Sutton and East Surrey Water

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Dear David

Water 2020 Initial Proposals

This response to your Water 2020 Initial Proposals seeks to provide an overview of Sutton and East Surrey Water's views on the wide-ranging nature and topics raised by your consultation. It complements more targeted responses to your follow-up requests for information (on company-specific debt structures, for example) and seeks to put into context our responses to some of the key issues raised. We consider this critical to avoid the inevitable focus on the highly contentious elements of the consultation (in particular your proposals on changing the basis of RCV indexation) completely over-shadowing the many aspects of your proposals that we strongly support. We record our support for these areas before addressing the more substantive areas of disagreement.

Broad Welcome for Approach to Engagement

We have greatly appreciated the continued evidence of active, flexible and open engagement we have seen from Ofwat in the last year or so. The general approach to this consultation at all levels – from engagement at Managing Director and Board level, through the joint working with Water UK and individual companies, to regular contact at working level by designated liaison officers for each company – has ensured that companies have not been surprised by planned publications. This has been particularly welcome for a smaller company attempting to focus scarce resources on key aspects of the many consultations currently being produced.

We also appreciate the recognition that joint working at an early stage in the development of proposals can help smooth the Price Review process for the benefit of all parties. We particularly welcome the firm commitment from Ofwat to joint working on cost assessment and further engagement on the approach to outcomes and on the cost of debt, and have been pleased to see these commitments already being translated into action (by meetings on, for example, costs assessment).

We are also pleased that the consultation does not shy away from contentious issues, allowing good time for them to be debated and intentions to be made clear before methodologies are established. We are however surprised at the extent to which your proposals focus on "minded-to positions" at this early stage. The preferred option for the use of inflation indices in setting future prices in particular has generated real investor and rating agency concern at what appears to be a relatively firm policy stance. Reassurance at working level that the potential costs (and benefits) of alternative approaches are still being considered suggests a rather less settled position, which we would welcome.

Welcome for Continuity from PR14

We are pleased that the most valuable aspects of the last price control review – outcomes focused approach, customer engagement supported by customer challenge groups, an emphasis on Board ownership of Business Plans, and the risk based review – will be maintained.

On customer engagement and outcomes we particularly welcome your commitment to further consultations in November. Areas that we feel need to be debated before that consultation are:

- How companies can help Ofwat put into practice the principle that it should "*help facilitate and incentivise good practice customer engagement*"[1]
- How the use of comparative benchmarking can be aligned with delivery of outcomes our customers support. For example, by making it clearer how customers' views will be reflected by Ofwat in the decisions it makes.
- Whether comparative or bespoke outcomes and commitments drive the best outcome for our customers.

These points relate to setting the framework under which companies operate. It is then quite rightly up to companies to deliver the high quality engagement that we have promised our customers and other stakeholders.

We also welcome your planned approach to customer challenge groups (CCGs). Our recently refreshed Customer Scrutiny Panel is also supportive of the proposals you have put forward on the role and process for CCGs going forward and see this as an important means of addressing some of the difficulties they encountered with the PR14 process.

We are pleased to see some commitment made to publishing information on the cost of capital and return on regulated equity (RoRE) ranges earlier in the process. This will help us have more meaningful conversations with our CCGs and customers on the impact that our Business Plan proposals will have on bills.

The Major Issue – Moving to CPI for RCV Indexation

We accept the rationale for moving from RPI to CPI as the "headline" measure of inflation for future price controls. This is based on the more widespread adoption of CPI as the Government's published measure of inflation and the technical deficiencies in the way in which RPI is calculated. This suggests that prices should in future be linked to CPI.

However price controls must still allow for efficient costs to be recovered. Therefore any mismatch between CPI and the expected changes in efficient costs will need to be taken into account in the price control framework. These real price effects (RPEs), the gap between the inflation index applied to revenues and the movement in the type of costs we incur, have been taken into account in all previous price reviews (albeit imperfectly, we would argue) and in principle the same approach could be adopted if CPI were used rather than RPI. The key issue is that the current proposals give inadequate assurance that this will be the case in practice.

Thus, while we welcome your commitment that the change in RCV indexation would be neutral for both company (nominal) revenues and customer bills in net present value terms and we are prepared to commit to work with you to ensure that this aim is achievable, uncertainty has been created on exactly how it will be achieved and therefore the resulting impact on our financeability and customers' bills. It is critical that you quickly produce sufficient evidence to

[1] Water 2020: Regulatory framework for wholesale markets and the 2019 price review, page 145

convince investors that this promise will be kept in practice. Otherwise the credit negative warnings from rating agencies will translate into higher financing costs for companies and their customers.

We have always accepted that financing decisions are matters for companies, who accept the risks as well as rewards of their decisions. However, such decisions have been made against an established policy (applied consistently over all five price reviews since the current regulatory regime was established) that efficiently incurred expenditure added to the RCV would be indexed by RPI. Companies have therefore put in place long-term financing structures that reflect the long-term nature of the industry's assets and the settled regulatory regime that has enabled customers to benefit from low cost financing. Any move away from this regime must respect commitments efficiently incurred in the past and make adequate allowance for their unwinding. This will differ from company to company, and the standard assumption on financing structure applied in previous price reviews (against a stable regulatory framework) will no longer be adequate. The easiest way to address this legitimate difference between companies – and the differing costs of transition they will face – is simply to apply CPI to new investment only, allowing the use of RPI for indexation of existing RCVs to unwind with the assets it was used to finance. Whilst this may perpetuate the use of RPI for RCV indexation for a number of future price controls, it remains consistent with the indexation applicable to financing costs and will not impair the use of CPI for headline price changes visible to customers. It therefore strikes an appropriate balance between maintaining investor confidence in the regulatory regime and customer confidence in the link of prices to headline inflation.

The reasons why financing costs for companies will be higher if CPI were to be used for indexation of RCVs – including the lack of a liquid CPI-linked debt market within the foreseeable future – are articulated in the report produced for Water UK by NERA[2], which we support. The finding that "in general investors consider that Ofwat has not made the case for a change to RPI" is important in an environment where investors have many choices about where to invest. The success of the industry in attracting low cost finance for over 20 years cannot be taken as a guarantee that this will always be the case.

There is one more distinct consideration for the smaller water only companies – that efficiently incurred historic financing tends to be more consolidated than equivalent financing vehicles for the larger companies. In particular, low cost index-linked Bonds were originally only accessible in larger amounts. In Sutton and East Surrey Water's case, our single £100m Index Linked Bond issued in 2001 (with a maturity between 2026 and 2031) was an efficient financing mechanism (with a AAA rating guaranteed by FSA (now Assured Guaranty) and still represents 85% of our gross debt. Early redemption has been considered by our current owners on acquisition in February 2013 but considered uneconomic. An industry-average approach to transition will clearly leave the Company significantly disadvantaged for having made efficient decisions in the past against a reasonable expectation that such a fundamental feature of the regulatory regime as the link of RCV to RPI would remain in place.

<u>Our Response to Other Policy Proposals</u>

Water resources market design and access pricing

We support proposals to reduce barriers to water trading. We consider greater sharing of information, through establishing an information database, as a positive step forward. We are however nervous about the extent to which such a database could place additional regulatory burden on us through the collection, analysis and assurance of data that we may not currently record. Collaboration by impacted parties on the design of the database and the information requirements is necessary to limit the potential burden. We look forward to being part of this

[2] Use of inflation indices in the water sector, NERA, January 2016

design work and feel that the work of the Water Resources in the South East Group may provide useful insight for this process.

The extent to which an effective bilateral market develops for water resources is uncertain. Clearly it cannot develop until the relevant sections of the Water Act 2014 are brought into effect. We appreciate that for bilateral markets to operate access pricing is necessary. The proposed approach to access pricing is complex. Its complexity is, in part, driven by the proposed separate binding price control for water resources.

Reiterating our view in response to the “Towards Water 2020” consultation - the needs case for an additional binding price control has not been sufficiently evidenced. An additional control will increase the complexity of operating under these regulations. As a smaller company in the water industry we see more acutely the impact of managing a more and more complex regulatory framework.

The options analysis diagram[3] suggests that you consider the creation of a market information database to be conditional on a separate binding price control. We do not think this is the case. Relevant, targeted and useful information can be gathered and shared without the creation of an additional price control. The consultation also suggests that separate controls will allow for more targeted regulatory incentives. If this is the case then it would be useful to understand the incentives that you intend to target on water resources and how different you see these being from other parts of the wholesale value chain.

We welcome the commitment to protect efficient investment included in the RCV until 31 March 2020. If there is to be a separate price control for water resources then the rationale for allocating the RCV using an unfocused approach is reasonable.

Protecting the RCV to 2020 does not however remove all stranded asset risk. One of the reasons given for low likelihood of stranded assets is that competition is limited to the non-household market. There is now a clear steer from Government that it is in favour of household competition. With long life assets the expectation of retail competition for all customers, even if its implementation were to still be some way off, leaves the risk of stranded assets higher than assumed. The proposed approach to protecting against stranded asset risk needs to be looked at in the context of potentially greater competitive retail activity. We agree that the approach should be mechanistic, simple and transparent.

Direct procurement

As a principle we have no objection to the proposal to require companies to test whether direct procurement would deliver benefits in terms of cost and service. We think it is right that water companies should be subject to competitive pressure where benefits to customers can be identified.

The practicalities of implementing this proposal have still to be thought through. In particular how the legislative and regulatory barriers will be addressed. The policies you quote in the energy industry have taken, and continue to take, many years and a large volume of work to put into practice.

We were encouraged to hear Ofwat acknowledge at the recent Water UK/Ofwat workshop on Water 2020 that there was a broad range of thinking still to be done in this area. If companies are to be required to take direct procurement options into account in their PR19 business plans this thinking needs to be advanced very soon. Companies are already starting to build up to the next business planning process.

[3]Water 2020: Regulatory framework for wholesale markets and the 2019 price review, page 56

The proposed threshold of £100 million means that it is very unlikely that any of our projects would be subject to direct procurement. We agree that a threshold is appropriate as there would be a cost to running such a process. Whether £100 million is the right threshold should be considered further as it becomes clearer how this proposal will operate in practice as only then will we be able to understand the true cost.

Outcomes

There are some fundamental features of the regulatory framework that need to be addressed in relation to outcomes. Once any changes to the existing framework are better understood we will be more equipped to address the question of whether submitting definitions of performance commitments in early 2018 would be beneficial. The benefits are currently unclear as it would mean reducing the timeline for engaging with our stakeholders on the priorities they would like to see delivered.

In-period revenue adjustments

We agree with the majority of the identified benefits in applying in-period adjustments to revenue to account for performance.[4] Currently performance in the first year of a price control would not impact revenue until at least five years later. This mismatch between performance and impact is exasperated by the application of blind-year adjustments. These benefits must however be considered against the backdrop of the value customers place on stable charges and how retailers will manage the risk of volatility in wholesale charges.

We believe customers value stable charges so the question must be whether the benefits noted outweigh the concerns our customers may have with the price control framework creating more volatility.

The volatility of charges is also likely to become more of a concern as competition in the retail market expands. Retailers will want to have as much certainty as possible on the wholesale charges that they will face, especially if a market for multi-year fixed price deals develops. Ofwat have acknowledged the concerns retailers have with the year on year movement in wholesale charges. Information sharing between parties can go some way to mitigate the impact but how this would work in practice needs to be developed. This proposal cannot be looked at in isolation and must be considered alongside proposals for charging so that we do not end up in a situation where the regulatory framework creates contradictory arrangements which companies are left to manage.

In conclusion, we support this policy but the implications it has need to be acknowledged and the most appropriate mitigations factored into the policy design.

Household competition

This is one area that receives limited attention in your consultation (for understandable reasons of timing) but has the potential to have significant impact on the effective conduct of the PR19 Price Review. In general we support any measures that increase effective choices for customers and have welcomed the opportunities that competition for non-household customers will create. However, the introduction of competition into a previously monopoly sector is complex, requires effective planning and coordination and has the potential for creating unintended consequences. Moreover, the potential impact on particularly vulnerable customer groups – including those now benefitting from the successful implementation of social tariffs –

[4] We do not agree that it would reduce the need to clarify how incentives will be treated in terms of tax and time value of money adjustments. This is necessary even for in-period adjustments as there will still be a delay between performance and impact on revenue.

will need careful management. The ability to undertake these complex and resource intensive tasks in parallel with opening a market for non-household customers and completing a more complex price review for all elements of the value chain needs careful consideration. We look forward to contributing to Ofwat's assessment of the costs and potential benefits of the Government's policy proposal. We appreciate that a decision on when household competition will be introduced is outside of your direct control.

Concluding remarks

We welcome many aspects of the proposals put forward in your consultation document and look forward to working with you in their effective further development. We do not, however, consider that the case for moving away from indexation of companies' existing RCVs by RPI has either been made – or is necessary to achieve the legitimacy sought. We would welcome Ofwat providing the assurance needed to satisfy investors that the attractiveness of the industry as a vehicle for secure, low cost investment is not being undermined.

We would be pleased to expand or debate any of the points we have made in this wide ranging response in any way that you would find helpful. In the first instance please contact Joanna Campbell, Economic Regulation Manager (JoannaC@waterplc.com, 01737 785 692).

Yours sincerely

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