WELSH GOVERNMENT RESPONSE TO OFWAT'S CONSULTATION – WATER 2020: REGULATORY FRAMEWORK FOR WHOLESALE MARKETS AND THE 2019 PRICE REVIEW

1. Introduction

We have set out our thoughts on the overall approach of the regulatory framework in the covering letter. The following response aims to address specific issues within the chapters of the consultation document.

2. What are we trying to achieve with our approach to market and regulatory design?

Section 2.2 Addressing known problems

We note that this section acknowledges combined risk of Climate Change and population growth. However, there is no mention of the Climate Change Risk Assessment (CCRA) (at a UK or devolved level) or Adaptation Reporting Power (ARP) and we feel that more emphasis is needed on the legislative differences between the UK Government and the Welsh Government, in particular recognition of the Wellbeing for Future Generations (Wales) Act 2015, the Planning (Wales) Act 2015 and the Environment (Wales) Bill which together put in place the framework needed to secure the long-term well-being of Wales.

The CCRA provides evidence of risks to the water industry with the aim of helping to ensure that they are aware of key risks, and that actions are put in place to address them. As such, we feel that it should be referenced in this framework document. In terms of saving costs and efficiencies there is no mention to emission reduction which is disappointing given that the water industry is large emitter.

Resilience is considered in the document, but appears stand alone and does not link to statutory documents. We feel that there should be a firmer commitment towards better co-ordination through engagement, partnerships, collaboration and markets to improve the water sector's resilience by enabling water companies and others to take better-informed long-term decisions. For example, a joint letter sent to the water industry from Defra, Welsh Government, the Environment Agency and Natural Resources Wales regarding their expectations for Water Resource Management Plans explicitly refers to resilience going forward, in that the organisations *"…expect you to set out clearly in your plan the outcomes you intend to deliver for your customers, including the resilience of your supply, the risks to delivery of those outcomes and evidence that you have considered the full range of options for mitigating those risks."* As Ofwat were also involved in this process, we would expect to see a clear reference to this work and support of this expectation.

3. What are the key issues we need to consider in setting out design?

Section 3.6 Managing co-ordination issues and challenges

While this section implies that Ofwat have considered the need to co-ordinate and work with a range of stakeholders, it appears to be very much from an economic point of view and specifically around opening of markets. What it doesn't address is the need for co-ordination with policy makers and other regulators to address the legislative, environmental and social barriers which currently exist in relation to some of the proposals put forward in the framework.

One very specific comment – figure 4 (Illustration of water sector planning and regulatory processes and interactions) makes no reference the Welsh Government and therefore implies that these processes are managed wholly by the UK Government, which isn't the case.

4. <u>How will we promote markets to deliver benefits?</u>

General comments on Chapter 4
You have set out estimates of Net Present Value of trading water and we would be interested to understand whether you are planning carry out or commission a similar analysis for sewage sludge. We feel that this analysis would be useful to identify the potential benefits of opening this market.

Section 4.5 Market design in relation to sludge treatment, transport and disposal
In principle, we would support an approach that leads to the reduction, or where appropriate the recovery or recycling of sludge. Where possible we would like Ofwat's approach to consider the EU's approach on a Circular Economy to try to boost global competitiveness, foster sustainable economic growth and generate new jobs. However, we would need to ensure that this was possible within the current legislative framework for the Welsh Government as we do have some reservations around whether the current legislative framework will enable this option to be pursued in Wales. Amendments to primary legislation can take a relatively long period of time to deliver if it was agreed by Welsh Ministers to move forward with work in this area. In addition, there is some concern that full consideration has not been given to the environmental regulation of organic wastes. In section 4.5.2, under the 'environmental regulations' bullet point, you state *"… to the extent that our reforms create more visibility regarding the value of sludge, this in turn may influence environmental policymakers over time".* Firstly, it is important to point out that environmental regulation is in place, not only to protect the environment, but also to protect human health. We would therefore have to be reassured that the potential for increased movement of these wastes from the opening of the market would have no adverse environmental or public health impact. In addition, please note that the regulatory barriers you refer to are often linked to European Directive requirements and therefore, any regulatory changes would have to take this into account to ensure the UK did not face infraction risks. There have also been issues raised in the past about the use of water industry infrastructure to treat other wastes and how this could affect the waste sector, in particular the anaerobic digestion sector and other small businesses.

For some time now the European Commission ("the Commission") has been considering a revision of the Sewage Sludge Directive. Since its introduction, a number of member states have implemented much stricter limit values for heavy metals and other contaminants and a study was completed back in 2010 which gathered information for the Commission on the use of sewage sludge on land. Following this a further study was then instigated to look further at the levels of emerging contaminants and the potential for pollution of the land. In addition, you should also be aware that the Commission has recently undertaken a study to assess the impacts of different classification approaches for the hazard property 'Eco-toxicity. Any changes to the definition of when something is eco-toxic could increase the amount of waste that is classified as hazardous due to levels of metals such as Copper, Zinc etc. Hazardous wastes, by their nature, require a much higher level of regulation and this should be taken into account when considering market design.

There has always been a concern that there is a regulatory gap in terms of the use of sewage sludge The Environment Agency, with input from Natural Resources Wales, were asked to work with industry to set out options and an impact assessment on this but final recommendations have not yet been published. Defra have been considering this issue for some time and, in particular, whether sewage sludge ought to be brought under the umbrella of the Environmental Permitting Regulations; if this change takes place there will be potential changes to the way the Environment Agency and Natural Resources Wales regulate this waste stream. Both organisations have been revisiting this work recently, and we are awaiting an update. In addition, we understand that the Commission are currently undertaking a revision of the Waste treatment Best Available Technique (BAT) Reference document (known as a BREF), although we are not currently aware how this will be amended.

The Commission have started to develop an End of Waste Criteria for biodegradable waste subjected to biological treatment, and commissioned a JRC report which was published in January 2014. It is unclear whether the Commission will be taking this forward but again, it is something else that you may need to take into account when considering the opening of the a market for sewage sludge.

Section 4.6 Market design in relation to water resources
As stated in our covering letter, there is no split between England and Wales as to the potential savings of £1 billion. Any Welsh figure should be based on evidence gathered within Wales, not on a proportion of the estimated English / Welsh figure. The overall approach set out needs amending in respect of water undertakers that are wholly or mainly in Wales as it currently does not reflect that of the Welsh Government - this will be set out in our Guiding Principles for Developing Water Resources Management Plans and our strategic policy and objectives statement to Ofwat.

Water companies in Wales should only agree to water trading supplies where they can demonstrate that it would not be detrimental to their customers or to the ecosystem of the catchment area from where it is taken. We believe that opening up these markets has the potential to create additional environmental risks, which will need to be managed carefully, in particularly when considering the Habitats Directive and Water Framework Directive. For example, additional trades developed through a water resources market must not cause Water Framework Directive (WFD) water body deterioration in status or any individual element deterioration. The Welsh Government expects water companies operating wholly or mainly in Wales to only agree bulk supplies where it would not be detrimental to the customers on the appointment area of the incumbent company.

Where a water company's preferred solution to meet demand includes an option to transfer water from a water resource zone of a water company which is wholly or mainly in Wales, it should provide opportunity for Welsh Ministers to give representations on its water resources management plan. The expectation is that any proposals should be explored during the pre-consultation phase of developing a plan. If such options are likely to be considered as part of the preferred solution, water companies are expected to consult the Welsh Government on these options as early as possible in the process.

We have concerns that the proposals for water resource trading will lead to the promotion of this one mechanism and, by default, lead to incentivisation of behaviours or use of water resources that aren't necessarily in the best interests of England or Wales. As with other proposals within the framework, you have primarily considered the economic benefits without considering that other mechanisms may have wider environmental and social benefits and be more resilient in the long term.

Information requirements
On page 41 you have identified the benefit of having a centralised information platform which is managed by an independent third party. This would lower search costs of potential entrants in seeking out information. However, we wish to understand who would be paying the third party to undertake management of the platform, and who would pick up the final bill for this? If costs land on incumbent companies, they may view this as handing some advantage over to entrants whilst they shoulder the burden of the costs. This could also squeeze any potential profits if there trading opportunities taken up between an entrant and the incumbent.

On sludge, you have advocated the centralised platform to reduce costs for market participants and incumbents and stated that undue burdens are not placed on them. However, there do not appear to be any details on where the costs would be met.

In relation to the water resources market, you state on page 57 that information must be submitted by the licence holders and by other participants on a voluntary basis. You propose to work with Drinking Water Inspectorate, the Environment Agency and companies to ensure any undue burdens are placed on the parties involved. We feel that this would still have to place some costs on licence holders in supplying the information.

Although the sharing of information could lead to profitable trading opportunities for both incumbents and entrants, we would be interested to understand how willing would incumbent companies be to divulge information on their costs/capacity. We are also not clear as to whether disclosure is intended to be mandatory - the proposed information sharing would be mandatory for water licence holders, (page 51) but that is not made explicit for sludge. It needs to be made clear that we do not currently intend to take this route in Wales so further clarity around the disclosure of information is required, in relation to the possible different approaches in England and Wales.

5. <u>How will we apply effective regulation where it remains?</u>

Section 5.7 – The indexation of future price controls (RPI versus CPI)
Whilst CPI is recognised as less volatile than RPI, the change to CPI could cause some initial volatility to customer prices. It is hard to see what the overall long term net effect will be, and if overall volatility will be sufficiently low enough to offset the initial volatility caused by the change. It should, however, be recognised that this initial volatility would be mitigated by the suggested transition mechanism and companies are encouraged to smooth customer bills.

Figure 26 shows that the impact on customer bill should even out over the long term (assuming no PAYG levers). However, companies would bear additional risk due to the mismatch between revenues and debt costs. This would result in higher costs in terms of hedging against this mismatch (page119) – we would like clarity from Ofwat as to whether the customer would ultimately bear this cost. If so the impact of the change may not be neutral for the consumer, depending on how high the hedging costs are and there is not sufficient detail provided to assess the impact.

Allowing RPI debt to unwind by continuing to uprate this proportion of RCV by RPI and uprating any investments based on CPI linked appears to be sensible. However, as noted on page108, the CPI debt market is still emerging, so it could be difficult for companies to acquire debt on this basis. It would be useful to know if there are more planned issues of CPI based debt.

On page119 it is highlighted that the hedging costs could be mitigated by raising CPI linked debt. The document gives details of the three CPI debt issuances, but there is no indication of anything further in the pipeline.

Page 112 notes that there are variations in the level of RPI index linked debt between companies. If there is a fixed proportion of RCV that is to be uprated by RPI (around 50% on page 113), it could be implied that some companies could be placed at a relative disadvantage. Companies would have time to alter their debt structure in advance of the introduction of the indexation change, but it is hard to know what practical difficulties companies might face in the transition.

There does not appear to be any reference to the impact on competition between companies, although the document does acknowledge some variation and that some companies such as Portsmouth Water and Dee Valley Water have most, if not all debt linked to RPI. Some material that was presented at meetings with Ofwat suggests that the proportion of RPI debt does vary between companies, so the uprating of 50% of the debt by CPI and the remainder by RPI could have a larger impact on some companies relative to others.

Section 5.7.8 (page 120)

You state that "*Moving to CPI indexation may therefore be a better reflection of water company costs and so reduce the volatility of returns and therefore the cost of equity. The scale of benefits would be dependent on the degree to which CPI is a better measure of water company costs than RPI."* It could be worth noting that water companies' costs might not track CPI – they may be affected by wage costs more rather than the price of a 'representative' basket of goods for consumers. This mismatch may well mitigate any beneficial effects of the indexation move.

Section 5.7.9.6 (page 127)

You say that any deviation between actual and forecast CPI/RPI would be borne by the customer and not the company via their 'true up' correction. This could yield additional volatility to customers – which goes against the intention of the indexation change which is to reduce volatility in bills.

5.7 – Indexation of future price controls (RPI versus CPI)

Regulators, investors and companies recognise that the indexation of both revenues and RCV has played a significant part in making the water sector in England and Wales attractive to investors. This, in turn, has enabled companies to raise capital to fund service and environmental improvements at low rates of interest, and therefore lower bills for customers. This is partly because investors (such as UK pension companies and life assurance companies) have a large appetite for RPI linked debt (for which there is a deep and liquid market as a result of the large government issuance of RPI linked gilts); and partly because investors value the low risk, stable nature of the RPI-indexed RCV asset base.

In particular, companies have been able to raise long term RPI index-linked bonds (and other RPI-linked instruments). This has the advantage of "matching" the profile of the servicing and repayment of the debt to the way in which the investment that it finances is remunerated under the regulatory regime. These bonds have proved attractive to institutions with long term RPI index-linked liabilities, typically pension providers. The water companies regulated by the Welsh Government have raised RPI linked debt maturing beyond 2050. If these commitments are in future linked to CPI, the companies will incur a cost – either through incurring exit penalties so that they can enter into CPI linked agreements, or through a shortfall between Ofwat linking them to CPI which has mostly been lower than RPI in the past.

Unlike RPI-linked debt, for which there is an established, efficient and "liquid" market (which means low financing costs and therefore low bills for customers), the market for CPI-linked debt has not fully matured. The market for CPI debt (and RPI:CPI swaps to hedge existing RPI linked debt) is therefore inefficient and expensive. The Government is still issuing RPI-linked Government bonds, and appears set to continue to do so for some time yet, there seems little prospect of a rapid development of a CPI-linked market in the foreseeable future. Ofwat acknowledges that there is often 'chicken and egg' argument: that the market is not mature, but that demand will create supply. Ofwat proposes transitional arrangements that would entail a phased shift from RPI to CPI, with a combination of both indices being used for indexation during the next price control period (2020-2025), and full completion of the shift to CPI over the longer term.

The Welsh Government requires:

- Clear evidence that a change from RPI to CPI benefits customers of water companies that are regulated by the Welsh Government, and that they are not adversely affected either in the long or short term by these proposals.

- Clear evidence that the undertakers in Wales will be able to access CPI linked funding at no greater cost than RPI linked funding.
- Clear evidence as to how the proposed change will affect the bills of both Dee Valley Water in the short, medium and long term.
- Transitional measures that take into account the financial profile of the individual water undertakers in Wales, not a general measure that is based on averages across England and Wales, as this consultation seems to suggest. Thus requires either:
    - Alternative transitional measures, such as continuing to use the RPI index in respect of commitments entered into by water companies until they expire, and using CPI for future commitments from an agreed cut-off date acknowledging that some commitments extend beyond 2050; or
    - Setting a transitional combination of CPI and RPI on an individual company basis based on their individual commitments; or
    - Consider a common Welsh formula, based on the companies regulated by the Welsh Government. This would be less disadvantageous than an English / Welsh formula, but more beneficial than a common England / Wales formula.

6. <u>How will our proposals impact the level and balance of risk?</u>

It is difficult to provide comments on this matter at the present time as we still have concerns around the proposals for sewage sludge and water resources, in relation to Wales. Any work looking at risk and reward must be done in the context of Welsh Government policy as will be set out in the strategic policy statement, and as already reflected in current strategic documentation and legislation.

7. <u>How will we approach outcomes and customer engagement?</u>

Section 7.1.1 Summary of key points in the July discussion document

In the bullet point entitled 'Customer representation and the role of the customer advisory panel (CAP)', you make reference to the Wales Water Forum as a means of engaging a range of stakeholders on water issues in Wales. While we would encourage Ofwat to continue to engage through the Water Water Forum, we would not want this to become the default, or only, route for engagement with Welsh stakeholders as many of the issues relating to the regulatory framework require more detailed discussions than would be possible through this Forum.

Since 2009, the Welsh Government has established a separate forum specifically for Price Reviews, which enables key stakeholders to inform the development of water company business plans and to arrive at a position where the proposals set out in those plans, in going forward to Ofwat, are endorsed by the Forum as being robust, fit for purpose, affordable and reflect policy priorities in Wales.

The Welsh Government will be establishing the PR19 / Water 2020 Forum (name to be confirmed) later this year, to continue this process. While this Forum will not produce a report on the business plans, the Welsh Government will write to Ofwat following the submissions of plans by the Welsh water companies, either to highlight that we are content from a regulatory and governmental perspective, or to highlight the positives and negatives of the process, as appropriate. The forum will involve key regulators, the water companies, relevant Welsh Government departments, Consumer Council for Water and the Chairs of the CCGs in Wales. We would, of course, welcome Ofwat's engagement in this process.