PR19 Draft Methodology
Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA
By email: water2020@ofwat.gsi.gov.uk

30 August 2017

Dear Cathryn,

Bristol Water plc. – Response to PR19 Draft Methodology Consultation

Thank you for the opportunity to respond to the PR19 Draft Methodology. We welcome the open and substantive engagement that Ofwat has carried out over the preceding year in the development of the methodology. The general level of detail, at this stage of the process, on Ofwat's expectations and assessment criteria for companies' business plans is helpful and we support its early publication in the price review process.

There are a number of very positive developments in the proposed methodology. Ofwat's focus on its four strategic priorities for the review: great customer service; long-term resilience; innovation; and affordable bills, is welcome and resonates with what our customers, communities and stakeholders are saying is important to them. We also welcome the further differentiation in assessment categories and the introduction of additional rewards for "exceptional" Business Plans, as well as the level of detail on the expectations to achieve each assessment category.

The consultation document proposes ambitious and challenging financial and non-financial targets for the 2020-25 price review period. In developing our Business Plan, we are engaging with our customers, communities and stakeholders to understand their needs and priorities. We have been challenging ourselves and aim to be ambitious in the level of service and the cost of delivering those services, seeking to meet our customers' increasing expectations for improvements. In the detailed response we have addressed each proposed performance target separately. The combined effect of the individual elements and the resulting increase in financing risk, and therefore our ability to finance the business adequately, is an issue which we would like to discuss further with Ofwat. Ultimately it will not be in our customers' interest to bear higher costs in the long-term (in future price reviews) as a result of short-term over-ambition and higher levels of risk. The Methodology Consultation document includes proposals that potentially change the structure of the regulatory model by placing increased weighting on performance incentives within the allowed revenues. We suggest further analysis is needed on the potential implications for customers of the combined impact of the proposed financial and non-financial targets.

We have reviewed the Draft Methodology Consultation in detail, and discussed with the PR19 committee of the Bristol Water plc Board. We agree with the majority (46) of the proposals, and only disagree or strongly disagree on 13 proposals. In summary, we would like to offer the following main comments on the proposals:

Customer Focus – We support the introduction of C-MeX and D-MeX and widening the scope of the common customer experience measures. We strongly support the Ofwat preferred Option 1 as it focuses on measurable customer satisfaction directly. A consequence of the increase in the weight of ODIs to RORE to 3% is a significant reduction in the relative weight of customer-focused incentives compared to the other ODIs, particularly when compared to the relative weighting of SIM in the current price review period. This reduction does not appear to be proportionate to the importance of customer experience to customers when compared to other ODIs. We therefore believe that companies should have greater flexibility on setting the relative weighting and scale of incentives, particularly for C-MeX and D-MeX. We also recognise that the contribution of the wholesale business is an essential component of the overall customer experience and suggest that the incentive package continues to reflect this, particularly in preparation for any future changes in the industry structure.

Leakage – Leakage reduction is an important control measure to improve water availability in Bristol Water's water resources management plan, and it is strongly supported by our customers, as well as being aligned to the strategic objectives of the government and other regulators. Bristol Water is already a strong performer within the industry on leakage, performing better than the upper quartile in the current price review period and already targeting a 12% reduction from 2015 to 2020. We intend to challenge ourselves on further reducing leakage during the next price review period, and we consider that a robust approach for understanding customers' priorities and their preferences for service levels and associated bill impacts is the correct mechanism for setting targets. The relative marginal cost of leakage improvements increase the closer a company is to the frontier level of performance. The proposed imposition of a universal target of a 15% reduction in leakage may result in the customers of high performing companies paying disproportionately higher costs for further improvements. An alternative approach to achieve an overall 15% reduction in leakage across the industry would be to set individual leakage targets for each company based on how far their current performance is from the industry average level, with those further behind the average being set a more challenging target than 15% and those performing better than the average being set lower targets. This approach is likely to produce the same aggregate level of leakage reduction and improve industry performance at much lower overall costs to customers.

Performance and Efficiency Targets – We recognise and support setting stretching but realistic targets within the forthcoming price review period that reflect the increasing expectations of our customers and improves industry performance in the medium to long-term. Setting performance targets at upper quartile levels at the start of the period may not be in the best long-term interests of our customers. Having established our customers' priorities and expectations for the current price review period, some of which were based on upper quartile benchmarks at the time, additional costs are likely to be incurred in achieving different levels of performance and efficiency targets by the end of the current price review period. We propose to consult with customers on the timing of delivery of the performance commitment targets and the efficiency areas appropriate to the level of performance required by customers during the next price review period. This is also more consistent with Ofwat's historic approach and precedent which has rightly recognised that regulated companies, especially those in capital intensive industries like water, need time to implement innovations and make improvements in an efficient and effective manner.

Resilience – We welcome Ofwat's additional focus on the importance of long-term resilience and agree with its business-wide interpretation. Bristol Water has made significant investment in resilience over successive price review periods, to improve the reliability of our network, provide greater inter-connectivity and increase the robustness of our business. The addition of company-wide resilience to the assessment framework will help to ensure that we continue to deliver long-term stability at an efficient cost to future generations of our customers beyond 2025. We believe that the water industry should aim to achieve this, not only by additional investment but also through operational monitoring, improved response and recovery procedures, and improved risk control interventions in order to provide lowest cost of achieving resilience in the long-term. We are developing our resilience planning methodology to align with the above principles and we would welcome the opportunity to present to Ofwat.

Cost Assessment Framework and Special Cost Factors – We welcome Ofwat's engagement with the industry in developing the methodology for the cost assessment framework for PR19. Additional clarity on the detail of the cost assessment methodology is still required and we look forward to developing the cost assessment framework with the industry and Ofwat. Given that the wholesale cost assessment forms a substantial element of the determination, we consider that a range of cross checks are required against the outcome of econometric modelling. To support the assessment process, we would encourage Ofwat to publish its cost assessment model or details of its intended specification before the publication of companies' Business Plans. This would support the customer engagement process as the projected bill implications of companies' plans could be aligned with the likely outcome of the cost assessment process, allowing customers to provide a view which takes into account the relative efficiency of company expenditure proposals. The additional clarity provided on the timetable and flexibility of the assessment process for special cost factors would also be welcome. The early submission of companies' proposed factors will also provide improved transparency in the process and we would welcome these submissions to be shared across the industry at the time of submission. Early confirmation of the variables to be applied in the cost assessment models would support this process by allowing companies to consider which special cost factors may be adequately recognised within the model and which are not captured.

Cost of Embedded Debt - We are supportive of the need to act to ensure legitimacy of allowances for debt costs, including the key role that an appropriately structured approach to indexation of new debt will play over future years to address negative perceptions. We feel that the proposed approach for existing debt, in particular as it may apply to Artesian debt which has provided a good proportion of Water Only Companies' (WOCs') financing needs, is likely to have the consequence of giving rise to stranding of existing, efficiently incurred and legitimate debt costs to the detriment of credit metrics and RORE performance, and not in the long-term interests of our customers. An alternative and improved approach would be to consider the context of individual companies' financing (as well as that of WOCs in general), including existing debt, maturity profile, the needs and access to potential new debt instruments (such as the EIB which has so far been available to WaSCs and not WOCs) and to do so in an integrated fashion with financeability analysis.

Cost of Equity – The proposal to place greater reliance on subjective assessments of market conditions through Total Market Returns (TMR) in determining the cost of equity for the next price review period represents a departure from previously established Ofwat approach. TMR has proven in the past to be a particularly difficult component of the WACC to forecast, and therefore a long-term historical review has been consistently adopted by regulators to minimise subjectivity and address margin of error in estimation - an approach which continues to be supported by considerable body of academic literature. We believe retaining such an approach would more appropriately account for the level of risks involved, which form part of the reasonable expectations of equity providers.

Company-Specific Adjustments to Cost of Capital – Bristol Water is updating the analysis of the main factors determining small company finance costs (asset beta, new debt and embedded debt). Our initial analysis supports previous regulatory decisions that there is still an observable differential for small companies for both debt and equity beta warranting an adjustment within the price review. As part of our analysis we are developing alternative approaches that recognise the linkages across other areas of the price review. We propose to discuss the output from of our work with Ofwat once it is sufficiently advanced.

Financeability – The Methodology Consultation document includes proposals that potentially change the structure of regulatory model by placing increased weighting on performance incentives within the allowed revenues. As a consequence, the overall assessment of financeability now takes into account incentives as well as cashflow and WACC. When considering all of the above issues in the round in assessment of financeability, based on Ofwat's proposed view of a notional company, even individual companies that are operationally efficient may not meet credit rating ratios under a range of different scenarios. A company performing better than industry average across a broad range of outcomes should be able to service capital providers; our initial modelling for Bristol Water indicates that this may not be the case. We would welcome additional discussions on such financeability considerations over coming months.

Finally, we want to assure Ofwat that Bristol Water has the ambition to further improve our great customer service, and to use innovation to provide a resilient and efficient water company for all of our customers and communities, with particular focus on ensuring we protect those customers in vulnerable situations. We want to work closely with Ofwat to put in place a Business Plan that is in the long-term interests of our customers and communities.

Our responses to the consultation questions and comments on the proposed data tables and financial model can be found in the attached prescribed response template. Please do not hesitate to let me know if you have any immediate questions or if we can be of further assistance.

Yours sincerely,

Mel Karam
Chief Executive