

**PR09 Price Review
Expenditure and incentives –
a water company view**

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Objectives in Setting the Incentive Framework

- **Activities and Costs**
 - Encouraging efficiency
 - Right opex-capex balance
 - Innovation and sustainable long-term solutions
- **Returns**
 - The right risk-return balance
 - The right capital structure
- **Outputs**
 - Encouraging improvements where justified
- **Regulation**
 - Minimising regulatory costs
- **Setting Prices**
 - Getting accurate cost estimates

How does the current framework match up?

- **Activities and Costs**

- Has encouraged cost savings, but may not have delivered best, sustainable solutions

- **Returns**

- Returns have been satisfactory – but there is a risk that reductions from company estimates will lead to the wrong result

- **Outputs**

- Improvements delivered but concern about over-spending has limited investment

- **Regulation**

- Current approach has led to increasing information requirements and monitoring of activities, increasing costs to company and regulator

- **Setting Prices**

- Cycle of companies submitting high cost estimates, subject to reductions by the regulator

Where we want to get to

- Business plans for price reviews which:
 - Are best central estimates of expenditure, requiring less regulatory scrutiny
 - Represent stakeholder views
 - Deliver efficient, sustainable outcomes
- Price limits which allow adequate returns for efficient companies

Potential benefits of menu regulation proposals

- Reducing the chances of setting price limits at the “wrong” level.
- Allowing companies to select their own investment level to meet stakeholder needs.
- Incentivising plans reflecting what companies believe they need to spend.
- Increased ability to respond to new needs between price reviews due to the symmetrical treatment of capex.
- Potentially lowering the regulatory burden – in the medium term, an opportunity for less detailed scrutiny of business plans.
- Can be linked to higher-level outputs which encourage more efficient and innovative solutions.

Ofwat menu proposals

- Key issues
 - Setting the baseline – proposed approach currently unclear
 - What does a simplified approach to capital maintenance mean?
 - How will the balanced scorecard be applied?
 - Ofwat commitment to the mechanism
 - Are the incentive rates right?
 - Method and timing for “settling up”
 - Should it be extended to opex – avoiding opex-capex distortions?

The approach to operating costs

- Ofwat view:
 - opex relatively predictable
 - established methods (current base less efficiency based on comparisons) appear to perform well
- Companies have more concern about overspends on opex
- UKWIR review noted limitations of current modelling – but didn't produce a superior alternative
- Current UKWIR project looking at past extent of catch-up – to inform future assumptions

Output incentives

- Menu regulation – reduced penalty on additional investment
- Need for positive incentives?
- OPA has encouraged service improvement but:
 - Are the incentives at the right level?
 - Does it encourage too high a standard on some aspects of service?
- Potential development of Overall Performance Assessment
 - Based on customer willingness to pay
 - Regionally based rather than national standards?
 - Relative to company commitments rather than absolute standards?
 - More emphasis on customer satisfaction with problem resolution
 - Some aspects dropped where further improvement not worthwhile

Issues for Discussion

- Will the menu approach encourage accurate business planning?
- Simplified approach to capex assessment and higher-level outputs – a change for the better or an increase in risk?
- Are the incentive rates right?
- What are the issues on setting the baseline?
- What output incentives need to be in place?
- How should opex be handled?