PR19 Draft Methodology
Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

30 August 2017

Dear Sirs,

Delivering Water 2020: Consulting on our methodology for the 2019 price review

Thank you for the opportunity to respond to your consultation on the PR19 price review draft methodology. We have included, as an appendix, our response to the specific consultation questions raised in the publication using the consultation template provided. We have set out below a small number of the most significant points we wish to highlight specifically in addition to our detailed comments.

Overall comments

Affinity Water is committed to building on the community-based approach we put in place at the last Periodic Review, and which has formed the basis of our engagement with customers subsequently, by developing a plan for PR19 which demonstrably meets the requirements and expectations of customers and stakeholders. We are already engaging with customers on priorities for the next five years, and the Board is directly involved in reviewing the issues emerging from our engagement to ensure that the business plan we submit next September is robustly based - affordable and deliverable.

We have been consistent in our support of Ofwat's strategy to ensure customers and wider society have trust and confidence in vital public water and wastewater services. The development of the draft price review methodology for PR19 is another important step in delivering this strategy and we are appreciative of the way in which the process of developing the PR19 methodology has been managed.

The changes and improvements to the methodology over PR14 have been well trailed through the Water 2020 process. This methodology paper represents an evolution of the previous papers and we welcome the next level of detail provided in many areas. We strongly support the four themes: Great Customer Service; Resilience; Affordable bills; and Innovation. These four themes capture effectively the challenges facing our industry in the medium and long-term.

We are also supportive of many of the more detailed proposals within the methodology including the emphasis on supporting customers in vulnerable circumstances, the continuing commitment to the Totex based regime, the inclusive approach that Ofwat has taken to the development of its econometric models and the restatement of RCV guarantees.

Regulatory Challenge

We fully appreciate the regulatory challenge for Ofwat in seeking to establish a price setting regime that creates the right framework of incentives to align the interests of customers, investors and stakeholders. The incentives need to drive higher standards, where appropriate, and better value for customers while enabling appropriate returns to investors, who continuously assess the relative position of water industry investments against other opportunities.

It is vital to the long-term success of the industry and the wider interests of society that the price setting framework does not lead to unintended consequences. This could arise where long term issues such as resilience are brought into conflict with short term issues such as affordability and service standards over the next five years. The draft price review methodology seeks to reconcile this conflict by concluding that further efficiency gains, such as a step change in efficiency from the introduction of Totex, or significantly lower[1] allowed returns, will be sufficient to finance longer term challenges facing the industry.

The implications for the overall balance of risk and reward represent an area of substantive concern. Recent evidence on interest rate projections show that bank rates over the short to medium term are expected to rise and that any assumption of 'lower for longer' is not currently supported by market expectations[2]. The risk is that longer term issues such as resilience are not adequately addressed.

Performance Commitments & Outcome Delivery Incentives

We support the proposal to require several common performance commitments (PCs), and bespoke PCs including supporting outcome delivery incentives (ODIs). While it can be argued that this part of the methodology is quite prescriptive, certainly when compared to the approach at PR14, we do recognise the need for Ofwat to balance comparability and consistency between companies with the recognition of unique company circumstances. There are however important points of detail and implementation to resolve.

We remain unconvinced around Ofwat's proposals in relation to the level of PCs. We think that the case for setting upper quartile benchmarks as future targets (without taking into account the views of customers and stakeholders) is not well made. This is not to say that upper quartile levels of performance are necessarily inappropriate, for the forthcoming review at least. However, we strongly believe that informed customer views and effective engagement with customers must be the primary basis for establishing PC levels. We would therefore welcome, in the final methodology decision document, a clearer explanation of how Ofwat will assess PC levels established with robust input from customers and stakeholders that do not align with the expectations that Ofwat have set out in the draft methodology. We acknowledge that the draft methodology does address this point to some degree. Nevertheless, we think the final decision document is an opportunity to be more explicit about this point by putting customer and stakeholder views at the heart of establishing appropriate PC levels.

We also think it is important that, where a PC level is established that is leading to a significant improvement in performance, there should be provision for a glide path to the new performance level. The glide path must reflect a realistic and affordable rate of change to achieve the improved

[1] Ofwat (2017), 'Delivering Water 2020: consultation on PR19 methodology', p20
[2] See, for example, recent OBR forecasts, consensus forecasts, overnight index swaps/yields and Bank of England interest rate projections as referenced in the supporting report 'A Review of Ofwat's proposed approach to total market returns'.

level of performance. The existing proposals effectively create an instant performance gap. Depending on the type of performance commitment, this has the potential to create a one-way incentive in the form of a penalty that cannot be avoided. This fundamentally changes the balance of risk and reward.

Retail Household

We are deeply concerned about the package of proposals for the retail household price review.

While we welcome the move towards econometric modelling, which we see as an improvement over the cost to serve methodology, we are perplexed by the proposal to ignore inflation in the retail sector. Clearly the retail sector is subject to general price changes, just like any other sector, but perhaps more so given that a significant proportion of the retail cost base is made up from labour costs.

This is not to say that future efficiency is not available in relation to these activities, but this is not directly related to the rate of inflation. The risk with Ofwat's current approach, which effectively sets an ongoing efficiency target at the level of future inflation, is that this target becomes a random exogenous factor which is outside the control of companies. This will add to the overall level of risk to which the sector is exposed.

We also note that 2% (the central expectation of CPI inflation) is a high target for ongoing efficiency improvements in any industry. CPI, because of the way it is calculated, already takes account of the average efficiency gains in the economy. We suggest that the use of a time-series variable in the econometric modelling, such as that used at PR14 for wholesale cost assessments, would be a much better way of forecasting real efficiency gains in the retail household price review.

The proposed approach to bad debt costs benchmarking also appears to be unrealistic. The inability to deny service to customers or to install pre-payment meters have very significant effects on the ability of a company to enforce payment with some groups of customers. Any attempt to compare water companies to sectors which can enforce payment is not a valid comparison, and should certainly not be used for price setting purposes, or should at the very least explicitly consider the lack of comparability. Equally, Ofwat needs to be clear that it is benchmarking to equivalent single product businesses as opposed to businesses who can plan and react to customer needs through product replacement or substitution.

Overall, the effect of these proposals appears to be excessive. As we have stated earlier, we recommend that Ofwat thinks again about the intended and unintended consequences of this package of proposals and the potential impact this could have on end customers. There are also implications for the attractiveness of the sector to new entrants should future legislation enable the implementation of full retail household competition.

Initial Assessment of Plans

We are very supportive of Ofwat's plans to conduct Initial Assessment of Plans (IAPs) which builds on the success of the risk based review at PR14. We are very well placed to provide comments on the process from having been part of the fast track process at the last price review. We have what we hope are some important and helpful contributions to make on these proposals.

One aspect of the IAP is how Ofwat considers the performance of companies in AMP6. This is an important point in the context of multiple price reviews and the incentives for companies to push themselves to put forward ambitious business plans. It is not clear from the proposals how Ofwat will consider companies with different levels of performance in AMP6 relative to the ambition of their underlying plan. Will the IAP assessment conclude that a company that outperformed an average plan in AMP6 is comparatively stronger than a company that has not outperformed an ambitious plan? This question is critically important in the context of the overall incentive package. If there is any sense that putting together an ambitious plan, which will be tough to deliver, could end up undermining a future IAP assessment, then this could weaken incentives for companies to push for 'Exceptional' status.

We know that Ofwat recognise this issue and proposals to improve consistency of measurement and consistency of PCs will help. Nevertheless, we think it would be helpful for Ofwat to be explicit about how it will address this issue in the final decision document when assessing AMP6 performance as part of the IAP.

More broadly we have concerns that overall incentives are heavily skewed to avoiding the downside rather than rewarding the upside. Incentives to achieve 'Exceptional' status appear weak. The financial rewards appear to be weaker than in other industries and weaker than PR14. 'Exceptional' status appears to offer less upside than some of Ofgem's past determinations for slow tracked DNOs (around +4.5% RoRE upside). One possible outcome will be that companies, particularly considering the potential risk and rewards available, decide that 'Exceptional' or 'Fast Track' status is not sufficiently incentivised and so focus on avoiding the lowest IAP category. This would be an unintended and disappointing outcome. We think the balance of incentives merits further consideration ahead of the final methodology decision document.

Risk and Reward

There are several factors, some of which we have discussed already, which if taken together, result in much greater risk for companies as well as a preponderance of downside risk; PCs based on upper quartile performance with no glide path; inflation risk in retail; increased bad debt risk in the absence of legal rights to deny service.

Such a shift in underlying base risk would normally be reflected in the cost of capital. However, Ofwat are also proposing a significant reduction in the headline cost of equity for PR19 resulting from a major change to the approach previously employed with respect to estimating a key component of the cost of equity; the total market return (TMR).

In setting the market-wide parameters for the cost of equity, regulators have ordinarily placed weight on long-run methods i.e. a "through the cycle" view. Past decisions therefore generally adopted a long-run, ex -post returns figure to set TMR, which resulted in TMR estimates of approximately 7.0% real. This followed the 2003 and 2006 Smithers reports which concluded that long-run ex post returns were the appropriate bases on which to set TMR for charge control purposes.

In the NIE 2014 appeal, the CMA moved away from the 7.0% real TMR to a range of 6.0% to 6.5%, with weight being placed on the upper end of this range. The Smithers reports and the CMA's 2014 NIE case have been an ongoing source of reference by UK regulators and recent regulatory decisions have all set a TMR of around approximately 6.5% in real terms. No final determination has resulted in a TMR lower than 6.10% real.

The use of a common approach and long -term averages has resulted in low TMR variances over time contributing to overall regulatory stability. The long-term stability and predictability of the UK framework for utility regulation has contributed to the success of the sectors in attracting large amounts of capital at relatively low costs, benefitting the sectors' customers.

Ofwat's proposal to move to a new and untested method does not seem to have been justified. This appears to fail to meet the first of the principles it has signed up to as a member of the UKRN cost of capital group[3]. At the very least we would have expected Ofwat to wait for the findings of the academic review of cost of equity finance to be commissioned by the UKRN as part of its 2017-18 forward work programme[4].

When these issues are considered in the round, there is a concern that the overall level of regulatory and performance risk that companies are being exposed to could be potentially damaging to customers' long term interests and the industry in terms of trust and confidence.

Conclusions

We believe that Ofwat has managed the process of developing its methodology for PR19 effectively up to this point. We are particularly pleased to see that some of the processes and methodologies that Affinity Water adopted at PR14 are now proposed to become industry benchmarks, particularly in relation to customer engagement, scrutiny and board assurance.

However, there are some significant areas of concern in terms of the balance of risk and reward, as currently proposed, that could lead to unintended consequences. The overall level of regulatory and performance risk that the companies are being exposed to could be damaging to customers' long term interests and the industry in terms of trust and confidence. We urge Ofwat to address these concerns in finalising its methodology for PR19.

If you have any further questions regarding our response, please do not hesitate to contact me.

Yours sincerely,

Christopher Offer
Director of Regulation & Corporate Affairs

Appendix A: Consultation Response Template attached as a separate excel file
Ends.

[3] "Consistency - recognise the benefits of consistency and stability in our own and collective regulatory approaches - explaining why if a different approach is taken, and reflecting our own duties." (see http://www.ukrn.org.uk/wp-content/uploads/2016/07/2016MarCoC-Principles.pdf, and the latest update report at http://www.ukrn.org.uk/wp-content/uploads/2017/05/20170503-UKRN-Annual-WACC-Comparison-Report_FINAL.pdf).
[4] (http://www.ukrn.org.uk/wp-content/uploads/2017/07/UKRN-Work-Progamme-2017-18.pdf):