“I love it when a plan comes together” Hannibal Smith

With the publication of Ofwat’s final methodology, the next milestone for PR14 looming on the horizon is the submission of water company business plans. But what does the new emphasis on “company owned” plans really mean? And what potential benefits and pitfalls might lie ahead for the industry?

A new emphasis on ‘company owned’ plans

For PR14 Ofwat has made a ‘step change’ in its approach to how it both sets expectations for, and subsequently evaluates, water company business plans. At the heart of this is a desire to be less prescriptive and detailed with respect to *how* companies should develop and evidence their plans – and instead to place the onus on company Boards to take ownership for the plans they make and submit to the regulator. By doing so, Ofwat’s hope is that companies will become more customer, rather than regulator, focused. To enable this change Ofwat has emphasised the need for company Boards to provide robust assurance statements in support of their final plans.

In place of prescriptive requirements, Ofwat is instead focusing on assessing the overall quality of company plans and, relatedly, to set transparent incentives that encourage companies to build high quality plans. Ofwat has indicated that will consider plans to be of high quality if they: are designed to deliver good outcomes for customers; are based on a coherent narrative and are supported by evidence; ensure that the company can meet it statutory obligations; reflect good quality customer engagement; are cost efficient with robust projections; balance risk appropriately between stakeholders; come with a high level of assurance; and do not seek to game the regulatory process.

Whilst there was some variation across the industry with regards to Ofwat’s intentions for increased company ownership of plans, this aspect of the regulatory package was largely welcomed. For example, Water UK stated that it: *“supports Ofwat’s ambitions for PR14 – based*

around 'company owned' high-quality business plans that fully reflect the views of customers, focus on longer term outcomes and give companies ownership of the risks they face."

Setting incentives

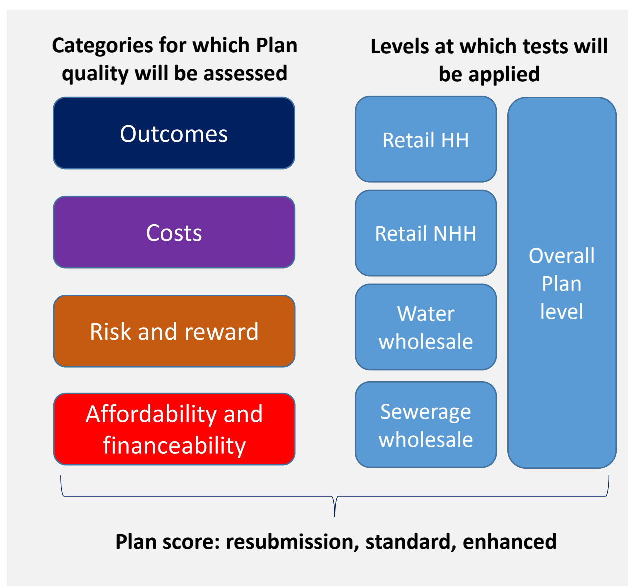
Rather than specify what companies must include in their plans with respect to the above criteria, Ofwat has further designed a set of incentives within its new risk based review framework, which are intended to focus companies on delivering the right outcomes. These incentives are reputational, procedural and financial in scope.

"Companies' Boards are free to set out their business plans in their own way, making them accessible to customers, us, and other stakeholders." Ofwat

When assessing plans, Ofwat will do so with respect to: their associated outcomes; costs; risk and reward; and affordability financeability. For each Ofwat has set out a set of 'tests' that it will apply to determine quality. Related to this, Ofwat will further test companies' plans at both the 'element' level (i.e. they will assess plans in relation to household retail, non-household retail, water wholesale and sewerage wholesale) but also at the whole-company level. Ultimately plans will be graded as being: 'resubmission,' 'standard,' or 'enhanced;' where the overall classification will be based on the lowest score received for any individual plan element.

Ofwat's approach to evaluating plan quality is shown in the diagram below.

Figure 1 : Ofwat's approach to risk-based review tests



The economics of company owned plans

From an economics perspective, one of the most interesting aspects of a 'company owned' approach is that, with regard to a number of key parameters, it will be for companies to propose input assumptions within their plans, which Ofwat will then evaluate using its risk based review framework. Examples of this include: the PAYG / RCV ratio; RCV run-off rates; projected wholesale totex costs; and the overall gross margins assumed within retail default tariffs. This more 'flexible' methodology contrasts with the historic approach where, ultimately, the central parameters were typically set by the regulator.

In essence, therefore, Ofwat's approach means that – in reaching its views as to the overall quality of plans – it will consider both: (i) whether key parameters assumed by companies lie within ranges that it considers to be appropriate; and (ii) the robustness of the evidence and narrative used in the setting of those parameters in the first place (e.g. how did a company determine an appropriate level of efficiency saving within its projected totex costs?)

There are various potential advantages – but also challenges – posed by this new approach, which raise a number of pertinent questions:

- ***To what extent will the new methodology genuinely incentivise a more customer centric approach across the companies?*** In theory, by incentivising companies to be more customer focused the new approach has the potential to deliver material benefits through encouraging companies to focus resources where they are most valued by customers. This same cultural change could also lead to dynamic efficiencies through innovation – as noted in the impact assessment recently published by Ofwat.

- ***Is further information 'revealed' to the regulator by virtue of requiring companies to independently form a view as to the values for these parameters without regulatory guidance?*** A clear in principle benefit of Ofwat's new approach is that it could result in it having far more data points for each key price control parameter, with less scope for there being a 'collective industry viewpoint.' This, in turn, could contribute to improved allocative efficiency within the determinations and thus enhanced welfare for consumers. In practice, the value of these data points will in part depend on some of the issues raised below.

- ***Are there economically valid reasons for key parameters (which critically, will determine end prices paid by water consumers) to vary across companies?*** For certain parameters, a justification for variance is doubtful. One example of this relates to the gross margins within retail default tariffs. Here, given that the non-household retail market is considered to be national in scope, allowing cross-company variance means: (i) that customers in some regions will receive more regulatory protection than in others prior to competition developing, with no economic basis; and (ii) competition itself might ultimately take a more regional form, which could give rise to consumer detriment (although this will depend on the levels at which default tariffs are set).

- ***When assessing the 'quality' of company plans, what relative weight should be placed on (i) the levels of parameters assumed by the companies; and (ii) the quality of evidence used to support them?*** For example, it would seem undesirable that a company whose plan has limited supporting evidence, but where its key parameters align to the regulator's view of the world, should achieve a higher quality score than a company whose plan has considerable robust evidence, but where certain parameters lie outside of the range deemed appropriate by the regulator. This is because by attaching too much weight on the 'value' of parameters, the independence of evidence received by the regulator becomes diluted, creating a self-fulfilling cycle that serves to reinforce existing regulatory precedent.

- Related to the above, ***what degree of 'tolerance' should be allowed between companies' proposed parameter values and the range that Ofwat considers appropriate*** – and at what point should any divergence lead to an adverse grading of a company's plan? Setting too low a level of tolerance runs the risk of companies 'self censoring;' and thus being risk averse regarding their input assumptions. This could rob the regulator of valuable information.

In addition to the above conceptual issues, a number of practical matters also arise. For example, whilst a company owned approach may contribute to a lower regulatory burden, it might also place greater resource pressure on Ofwat during the determination phases of the price control process, relative to the historic approach.

When a plan comes together

There are clearly a number of in principle benefits that could be derived from the more 'company owned' approach developed by Ofwat for PR14. However, a number of important economics questions remain outstanding, which raise challenges that will need to be overcome. As the regulator seeks to apply its new methodology in practice, we suggest that the above issues need to be addressed as transparently as possible – as ultimately, how they are dealt with will in no small part determine the real world benefits and costs of the price control.

Further information

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