Severn Trent Water

Severn Trent Water Ltd
2297 Coventry Road
Birmingham
B26 3PU

Tel 0121 722 4000
Fax 0121 722 4800

Direct Line 0121 722 4904

Contact
Your Ref

Our Ref TB/JC

6 September 2010

Hannah Nixon, Partner
Transmission and RPI-X@20
Ofgem
2nd floor
9 Millbank
London
SW1P 3GE

Dear Hannah

Regulating energy networks for the future: RPI-X@20 Recommendations

I am writing in response to your invitation to comment on the recommendations for changes in the regulatory framework arising from the RPI-X@20 review. We consider that many of the issues raised are common to regulation of all utilities and therefore hope that we can make a contribution on these general issues.

There is much in the proposals which we support and which would contribute to meeting the challenges which utilities face. We agree that an increased focus on incentives and on high-level, longer-term outputs will encourage innovation and delivery of sustainable solutions. We have set out our views on these issues for the water sector in our own publication, "Changing Course", a copy of which is attached. Our proposals on improvements to the economic regulation framework are set out on pages 44 to 51.

Our comments on the individual recommendations are set out below.

An evolutionary approach to the price control framework

We support the retention of the basic framework, with an "ex ante" approach, setting prices up front, and returns continuing to be based on Regulatory Asset Value. This retains incentives for efficiency and maintains investor confidence.

Extending the price control period

Extending the price control period, as proposed in your consultation, has the potential to encourage longer-term thinking. Some outputs would need to be reviewed more frequently than eight years but, where possible, setting outputs for a longer period would enable planning to deliver solutions more cost-effectively and in more sustainable ways.

Stakeholder engagement

We agree that there is scope for an increased role for stakeholder engagement in the price review process. We consider that this could involve some decisions on services being made by agreement between companies and representative bodies, rather than being taken by the regulator. The relative roles of companies, economic regulator and representative bodies at each stage of the process need to be clear in order to avoid duplication of effort.

Focus on outputs and outcomes

We support the approach whereby primary outputs would be related to service delivery to customers, rather than related to company activities. We recognise that providing for secondary outputs is desirable in some cases, to encourage projects which have up-front costs but may not deliver service benefits until future price-setting periods. These would need to be limited, however, in order to ensure that the primary focus was on service delivery to customers.

Benchmarking

We support the intention to base benchmarking on total expenditure. This is an important part of equalising opex and capex incentives. Comparisons would, however, have to separate out expenditure on improvements from maintenance, to recognise differences in scale of improvement programmes between companies.

Incentivising service improvement

We agree that it is appropriate to provide for rewards and penalties for over or under delivery of service. The scale of reward should be based on customer valuation of improvements. Normally the rewards and penalties should be symmetric but we recognise that where consequences of failure are severe it may be appropriate to adopt an asymmetric approach.

Proportionate assessment and encouraging high-quality business plans

We support the proposals to encourage high-quality business plans and to vary the level of scrutiny according to past record of delivery and quality of plans. We consider this to be an essential part of a move towards higher-level outputs.

Financing issues

We consider that an approach needs to be adopted which ensures continuing equity participation and attracts new equity finance to finance additional investment, and that the proposals need to be developed further to achieve this. We have set out our position on this in "Changing Course", page 45.

Both energy and water industries are likely to have large capital programmes in future. Continuing to finance the capital programme through increased borrowing, as has happened to date, looks unsustainable, in that costs of financing will rise and there will be an increasing risk of difficulties in obtaining finance. There is a potential transfer of risk to consumers from financial distress – a company being in financial difficulties would lead to pressure to relax the regulatory contract. Such financial difficulties would be likely to increase the cost of capital for regulated industries generally.

In addition, highly-geared companies are likely to be too risk-averse, which will discourage the innovation which is needed to meet new challenges.

Varying the assumed rate of return according to a company's actual gearing could incentivise continued equity participation in the sector. This would be a further development of your proposals for companies within the same sector to have different levels of notional gearing where there is a significant difference in the risks facing them.

We recognise that there is a case for adjusting price limits each year for changes in cost of debt and that this case is strengthened if the price review period is to be extended. However, your report shows that customers have not had to pay a significant premium for cost of capital being fixed in advance. Before making this decision it needs to be considered whether there would be undesirable consequences in terms of excessive incentives to adopt a particular structure for debt, which could lead to inefficient financing.

I hope that you find these comments useful and we would be pleased to provide further information on any of the points we have raised.

Yours sincerely

pp Dr Tony Ballance
Director of Strategy and Regulation