

OFWAT DRAFT PRICE REVIEW METHODOLOGY WELSH GOVERNMENT COMMENTS AUGUST 2017

Thank you for the opportunity to comment on the draft Ofwat PR19 methodology.

The Cabinet Secretary for Environment and Rural Affairs wrote to Cathryn Ross on 18 August (copy enclosed) setting out the Welsh Government's high level response to the draft methodology. This set out the expectation for further engagement between Welsh Government officials and Ofwat once the consultation period ends to consider the responses from Welsh stakeholders and other Welsh specific issues to ensure the final methodology fully reflects the Welsh legislative and policy framework.

As the Cabinet Secretary acknowledges, this draft methodology includes some useful material setting the proposals in the Welsh context. However, the suite of documents were lengthy and technical, and it was not always apparent why UK Government policy was being adopted in respect of Wales. The document lacks justification as to why certain proposals are fit for purpose in the Welsh context.

We also consider the timing of the consultation and the timescale to respond extremely challenging. The draft methodology was issued in mid July with a closing date of end of August – only 6 weeks over the peak summer holiday period.

We do not know what the final document will look like, but we suggest 2 documents be prepared – PR19 England and PR19 Wales. Whilst they may be substantially the same, the Welsh document should strip out all references to UK Government policy and be set entirely within the Welsh context addressed to a Welsh audience.

General comments

Section 2 of the Water Industry Act 1991 sets out the general duties with respect of the water industry. That section talks about consumers which captures both existing and **future** consumers (see section 2(5A)). We feel the methodology could go further in how it applies to future consumers (either future generations of consumers or those consumers who are not currently served by a public water supply or sewerage services).

Whilst we welcome the 4 key themes set out in the draft methodology, when considering the detail it seems the focus is very much on lower costs. We do not wish to see the essential services that companies provide at risk as a result of a market approach to efficiency. Ofwat should not seek to introduce competition where this could reduce the accountability for the delivery of excellent service to customers and the environment. There should be no threat to the integrity and the efficiency of the network.

The final methodology should refer to the Welsh Governments SPS.

It would be useful for an explicit explanation as to how this methodology fits the business model of DCWW. For example the cost sharing incentive is based on

shareholders sharing costs and savings, whereas DCWW members have no financial stake. This is a question often asked in Wales.

Ofwat expects undertakers to engage with customers and demonstrate how their views have been taken on board, how will it consider any conflict between customers views and Government policy?

Welsh Government officials have identified the following points for consideration. These should either be explicitly addressed in the final PR19 methodology, or, if this is not possible, the methodology should be amended in respect of Welsh undertakers.

Section 1- Overall framework

Environmental challenges – focus seems to be on the water supply side. There is reference to more intense and less regular pattern of rain but lack of focus on the potential impacts on the sewerage and drainage infrastructure and whether the infrastructure is fit for future purpose.

Affordable bills refers to bills that offer value for money and the scope for price reductions if that is what customers want. Whilst we do not disagree with this principle, we do not think value for money is a term used consistently throughout the methodology. The same part refers to companies delivering a step change in efficiency to give customers better services and bill reductions. We do not necessarily agree that best value for money equates to bill reductions. Best value must take account of the wider multiple benefits the water industry can offer.

Section 2 – Engaging customers

We welcome principle 1 of good customer engagement where it refers to water companies should deliver outcomes that customers **and society** value at a price they are willing to pay. However much of the detail and the technical aspects of the methodology does not reflect the wider societal benefits referred to in this principle. We believe that views of key stakeholders such as NRW, local authorities and Public Service Boards need to be taken into account and reflected in the final methodology.

This section also lacks detail on how the price review engages on future customers.

Section 3 – Addressing affordability and vulnerability

We welcome and support the approach in this section. We expect Ofwat to consider both current and future affordability in the design of its regulatory framework. Average bills should be determined by service and resilience needs over the long term. We expect social tariffs to be available for those who struggle to pay, reflecting the views of the generality of customers.

We must not delay investment to make short term savings at the expense of future bill payers. Assets should be maintained continuously so as to prevent a build-up of maintenance obligations for future bill payers.

There is no reference to companies sharing best practice or the role of Ofwat in doing so – I appreciate that this may not necessarily be an issue for this methodology but it would be useful to have the discussion about sharing best practice in general.

In terms of affordability – what work has been undertaken to address potential increase in those struggling to pay and the long term impact this will have across generality of customers. I'm thinking in particular of the potential impacts of Brexit on day to day bills, higher prices for food and general goods.

In respect of the common measures for assessing how companies address vulnerability:

- Some vulnerable groups (e.g. older generations) may be too proud to talk about any assistance they receive – how do we therefore capture satisfaction?
- Will the category of “eligible customers” be different across the companies – if so, is it possible to have a common measure?

Section 4 – Delivering outcomes for customers

- Enhanced rewards and penalties - consideration should be given to capping the value of any rewards as to the cumulative amount the companies can receive (possibly a maximum average per bill).
- 4.3.7 – reference to companies to meet their performance commitment levels in the first year and therefore they should not incorporate any transition period (or glide-path) to reach their stretching performance commitment level – could this lead to unintended consequences where companies focus majority of investment on one of these targets just to meet these levels or is it expected for companies to meet all these commitments within the first year?
- Page 69 – Proposed approach in respect of leakage in line with UK Government draft SPS, there is no mention of how the approach is in line with Welsh Government SPS
- Under the section dealing with leakage there is no acknowledgment of the commitment in the Water Strategy for Wales to investigate the costs and benefits of transferring ownership of the portion of water supply pipes that are currently privately owned, to the water supply companies. If this policy were to be introduced within the AMP period how will the leakage outcome be adjusted (if at all) to reflect this?
- D-MeX information and how it will be applied is limited at present – further information is needed before we can form a view on that aspect.
- How is there protection against undertakers deciding it is cheaper to pay a penalty than deliver the required standard of performance?
- A number of concerns have been raised regarding the proposed removal of glide paths. We would like to discuss these with Ofwat.
- In relation to the pollution incidents metric, Natural Resources Wales have moved away from the 1,2,3,4 categorisation used in England. This means that

Welsh companies may not be able to provide data that is directly comparable with English companies. Ofwat should align any proposed common performance commitment for pollution incidents with this work by working with both NRW and EA.

- We would like a response from Ofwat to the following comment from DCWW “We are not convinced that enhanced rewards and penalties is in the interests of customers. You would not expect customers' willingness to pay to increase with performance. Also, we would argue that the proposal does not mimic a competitive market as no firm would be able to charge extra for higher service quality if that price increment exceeded the valuations of its customers. Customers of one company receiving an enhanced reward would, in effect, be paying for the 'industry benefit' to all customers for breaching the frontier of good performance. Ofwat's justification for enhanced rewards, in terms of incentivising frontier-shifting performance, does not appear to work for enhanced penalties. We cannot think of a justification for enhanced penalties that go beyond the penalty rate agreed on the basis of customer engagement and other relevant factors”.
- We welcome the introduction of a risk based metric for drought, although we have some concerns with the current parameters of this metric of specific 1:200 year drought reporting. The Welsh Government and Natural Resources Wales did not require Welsh companies to plan to a 1:200 year drought across the 25 year planning period or to provide a Reference Level of Service. Instead the water companies are expected to follow the risk based planning methodology to establish which drought scenario to plan to. We recommend that you Ofwat apply a 'flexible' resilience measure to account for each water companies drought scenarios used for their water resource management plans, 1:50, 1:100 and beyond, as appropriate and that further discussion is required on whether 25 years worth of data is appropriate for this metric.
- Ofwat should consider A common environmental measure, Wales' legislative framework places a duty on companies to seek to maintain and enhance biodiversity and promote ecosystem resilience.

Section 5 – Securing long term resilience

There is a paragraph on page 93 which states:

Resilience has always been part of our regulation of the water sector. Water companies have a duty to maintain a water supply system and provide a wastewater system. These are legal obligations on the companies which they must fulfil regardless of the funding we allow water companies.

This seems to contrast Ofwat's primary duty to secure resilience as defined in section 2DA of the Water Industry Act 1991. It also seems to contrast with other sections within the methodology e.g. direct procurement – how can water companies

fulfil these legal obligations if they do not control their network from source to tap to sea.

Q1. do you agree with our resilience planning principles?

A naturally resilient water sector (pg97,99) – Alongside the principle and proposals for resilient ecosystems and biodiversity, we expect Welsh Government policy and legislative approach for the sustainable management of natural resources to be integral to the decision making process for ensuring resilient services. Water undertakers should take a more systemic approach to resilience for systems and services across the entire business, by ensuring their management and use of natural resources is undertaken in such a way that does not diminish the ability of those resources to be able to deliver multiple social, economic and environmental benefits over the long term.

Customer focussed approach to outcomes (pg97,99) - Where the principle and proposals for resilience planning outcomes encourage a customer focused approach, water undertakers should develop resilience measures which are also evidenced based in relation to factors such as drought, flooding, major pollution events, climate change projections, population growth and new industrial, business and domestic developments. We want water companies to be proactive in educating and working cooperatively with customers on these issues and to have the flexibility to develop measures which offer sustainable solutions for current and future customers, which have the support and co-operation of customers but may not necessarily be a clear preference of present customers.

Q2. do you agree with our approach to assessing resilience in the initial assessment of business plans?

Resilience mitigation options that represent the best value solution over the longer term (pg98,99) - Where the PR19 proposals focus on securing long term resilience through measures representing best value, we expect to see encouragement for water companies to balance short-term affordability against the ability to meet long term needs. Water undertakers should plan for the long term to protect present and future generations from challenges, this means having the flexibility to plan for investments that will result in long term benefits which offer the most sustainable solution as well as representing the best value solution but may not necessarily be the best value for money option.

Improvements in longer-term water planning (pg100) - Where proposals promote improvements in long-term water and waste water planning, water undertakers should also support the delivery of River Basin Management Plans and Natural Resource Area Statements (due to be published by NRW at the end of 2019) in their business planning as well as taking into account WRMPs and input from regional planning groups.

Resilience mitigation options that represent the best value solution over the longer term – reference to Cabinet Office 4Rs – how is Welsh Government approach reflected?

Section 6 – Targeted controls, markets and innovation: wholesale controls

Wales is not projected to have shortages to the degree forecast for the South East of England. Most of Wales is served by one undertaker. The evidence and narrative supporting water trading this in PR19 relates to areas of England. Where it has no adverse or a beneficial affect for the environment ,people and economy of Wales there is no objection to water trading, and Welsh undertakers should be able to consider this, We suggest the PR19 methodology should therefore make clear that water trading incentives apply to English undertakers, and that Welsh companies will not be penalised for not participating in water trading.

What evidence is there that the following paragraph taken from page 111 applies to Wales? “In relation to water resources, trading is below its optimal level, and taking steps to reduce identified barriers to this could result in significant benefits for customers. There is also scope for participation from third parties to sell water into the public water supply and, looking further ahead, third parties in England negotiating directly with water retailers as the retail business market develops in line with the Water Act 2014 (the bilateral market).”

Page 111 also says “Our regulatory approach will promote a greater role for markets to inform, enable and encourage greater efficiency in England and, where it aligns with Welsh Government policy, in Wales.” What approach is proposed for Wales and how does it align with Welsh policy?

Promoting Wholesale Markets

We recognise the scope for developing markets for bio resources services, but we have not identified a need to promote markets for water resources. We would like more detail, on how and why this would operate in and benefit the people and environment in Wales and water resilience in Wales , otherwise this should apply to England only.

Section 7 – Targeted controls, markets and innovation: direct procurement for customers

We do not consider that this proposal is a matter for Ofwat – a decision to remove key elements of water company obligations and licence conditions should be a matter for Government supported by the necessary changes in legislation.

This is in our mind introducing upstream competition and Welsh Government has been clear over the years on their position on upstream competition. We cannot therefore support this proposal and it should therefore be removed from the final methodology.

We are concerned about 3rd parties operating key assets that are part of the network. Undertakers need to manage their whole network, as there are many interdependencies. There is also the risk of unclear accountability if something goes wrong, and complex contractual disputes. Though there may be benefits to be

gained in terms of innovation and cost-effectiveness, this may be at the expense of an increased risk to the environment

Undertakers are licensed to carry out key functions – it potentially means they won't be fulfilling the areas they are appointed to carry out (the licence conditions) as these will be sub contracted. Will there be any consequential licence changes, if so, what will these be?

Undertakers will still be accountable for the end product (and liable for financial penalties) but won't have control over it as it will be subject to complex agreements and contracts. What happens if the third party gets into financial difficulty – the undertaker would need to pick up the bill which ultimately means the customers. How is this risk managed?

Is there a risk the water companies upon the end of the contract and when the asset is transferred will be left with an asset that has not been properly maintained and ultimately the higher costs will be placed on future generations?

The water companies are best placed in understanding the network and the business but they will not be allowed to tender for works caught under this proposal – this does not make sense when we are trying to achieve a resilient water industry fit for the future.

It adds complexity to already complicated regulatory framework

How will requirements under the NIS Directive be fulfilled if third parties are not classed as operators of essential services?

How will the third parties be regulated? Will the legislation be amended so that they fall under Ofwat regulatory framework – what about NRW or DWI?

We did have a discussion about this proposal but Welsh Government is not at all assured about this proposal.

Section 8 - Targeted controls, markets and innovation: retail controls

We support the setting of retail price controls for **all** business and household customers of Welsh undertakers.

There is a need to provide flexibility to allow the industry to respond to changing circumstances but this needs to be balanced against the additional resources required to conduct more frequent price reviews. We would like more detail on the proposed methodology and scope of an additional price review after 3 years for retail price controls. We suggest you consider making a five year determination but with the option of another determination after three years if evidence suggests it is necessary or desirable.

Section 9 – Securing Cost Efficiency

We are not convinced with the proposed approach to deal with input price pressure as part of the totex allowance. Forecasting the factors which will influence input price pressures on labour costs and wholesale charges (which drive doubtful debt costs) over a 5 year period is complex and prone to error. Any inaccuracies will be borne by either companies, in terms of unrecovered charges, or customers, in terms of higher than inflation prices.

We believe that Ofwat should index the retail price controls in the same way that wholesale price controls will be indexed, as this will protect customers from above inflation price rises, as well as ensuring that companies recover their allowed retail costs.

We believe further consideration should be given to retaining the transition mechanism as it a useful tool to ensure that early expenditure for the benefit of the customer and or the environment can be incorporated in the price control mechanism without going through the totex incentive scheme. It also enhances the efficiency of business planning by allowing design and planning activities to start early

The PR19 timeline presents challenges in terms of developing a comprehensive programme of environmental requirements. By September 2018 many of the investigations scheduled in the current AMP period will not be reported and revisions to the latest WFD classifications and River Basin Management Plans will not be available

NRW has set out its approach to developing the National Environment Programme in its PR19 expectations and obligations paper. They are developing a programme supported by strong evidence by the timescales for the periodic review and aim to be as clear as we can be about the likely scale of any future environmental requirements. This uses " traffic lights" to indicate certainty at the programme level for each statutory obligation. Where there is less certainty of the scale of a programme and exact requirements (i.e. amber) companies should be fully funded with a clear mechanism for adjustment, in order that that the implications for the environment aren't prolonged and that financial barriers to companies responding to such risks are removed.



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Minister Reply T...