South Staffs Water

Green Lane, Walsall WS2 7PD
www.south-staffs-water.co.uk

Water 2020,
Ofwat,
21 Bloomsbury Street,
London,
WC1B 3HF.

By email: water2020@ofwat.gsi.gov.uk

10th February 2016.

Dear Ofwat,

South Staffs Water welcomes the comprehensive engagement that Ofwat is delivering in advance of the PR19 price preview. The Board of Directors has discussed the Water 2020 consultation in detail, and has been fully engaged on the formation of this response.

As with PR14, PR19 will be introducing significant areas of change for the industry, and it is vitally important that all stakeholders understand these changes and have the opportunity to constructively contribute to how these new mechanisms are designed and implemented in an open and transparent manner.

We welcome the reform agenda being proposed by Ofwat and we recognise the benefits it has to future regulation and to customers in the long term. However there are some areas of concern or where further clarity is desired, and therefore we have structured our response around these areas.

Yours sincerely,

P. J. Saynor

Philip Saynor,
Director of Finance and Regulation

Consultation Response

Sludge markets: Q1 through Q6.

As a water only company we do not have experience of the sludge element of the value chain. We will therefore make no comments on Ofwat's sludge proposals for these questions or throughout the remainder of our response.

Water resource markets, RCV allocation and access pricing: Q7 through Q23.

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

We believe that it is important to enhance incentives to encourage the inter connection of separate networks in order to facilitate trading. We also support the introduction of a separate binding price control for water resources.

We are however concerned that further separation of elements of the price control increases the regulatory burden on companies of our size and that these additional costs could outweigh the uncertain benefits of separation, especially as our water resources RCV is a small proportion of the total.

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

We welcome increased trading of water as it may help mitigate the need for large scale future investment in water resources and also treatment.

However, we are mindful of our statutory obligations - for supply resilience, water quality and environmental standards - in any future trading market. It is vitally important that any new market does not add additional risk to these statutory obligations and therefore any new resource, whether commissioned in-house or through a third party, should be subject to the same level of scrutiny, control and assurance as currently exists.

Ofwat should ensure that the new market design supports existing statutory obligations fully, and that the presence of a trade does not impact on a company's ability to rely on the availability or quality of that water resource. In our view it is not sufficient to rely solely on commercial arrangements to mitigate these risks. We also believe that it is important to ensure that the other regulators are aligned on achieving this outcome.

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 Ofwat's proposal to protect the 2020 RCV for water resources however further detail is needed on how the proposed income guarantee mechanism will work in practice and particularly beyond 2025.

Direct procurement: Q24 and Q25.

We recognise the benefits that could arise from this proposal when companies need to finance significant investment. We do however think that the costs of implementation for a company would be significant, and that the proposed £100 million threshold is therefore at the lower end of viability when compared to the high transaction costs that will be involved. Further detail is necessary on how the mechanism would work in practice and how an externally financed investment would be accounted for.

Risk based review: Q31 through Q33.

We support Ofwat's proposals to reflect legacy performance in its risk based review, since we believe that a company's historical performance is a good indicator of its likely future performance. We also support Ofwat's view that the RBR should consider the longer term as stability and forward planning is important in this long term industry.

In-period adjustments: Q38.

We understand Ofwat's case that in-period adjustments could result in a closer link between performance and revenues, or between cost forecasting and revenues, which may provide further incentives for companies to improve on their performance in these areas. In-period adjustments also partially remove the risk of a significant step change at each five-year price review.

However, we believe that in-period adjustments will considerably increase the risk of bill volatility within the price control period. The proposed adjustments could easily compound with each other (for example an ODI reward and a revenue shortfall recovery), and this could have extreme effects on bills in one year, with the corresponding return to normal the following year. Customer research has also told us that our customers prefer stable bills, hence the reason we did not propose in-period ODI adjustments at PR14. It may also be increasingly difficult to explain multiple in-period adjustments to customers especially if these result in upwards bill pressures or exceptional volatility from one year to the next.

On balance, we consider that the risk of bill volatility year to year, and the resultant customer impacts, outweighs the potential benefits of in-period adjustments as proposed.

Our preferred approach is to true up any adjustments as part of the price review process, as our customers supported at PR14 for AMP6. Any significant effects on bills could then be avoided by smoothing the impact over the five years using the PAYG and run off rate levers available to companies.

CPI indexation: Q39 through Q43.

We understand the legitimacy case being made by Ofwat on RPI, following on from the UKSA recommendations via the Johnson report. We acknowledge that for customers, CPI is the more visible inflation measure.

We are supportive of a CPI denominated price control provided the nominal cash flows remain unchanged from those under the RPI regime.

For RCV indexation, it is welcomed that Ofwat recognises the need for a transition to CPI, rather than a sudden step change. However we do have concerns with the proposed transition mechanism and believe there are alternative options. As any transition will maintain some link to RPI in the short to medium term, then the customer legitimacy issue cannot be fully eliminated immediately. The transition mechanism adopted should therefore be part of a long term strategy given the current levels of RPI linked debt that cannot be immediately unwound or hedged without significant cost impact.

The issue with Ofwat's proposed 50/50 transition is that it introduces significant financial uncertainty, and does not align with current availability of CPI linked debt or the current level of development of the CPI measure itself. As identified by published reports by Moody's and NERA:

- The initial bill impact to customers of the transition is significant, and to mitigate this Ofwat are proposing that companies use financial levers. We think that this reduces transparency of the regulatory process.
- The proposed 50/50 split is not appropriate for all companies due to differences in the levels of embedded RPI linked debt. WOCs in particular have higher levels of RPI linked debt. There is also no information on transition plans beyond 2025.
- It is not transparent at the moment on how revenue neutrality is achieved especially when based on a notional industry debt structure. It is important that the mechanism to achieve revenue neutrality is fully transparent and how it flows in to all aspects of the price review is clear. Additionally, it is not clear whether the neutrality commitment takes increased financing costs into account.
- The current CPI debt market is small and short term, also leading to increased financing costs.
- An efficient CPI market is unlikely to develop until a UK government led market is developed, and there remains considerable uncertainty around this. There is also uncertainty on the exact form of the CPI measure that will be used, for example a CPI-H linked debt market does not currently exist.

We therefore support an approach that allows a transition but which does not create the financial uncertainties identified above. We believe that CPI could be applied to new investment post 2020 and the 2020 RCV could continue to be indexed by RPI under this arrangement, maintaining the link back to historical RPI financing. The RPI linked RCV would then naturally reduce as a proportion of total RCV according to companies' run off rates. A company could have the flexibility to alter its run off rate to control the speed of the transition, according to its own financial structure. This approach, which has been set out in some detail by Anglian Water in the marketplace of ideas, has significant advantages over Ofwat's 50/50 approach:

- Most importantly there is no immediate rise in bills, and so no need for companies to implement large step changes in their PAYG ratios as mitigation, and therefore there are no impacts on credit rating.
- Customers would see the CPI measure as the headline bill inflator and this would address initial RPI legitimacy concerns.
- The link to RPI is maintained for historical RCV and so no hedging is required, which would carry a cost premium.
- It allows future financing to be CPI linked and the CPI linked RCV to grow at a pace which is aligned with the development of the CPI debt market.
- It aligns with the objective of UKSA to reduce the reliance on RPI and ultimately to phase it out.
- Whilst RPI would still be used in the background, this would unwind over a period of time aligned with the natural run off rate of RCV. The time period for this to occur would also be generally aligned with the UK government's commitment to maintain RPI until its existing RPI gilts mature in 2068. The option is therefore well aligned with government strategy.

We would also strongly favour that this transition mechanism, if adopted, is reflected in the licence, given the significance of the change.

Customer engagement and CCGs: Q46 through Q48.

We are supportive of Ofwat's consultation in this area and welcome that the consultation is supportive of companies gaining a richer set of evidence and to utilise more data that comes from day to day business interactions with customers.

We note that Ofwat's consultation expresses strong views on the use of revealed preference information, however our understanding is that there are significant practical limitations to this approach given the nature of the water service. We would welcome further engagement by Ofwat on how it expects this objective to be achieved.

Outcomes: Q49 through Q52.

We are supportive of Ofwat's proposal for longer term performance commitments as we believe that the very short term nature of ODI glide paths at PR14 drives companies towards reactive behaviour rather than longer term planning to address the root causes of (relatively) poorer service levels. Often, it will be legacy assets that contribute most to these service levels and companies cannot solve this in only a few years in a cost effective way. We therefore support longer term ODIs, with appropriate long term glide paths and sufficient funding, to drive sustainable service level improvement, with the support of customers.

We note that the consultation does not discuss Ofwat's previous suggestion of dynamic upper quartile targets. In advance of the November consultation we would like to raise our view that we do not think dynamic targets will drive service improvement. Firstly, it is again likely to drive highly reactive behaviour in companies with little change in the underlying asset base that is driving the service levels in the first place. Secondly, it is likely to introduce issues of funding where a dynamic target shifts and a company may not have any plans, customer support or funding in place to deal with it. On balance we think that dynamic targets will undermine legitimacy of the process and incentivise companies against delivering service level improvements in a sustainable, targeted and long term manner.

Cost of debt uplift.

We note that the consultation does not discuss the cost of debt uplift for small companies. At PR14, it was evidenced that small companies, with more limited access to capital markets and a less diversified portfolio of debt instruments, do incur a higher cost of debt. At PR14, Ofwat chose to apply this only where a company could show that this benefited customers, evidenced only through a company's position in the relative totex efficiency ranking which was a very limited test scope.

It is our view that the uplift should apply to all companies where a higher cost of debt can be evidenced, without a customer benefits test. The uplift reflects real debt market conditions for smaller companies and places them on a level playing field with larger companies with more market power.