Water 2020
Ofwat
21 Bloomsbury Street
London
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10 February 2016

Dear Sirs,

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

Overall we welcome the content of the Water 2020 consultation. We fully support your efforts to lay the main issues, on the table, for discussion early in the process and we commend you for the considerable effort that has made to publish this set of proposals for consultation. We acknowledge the genuinely consultative spirit in which Ofwat has engaged with the water companies and other stakeholders.

Our response is structured in two parts. Firstly we have set out our general comments and observations regarding the Water 2020 consultation. The second part, Appendix A, sets out our response to the questions set out in the publication.

While we welcome the opportunity to respond, given the volume and depth of the regulatory issues under consideration we expect to take the opportunity to offer further thoughts and comment over the next couple of months mindful of your target to delivery the next publication in May 2016.

General comments

Separation of Water Resources

We do not object in principle to the separation of water resources. However, we are concerned about the potential for competition to be introduced in way that achieves better outcomes for the environment and customers. This is particularly the case in the southeast of England, a region with acute water supply issues facing the prospect of greater supply and demand imbalance in the future. It is not clear to us that practical operational implications of the proposed approach have been fully thought through.

Fundamentally water is not homogenous; it is expensive to move and has temporal, locational and chemical and biological characteristics that have the potential to distort any future market mechanisms. Water quality standards and required treatment solutions will constrain the potential for trades and physical transfers. The cost of transporting water will also act as a constraint. The temporal characteristics of water supply mean that it is likely that peak rather than average conditions will persist for long durations, during droughts, across large regions. This has the potential to lead to an economic outcome that could be worse for customers. We would urge Ofwat to work closely with industry to ensure that its detailed proposals are practical and workable; something that Ofwat itself recognises is essential.

The industry has made great strides in quality compliance over the last twenty years. There is a danger that this achievement can be taken for granted, and we may lose sight of the system that has achieved it. At the moment, each company has a clear accountability for the quality of water from source to tap. We are concerned that the introduction of third party suppliers may undermine this accountability.

Many quality failures in recent years are related to Metaldehyde, a molluscicide, commonly used in slug pellets. It runs off surface water and ends up in raw water sources, where it is difficult to remove. Our management is highly focussed on this problem, but it is not clear how this would work in the case of competition for the supply of raw water. Would the network operator have the right to reject contaminated supplies? Would network operators be penalised for onward transmission of non-compliant supplies? If there was a failure in a sample where the water could have come from more than one raw water source, who would be accountable?

We and the DWI remain deeply concerned that separation of the upstream from downstream splits the supply system in half when the very essence of Drinking Water Safety Planning is the source to tap approach with accountability throughout. These issues are not necessarily an insurmountable barrier to competition, but it is necessary to find answers to these questions which are acceptable to both the companies and, particularly, the DWI.

We can see the argument for greater separation of activities within wholesale water and sewerage to improve cost transparency, improve the provision of information, facilitate choice and value creation. However, we believe that by focussing on separation of activities within the water and sewerage value chains Ofwat has missed the opportunity to formally separate water and sewerage activities from each other. We believe this form of separation could provide the possibility of much greater value creation than the existing proposals around separation. We would urge Ofwat to consider or reconsider this form of separation given the potential benefits that could be achieved from such an approach.

CPI and RPI

We recognise the concerns around the legitimacy of the current use of RPI in the eyes of our customers. We do not, however, agree with Ofwat’s proposal as it stands. We recognise the benefit of implementing a CPI based approach to revenues (prices) but remain concerned about implications for customers of implementing a CPI based approach to the RCV. The principle problem is the absence of a functioning market for CPI debt which is likely to mean costs to customers and companies of CPI based financing will be higher than under current arrangements.

The speed and nature of any transition needs to reflect the long term nature of the industry's financing arrangements, which last over many price reviews. We think it is important that the sector does not lead the development of a CPI-linked debt market as this is will likely increase risk and raise financing costs ultimately leading to upward bill pressure for customers. We would support a transition where the underlying basis of companies' existing long-term debt arrangements are preserved as at 2020, with the transition focussed on arrangements for indexing future growth in the RCV.

We fully support Ofwat's commitment revenue and value neutrality. This is a positive development but as Ofwat has identified stakeholders need to have confidence in this commitment that can only be delivered by Ofwat demonstrating how revenue and value neutrality would be implemented in practice, and by incorporating this commitment into a licence condition.

Customer Engagement, Outcomes and Incentives

We welcome Ofwat's continued commitment to customer engagement. This was significant success of PR14. In particular, we agree that the CCGs are a valuable addition to the regulatory environment.

We agree with the many of the customer engagement principles set out in the publication. In particular we support the development of revealed preference techniques and particularly the integration of information obtained from day to day customer interactions. We are also strong advocates of acceptability research to test different packages of service levels and associated bill impacts.

We are a little surprised at the extent to which Ofwat has felt the need to prescribe what should be in the CCG report, who the membership should be, what the remit of the group should be and what its governance arrangements should be. It seems to us that these are matters for company Boards and management.

We are disappointed to see proposals in relation to outcomes and incentives that appear to be moving us back to a regulatory regime that is dependent on comparative information. This has the potential to undermine the step change in customer focus that was achieved at the last price review. It seems to us inevitable that greater comparative assessment will shift attention to Ofwat and the regulatory mechanisms needed to facilitate comparative regulation. We see this very much as a backward step.

Indexation of debt

We understand that Ofwat would welcome comments on the indexation of debt as recommended by the Public Accounts Committee. Indexation of debt transfers risk from the companies to the customers. We have no objection to the introduction of such a mechanism at this time but this would have a substantial impact on the broader question of risk and reward.

Yours sincerely,

Christopher Offer
Director of Regulation

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

Q1 through Q6

n/a

Q7 Do you agree with our proposal to have a separate binding price control for water resources?

We do not object in principle but remain concerned about the potential for meaningful competition to be introduced in way that achieves better outcomes. The southeast of England is a region with acute water supply issues facing the prospect of ever greater supply and demand imbalance in future. It is not clear to us that practical operational implications of the proposed approach have been fully thought through.

Fundamentally water is not homogenous; it is expensive to move and has temporal, locational and chemical characteristics that have the potential to distort any future market mechanisms. Water quality standards and required treatment solutions will constrain the potential for trades and physical transfers. The cost of transporting water will also act as a constraint. The temporal characteristics of water supply mean that it is likely that peak rather than average conditions will persist for long durations, during droughts, across large regions. This has the potential to lead to economic outcomes that could be worse for customers. We would urge Ofwat to work closely with industry to ensure that its detailed proposals are practical and workable; something that Ofwat itself recognises is essential.

We can see an argument for separation to improve cost transparency, provision of information, facilitation of choice and value creation. However, we believe that by focussing on separation of activities within the water and sewerage value chains Ofwat has missed the opportunity to formally separate water and sewerage activities from each other. We believe this form of separation could provide the possibility of much greater value creation than the existing proposals around separation. We would urge Ofwat to consider or reconsider this form of separation given the potential benefits that could be achieved from such an approach.

Q8 Do you agree with our proposal to implement an offset mechanism to ensure that entrants can recover the cost of new resources appropriately, while also ensuring that prices reflect average costs?

We support the proposal to implement an offset mechanism.

Q9 Do you agree with our proposals to create a market information database and bid assessment framework to allow for the 'bidding in' of third party resource options on an ongoing basis – as set out in the Deloitte report?

Yes in principle we agree with this proposal and recognise that it could improve transparency for abstraction licence holders who may not have previously considered trading their water. However, we believe companies already have strong incentives to select least cost resource options during the development of water resource management plans and so it is not clear how effective this proposal might be.

Q10 Do you agree that a third party organisation may be best placed to manage the information database?

We agree a third party would be best placed if an information database is introduced.

Q11 Do you agree that measures should be introduced to increase transparency and certainty around security of supply for water trading? How can this objective best be achieved?

It is essential that measures are introduced to increase transparency and certainty around security of supply for water trading. Without such measures it is difficult to see trading volumes increasing. This could be achieved through the amendment of contractual obligations so as to ensure that physical supplies are maintained under prescribed circumstances instead of on a 'best endeavours' basis. However, any such change will have cost implications. Given the temporal and locational characteristics of water supply, outlined in Q7 above, it is possible that increasing transparency and certainty around security of supply could involve significant cost, that could get ultimately get passed through to customers.

Q12 Do you agree with our rationale for allocating the RCV?

We understand the rationale for allocating RCV as set out in the publication. We are not necessarily persuaded by the arguments presented, particularly when any form of allocation will be subject to inaccuracy and is not necessarily reflective of asset replacement values.

Q13 Do you agree with our proposed approach for allocating the RCV for sludge?

n/a

Q14 Do you agree with our proposed approach for allocating the RCV for water resources?

We understand why the unfocussed approach to RCV allocation for water resources is proposed but we question the appropriateness of an answer that has been reached because it raises fewer material issues than any other alternative. We remain concerned with the proposed approach. Certainly it will be important for companies to undertake an MEAV exercise to inform the further work Ofwat will need to do to ensure any split between water resources and other elements of the water value chain is robust. This is particularly the case where separation of assets at small borehole sources makes little to no sense.

Q15 Do you agree with our proposal to address stranded asset risks by extending our commitment to protect efficient investment included in the RCV to 31 March 2020?

We welcome the proposal to address stranded asset risks by extending the commitment to protect efficiency investment. However, we believe that the approach of Ofwat making decisions on RCV protection in a piecemeal fashion, extending the protection in five year increments, in itself has the potential to undermine the confidence of investors. We do not believe it is correct to anticipate that the proposed approach will materially mitigate any potential adverse impact on financing costs.

Q16 Do you agree with our assessment that there is no prospect for stranded assets due to the proposed form of control for sludge and water resources for the 2020-25 period?

It is not clear to us that the Ofwat assessment regarding stranded assets is true. The regime is not yet fully defined. We acknowledge Ofwat's intention and the principles set out support the intention.

Q17 Do you agree with our proposed approach of an income guarantee recovered through the network plus control for protection against the risk of stranding, if a mechanism is required? How do you consider that such a mechanism could be designed to provide a simple, transparent, largely ex ante mechanism that preserves incentives for efficiency?

We are satisfied with the proposal in its initial form and welcome the commitment to an income guarantee recovered through the network plus control. The design of simple, transparent mechanism is something we are thinking through carefully but we do not have an approach to share at this time.

Q18 In relation to water resources, do you agree with our proposals to implement an approach based on the average cost of providing 'network plus' activities?

This is a highly complex area and while we can see the merit of the proposed approach we would need to see much more detail, including worked examples of how it might operate in practice.

Q19 In relation to access prices for water resources, do you agree with our proposal that companies should be responsible for calculating and publishing these? Do you agree they should be published by water resource zone, with network distribution and treatment costs separately identified?

This is a significant question and very little detail is provided in publication. The detail is important here. What is presented is largely theoretical and assumes near perfect understanding of costs, activities, assets and resources at water resource zone level. In our experience the level of information and data required to deliver locational access prices, with the network distribution and treatment costs separately identified, is not in many cases available. We would urge Ofwat to work closely with the industry to ensure that proposals are refined and only introduced when we are confident that data quality is sufficient as to not undermine the intended outcome sought.

Q20 In relation to water resources, do you agree with our proposals to implement a mechanism that offsets the difference between the LRIC (or potentially the AIC in the absence of LRIC data) of new resource and the prevailing average cost of resource?

The proposal to implement a mechanism seems to us reasonable. The calculation methodology will be important and we are concerned that any such mechanism is transparent and simple to apply.

Q21 Do you further agree that it is the incumbent's, rather than the entrant's LRIC, that should form the basis of the payment, to provide a stronger incentive for entry?

We agree.

Q22 and Q23

n/a

Q24 Do you agree with our proposals relating to the use of direct procurement on behalf of customers?

We have no objections in principle to use of direct procurement on behalf of customers. However, we would point out that the majority of our investment programme is delivered by contractors and sub-contractors who form part of our supply chain that is subjected to robust and highly effective procurement practices.

It can be argued that increasing direct procurement could potentially reduce the scope and incentives for outperformance in capital delivery. Outperformance or the potential for outperformance is a key component in the assessment of overall risk and reward. Reducing the potential for outperformance may therefore have implications for other elements of the risk and reward package.

Q25 Do you have any views on our specific proposal to set a £100 million threshold above which point we would expect companies to procure at market on a standalone basis?

This level of threshold is unlikely to affect us. Nevertheless this seems somewhat arbitrary and we would expect the final level of threshold to be established based on analysis of available evidence to demonstrate the benefits that could be achieved.

Q26 Do you agree that our proposal for four binding wholesale price controls should apply to companies whose area is wholly or mainly in Wales, as well as to companies whose area is wholly or mainly in England?

n/a

Q27 Do you agree with our initial view that the network plus controls for water and wastewater and the water resources controls should be total revenue controls?

We agree.

Q28 Do you agree that future investment in relation to sludge treatment, transport and disposal should be exposed to volume risk and, accordingly, what are your views regarding the appropriate form of control in this area?

n/a

Q29 In your view, how should new investments be remunerated in the sludge and water resources controls from 2020?

For water resources we believe that RCV remuneration is appropriate as suggested.

Q30 How can we best ensure that long-term contracting arrangements are not dis-incentivised – and that any continued application of a return on RCV approach for incumbents is on a level playing field with third party providers?

This is a complex issue that will believe requires further development including practical worked examples. It is too early for us to reach a definitive conclusion or recommendation.

Q31 Do you agree with our proposal to retain our RBR approach for PR19?

Yes we think the retention of the RBR is sensible but recognise that it should evolve.

Q32 Do you agree with our proposal to reflect current performance in our RBR assessment (and for CCGs to consider this as part of their report?)

We think it is important that current performance is reflected in the RBR assessment and that CCG's should consider this as part of their report. As part of this assessment it is essential that companies are assessed against the level of ambition within their plans. Failure to recognise the stretching and challenging nature of a company plan could undermine the very incentives that were introduced to encourage companies to submit innovative, ambitious and 'enhanced' plans. We recognise this is a difficult balance to achieve but essential to ensure companies continue to have genuine incentives to push themselves and ultimately deliver better outcomes for their customers and stakeholders.

Q33 Do you agree that the RBR assessment should consider the extent to which the business plans are part of a longer term plan?

We strongly support this proposal and think that it essential that business plans are clearly set out within the context of longer term plans and the important issue of resilience. As we stated in our response to Ofwat's discussion document, we welcome the recognition that resilience is a key component of Water 2020 and a theme for AMP7. We appreciate there are substantial challenges in developing the regulatory framework to achieve the optimal balance of incentives to underpin cross company and regional resilience including innovative approaches with third parties across multiple sectors.

We believe future challenges, particularly around resilience, will be dominated by underlying resources at the level of the catchment. We expect to see greater convergence between water resource plans, drought plans, emergency plans and business plans as well as greater emphasis on the work and findings from partnerships such as the Water Resources South East (WRSE) and Water Resources East Anglia (WREA). It is critical that the development of the price setting framework for PR19 and the RBR reflects this.

Q34 Do you agree that the consideration of disaggregated cost models is appropriate given the price control structure proposed?

We believe this is essential and we struggle to see how else disaggregated cost assessment could be done. We had some concerns with the approach adopted for the PR14 price review where aggregated service level cost models were used that lacked transparency. We note that this concern was shared by the CMA during its review of Bristol Water. We fully support the CMA position that aggregated regression modelling is not suitable for assessing capital enhancement expenditure.

Q35 Do you agree that the development of detailed cost allocation guidelines is appropriate?

We agree that detailed cost allocation guidelines are essential to ensure comparability. We believe that cost allocation between activities within water and sewerage services is just as important as the wider question of allocation between water and sewerage services. As set out in Q7 above, we believe that formal separation of water and sewerage activities could provide the possibility of much greater value creation than separation of activities within the two services.

Q36 Do you agree with our proposal to retain the current timings of our price controls – that is, not change the duration of wholesale price controls, not to stagger wholesale water and wastewater price controls and not seek to further align the timing of controls with other planning processes?

We agree with the proposal to retain the current timing of price controls, in particular the five year period for wholesale controls. We believe that if Ofwat was to undertake formal separation of water and sewerage services so as to treat these definitively as separate businesses that there should be no reason why this could not be staggered to reduce the impact of the regulatory price review cycle. While the water and sewerage services remain indicative it makes it almost impossible to develop a staggered approach to price setting.

We are very disappointed that Ofwat is not seeking to further align the timing of controls with other planning processes. We find it almost incomprehensible that water resource planning and business planning timetables are not aligned. We would strongly recommend pushing back final business plan submission and bringing forward water resource plans to overcome this. We understand this is widely supported within companies and all reasonable efforts should be made to facilitate this.

Q37 Are there any other measures, not considered above that could help to encourage a longer-term approach?

One proposal we have to encourage a longer term approach to price setting could be to set a given level, say 70% of base capital maintenance totex (botex) on a 10 or 15 year basis with the remainder, up to 30% assessed on a five year basis. This would enable long term procurement and capital delivery alliancing. This would have the benefit of potentially avoiding inefficiency around the AMP investment cycle for the majority of investments while enabling the price review to focus on enhancement expenditure and the efficiency assessment of capital maintenance. The efficiency assessment would apply to all expenditure in a five year period but would be implemented as an adjustment to the 30% of base totex every 5 years. We would be happy to explore this further with Ofwat.

Q38 Do you agree that we should amend the licence to allow for in period adjustments for some or all of the following: outcome delivery incentives, revenues and cost sharing?

We have no objection in principle to in period adjustments and understand that some companies have already had licence amendments applied to enable ODIs in period adjustments. Our concern around this proposal is twofold. Firstly this will introduce complexity to the regulatory regime at the end of each year rather than once every five years. Secondly, and far more importantly our customers told us very clearly that they valued bill stability over the five year period and did not support any in period adjustments.

Q39 Do you agree with our proposal to move to CPI (subject to the UKSA's final recommendations)?

We recognise the concerns around the legitimacy of the current use of RPI in the eyes of our customers. We can see that a transition over time away from RPI to a different index will be required for the indexing of prices and that PR19 is the right time to start this transition.

Q40 Do you agree with our proposal to implement a CPI based approach, for both revenues (prices) and the RCV, subject to a transition process?

We do not agree with the proposal as it stands. We recognise the benefit of implementing a CPI based approach to revenues (prices) but remain concerned about implications for customers of implementing a CPI based approach to the RCV. The principle problem is the absence of a functioning market for CPI debt which is likely to mean costs to customers and companies of CPI based financing will be higher than under current arrangements.

Q41 Do you agree with our proposal to transition to CPI over time, both in terms of the overall method and the specific proportions of the RCV we are suggesting would remain indexed by RPI?

The speed and nature of any transition needs to reflect the long term nature of the industry's financing arrangements, which last over many price reviews. We think it is important that the sector does not lead the development of a CPI-linked debt market as this is will likely increase risk and raise financing costs ultimately leading to upward bill pressure for customers.

We would support a transition where the underlying basis of companies' existing long-term debt arrangements are preserved as at 2020, with the transition focussed on arrangements for indexing future growth in the RCV.

Q42 Do you agree with our commitment to ensuring that any such change is value and bill neutral in NPV terms over time in nominal terms? What steps could be taken to make this commitment as credible as possible?

We fully support Ofwat's commitment revenue and value neutrality. This is a positive development but as Ofwat has identified stakeholders need to have confidence in this commitment. This confidence can only be delivered by Ofwat demonstrating how revenue and value neutrality would be implemented in practice, and by incorporating this commitment into a licence condition.

Q43 Do you agree that we should calculate the RPI linked element of the RCV based on forecast RPI with a true up at the end of the period to protect companies from changes in the difference between RPI and CPI over the control period?

We agree the proposed approach.

Q44 To what extent does the current balance of risk and opportunities vary across the proposed wholesale controls and how does this impact on the cost of capital?

We are not convinced that the analysis presented is particularly useful in assessing how the proposed wholesale controls balance risk and opportunity that would enable us to comment on how we might expect this to impact the cost of capital. The analysis assumes rather simplistically that the cost of capital is a mechanistic calculation when we know that it is not. The balance of risk and opportunity will be significantly impacted by investor perception and it is difficult to argue that the proposals in themselves will not be seen to increase risk for investors.

Q45 To what extent would our proposed market and incentive reforms impact on the balance of risk and opportunities and the cost of capital and would this vary across the proposed wholesale controls?

See Q44 answer above.

Q46 What does good customer engagement look like? What are your views on the principles outlined above? How could companies draw on good practice from within and outside the sector? How can companies make use of revealed preference techniques and information obtained in their day-to-day interactions with customers to develop a richer set of evidence of customers' needs and requirements?

We agree with the principles set out in the publication. In particular we support the development of revealed preference techniques and particularly information obtained from day to day customer interactions. We would however argue that companies should continue to use stated preference research as an input to investment optimisation decision making. We believe it is important that stated preference research is not called 'willingness to pay' research. It is misleading to call it this as it is not actually a willingness to pay but research to understand customer valuation. We are also strong advocates of acceptability research which is much better test of the acceptability of a package of services and associated bill impacts.

Q47 What are your views in relation to our proposals on future CCG remit; scope; timetable; governance arrangements; and membership? In relation to the quality of a company's customer engagement, do you agree with the above list of issues that should be covered by the CCG report? What are your views on the division of responsibilities between CCGs and Ofwat?

We are broadly happy with the proposals as set out which reflect the development of our own CCG into our Customer Scrutiny Group (CSG). We are a little surprised at the extent to which Ofwat has felt the need to prescribe what should be in the CCG report, who the membership should be, what the remit of the group should be and what its governance arrangements should be. It seems to us that these are matters for company Boards and we question the appropriateness of Ofwat's approach.

Q48 What are your views on our proposal to facilitate more collaboration between CCGs? What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early? Without inserting ourselves between companies and their customers, what else could we do to incentivise and encourage good quality customer engagement?

We are not convinced that CCG collaboration is necessarily a good thing based on experience at the last price review. It is essential that technical parameters such as WACC and efficiency assessment are provided as early as possible to improve the validity of customer acceptability testing and development of bill and service level options. We would question the scope of some material that Ofwat suggests should be shared with CCGs. An obvious example is the RoRE range which is highly technical and well beyond the understanding of the lay person.

Q49 How can the outcomes framework encourage a longer-term approach? Should we encourage, or even mandate, that certain measures - for example asset health – span more than a single regulatory control period?

In principle the idea of measures that span more than one period is a good one. Our industry is characterised by long-term assets, and it is important to recognise this. We would strongly reject any proposal that involves Ofwat mandating the use of certain measures covering more than a single regulatory control period. This is precisely the sort of question that companies should take ownership of and seek to engage with their customers and CCG's.

Q50 What are your views on the proposed contents of our November 2016 consultation on outcomes (balance of bespoke versus comparative measures, and role of comparative information)?

We are disappointed to see that Ofwat is proposing to step back from its approach at PR14 of giving ownership of these issues to companies. We seem to be moving back to a regulatory regime that is far more dependent on comparative information. This has the potential to undermine the step change in customer focus that was achieved at the last price review. It seems to us inevitable that greater comparative assessment will shift attention to Ofwat and the regulatory mechanisms needed to facilitate comparative regulation. We see this very much as a backward step.

Q51 What are your views on our proposal that companies submit the definitions – but not the targets or any associated incentives - for their performance commitments to us in early 2018 before they submit their business plans?

See Q50 above, this is an example of company focus shifting to the regulator away from customers.

Q52 What are your views on our proposal for a licence modification to allow for the in-period payment of outcome delivery rewards and penalties?

We do not object to this (subject to the comments above in answer to Q38)

Q53 Do you agree with our summary of potential licence changes and the process for achieving these outlined in section 9.1 above?

We agree these are the potential changes if one accepts, that we do not, that each of the changes are required. We fully support the process for achieving any licence change as set out.

Q54 Do you agree with the next steps for establishing the necessary data for the 2019 price review outlined in section 9.2?

This appears to be a sensible way forward.

Q55 Do you agree with our indicative timetable for the Water 2020 programme?

Please refer to Q36.