

Water 2020: Regulatory framework for wholesale markets and the 2019 price review

Southern Water's Response

February 2016



Southern Water's response to Ofwat's Water 2020 consultation paper

Overview

We welcome the opportunity to provide our comments on the Water 2020 consultation paper. The quality of Ofwat's engagement to date, with early sight of proposals for reform, has meant that there were no significant surprises in the consultation. This has improved the quality of discussions that we have been able to have with our Board - our Board and shareholders have been fully involved in shaping our response.

We are supportive of much that is proposed in the consultation document. In particular we welcome:

- the continued focus on customers and outcomes;
- a more clearly defined remit for the CCG;
- the recognition that the resilience challenge requires a long-term focus; and
- the commitment to extend the RCV protection to March 2020.

However, there are a number of proposals within the consultation that cause us concern, specifically:

- the proposed transition from RPI to CPI;
- the allocation of the RCV to sludge and water resources; and
- the introduction of two new price controls for sludge and water resources.

Given our concerns in these areas, we have provided more detail on the RPI / CPI transition issue and the proposal to allocate the RCV in two separate discussion papers. We are keen to share our experience and thinking on Outcome Delivery Incentives (ODIs) and the potential for market mechanisms to deliver solutions in the water resources area. We have also produced two discussion papers on these subjects.

Our response is structured in three sections:

- This document summarising our key areas of focus;
- Four separate papers have been produced on indexation, RCV allocation, our experience of ODIs, and introducing market mechanisms in to water resources.
- The excel spreadsheet response to Ofwat's consultation questions.

The remainder of this document provides our comments on what we see as some of the key Water 2020 proposals. These are:

- (i) Customer focus and Customer Challenge Groups
- (ii) Sludge market opening
- (iii) Water resources market opening
- (iv) Separate price controls and RCV allocation
- (v) RCV protection
- (vi) Indexation
- (vii) Third party procurement
- (viii) ODIs / Incentives
- (ix) Timetabling

(i) Customer focus and CCG

Ofwat's proposals to enhance the role of customer engagement for PR19 are welcome and are broadly in line with the recommendations we made in our Water 2020 Customer Engagement discussion paper, including:

- the need for a clear remit for CCGs;
- the use of a broader evidence base for customer insight;
- early sight of key regulatory parameters such as the WACC; and
- customer engagement as business as usual.

We particularly welcome Ofwat's acknowledgement of the value of providing earlier sight of key regulatory parameters, such as the WACC and RORE, including the methodology for arriving at the proposed figures. This will give greater clarity to our business planning process and ensure that our engagement is built on the best available information. We would also like to see a clear indication of the size of Ofwat's likely efficiency challenge ahead of engagement with customers, to give customers the best possible view of bill ranges.

The recognition of the need to move away from an over-reliance on stated preference surveys, towards the use of broader, more innovative ways of capturing customer preferences is also welcome. However we continue to need to value benefits to support cost benefit analysis and risk comparisons for planning purposes. We would therefore advocate using a simpler, more focussed survey approach to provide a basic set of values. These could be augmented through the use of other approaches such as choice experiments. Simpler stated preference surveys would also enable more consistent approaches to be adopted across companies, reducing the uncertainties introduced from methodological differences.

We are pleased to see Ofwat's continued commitment to the use of customer challenge groups (CCGs) for PR19. The greater clarity over the remit of CCGs will be helpful. This will ensure more commonality between the groups and mean that the impact of CCGs on Ofwat decision making is more transparent. We also support the call for greater collaboration between CCGs. This was a model adopted by our CCG and those of our neighbouring water companies to enable consistency of approach where customers and their priorities were likely to be the same.

We do not believe Ofwat should over-specify how CCGs operate. This would inhibit the scope for innovation and new ideas. For example, we do not believe Ofwat should require CCGs to have common terms of reference or specify the structure of reports. We continue to believe that it is not appropriate to include the statutory regulators as members of the CCG. The relationship with these key regulatory stakeholders is better managed on a bilateral basis, that reflects and respects these organisation's specific statutory duties, rather than as part of a wider, customer-focused group

(ii) Sludge market opening

We agree that there is an important role for market mechanisms to play in driving efficiency and innovation in the water sector. However, we have not yet seen a full discussion of the purpose of market opening from Ofwat. In addition the potential impact of greater competition on issues such as resilience, sustainability and public health needs to be understood fully. Only once the desired outcomes and effects from market opening have been clearly set out is it appropriate to consider what the design of the market might look like.

With respect to sludge treatment and disposal, we agree that there may be some unexploited opportunities to drive efficiencies through trading between water and sewerage companies and firms operating in wider organic waste markets. Ofwat's proposals for information disclosure should help both incumbents and new entrants identify where such opportunities may be available and we support them. However, we are not convinced that it is necessary for this to be published on an information platform hosted by a third party. This would simply add costs for customers without any clear benefits. Instead, we propose that companies publish such information on a dedicated area of their website in a pre-agreed format. In considering the type of data that is published, it is also important that companies are not required to disclose commercially sensitive data, such as contracted transport costs.

In assessing the scope for beneficial trades between incumbent sewerage companies, it is important to understand that the observed differences in costs may not reflect differences in efficiency. The current sludge market is not a distinct operation that can be considered in isolation and the relationship between, for example sewer network costs, the location and scale of wastewater treatment works and sludge treatment costs needs to be understood. It may not be obvious as to how to allocate costs to individual elements of the value chain where sludge treatment centres are co-located within sewage treatment works and share many of the same overheads. A simple comparison of Southern Water's costs will show that we appear to have high unit costs. However, this reflects the nature of our region and our infrastructure inheritance as much as any operating efficiency differences. One of the most significant costs we face is the transportation of sludge, an activity that is already provided by the market through a competitive tender process.

Notwithstanding the stimulus that information publication might provide, there remain significant barriers to full market opening, including the very real constraints on co-digestion imposed by environmental regulations. This may explain why companies have not already made significant use of market mechanisms in this area. Until these barriers are addressed, there will be a natural limit to the scope for competition *in* the market. We thus see more opportunity for competition *for* the market to develop in relation to sludge transport and the development of new infrastructure, which could both be put out to competitive tender.

Finally, Ofwat's commitment to ensuring investors are made whole on any historic investment in sludge assets through a true-up mechanism is important to maintaining confidence in the regulatory regime were markets to open to competition. We believe it will be necessary, subject to companies demonstrating that they have engaged with other market-based options, for Ofwat to provide some level of assurance over cost recovery for future investment. If all capital expenditure post-2020 is entirely at shareholders' risk (both for incumbents and new entrants) then there is a very real prospect that the level of investment, particularly in new treatment assets will be insufficient.

(iii) Water Resources market opening (Further information provided in a separate discussion paper)

We support Ofwat's clear focus on competition for the provision of new water resources, through the provision of better information to stimulate increased trading between existing companies and with third parties. We recognised in our own Water 2020 discussion paper that a lack of information, along with problems with the existing planning process, has stifled the potential for new entrants to 'bid in' to proposed water resource management plans.

In particular we are supportive of proposals to increase water trading between companies. We were one of the founding members of the Water Resources in the South East of England group and we recognise that groups like this will continue to play an important role in deciding the capacity requirements of the region for the future, whilst indicating the potential utilisation rates of schemes and strategic developments. As a result of this group, three new bulk supply arrangements have been identified for Southern Water. We believe there is a need for a series of these types of groups across the country, which stimulate the development of wider markets in the future.

However, we believe that the bid assessment process proposed by Ofwat could give rise to an additional level of unnecessary administrative burden for Ofwat and for companies. Given that companies are already subject to procurement law and the Competition Act, further requirements imposed by Ofwat seem unnecessary and at odds with Ofwat's approach in the retail market, where Ofwat has left it to companies to develop their own compliance strategies.

In terms of the second leg of the proposals for water resources, the potential benefit of encouraging efficient entry by new suppliers, through so called bilateral trades, appears to us to be very limited (particularly as the Water Act 2014 limits the scope of such competition to the provision of new water resources to non-household customers only). Given this limited scope, we believe Ofwat should set out some clear principles for facilitating competition in the market, but these should not be overly prescriptive, so that the market can develop in response to specific local opportunities. Ofwat should also consider how this market could be developed or stimulated through access to green market funds.

(iv) Separate price controls and RCV allocation (Further information on RCV allocation is provided in a separate discussion paper)

We do not believe that separate price controls or allocation of the RCV are necessary in order to deliver the benefits for customers that Ofwat has identified from its reforms. Set against a lack of clearly identifiable benefits, we think that there is a real risk that disaggregation of the wholesale value chain will distort company decision making, leading to sub-optimal investment decisions.

Activities carried out by water companies are not discrete. There are complex interactions across the value chain. Our Integrated Water Cycle Management approach reflects the need to develop a more holistic approach to managing the water environment in order to meet the long term challenges faced by the sector. This model takes account of interactions between water and wastewater management, across the water and wastewater value chain, and between different users of the water environment.

Introducing separate price controls for sludge and water resources risks distorting management decision-making and sub-optimal outcomes if management is focused on individual elements of the value chain rather than whole system optimisation. We accept that increased focus on individual parts of the value chain may help shed light on opportunities for efficiencies. But, we think this can be achieved equally well through accounting separation

Similarly, whilst we understand Ofwat's objectives in seeking to allocate the RCV to support market opening, we believe there are better alternative approaches. An approach based on a 'shadow' allocation could be equally transparent and supportive

of a level playing field for potential new entrants. This shadow RCV approach is described in further detail in our accompanying discussion paper.

We think it is premature to formally unbundle the RCV in a way that may be difficult to reverse in future, before we understand the extent of and scope for competition to develop. It is likely that as we learn more about how markets will develop, we will need to reflect further on the approach to RCV allocation. An approach based on a shadow allocation better provides this future flexibility.

(v) RCV protection

Ofwat's previous commitment to protecting the RCV as at 31 March 2015 was a strong signal to investors of the continued regulatory commitment to the RCV model, but did leave some uncertainty about post-2015 investment. We therefore welcome Ofwat's updated commitment to protect efficiently incurred investment through the RCV to 31 March 2020. The protection of historic investment during a transition to competition is strongly supported by economic principles, established regulatory best practice and precedent.

Companies have made long-term investment decisions in the context of a secure and well understood regulatory regime. Without a strong, ongoing commitment, companies would face a higher cost of capital as a result of an increase in regulatory risk and companies' incentive to invest would be undermined if there was a question mark over companies' ability to recover the cost.

Looking beyond 2025, Ofwat state that "it might be prudent to engage in early consideration of any regulation mechanism that might be required to enable companies to recover any associated stranded asset costs". We believe the establishment of such a mechanism to mitigate stranded asset risk is vital to the acceptability of Ofwat's proposals on market opening for sludge and water resources.

On a related matter, we are disappointed that Ofwat has still not concluded on the issue of how or whether to make the PR09 RCV reconciliation adjustment. Ofwat's proposal in the PR14 reconciliation rulebook consultation to adjust all companies' RCV at the next price review in respect of performance during AMP5 would represent a material reduction to our RCV (and associated gearing levels) at the start of PR19. This has consequences for financing and company behaviour during AMP6.

Ofwat stated that they would reach a conclusion on the adjustment issue following the conclusion of the CMA inquiry into Bristol Water. As the CMA published its full report in November we expected to see some consideration of this issue as part of the Water 2020 consultation. Given the materiality of this issue, we would expect Ofwat to be actively engaging with companies on any further proposals to address it.

(vi) Indexation (Further information provided in a separate discussion paper)

We understand and accept the legitimacy concerns related to the continued use of RPI for indexing customer bills in light of the Johnson report.

However, we have serious concerns about the financing risks and consequent customer bill impacts associated with Ofwat's proposal to move to CPI indexation of 50% of the RCV by 2020. Having considered carefully Ofwat's objectives for the proposed change, we have concluded that a better solution would be to adopt the method used by the Civil Aviation Authority, whereby customer bills (and allowed

revenues) are set on a CPI basis (in real terms), but the RCV remains indexed by RPI. This would allow companies to continue to access low-cost, liquid index-linked debt markets and avoid a step change in customer bills, while addressing the customer legitimacy challenge of indexing bills to RPI.

Ofwat's proposal to transition to CPI appears to be a pragmatic initial step. However, our analysis suggests that, given the long-dated debt held by Southern (which is representative of the rest of the industry), the transition process would need to be in place for a number of years. Hence we would advocate that the pace of any further transition is controlled by each company.

Furthermore, each company will need to be given the freedom to determine how best to manage the impact of any RPI to CPI transition on customer bills. Companies will also need to be careful in their use of changes to the speed of money (PAYG or RCV run-down). This is because investors will expect companies to continue to adhere to a fundamental principle of borrowing to invest, and earning sufficient annual cash return from operating activities.

Ofwat's commitment to the revenue or value neutrality of any change is welcome. However it is problematic in practice. Under Ofwat's assessment it will take around 25 years just to offset the initial increase in customer bills, bringing them back in line with where they are currently. While mathematically this might be neutral it has significant inter-generational impacts. Many of those customers facing higher bills today will not be the same ones that enjoy the benefits of lower bills in the future.

NERA's report on this issue for Water UK also highlights the fact that investors are wary of regulators' ability to make such long term commitments that span several AMPs, especially given that we do not yet know how the transition mechanism might be applied. In our discussions, Ofwat has recognised this as an issue and has asked for ideas on how it might underpin this commitment in a meaningful way.

Having reflected on this issue, we believe that the most credible mechanism would be a licence modification that committed Ofwat to an annual assessment of revenues under RPI and CPI, with an adjustment at the subsequent price review to ensure value neutrality. We are giving this issue further thought and will write to you with a further proposal. The condition should reflect Ofwat's commitment to value and revenue neutrality and cover two distinct points: (i) Ofwat's commitment to revenue neutrality under any future price determinations versus the counterfactual 2014 RPI Methodology; and (ii) publication by Ofwat of bills under the 2014 RPI methodology at each price determination from 2019 with an assessment of the NPV versus the final determination in effect in order to demonstrate how this commitment had been met.

Understandably, most focus and discussion to date has been given to the financing impacts of the change to CPI. It is also important that we do not lose sight of the cost assessment implications. Further work is required on how CPI will be used in an assessment of totex, in terms of discovering which costs are correlated with CPI, which with RPI and which are exogenously determined. The costs that a regulated water company incurs are not influenced by Ofwat's choice of indexation. These future costs in nominal terms are influenced by external factors outside of the regulatory system. This will produce a nominal revenue requirement that should be unchanged.

(vii) Third Party Procurement

As we made clear in our response to the July consultation, markets can play an important role in delivering the best value for customers. Within the sector there is already extensive market testing and the use of third parties to provide services and deliver investment. In our case 100% of our capital programme is delivered through competitively tendered contracts and around 50% of our operations expenditure is tendered. Given this, the benefits of a new regulatory third party procurement model are likely to be limited.

In the current model, companies play an essential role in co-ordinating these activities and multiple providers to deliver services to customers. Introducing third party ownership and control into discrete parts of the network risks a lack of clarity over responsibility for safeguarding public health, protecting the environment and wastewater and flood management. There is clear evidence from the rail sector that, where ownership and accountabilities are split between parties, the result is an undue focus on allocating blame rather than delivery for customers.

We do not believe there is any evidence to suggest that, in the context of the water sector, more widespread use of a direct procurement model would be in customers' interests. We also do not believe that there is an obvious rationale for a fixed threshold of £100m. Whilst this may represent a substantial investment for some of the smaller water only companies, for Southern Water, this represents just 2.5% of our RCV and for Thames Water it is less than 1% of their RCV.

During the last AMP we successfully delivered the award-winning new wastewater treatment works at Peacehaven in East Sussex, a project costing £300m. This demonstrates that, as an integrated company, we are able to deliver projects on time, under budget and to a high quality. The Government made it clear that the legislation introduced for the Thames Tideway Tunnel was only intended to be applied to very large scale investment projects. It is not appropriate for Ofwat to effectively seek to mandate its use by suggesting that "a well managed company" would adopt this approach in their investment activity.

(viii) ODIs / Incentives (Further information provided in a separate discussion paper)

Ofwat's "outcomes" approach to assessing company performance and delivery introduced at PR14 contributed to a step change in the quality of companies' conversations with their customers and the quality of business plans. We support the continued use of this approach for PR19.

Ofwat's proposals within the consultation document consider three key areas: encouraging a long term approach; striking a balance between common and bespoke measures and developing better incentives.

In terms of encouraging a longer term focus, we are broadly supportive of the concept of in-period ODIs. There is a benefit, in terms of both management focus and customer legitimacy, of more proximately linking performance to revenues. There is some scope for increased customer bill volatility if a period of out-performance follows a period of underperformance. However, the scope of such variations is likely to be limited given the overall size of the incentive "pot". Any variations can be mitigated by the sensible application of multi-year averaging to volatile metrics.

We recognise that there will inevitably be some customer priorities that apply across all companies and it may be appropriate to have common measures for these. However these should be determined at the very start of the process, so that they are reflected in our engagement with customers.

Finally, reflecting the “better incentive point”, where common industry measures are applied, targets should be set in a consistent way between companies, based on robust data and reflecting upper quartile performance. This was not the case at PR14, where Southern Water was set a target for %PE wastewater treatment works compliance that is materially tighter than for other companies. This means that there is the potential for us to achieve performance in the upper quartile, and yet still incur a penalty.

It was clear from our engagement with customers at PR14 that they are supportive of rewards for excellent performance, as well as penalties for poor performance, where these are targeted in their priority improvement areas. But, the overall package of rewards and penalties needs to be broadly symmetrical and consistent across companies, to align with the overall risk / reward package, including the cost of capital.

We set out our perspective on ODIs in more detail in the attached discussion paper and we welcome the opportunity to be involved in the proposed further consultation on outcomes. Currently Ofwat propose to provide further thinking on this issue in November 2016. Given that our customer consultation on the business plan would need to start in Spring 2016 to meet the earlier business plan publication date, an earlier consultation date would be required to avoid unnecessary re-work or confusion in later engagement activity.

(ix) Timetabling

In our Water 2020 discussion paper on customer engagement, we set out a proposal for a shorter price review timetable that would allow companies to focus on keeping customers at the heart of the review process. We remain of the view that Ofwat should aim to shorten and simplify the price review process, to reduce the focus on the regulator and increase the business-as-usual customer-focus.

We are therefore disappointed that Ofwat’s proposals would bring forward the delivery of companies’ final business plan and extend the price review period by six months. This will require companies to start their customer engagement work on their draft business plans in spring 2016, only 12 months into the new AMP. Whilst we see a benefit in continuous customer engagement, it is not healthy for the sector to effectively be in constant price review mode rather than focussing on delivering for our customers.

Ofwat’s recognition of the concerns over the co-ordination of regulatory timetables and its commitment to work with Government and other regulators to improve the planning process is welcome. However, the proposed extension to the price review timetable exacerbates the issue with respect to the water resources management plan (WRMP). It is essential that Ofwat plays a lead role in coordinating PR19 with the timetables of the other statutory regulators to ensure an alignment between PR19, the water resources management plan (WRMP) and National Environment Programme (NEP). In our view, a better alignment with the WRMP could be achieved easily by moving the business plan submission date back, shortening the overall price review timetable. Given the learning from PR14 we believe this should be both realistic and achievable.

If timetables cannot be aligned further then companies must be given the ability to revisit their business plan commitments and undertake any required in-period adjustments if this is required to ensure compliance with other regulatory requirements.