers' understanding and financing problems for companies for delaying any compensation need to be carefully considered.

DELIVERING PRICE CONTROLS IN 2014

Q47- Q48 The criteria outlined in Section 10.2 provides insufficient detail to comment on whether they are appropriate criteria for assessing a high-quality business plan. It seems likely that the decision on fast tracking will require some comparison between companies and so it may not greatly reduce the timescales. It is also apparent that even for companies that clear the high bar they will still be required to make a menu choice so the overall timeframe will not be significantly different.

Q49 Given the uncertainties around how business plans will be assessed, it is clear that one-on-one discussions between companies and Ofwat must play a major part in the periodic review. The proposed timetable is challenging and this is compounded by the lack of specific dates in the overall Ofwat programme. Vague dates such as Easter or Summer do not assist programming by companies. This can only be to the detriment of the quality of business plan submissions.

One possible approach to address the tight timescale would be to split or defer the Final Determination to allow sufficient time for companies to engage with Panels, Ofwat and other regulators.

The baseline setting is a crucial stage in the periodic review process. As stated earlier, for a company such as DVW, with a relatively simple investment programme, it should be possible to set the baseline now and not wait for our Business Plan submission. It is unlikely that Ofwat's baseline would be significantly different to DVW's.

BUILDING FOR PRICE REVIEWS IN 2019 AND BEYOND

Q50 –Q55 Our concerns over the network plus approach have been raised in our previous response to the *Wholesale Incentive Consultation*. The main concern relates to the regulatory burden and is seemingly inconsistent with Ofwat's stated aim of lighter touch regulation. It risks becoming a sledgehammer to crack a nut.

The proposal to include an allowance for the specific additional efficient costs for the provision of high-quality network information is at odds with Ofwat's customer engagement approach. In effect customers will be paying for this information to be provided, have they been consulted on this? Also given that it is an additional cost it does restrict the ability of companies to increase bills to fund more beneficial tangible investment.

Dee Valley Water
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