Northumbrian Water response to

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

NORTHUMBRIAN WATER RESPONSE TO THE WATER 2020 CONSULTATION

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Introduction

Northumbrian Water welcomes the opportunity to comment on the Water 2020 consultation. We particularly appreciate the early publication to allow time for discussion, the clarity of much of the proposals and the level of detail laid out in them.

We have been an active participant in the marketplace for ideas, publishing two papers and we welcome Ofwat's reference to industry papers in its proposals.

Customer engagement and Outcomes

At Northumbrian Water we work tirelessly to ensure that our service is of the very highest standards and that we remain, at all times, highly engaged with our customers. Excellent customer service needs flexibility and two way conversations with customers. Companies that get this right are continually in tune with customer needs and are able to balance that with providing an efficient, resilient service to ensure high levels of trust, confidence and positive feedback.

We strongly supported the formal introduction of CCG's and outcomes that were a feature of PR14 and we fully support proposals in the consultation paper on the future role for customer engagement and the continued focus on outcomes. The improved clarity over the role of the CCG is very helpful and we support the desire for a richer set of evidence from customer engagement. We continue to support the role of comparative outcomes and we agree with the proposal for early definitions of the performance commitments.

RPI/CPI indexation

The proposed transition from RPI to CPI indexation of RCV is our greatest cause for concern and in forming that judgement we have consulted with investors and other key stakeholders. We feel that the proposal of a 50% transition is too abrupt and a longer transition period would be more appropriate. We support the option in the consultation of applying separate RPI indexation of the 2020 RCV with new investments being indexed by CPI[1].

This would avoid imposing significant upwards pressure on customer bills through the increase in real WACC. Adjusting PAYG to mitigate this could be difficult if the ratings agencies view the impact as affecting underlying credit quality, in line with their comments expressed on the treatment of PAYG during PR14.

The Ofwat consultation does not outline the future indexation transition beyond 2025, but existing RPI indexed debt will be in place up to 2060, so there needs to be more clarity over the longer term transition profile. We also note and endorse the NERA study "Use of inflation indices in the Water Sector"[2] which includes detailed modelling on this issue.

[1] *Marketplace for ideas:http://www.anglianwater.co.uk/_assets/media/CPI_transition_v1.pdf*
[2] *The NERA report is on the Water UK Marketplace for ideas*

The NERA study makes reference to investor's concerns over whether the transition will be value neutral as well as revenue neutral (i.e. that the necessary adjustments to the cost of capital will be made in full). These concerns should be taken seriously and, in the interests of transparency, Ofwat should publish an illustrative example of how the PR14 WACC would have been set under these circumstances.

Until the UK government issues CPI linked debt[3], there will not be a sufficiently deep market for corporate CPI linked debt, given the lack of a benchmark for investors to price such debt. The proposals as they exist could see an efficient source of financing effectively closed off for the industry, increasing the cost of debt and thus customer bills.

We do not feel Ofwat has made a compelling case for changing the indexation of the RCV at this stage, ahead of the development of a CPI linked debt market. We suggest a review of the debt market options in 2024 would be the more appropriate timescale. This would align the consultation commitment to protect the 2020 RCV with an associated commitment to its indexation.

New Markets in Water Resources and Sewage Sludge

Ofwat's paper identifies some opportunities for cross border trading for water resources and sludge. We are aware of such possibilities as we already have experience of trades in both these markets. However, in our experience it is important to understand that opportunities can often be limited by geography, scarcity of choices and the infrequency of major new investment decisions in what are often long term strategic assets.

We do not believe the case has been adequately made for a separate binding water resource price control. We do support the proposals for competition to provide <u>new</u> water resources (competition for the market). These have more potential as they align with the existing regulatory regime and the water resource planning process.

At this stage, we believe the water resources 'competition in the market' proposals are speculative, overly complex and create unnecessary risks. We agree that any allocation of RCV to water resources would need to be unfocussed which would, as noted by Ofwat, severely limit the market opportunity to compete against existing resources. The allocation of RCV and the access pricing proposals are highly complex and at this point quite uncertain. As such the potential for competition seems very limited and the uncertainty introduced disproportionately high. We believe it would be premature to introduce a separate binding water resources price control at PR19 in these circumstances.

Having expressed our concerns about water, we do have more confidence in the case for a separate control for sewage sludge where there are clear, if geographically bounded, opportunities for trading. The ability to use a focused allocation of the RCV makes the process of setting a price control much simpler and more transparent than in the case of water resources. The rate of technological change and the interactions with the market for other organic wastes also suggest that this is a more promising opportunity for expanding competitive forces.

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[3] *Barclays Note: Obstacles remain to UK CPI linked gilt issuance: 20th January 2016*

Concern over increased risk in the sector

We note that **Moody's**[4] and **Fitch**[5] recently found that the Water 2020 proposals are credit negative citing the creation of new markets, indexation changes and the proposals for household retail competition.

Similarly HSBC Equities[6] stated that Ofwat's proposals increased uncertainty and made the UK regulatory environment less attractive relative to markets such as the US. Given the global nature of investment markets these sentiments are a cause for serious concern.

We recognise that increased risk may be acceptable if it is accompanied by increased dynamic efficiency offering the prospect of commensurate returns to efficient companies. However, we feel that some of the Water 2020 proposals introduce excessive regulation to deliver aims that could be delivered by much simpler and less intrusive approaches. Complexity often increases uncertainty, which is unhelpful when the industry is looking to minimise the financing costs that make up a third of customer bills.

We agree with the Moody's, Fitch and the PwC 'Balance of Risk' report[7] that the proposals, as currently formulated, are likely to increase risk in the sector, both in terms of competitive market risk but also in investors perception of risk, as complex mechanisms are introduced to allow markets to develop with no evidence for the potential for such markets to deliver the competitive gains required to offset the associated increased costs.

Impact Assessment and the case for change

We note the draft impact assessment is qualitative rather than quantitative. It is easy to under estimate the cost of changes in a high level impact assessment. The implementation of the non household retail market has generated significant costs for companies, market operator and regulator, far in excess of those originally envisaged in the original impact assessments. Ofwat should be mindful of this experience when publishing the updated Water 2020 impact assessment in May.

The impact assessment should include not only the direct costs of implementing changes plus the incremental operating and financing costs but also the costs associated with introducing increased complexity and greater disaggregation; such as the potential loss of integration and whole service optimization and the resulting increase in co-ordination costs. An example would be the potential loss of economies of scope identified by the Cave review (Stone and Webster 2004). The potential impact of increased uncertainty and risk on the cost of capital should also be considered.

A separate point is that Ofwat should not seek to influence the organizational structure adopted by companies by any tilting of the playing field. In particular, it is important that regulatory efficiency incentives should not be designed in such a way as to favour any particular organisational structure, whether it is integrated or disaggregated.

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[4] *Moody's sectoral note: 'Water 2020' proposals are credit negative – 13th January 2016*
[5] *Fitch sectoral note: UK Water Sector Flooded by Signalled Reforms, proposed reforms credit negative 28th January 2016*
[6] *HSBC Global Research: The end of the UK regulatory asset growth model: 15th Jan 2016*
[7] *http://www.ofwat.gov.uk/wp-content/uploads/2015/12/rpt_com201512pwcrisk.pdf*

NWL Responses to the questions set out in the consultation

Sludge treatment, transport and disposal market design

Q1 Do you agree with our proposal to have one separate binding price control for sludge treatment, transport and disposal?

We agree with this proposal in principle at this stage, although we await the full methodology before we can fully concur. A separate binding price control with volume risk will provide appropriate incentives and allow this market to develop on a commercial basis.

There is scope for sludge trading, both cross border between WaSCs and through interaction with the other organic waste markets. The scope may be restricted by transportation costs and environmental legislation, but we agree with the intention to create the opportunities for trading. Northumbrian Water is currently taking sludge from nearby WaSCs on a commercial basis, and we intend to participate in further market opportunities where they are viable.

We welcome the Ofwat focused review into sludge operations including the questionnaire to establish current practice across the sector. This should help to inform decisions on regulatory design and market reform in this area.

Q2 Do you agree with our proposal to make a range of cost, price, capacity and location information available to facilitate the identification of trades? Do you agree that the data should be published on a STC and STW site level? Do you agree that the data should be published annually? Do you agree with the categories of data that we are proposing are necessary and appropriate, as illustrated in the tables? Are any missing?

We agree with the publication of annual data on the capacity, usage and costs of the sludge treatment centres (STCs). This should reveal opportunities to export sludge to those sites and to compete with those sites by offering lower charges.

We are less convinced about the necessity to publish data on <u>every</u> STW, as per Table 2. Northumbrian Water operates over 400 sewage treatment works, including many very small rural treatment works which produce no sludge or amounts that would be unviable to transport or trade. The sheer quantity of data and the regulatory burden of collecting, assuring and publishing such data would be disproportionate.

For NWL, the sludge from many of the smaller sewage treatment works is taken to one of our 5 sludge handling centres (SHCs) for dewatering before taking to a STC. We feel it would be more appropriate for the market to publish the sludge data at these collection points, as this is a more likely market interaction point.

Q3 Do you agree that the information should also contain details of 'bids' in from third party providers, and that there should be guidelines for ensuring that such bids are assessed on a level playing field basis?

There should certainly be guidelines to require level playing field consideration of third party bids. There should be a requirement for no undue preference for incumbent versus third party offers.

Q4 Do you agree that the data should be made available centrally through some form of information platform? Do you have any views as to how this might best be managed?

We agree that a central information platform would be the most efficient way of sharing market information. This would be best run on a separate website by a trusted industry body.

Q5 Do you agree with our proposals not to make any changes to the status quo in relation to system operation activities?

We agree that the system operator role is best delivered through guidelines and possibly a market code of conduct rather than any formal functional separation. The key to any efficient system operator is that they are indifferent to the ownership of bids, and instead assess them on a rational economic basis.

Q6 Do you agree with our proposals not to have any specific financial incentives to support trading in relation to sludge at this time?

We agree there should not be financial incentives to support trading at this stage. It is right to remove barriers to trade and to minimise the transactional costs of trading. To go beyond this and introduce positive incentives to trade could risk economically sub-optimal trades occurring, increasing prices for customers with no net benefits. The aim should be to encourage efficient trading not trading for the sake of it.

Water resources market design

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

We do not believe the case has been adequately made for a separate binding water resource price control. For water resources, we believe the current ‘competition in the market’ proposals are unclear, speculative, overly complex and create unnecessary risks.

We agree that any allocation of RCV to water resources would need to be unfocussed which would, as noted by Ofwat, severely limit the ability of new entrants to compete against existing resources. The allocation of the RCV and the access pricing proposals are highly complex and at this point quite uncertain. As such the potential for competition seems very limited and the uncertainty introduced disproportionately high.

We believe it would be premature to introduce a separate binding water resources price control at PR19 in these circumstances. Significant work is required on the complex issue of access pricing and the calculation of Long Run Incremental Costs (LRIC) and Average Incremental Cost (AIC) costs. Depending upon the progress made on these and other issues there may be a case for initially introducing a non binding control, perhaps with a shadow RCV allocation, to trial the concept.

We feel the proposals for competition to provide new water resources (Q9) have more potential as they align with the existing regulatory regime and the water resource planning process.

Ofwat may be interested in the link below to a 2011 study carried out between Anglian, Essex & Suffolk and Cambridge on the opportunities and barriers to water trading. Many of the barriers were outside the scope of this consultation, but some are addressed in these proposals.

http://www.anglianwater.co.uk/about-us/statutory-reports/trading-theory-for-practice.aspx

We note that Appendix 2 Table 12 identifies a possible cost beneficial water resource export from Essex to Thames. We recently commenced such a trade with Thames, full details will be in our bulk supply data for 2015/16 onwards.

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 agree that such an approach could be applied, although we note there are many ways this could work that these alternatives require further analysis. The calculation of LRIC or AIC costs can be complex and volatile over time, but we agree that the principle of a compensation payment could be applied. Significant work is required to identify the most appropriate and practical mechanism for doing this. The industry should be fully involved in the development of this thinking.

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?

We strongly support the aim of allowing 'bidding in' by third parties to future resource provision. This aligns well with the Water Resource Management Plan process and could encourage parties with spare resources to participate in the process of providing least cost future resources.

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

Any practical information database should hold all industry data in one place, so it cannot be held at separate company level. For further practical reasons, a third party organisation seems the most appropriate organiser of such a database. This would be best run on a separate website by a trusted industry body with transparent governance arrangements.

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?

We agree that, to encourage water trading, all possible steps should be taken to ensure companies are indifferent to whether they own the resource or have a contract with a third party for the water. If this included a duty for resource providers to show no undue preference between meeting their own requirements and meeting those supplied to others under a contractual arrangement, this could reassure potential water purchasers that water trading did not increase their security of supply risk.

Allocation of the RCV

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

We agree with the approach for sludge, but we are less convinced that the water resources service requires RCV allocation.

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

We agree that a focused approach to allocating the RCV to sludge is appropriate. The comparison between net MEAV and net capex confirms that using net MEAV to set RCV should provide a level playing field for third parties.

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

We agree that if it is necessary to allocate RCV to water resources it will be necessary to adopt an unfocussed allocation approach. This means that it will be very difficult for any market to develop that challenges existing water resource provision. Given this, we believe Ofwat should, if it wishes to pursue a separate water resource price control, explore options that do not require RCV allocation.

The water resources RCV could remain ring-fenced within the wholesale business, with the contestable area paying a transfer charge into the network for use of the legacy assets. Whilst this approach would require a form of shadow RCV allocation to set the payments, it would avoid the need for formal RCV separation, thus reducing investor perception of risk.

The market for water resources works best in the provision of new resources and we believe the focus for PR19 should be on this area.

Protection of the RCV

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 strongly support the protection of efficient investment in the RCV to 31 March 2020. The terms and setting of the PR14 determination strongly implied this and it would be retrospective to introduce any stranded asset risk before a market opening approach was consulted upon. We also believe it is important to provide greater certainty on the extent of risk to RCV post 2020 and to minimise this risk in order to reduce investor concerns.

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?

We welcome the statement that there is no prospect for stranded assets in the 2020-25 period and we think this objective is achievable within Ofwat's proposed framework. This is a very important consideration for investors and the required mechanisms need to be clearly established and consulted upon.

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 support the proposed approach of an income guarantee recovered through the network plus control for protection against the risk of asset stranding.

Access Pricing

Questions 18 & 19
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?
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?

Notwithstanding our concern about unnecessary complexity as noted in Q7, we make the following additional comments.

Appendix 3 page 19 states that *'we consider it is appropriate for water resource providers to pay average network plus charges for distribution throughout the appointed area.'* We welcome this support of geographical averaging and thus stability of customer bills.

However, the explanatory document page 80 states *'Further to the above, <u>to reflect regional differences</u>, we would expect companies to publish access prices <u>for each water resource zone (WRZ)</u>.'*

To ensure these two statements are consistent, we assume that the 'regional differences' referred to by WRZ are the water resource AIC/LRIC costs. We assume that there are no WRZ differences to be assessed by network plus costs, as per the first statement. If Ofwat could clarify this it would be very helpful for all parties.

We do not support the separate identification of network distribution and treatment costs. Such a separation implies separate price controls and would require an allocation of the RCV between the two areas. As there are no current proposals for markets in treatment or distribution, it is not clear what the value of the 'transparency' provided would be.

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?

We agree with the proposals, although we note that LRIC and AIC can vary significantly between regions and over time.

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 with this – there should be an incentive for efficient entry, and efficiency in this case is a scheme with LRIC lower than the incumbent's.

Q22 In relation to sludge, do you agree that price and non-price terms should be the outcome of commercial negotiation, supported by the cost or price and capacity information previously set out?

We agree.

Q23 Do you support our proposals to develop high-level guidelines as to how rival offers in relation to sludge treatment, transport and disposal should be evaluated?

We agree, there should be high level guidelines.

Direct Procurement

Questions 24 & 25
Do you agree with our proposals relating to the use of direct procurement on behalf of customers?
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?

The Thames Tideway project benefitted from significant Government guarantees that are unlikely to be repeated for other smaller projects. In our view, this model has limited further application, as without an explicit Government guarantee, the costs of financing are likely to be greater than under the standard regulatory model.

We believe that direct procurement approach should be restricted to the very rare circumstances where a scheme has a significant effect on a company's financeability and where there is a material impact on customer bills. It is the impact the Thames Tideway had on customer bills that required an increased level of transparency over the costs of the project.

We suggest that a much higher threshold of say £250 million, or a 5% impact on customer bills should be used.

Finally, it is important to bear in mind that procurement is only one part of an efficient approach. It is arguably more important to consider all possible options and choose the most efficient than to minimise the costs of the option chosen. Direct procurement does not guarantee the most efficient option is selected for tendering.

Forms of Controls

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?

We have no views on this.

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, total revenue controls are a very good way of ensuring revenue variations are corrected for in-period rather than aggregated and applied at the end of the control period, thus avoiding the risk of creating financeability issues, temporary revenue windfalls or large impacts on customer bills.

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?

We agree that sludge investment post 2020 should be open to volume risk post 2020. Ofwat will need to clarify whether this is includes customer demand variations or is limited to volume variations due to competition. As per the PwC report, volume risk will mean increased investment risk and a higher expected return for investors.

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

New investments in sludge and water resources should continue to be included in the RCV post 2020. Any change could only be considered if a working market with demonstrable market prices had been established and would need to fully take into account the impact on investor sentiment and the cost of capital arising from the increased risk profile.

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?

We agree that, to encourage sludge and water trading, all possible steps should be taken to ensure companies are indifferent to whether they own the facilities or have a contract for the use of the facilities. This could include a duty for resource/sludge service providers to show no undue preference between their own requirements and those supplied to others under a contractual arrangement.

The Risk Based Review

Questions 31 -33

Do you agree with our proposal to retain our RBR approach for PR19?
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?)
Do you agree that the RBR assessment should consider the extent to which the business plans are part of a longer term plan?

We support the retention of the Risk Based Review process and the inclusion of current performance in the RBR assessment.

A pre-requisite for consideration for enhanced status should be excellent current company performance in efficiency and outcome delivery as these are empirical and directly relevant to customers. Having met these base conditions consideration should then be given to other factors such as demonstrating innovation and adoption of best in class long term planning approaches.

Cost Assessment

Questions 34 & 35
Do you agree that the consideration of disaggregated cost models is appropriate given the price control structure proposed?
Do you agree that the development of detailed cost allocation guidelines is appropriate?

We agree that there is scope for using disaggregated cost models. However, we feel it is a priority to separate enhancement costs from base totex before such models are created. We also feel that comparative industry cost adjustments such as regional wages should be adjusted before the models are applied. These two recommendations were made by the CMA in the Bristol determination and in our view are more important than further disaggregation of data.

Detailed cost allocation guidelines are necessary for disaggregated data to be relied upon. There is however a danger that disaggregated cost modelling could provide incentives to “manage” cost allocation. Ofwat must ensure that, after the disaggregated models have been applied, any upper quartile benchmark should be set using aggregated totals. This approach was successful in the previous opex efficiency models.

Timing of price controls

Questions 36 & 37
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?
Are there any other measures, not considered above that could help to encourage a longer-term approach?

Our preference is for longer price controls but we accept that given the various changes and uncertainties at this stage, on balance we should stick with five year periods for now. There will be opportunities with disaggregated price controls to vary timings in future reviews.

There are opportunities to present the five year proposals within the framework of a longer term plan that should help all stakeholders understand the wider context. We intend to take such an approach for PR19 and beyond.

In Period Adjustments Licence Changes

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 do support proposals to allow for in-period adjustments, particularly for outcome delivery incentives and revenues. For cost sharing, we are less convinced – care would have to be taken to ensure incentives for efficiency were preserved and that 'lumpy' totex expenditure did not generate volatility in customer bills.

Indexation

Questions 39 to 43
Do you agree with our proposal to move to CPI (subject to the UKSA's final recommendations)?
Do you agree with our proposal to implement a CPI based approach, for both revenues (prices) and the RCV, subject to a transition process?
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?
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?
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 that revenues and thus customer bills could be indexed by CPI, as this is the index that will be familiar to customers for most other purposes. We agree in principle with the proposal to gradually move to CPI indexation for the RCV. However, we have serious concerns over the impact of the proposed transitional approach.

The consultation suggests that separate revenue and RCV indexation is not sustainable. In fact from privatisation until PR14 we did have separate indexation as COPI was applied to RCV but not to customer bills. The precedent of the use of RPI and COPI suggests that a split indexation approach can work.

In our view, using 50% as the proportion of the RCV indexed by CPI in 2020 is too abrupt an adjustment. Our preference is either for retention of full RPI indexation of the RCV, or a more gradual application of CPI to only new investment in the RCV with RPI applied to the legacy RCV [8]. We also note and endorse the NERA study "Use of inflation indices in the Water Sector" which includes detailed modeling on this issue.

The impact on customer bills of the higher WACC required to maintain nominal cashflows given a partial switch to CPI indexation needs to be considered. Assuming a 1% difference between RPI and CPI, a WACC increase of 0.5% would increase customer bills by 2.5% - a material amount that will be difficult to explain to customers.

One possible alternative approach could be to apply a cost of debt tracker that also followed the decline in the actual proportion of RPI linked debt (assuming this proportion does indeed reduce over time). This would provide an automatic link between the basis of indexation and the timing of CPI debt market development.

Until the UK government issues CPI linked debt, there will not be a deep market for corporate CPI linked debt, given the lack of a benchmark for investors to price such debt. The Barclays[9] note referenced below recognises the many obstacles to UK Government issuance: *"Not much has changed since the government decided not to issue CPI linkers in 2011.. Broad expectations of CPI linked gilt issuance are now lower than before"*.

We do not feel Ofwat has made a compelling case for changing the indexation of the RCV at this stage, ahead of the development of a CPI linked debt market. We suggest a review of the debt market options in 2024 would be the more appropriate timescale. This would align the consultation commitment to protect the 2020 RCV with an associated commitment to its indexation.

For the indexation of totex costs, there needs to be more analysis carried out, as RPI is still a driver of many costs, including business rates for example. It is possible there may need to be an adjustment for real price effects in any totex calculations carried out in PR19.

Risk and Reward

Questions 44 & 45
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?
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?

The introduction of market mechanisms is likely to increase risk for the water resources and sludge parts of the business. The PwC report on the balance of risk and reward across the water and sewerage chain commissioned by Ofwat confirms this.

Setting separate price controls for water resources and sludge will require consideration of separate RCVs and separate WACCs reflecting the risks in each sector. The risks for the two new controls, water resources and sludge, will be higher but there is no compensating reduction in risk in the network plus business areas. The overall risk will increase as a result

[8] *Marketplace for ideas: http://www.anglianwater.co.uk/_assets/media/CPI_transition_v1.pdf*
[9] *Barclays Note: Obstacles remain to UK CPI linked gilt issuance: 20th January 2016*

of the increased complexity and greater exposure to competition and this will increase industry financing costs in aggregate.

We note that Ofwat propose to examine whether to introduce a cost of debt tracker within an overall assessment of its approach to the calculation of the cost of debt. Any proposals on a cost of debt tracker would require full consultation – this is a complex area with significant potential for unintended consequences.

Customer Engagement

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?

At Northumbrian Water we work tirelessly to ensure that the service we promise meets the highest standards and is fully responsive to the changing moods of our customers, with whom we are at all times closely engaged. Our provision of a service of such resilience and proficiency is reflected in the high level of trust and confidence which our customers show in us.

We agree that good customer engagement needs to be two-way, continual and ongoing as well as focused where appropriate on longer term issues. Effective communication with customers is a fundamental part of this in order to gain informed responses. It is important to ensure that any educational material is unbiased so as not to detract from obtaining genuine views. We also intend to explore the most effective way to incorporate comparative information within this.

We support the objective to understand the needs and requirements of different types of customers and we intend to investigate more innovative approaches to customer segmentation as a precursor to identifying and engaging with harder to reach groups.

We support the proposed widening of the sources of customer engagement and agree that using regular day–to-day customer contact evidence as well as other innovative approaches should be incorporated. The proposed focus for the CCGs on this area should encourage companies to carry out innovations and experiments in customer engagement that are often restricted by an exclusive focus on the stated preference survey approach. At the same time we acknowledge the risk associated with using multiple sources of information, in terms of both the potential for conflicting results as well as information overload. To mitigate this risk we intend to explore best practice approaches to triangulating information from multiple sources.

We believe that stated preference approaches are likely to still have some role to play and are in agreement that companies should explore ways of improving and complementing these. In particular we intend to explore behavioural economics principles to understand how we can minimise the biases and limitations associated with stated preference surveys.

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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 welcome the clarity of the proposed division of responsibilities between CCGs and Ofwat. Confirmation that Ofwat does not regard it to be part of a CCG's role to challenge or assure costs, or to approve or endorse a company's overall plan, is very helpful. This will allow our Water Forums to focus on the quality of our customer engagement and the extent to which customers' views are driving our decision making and are reflected in our plan. With regard to the scope, the list highlights the important elements and the proposal to not limit scope will allow a risk based focus to be adopted reflecting the particular circumstances of each business.

We agree with Ofwat that some changes to governance arrangements and membership are needed to build the trust and legitimacy of CCGs. At NWL we already have high standards of governance of our Water Forums' processes; we are on track to enhance these further in several areas. We are in the final stages of appointment of an independent Chair. The Chair selection process has been transparent, with advertisement of the post then sifting and subsequent interviews of the selected candidates by the Water Forum Nominations Committee (which has a majority of independent members).

We plan to ensure that there is the opportunity for the Chair to establish an appropriate relationship with the Board primarily through a designated Non Executive Director. We plan to publish the Chair appointment information and to use an Independent Trust to remunerate the Chair. We will look to ensure we have an appropriate spread of expertise represented on our Forums and that members are supported by provision of relevant information and a comprehensive induction process.

We intend to improve and expand communication of Water Forum activity so that this is more visible to customers. We believe this will increase the credibility of the group. We will ensure the workings of the Forum are transparent by publishing regular updates including minutes, reports and evidence of challenge.

We agree with Ofwat that greater collaboration between CCG Chairs will bolster independence and would encourage Ofwat to support this.

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?

To aid customer engagement, it would help to have an early indication of target WACC and outcome RORE ranges before business plans are submitted. This would help avoid repetition of the May 2014 updates of the non enhanced December 2013 Business Plans, with the associated reworking burden for all parties.

The most useful approach Ofwat can take on customer engagement is to avoid prescription, both in guidance but also in terms of evidence collection. At PR14, the data capture tables constrained the format of the evidence collected, in some cases nullifying the more important narrative evidence submitted alongside it.

Outcomes

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?

Asset health is an outcome that does span more than one regulatory control period. Indeed, companies created asset health measures to reflect customer preferences for long term outcomes. It should be sufficient for Ofwat to encourage such an approach without intruding prescriptively into areas that are best delivered by companies and customers.

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 strongly support the role of comparative outcomes in the core areas they were applied at PR14. As Ofwat is applying comparative efficiency models, it is appropriate that levels of service should also be comparable wherever possible. It is also essential for credibility in the eyes of customers and other stakeholders that there is an ability to compare company performance on core performance measures on a like for like basis, particularly if rewards and penalties are to be associated with this performance. This is key to maintaining Trust and Confidence. The introduction of a core set of comparative outcome measures does not prevent companies introducing additional outcomes where supported by customers.

In our view, the November 2016 consultation on the role of comparative data is rather late in the process and would be better carried out in Summer 2016. It is important that Ofwat consults on the precise definitions of the comparative outcomes in order to ensure that they are truly comparable.

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?

The definitions of comparative outcomes should be identified and agreed for the whole industry in early 2017.

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 are in favour of the possibility of in-period payments for outcomes delivery rewards and penalties as this links incentives more closely to performance.

Licencing and next steps

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

We recognise there will need to be changes to condition B to allow for separate price controls for sludge and, if this proposal continues to be pursued, water resources. The introduction of associated market information databases and a market code would require further licence changes, as would the proposal to remove or substantially reduce the need for end of period wash-ups and allow in period adjustments instead.

On indexation we believe that both the change to the index and any transition mechanism should be specified in the licence changes.

The process for achieving these should be collaborative and consultative, as outlined in the consultation. Ofwat should ensure that only the changes required for Water 2020 are made at this stage.

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

We support the targeted review of water resource and sludge accounting. Further MEAV guidance would be particularly helpful.

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

We do agree with the indicative timetable, in particular the bringing forward of the methodology and business plan submission. As stated above we feel the consultation on outcomes in November 2016 is a little late – ideally this would be in Summer 2016.

Northumbrian Water Limited
February 2016