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

South East Water response

30th August 2017
## Contents

1. Executive summary .................................................. 3

2. Consultation questions ................................................. 9
   2.1 Chapter 3. Addressing affordability and vulnerability .......... 9
   2.2 Chapter 4. Delivering outcomes for customers ................. 10
   2.3 Chapter 5. Securing long-term resilience ..................... 19
   2.4 Chapter 6. Targeted controls, markets and innovation: wholesale controls ........................................... 19
   2.5 Chapter 7. Targeted controls, markets and innovation: direct procurement for customers ......................... 21
   2.6 Chapter 8. Targeted controls, markets and innovation: retail controls .................................................... 22
   2.7 Chapter 9. Securing cost efficiency ............................. 23
   2.8 Chapter 10. Aligning risk and return .......................... 26
   2.9 Chapter 11. Aligning risk and return: financeability ........ 40
   2.10 Chapter 12. Accounting for past delivery .................... 42
   2.11 Chapter 13. Securing confidence and assurance ............ 43
   2.12 Chapter 14. The initial assessment of business plans: securing high quality, ambition and innovation ............ 43
   2.13 Appendix 14. The initial assessment of business plans ........ 45

3. Reference list ......................................................... 46
1. Executive summary

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

Overall we support the general themes and objectives that Ofwat are trying to achieve for this price review. We believe the areas of focus are the right ones and the methodology is clear on its articulation of the approach required.

There are some areas where we do have concerns; we discuss these later in this section and in response to the questions posed in the consultation document. However, before commenting on the proposed PR19 methodology it is worth considering some lessons learnt from the last review that are still relevant. The last review created plans that companies owned, were supported by strong customer engagement and included a wide range and breadth of performance commitments that aligned with each company’s customer engagement. Overall stakeholder feedback was very positive on the step change this created from previous business plan processes.

One impact of this approach was that it created issues with the ability to compare companies on a level playing field and also, in a limited number of cases, seems to have created material ODI ‘windfall gains’ so far during this period. However we should not forget that having this range of approaches and commitments has also moved the industry quite a long way in its thinking and approach to performance, customer engagement and cost; indeed it could be argued that the breadth of approaches has contributed significantly to the PR19 methodology.

What is also evident so far, with the exception of a small number of outperforming wastewater related ODIs, is that companies are performing in line with these commitments and are likely, in our view, to achieve - at best - a small overall positive reward stemming from a genuine improvement in performance.

To illustrate this point, to date any ODIs related to the water supply elements have seen companies receive a net penalty of £1.4m in 2015-16 and a net penalty of £15.1m (including a Thames penalty of £8.5m) in 2016-17. The performance changes over the same period include water quality compliance improving from 99.95% to 99.96%, complaints relating to taste and odour reducing from 4.2/10,000 customers to 3.5/10,000 customers, discolouration contacts reducing from 12.7 to 12.0/10000 customers, interruption minutes per property reducing from 16 to 10.5, SIM increasing from 82 to 84 and complaints decreasing from 3.13 to 3.04 per 10,000 properties. The picture this seems to be portraying is a set of incentives on the water supply element that are already stretching as evidenced by the net penalty positions, yet still delivering continuous performance improvements for customers.

We agree and comment in more detail later in our response for the need to look at leakage incentives as the current approach does not seem to be driving improvements effectively enough. However, we are concerned that increasing the leakage challenge to upper quartile, or potentially frontier, and the desire for all performance measures to be more ambitious will potentially diminish the power of incentives as they become increasingly unachievable and certainly result in disproportionate and considerable penalties as well as a tangible shift in risk.

The methodology consultation also states that this level of stretching targets will result in average companies being in a net penalty position. We would suggest that this is the case now and that a further tightening of targets will result in only a small number of companies, if any, being in a net reward for water supply, significantly shifting the risk and reward balance of the regulatory regime especially when considered alongside the cost and financing challenges also detailed within the methodology.
We fear that some of the elements of the current consultation may be a reaction to the small number of what might be considered inappropriately set ODIs - rather than a focus on all the positive elements that were created when companies owned their plans, and with the input of customers, were able to set appropriate performance standards and associated rewards in a package that customers also accepted overall. We also believe that comparability, whilst important, should not be to the detriment of innovation; indeed the Frontier Economics study ‘Keeping up with the Joneses’\(^1\) demonstrated that customers’ choices about service were not affected by comparative information.

We are also concerned that such a level of prescription may result in a loss of ownership of plans, a reduced ability to innovate and companies will not be able to say that customers support performance levels at a price that they are willing to pay for and consider offers value for money.

We believe we have much more still to contribute to moving the industry forward. At the last review we created an approach to customer engagement that was innovative in its design and based largely on customer satisfaction. We produced the early thinking on the water resource market design and since then have begun to evolve our thinking across a number of areas. Prior to the methodology consultation we anticipated a continuation of the approach that allowed companies to design with their customers a range of new ODIs. Consequently we have developed an innovative way to segment and understand our customer base centred on their values, attitudes and association with water. Our intention was to set ODIs against these value-based segments moving away from the historic measure of average performance for the average customer. We have also created a framework around the concept of the resilient customer which we believe has significant scope to alter thinking on resilience and customer engagement; again we intended to support this innovative thinking with new ODIs centred around changing customer behaviour to the benefit of all. However we are now concerned that the level of prescription outlined in the consultation to try and achieve comparability could actually stifle our ability to implement these important innovations into how we deliver the services and ultimately what our customers want.

Overall we would strongly advocate a reduction in prescription by Ofwat to allow companies to innovate and be ambitious in the areas that are important to them and their customers, whilst recognising that it is important to maintain customer legitimacy by having plans based on customer needs and expectations.

We also outline below a number of other key areas that we believe Ofwat should consider in relation to the PR19 methodology.

**Customers**

On an overall point of the draft methodology the consultation document is silent on the issue of the potential for customers’ ambition to not align with that of the regulator. This is a real possibility as in some of the areas where challenges are laid down to increase ambition we know from previous engagement (and indeed some of our current PR19 research) that these are not supported by customers. This clarity – and how Ofwat intends to deal with it in the final methodology - is important both to manage the expectation of stakeholders such as CCGs but to maintain our legitimacy with customers. We do not want to find ourselves in a fait-accompli position - where we engage them on important issues and establish their views and support (or not) in key areas when ultimately their preferences are likely to be over written by regulatory methodology and target setting.

---

\(^1\) Frontier Economics, Keeping up with the Joneses, December 2016
Indeed, it is our view that customers cannot be central to a company’s business plan if performance commitments are overly prescribed by the regulator. In-built into that prescriptive approach is an assumed preference by customers that may not even be proven or supported by those customers, which we would argue is counter-intuitive to all the positive learnings from PR14.

Furthermore, we cannot see that there is any evidence of customer research undertaken in the sector to support the expectation that performance commitments should be more stretching - therefore it is highly likely that Ofwat may push the industry further than customers are willing to pay for or want, and risk compromising the relationship between customers and companies. The lack of customer support for Ofwat’s own ambitions also risks damaging our collective credibility (regulator and companies). If customers want improvements to be made in other areas there will be limited bandwidth to accommodate these preferences. Why? The compulsory ODI suite is so far ranging and the targets likely to be so challenging that they will absorb the majority of our financial and intellectual resource to achieve them.

Prescribed performance commitments and targets can also create an unwelcome tension in business planning. Potentially if customers do not support the performance improvements in the prescribed commitments then a plan aiming at upper quartile or better performance might rightly be viewed as ambitious - but ultimately is unsupported by customers. Conversely, a plan that reflects customers views and is not aiming at upper quartile performance could just as easily be considered unambitious by Ofwat - even though it is supported by customers. For the benefit of companies and CCGs, the final methodology should explain how this situation should be handled by companies within their plans and by Ofwat in its business plan assessment.

The automatic response to this challenge should not be “why would customers not want improvements in these areas if it is at no cost to them as they are delivered through efficiencies?” The answer is there would be a cost to customers – the cost arises because efficiency savings are not being allocated to areas where they have told us they do expect to see improvements. There is a risk that the high level of proposed prescription in the PR19 approach will limit the ability for companies to focus efforts on areas that matter most to customers. Again this is borne out of the drive to improve in areas where customers support has not yet been proven.

One specific area we are concerned about is the proposed leakage target. While we understand Ofwat’s aim to reduce leakage below the Economic Level this should be carried out in a proportionate way and be based on customer support. We also agree that the current methodology relating to SELL does not drive leakage down to what might be termed a customer’s ‘emotionally acceptable’ level of leakage. Our research shows that this level is broadly at or around 10% on the company’s own distribution system. The proposal moves to an arbitrarily set level with no customer or regulatory substance to it. We don’t believe this is appropriate - the choice should be between an economic or a customer’s accepted level of leakage.

In addition, Government advice to Ofwat on leakage reductions state this should be “where this represents best value for money over the long term”. We believe the proposed 15% reduction across all companies is too arbitrary and is potentially inconsistent with this advice.

Ofwat should review its approach in this area to provide clarity on this issue and how the targeting prescribed reflects both government advice and/or customer support to apply this arbitrary target.

Innovation

As outlined earlier we believe that more prescription across the performance commitments will limit the ability for companies to innovate.
Encouraging the industry to innovate by a) setting very low expenditure allowances and b) very ambitious performance targets does not necessarily generate the right type of innovation in the areas customers prioritise. In fact it is likely to drive short term innovation that focusses on ‘scope reduction’ rather than the type of innovation likely to benefit customers in the longer term.

Innovation also requires room within the methodology to achieve it. While we agree that some areas need prescription, particularly areas that are asset centric like asset health where the need to compare companies outweighs the likely benefits of innovative metrics, the prescriptive approach outlined in the draft methodology is so wide ranging, in breadth as well as in number, that it stifles innovation. It limits the ability to seek new ways of measuring and managing performance - as we are intending to do via customer segmentation – and makes it no longer viable as there is not enough room to introduce many more performance commitments. Even within the areas where bespoke performance commitments are encouraged the choice for bespoke is already described and defined, with no customer input to those. We would encourage Ofwat to narrow the prescriptive range of bespoke performance commitments, particularly relating to customer experience, to allow companies like ours to continue to innovate in this area.

**Incentives**

We support the retention of incentives to produce high quality business plans as we believe this was a key driver for the improvements seen in overall business planning at the last price review. However we are surprised that Ofwat seems have chosen to reduce the incentives when it is makes clear it is seeking high quality, ambitious and innovative plans. The construct of the assessment of business plans seems to make any financial reward less likely to be achieved; and the size of the reward is not proportionate when compared to the level of ambition and risk required to achieve it. The costs, both in terms of meeting and exceeding Ofwat’s business planning expectations and the totex reductions seemingly required to achieve exceptional status, are orders of magnitude greater than the reward on offer. While there are other benefits to being assessed as exceptional, including reputational benefits, there is a risk that companies will consider striving for this classification to be too costly and too risky – and so a perverse incentive occurs, which is the complete opposite of Ofwat’s desire as outlined in its current mechanism. In addition we see very little benefit in achieving the Fast Track status other than there being some reputational element to it, as the Final Determination for Fast Track companies is no earlier than for other categories; in fact we see the benefits of a quicker Draft Determination being of limited impact and would welcome stronger demarcation between Slow and Fast Track. We would recommend Ofwat examine their proposals in this area to ensure the power of the incentives are properly maintained and drive the right behaviour by a) increasing the financial incentives for exceptional plans and b) by providing greater financial differentiation in terms of the determination timing between the fast and slow track categories.

Despite Ofwat’s recent journey on reducing regulatory burden and prescription we believe there is a risk that PR19 is re-introducing a level of burden that was greater than pre PR14 with an increasing number of mandated performance commitments, incentives, and true ups, alongside an increasing and extensive set of data tables.

**Risk and return**

Aligning the interest of companies and their investors with the interests of their customers is an objective we wholly support. Customers need confidence that they will receive clean, safe, reliable drinking water over the long-term at a reasonable cost.
Our view however is that the approach to risk and return is not consistent with this objective in all areas. In assessing cost of equity, Ofwat has used a short-term Total Market Return approach which raises two important issues. Firstly, a short-term approach will (for reasons set out in the body of our response) increase risk for investors in the sector, which in turn will increase the cost of drinking water for customers over the long-term. Secondly, even if a short-term Total Market Return approach is adopted, which we think is not in the long term interests of customers, the evidence shows that the Total Market Return has not reduced since the last price review.

We are disappointed that Ofwat is retaining the same approach to embedded debt as in the last price review. This approach means that some companies will outperform the funded cost of debt while others will underperform – simply due to the timing of debt issuances, not due to the efficient raising of finance. This approach is not consistent with the CMA’s precedent on Bristol Water and Northern Ireland Electricity and drives companies to adopt shorter term financing solutions which are inconsistent with the longevity of the assets being financed.

We welcome Ofwat’s approach to financeability in most areas and agree with Ofwat’s overall approach to assessing financeability for a notional company. If financeability tests are to be applied it is important to retain the confidence of investors that the parameters used in assessing the cost of capital are consistent with those used in the financeability assessment. We would recommend that Ofwat ensure that the ‘speed of money levers’ are available to be used where there is customer support to do so – for example in relation to providing long term bill stability, balancing the level of investment required now and in the future and to help balance the level of bills between current and future customers. We see no reason to restrict customers from having a choice to re-profile bills from future to present or vice-versa in a way that is NPV neutral.

Aggregate effect

Each individual area where Ofwat is driving efficiency and performance can be seen as challenging but potentially achievable; however the summation of all of these challenges - the aggregate effect - appears to have not been considered and results in a cumulative challenge that is potentially unachievable. We believe that when considering water service elements only the current PR14 regime - at best - will see an average company achieving a small net reward. The aggregate effect of all the increased challenges posed in the new methodology is likely to mean only a limited number of companies, if any, will achieve a net reward in the coming period. Ofwat needs to examine the total potential impact of the ambition proposed and whether it is appropriate, as it could undermine trust and confidence with customers if companies achieve a net penalty while still meeting the high levels of overall performance they will achieve. This is particularly important around areas such as drinking water where there are established, high levels of trust already among customers about its safety and quality due to the industry’s excellent performance.

Cost assessment

We welcome the open approach to developing the cost assessment models that Ofwat has used to date and we hope this will continue. The accuracy of the models has always been vital but the proposed move towards frontier efficiency challenges makes the need for accuracy even more important, as single companies rather than averages will be in effect be used to set targets. That said we are not convinced this level of accuracy within the models can ever be achieved and so would encourage Ofwat to make uncertainty adjustments within the efficiency challenge as has become common practice across regulators (indeed Ofwat has used this in the past).
We are disappointed that Ofwat is creating reputational - and potentially financial - barriers to the inclusion of model adjustments. This approach seems to be borne from a reluctance to examine and assess the claims that are made, rather than any policy position. Models are tools that by their nature cannot capture all exogenous factors across the industry and so to create the accuracy needed to set frontier efficiencies it is important there is a robust and thorough mechanism for considering these factors. Ofwat's inclusion, which we welcome, of considering two-way model adjustments will potentially diminish spurious one-way claims; therefore we don't believe it is necessary to discourage adjustment claims any further. In addition, a number of model adjustments proposed at the last price review were due to uncertainty over the drivers likely to be included in the model. Full disclosure of the model form and drivers prior to the submission of adjustment claims is likely to significantly reduce the number of claims made by companies. It will also allow companies to assess the loss created by the models to improve the claim and pass one of the adjustment's key tests.
2. Consultation questions

2.1 Chapter 3. Addressing affordability and vulnerability

Q1. Do you agree with our proposal to use the five principles of customer engagement; customer support; effectiveness; efficiency and accessibility to assess how a company is addressing affordability in their business plan?

We support the five principles described in the consultation document for assessing affordability. However we would add that affordability cannot be assessed effectively at an average customer level and is specific to each customer. With that in mind we believe there is an extra principle relating to understanding relevant customers’ views at a segmented level rather than treating customers views in the round. Without this there is a real risk the views of those customers most critical to accessing the affordability service offering have their voices lost in the averaging exercise.

We would encourage Ofwat to place more emphasis on the outcomes and qualitative aspects of this assessment rather than looking purely at the number of customers on support schemes. Consideration must be given to how companies use their ‘standard’ range of tariffs and payment options to help customers who have affordability issues. It is not always the case that a customer who has affordability problems will require, or indeed want, to be placed on a support/social tariff. We therefore welcome the proposal to use a form of satisfaction as the principle for assessing and measuring affordability proposals.

Q2. Do you agree with our proposal to use information and measures, including possible common measures, to assess how a company performs against the five principles in addressing affordability in their business plan?

In principle we support common affordability measures. As outlined above this assessment should include both quantitative and qualitative measures, and we would urge Ofwat to carefully consider the balance of these. Any common measures used for this assessment should focus on the outcome for the customers on the schemes rather than just a count of customers who have been signed up (eg continued payments etc). Greater focus should be placed on customers’ satisfaction with the affordability options in place covering not only customers who have used them but the wider customer base as well. This is the most relevant measure and covers all aspects of the service.

When considering debt management costs as a percentage of the average bill, Ofwat should consider that water and sewerage companies will likely benefit from having a dual service (and therefore higher) average bill. For example the cost of a collection activity (telephone call, letter, visit etc) often does not vary with the size of the bill, therefore leading to WASCs appearing more efficient on this proposed metric. We note that when Ofwat set the cost allowances at PR14 it took account of the difference in single vs dual service so we would recommend that any metrics should also reflect these economies of scale.

Q3. Do you agree with our proposed option for requiring companies to propose bespoke performance commitments for addressing vulnerability in their business plan?

We support this proposal. The ability to provide meaningful bespoke options in all areas of the business plan process has the potential to be the most effective way to drive and share innovation and co-create solutions with (and for) customers so should be encouraged.
Q4. Do you agree with our proposed option for using measures in our assessment of companies’ approaches to addressing vulnerability in their business plan?

As outlined earlier any quantitative assessment should be undertaken alongside a qualitative assessment of the range of help offered. This ensures both breadth and depth when assessing vulnerability in company’s business plans.

Ofwat also needs to consider that the range of support / social tariffs that are in place across the industry vary and are based on customer research for what should be offered and funded within each region. Therefore the design of the scheme/tariff, the level of bill discount and the eligibility rules of who can apply for the tariff will all affect the number of customers on each tariff. Therefore a simple comparison of customer numbers may not be appropriate across the industry. It should also form an assessment test i.e. how well supported is the company’s offering on vulnerability to the wider customer base. It is not evident within the methodology that support for vulnerability service offerings needs support from the wider customer base due to cross subsidy issues. We assume as with all service changes that customer support is expected; we therefore propose it is measured and forms part of the vulnerability assessment by Ofwat.

2.2 Chapter 4. Delivering outcomes for customers

Q1. Do you agree with our proposals for common and bespoke performance commitments?

Q1a. Do you agree with the common PCs (1 - 14)?

Overview

With the introduction of a range of common PCs we can understand why Ofwat has increased the number of PCs to ensure coverage of all the water and sewerage service aspects. While we agree that some areas need prescription, particularly areas that are asset centric like asset health where the need to compare companies outweighs the likely benefits of innovative metrics, the prescriptive approach outlined in the draft methodology is so wide ranging that it stifles innovation. It limits the ability to seek new ways of measuring and managing performance - as we are intending to do via customer segmentation – and makes it no longer viable. Even within the areas where bespoke performance commitments are encouraged the choice for bespoke is already described and defined, with no customer input to those. We would encourage Ofwat to to narrow the prescriptive range of bespoke performance commitments, particularly relating to customer experience, to allow bold companies like ours who devised the customer satisfaction measure at PR14 to continue to innovate in this area. We would encourage Ofwat to re-examine the trade-off between comparator information, which according to the Frontier Economics study ‘Keeping up with the Joneses’ has limited impact with customers. Instead, we would urge Ofwat to consider the benefits that might arise from leaving companies room to create measures that have the potential to create innovation in itself - particularly in the developing areas of resilience, vulnerability and customer satisfaction.

Ofwat should ensure that the assessment of business plans also addresses this issue by ensuring an appropriate weighting is given to the range and nature of bespoke performance commitments that are proposed by companies. This is particularly the case for bespoke PCs that are introduced by a company that have the potential to collectively move the industry forward over the longer term and be used as a common PC in the future for the whole industry.
Resilience metric

We support the introduction of a resilience metric covering the risk of severe restrictions in a drought as proposed in the consultation document.

This is a simple measure but is powerful in describing the risks of drought and will allow comparisons both within companies experiencing the same levels of drought risk in a region but across the industry. However as the only metric we see it as too narrow when assessing resilience in the widest sense. What we have seen in the last few years is that customers have had their water supply affected by significant burst water mains (Thames, Bristol), water quality (United Utilities, Severn Trent), and flooding (Severn Trent). At the same time no customers have had restrictions for several years. It seems that a broader range of resilience metrics is required to improve service to customers given the likely threats the industry faces. We understand that this area is still developing and we have been actively engaged to date. We would encourage the use of bespoke ODIs in this area as this is likely to move the resilience debate forward so that a broader and meaningful set of resilience measures can be adopted at future price reviews.

Similarly, we think that as well as looking for the average risk to customers from a lack of resilience, companies should report regional variations so that all customers understand if they can expect the same level of resilience as other customers across the country; and to allow a conversation with customers to occur that considers a flattening of resilience metrics both within an individual company and across companies in the same regions via interconnections and asset sharing.

Water quality compliance metric CRI

In principle we support the use of the new DWI index, it is more meaningful and has complete supply system coverage. However care should be taken using this measure as there is no historical data for this and no common agreement on what level constitutes an acceptable value. This is particularly the case as there is a subjective element to the measure based on the DWI’s assessment of each failure which can have a significant impact on the calculated number. We would propose a reduction in the weighting associated with the qualitative assessment until the measure stabilises and is better understood, and there is greater confidence that the subjective element is consistent. The other consideration is one of overlap; virtually all of the proposed long list for above ground asset health measures will now impact on the CRI index so there will be double counting of each sample failure within the framework. If CRI is adopted then these serviceability options are arguably no longer necessary.

Per capita consumption

Per capita consumption is heavily influenced by a wide range of influences, including:-

1. Property age and type
2. Householder age
3. Householder occupancy
4. Householder affluence
5. Weather (regional and seasonal)
6. Government policy (planning, energy efficiency etc.)
A joint report commissioned by companies and undertaken by Artesia in 2017\(^2\) reached the following conclusions:

**Occupancy is a significant explanatory variable for household consumption, but other variables are also significant in explaining variations in household consumption.**

- These include (but are not limited to): Property type, age of occupants, socio-demographic factors (RV, social status, affluence, culture, lifestyle, values, metered or RV bill), metering and weather.
- These factors vary regionally, and should provide an explanation for the regional variation seen in household consumption.

Per capita consumption also requires a very good understanding of what the population is in any given area. Given uncertainty over population forecasts by experts, and variances within price control periods (e.g. caused by Brexit or immigration/emigration) it is difficult for companies to gain accurate estimates of population.

The Artesia report also states: **PHC is a better comparator for household consumption than PCC (due to the difficulties in accurately determining occupancy).**

We would therefore not support a relative measure using PCC but would support the use of PHC (per household consumption) against a target relevant to the individual companies’ WRMP commitments as these already account for the elements of its customer base that contribute to PHC - such as affluence, meter penetration etc.

Q1b. Do you agree with our approach to asset health outcomes?

In principle we support the introduction of the two asset health outcomes – mains bursts and unplanned outages. In particular we see the unplanned outage measure as a real step forward in providing confidence in asset performance and investment. As with burst mains it concerns itself less with the cause but focuses on the impact - making it more appropriate as a serviceability tool.

However ‘performance’ across the industry on these measures will vary and so it should be recognised that the levels are not comparable across the industry; an upper quartile or any form of relative ‘performance’ target therefore would not be appropriate. Companies have maintained their assets in at least a stable condition as required within their licences. Stable for each company is different and is defined with reference to specific historic performance commitments – this is appropriate and reflects a multitude of different historic and regional factors as well as flexible (but legitimate) asset maintenance strategies. There is, however, merit in using a single definition to allow that comparison to be made outside of the ODI framework and to allow industry dialogue around these issues to occur.

The introduction of any new measure should allow time for sufficient historic data to be built up if it is not already available and used in a proportionate way based on the level of accuracy attributed to it. Guidance will need to be prepared to ensure companies include/exclude data as appropriate; accuracy in this regard is more appropriate than any consideration of regulatory burden as the state of the industry’s assets is fundamental. This is particularly the case for above ground outage where the assessment for the purpose of a serviceability assessment is new - albeit measured and forecast as part of companies’ WRMPs.

\(^2\) Artesia Consulting, Planning for future uncertainty: a review of our understanding of household consumption in the UK, draft report [unpublished], 2017
The inclusion of mains bursts also needs to be considered against the potential for significant leakage reductions. Our evidence is that new technology and a drive to reduce leakage will identify leaks on mains that would not have been found in the past. The introduction of new technology can result in an increase of reported burst mains when in fact this is a result of companies being able to locate smaller leaks rather than any change in mains serviceability. Companies who use new technology or who are striving to reduce leakage should not then be penalised for it when they report the number of burst mains. We suggest the approach to the setting of burst main commitments allows companies to make an allowance for extra bursts being located in the additional drive for lower leakage rates, and not least it will ensure incentives are aligned.

Q1c. Do you agree with our approach to bespoke PCs including areas that bespoke PCs should cover?

Whilst we understand the objective for specifying areas that bespoke PCs should cover Ofwat needs to ensure there is enough flexibility in the ODI framework to allow companies to innovate in developing and introducing new bespoke measures.

Q2. Do you agree with our proposals on setting performance commitment levels?

Q2a. Do you agree with our proposals to setting bespoke performance commitment levels?

Q2b. Do you agree with our proposals to setting common performance commitment levels?

Our response to these questions covers a number of areas in relation to how performance commitment levels should be set.

Upper quartile PCs

While we agree that all companies should strive to improve their performance and delivery of service to customers, the consultation document sets out that performance should be at least upper quartile for a range of PCs. This aspirational approach to target setting may not be consistent with customers’ views, priorities and needs – not least as there should be a thorough understanding of the expenditure that will be required (and potential bill impacts – see earlier section on Customers) to achieve this level of performance.

In addition to the link to customer support for such performance levels, targets should only be set at an upper quartile level where there is a level playing field across all companies and specific circumstances do not significantly impact performance levels. For example, companies with only chalk or river water sources have virtually no issues meeting discolouration targets compared to companies operating in catchments rich in iron and manganese.

The consultation document outlines that Ofwat expects that for a number of the common performance commitment companies should set their performance commitment levels at least at the forecast upper quartile performance level in 2024-25. It also states that companies should 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. This should not be interpreted that companies must achieve the forecast upper quartile position of 2024/25 in the first year. This is not an achievable or appropriate proposal.
Glide paths

Ofwat has stated that companies should meet performance commitments levels in the first year of the price control period and should not include any glide paths. This may be an appropriate position to take for performance areas that instinctively allow a company to be more dynamic and deliver immediate improvements in performance, such as within retail services. However this is not an appropriate target where the performance improvement is related to longer term investment in the asset base of the company. In effect it represents an immediate unjustifiable penalty for a company that may well be meeting its performance commitments and the levels of service supported by customers for the current period. Glide paths should not be considered as a soft option to rewards - they represent a reasonable scientific approach to setting new targets where the commitment cannot be reasonably improved within 1 year.

Deadbands

The purpose of a deadband is to act as a legitimate mechanism that recognises inherent variability in the data and measurement of a performance commitment and that is highly unlikely to be due to a real change in performance. Our view is it is not appropriate to discourage or prevent the use of deadbands.

Ofwat should also consider the implication of the removal of deadbands and the proposal that ODIs should require in-period adjustments as a default. The removal of deadbands will mean a determination is required on virtually every performance commitment every year and an amendment made to the revenue requirement that will feed through to the charges we make to our customers. This process is complex and unnecessary when the adjustment is due to a statistically insignificant change in the underlying performance position. We would support a position that statistically derived performance deadbands are used to overcome the issues raised above.

Q2c. Do you agree with our proposals to setting leakage performance commitment levels?

While we understand Ofwat’s aim to reduce leakage below the Economic Level this should be carried out in a proportionate way and be based on customer support. We also agree that the current methodology relating to SELL does not drive leakage down to what might be termed a customer’s ‘emotionally acceptable’ level of leakage. Our research shows that this level is broadly at or around 10% on the company’s own distribution system. The proposal moves to an arbitrarily set level with no customer or regulatory substance to it. We don’t believe this is appropriate - the choice should be between an economic or a customer’s accepted level of leakage.

In addition, Government advice to Ofwat on leakage reductions state this should be “where this represents best value for money over the long term”\(^3\). We believe the proposed 15% reduction across all companies is too arbitrary and is potentially inconsistent with this advice.

Ofwat should review its approach in this area to provide clarity on this issue and how the targeting prescribed reflects both government advice and/or customer support to apply this arbitrary target.

Instead, the use of SELL should not be diminished or undermined but, however it should be strengthened to include a greater weighting to customers’ preferences on the matter. Companies use the SELL (as set out in the WMRP planning guidance) to forecast long term reductions based on

---

\(^3\) Defra, The government’s strategic priorities and objectives for Ofwat Draft for consultation, March 2017
financial costs (including the costs of reducing leakage, the costs of water saved, the costs of alternative supply demand options) and broader economic costs (including customers willingness to pay, environmental and social costs). This approach takes into account customers, stakeholders and CCGs, the future costs of water and improvements in efficiency. This approach is in line with Government guidance to Ofwat. Setting a level in the price review methodology that is inconsistent with the WRMP approach would undermine that important statutory process and is extremely problematic so should be avoided.

Our position is that the leakage level should be set at the customers’ acceptable level of leakage. The benefits in our view of achieving this level, particularly on the industry’s reputation, will exceed the costs. A major consideration though is that we need to ensure we are consistent with the WRMP guidelines, the Ofwat methodology and its aspiration. However the current position is that this is not possible. We would welcome a single regulatory approach to setting leakage targets aimed at achieving the leakage level acceptable to customers who have equally strong views on the issue and how much they are prepared to pay to reduce it further.

15% target reduction

If Ofwat wants to set aspirational targets there needs to be further consideration into how any target is derived in the first place; the proposal to set a target based on an individual water company’s performance commitment at PR14 has many flaws, not least as it does not take into account the relative performance of that benchmark company. For example, it is not appropriate for a lower quartile company to be used to set a % improvement required for an upper quartile company. The benchmark used to generate the 15% target was from a lower quartile company and therefore you would expect that company to have a higher percentage reduction than others in the industry. We also understand that most of the leakage reductions that particular company will achieve are as a result of a metering policy. Where companies have already implemented compulsory metering this option is clearly not available to them.

That said we strongly support a further reduction in leakage and this is key to our own strategy; indeed we not only have a challenging leakage target, we have also set ourselves the challenge of improving customer satisfaction with leakage which we are achieving - moving from 3.4 (out of 5) in 2015 to 3.9 in 2017. We do however consider the target - if not based on the economic level - should be set at the customers’ acceptable level either nationally or regionally by company to ensure legitimacy and a clear link to what our customers’ preferences and expectations are.

Three year average

While we understand the rationale for proposing a three year average for the leakage ODI, further consideration needs to be given by Ofwat about the practical applications of how this will be calculated and implemented; and how close in time any reward/penalty will be to the performance of the company. The current proposal would result in only one adjustment in year 5 relating to the 2020-25 period and so is already inconsistent with Ofwat’s view of having more in-period ODIs to achieve a smaller time gap between actual performance and bill impact.

Customer side leakage

A further issue for consideration relates to customer side leakage. The goal for the industry should be to increase the legitimacy of the industry in the eyes of customers and stakeholders. Leakage in its purist sense is a low order serviceability measure and is covered to a large degree in other measures such as burst mains and interruption times. Nevertheless the fact it has the level of importance it does is almost entirely related to a social legitimacy issue borne from historic performance issues. Ofwat
should consider the ongoing negative impact of apportioning customer side leakage to the industry (as the current methodology prescribes) and its consequential, negative impact on legitimacy. In our experience, and this is not surprising, customers have no awareness that the figures quoted contain leakage attributable to them. We believe there is now an opportunity to separate out leakage on a company’s system with leakage on the customer’s side of the network. As part of any demand management options there would still be the opportunity and incentive to reduce customer side leakage but crucially the legitimacy of the industry as a whole would be significantly improved - as would the immediate transparency afforded to conversations with customers should the apportionment of leakage be more accurately attributed.

Q3a. Do you agree with our proposals to increase the strength of ODIs by increasing the impact ODIs have on reputation, the greater use of in-period ODIs, linking ODIs to revenue rather than RCV and having a greater onus on financial ODIs?

Reputational and financial ODIs

We believe that reputational impacts still provide a good incentive for companies and so it is unnecessary for Ofwat to mandate that companies should include only or majority financial incentives for performance commitments where customers do not show support for this. Our own experience is that the Board monitors and concentrates equal effort to the ODIs with the highest reputational impact as well as considering those with financial implications – it is driving the right behaviour and cultural change right across our business.

Again this is an issue where mandated methodology rewards or penalties will potentially reduce the link to a customer-focused plan, should customers not support this approach - particularly where customer preferences do not align with the regulator’s ambitions.

In-period ODIs and linking ODIs to revenue rather than RCV

We do not believe that all ODIs should by default be revenue linked and in-period. The design of each ODI should be based on the characteristics of the performance commitment – eg retail performance commitments lend themselves to in-period revenue based ODIs, whereas it may be more appropriate for longer term asset/investment to be end of period ODIs.

Q3b. Do you agree with our proposals on enhanced rewards and penalties?

Again we raise the issue that the proposal as outlined may not be supported by customers and so clarity is needed for companies and CCGs on how to address in their plans if and when this situation arises. If evidence-based research shows this is supported by customers we would encourage the introduction of enhanced rewards and penalties to drive performance improvements and innovation across the industry; however Ofwat must carefully consider how these incentives should be structured to ensure that companies are encouraged to include these enhanced rates in their business plans proposals. If the likelihood of enhanced penalties is far greater than any potential enhanced rewards a perverse incentive occurs, which is the complete opposite of Ofwat's desire as outlined in its current mechanism - as it would likely have the impact of discouraging companies to put forward ambitious and stretching plans. So while the graph on page 76 of the consultation appears to represent a symmetrical position on rewards and penalties it ignores a fundamental issue – that is the likelihood is not symmetrical i.e. the actual likelihood of failures seems to be greater than rewards and so this needs further consideration when structuring incentives. As an example interruption minutes are prone to single burst main event effects that while controllable are not able to be fully mitigated; therefore the likelihood of achieving an enhanced reward is low, whereas the possibly of an extreme penalty is much more likely. The risk is that the enhanced reward is seen as unobtainable and
thereby loses any incentive properties that may be theoretically achievable – and the industry performance plateaus as a result.

While we understand the rationale for Ofwat proposing that companies share best practice to earn enhanced rewards this should be carefully considered in the design of the reward eg if rewards are based on dynamic relative targets throughout the period, then it would be counter-intuitive for companies to share how they have performed as this is likely to be to their own detriment - unless the incentive to share is stronger than the incentive to outperform its peers.

Q3c. Do you agree with our proposal to remove the RoRE cap?

We have the same issue with the removal of the RoRE cap as we do with enhanced penalties and rewards i.e. the issue of likelihood of rewards and penalties being balanced. The removal of the cap in effect increases the risk with an insufficient offsetting `upside' so that the incentives are diminished or irrelevant on the reward side.

Q4. Do you agree with our proposed Customer Measure of Experience (C-MeX)?

We support the introduction of a customer experience measure that picks up all customers’ views and not only those who have contacted the company. We also support Ofwat’s choice of the preferred option. We are encouraged that this represents a real example where bespoke innovative measures were proposed by South East Water at PR14 and have now been broadly adopted into mainstream performance commitments. This supports our view that less prescription and more room to innovate is likely to move the framework further forward to one that benefits the industry as a whole.

Comparison against other industries

We support the approach that the industry should use and benefit from relevant alternative industry comparisons. We think Ofwat should carefully consider how the C-MeX measure should/could be compared to other industries. It is essential that this is carried out on a fair, level playing ground basis with similar market characteristics. If this cannot be achieved then these different characteristics should be taken into consideration with any performance comparison.

For example comparison of a water company, that provides a full service to all customers where the service cannot be removed, with an energy company that offers limited service options (therefore at a lower cost) with the back-stop position of being able to remove the service is we would argue not necessarily an appropriate comparison to make.

Also when considering the use of UKCSI, we believe Ofwat should make some allowance for affluence controls in the customer sample data set. This would then be factored into any comparison between UKCSI scores and C-MeX scores on a fair basis.

Recording of social media complaints

We believe that only direct interactions with the company by its own customers should be included in any complaints measure. Any sentiment analysis on social media will be influenced by the level of social media presence by each company and many comments on twitter, for example, do not relate to actual customers of that company and would be very challenging to separate and measure. We are concerned that any approach that captures social media complaints will result in companies being reluctant to engage with customers in this conversation and engagement space. This effect has been recognised by commentators within the sector’s existing regime where conversations with customers are seen as risky as they represent an opportunity to create a complaint rather than an opportunity to
really engage. We would suggest that the overall non-contactor element of C-MeX is sufficient to capture any service issues that might be raised or not on social media.

Q4a. Do you agree with our proposed methodology for the C-Mex surveys, as set out in table 4.2 of Appendix 2?

We think the proposal is acceptable but we would prefer a larger sample size per company of 1,500 customers per year on each survey type and spread across the year evenly to prevent or flatten bill timing issues, seasonal impacts or impacts of individual incidents. One factor that has been proven definitively is that affluence affects customer satisfaction scores, with less affluent customers scoring higher satisfaction scores. This has been proven in a range of industries including utilities and our own ongoing customer satisfaction scores have a statistical difference between 4.36 for low income customer compared to 4.27 for households with incomes greater than £50,000. The affluence difference across the country is well understood and has the potential to have a significant difference between companies which is entirely unrelated to actual service performance.

There are a number of approaches to ensure this is adequately considered - the most appropriate being that the samples chosen are done so using set affluence quotas to ensure a comparable level of affluence within the surveyed sample across companies.

In relation to the survey method we advocate using whichever channel reflects the customer’s preference for contact. Currently well over 50% of contacts are made via the telephone, therefore a text or email survey alone may not therefore fully represent all customer segments. We would support a survey much closer to the contact date although recognise this may influence the number of responses where the query is not fully resolved. We are supportive of the 3 questions quoted with recognition that resolution may not necessarily be a measure of satisfaction.

Another important factor is that the percentage of metered contacts has a bearing on the speed of resolution, as many metered queries cannot be resolved at the point of contact – often they relate to a re-read of a meter or a leak investigation. Therefore consideration needs to be given to the level of metered penetration a company has, perhaps by splitting the survey into metered and unmetered contacts.

For non-contact customers, consideration needs to be made for areas of the country where water and sewerage services are provided by different companies. To help ensure the customer is fully aware perhaps an initial opening question should ask the customer who provides their service with subsequent answers based on this response - making the relationship with the two providers very clear.

Q4b. Do you agree with the C-Mex contact survey focusing on customer satisfaction with both contact handling and resolution?

Both of these elements are fundamental to the service received by customers and are integral to satisfaction with the contact. However there is no need to specifically mention resolution if the questions to customers is “how satisfied were you with the interaction with your water company” - resolution then becomes a significant influencing factor on how the customer answers this question and it picks up all elements. Our experience is there is no need with satisfaction questions to be overly prescriptive. Extra prescription results in narrow answers that may not pick up the real issue the customer may have.

We would prefer that any inconsistencies between when companies might consider a contact resolved be removed from the process by ensuring the survey deals with all contacts – whether they are resolved or not.
Q5. Do you agree with our proposed Developer Measure of Experience (D-MeX)?

We agree that developers’ satisfaction is important and we support the Ofwat preferred option. We do have two concerns, however. The first relates to the sample size being small and not significant enough to create meaningful comparisons and the second relates to the influence individual developers may have on the score, and that this influence may in turn not be healthy for ongoing developer-wholesaler relationships. A more regional issue is the need to recognise that in areas where developers are more likely to pick up costs relating to growth i.e. in the south east that their satisfaction may at least in part be related to the need to contribute to that extra cost. We welcome the work that is proposed in this area and we would recommend that the survey design be explicit about service and price separately.

Q5a. Do you agree with our proposed approach to implementing D-MeX, in particular by conducting a satisfaction survey amongst past developer services customer contacts?

This seems the only sensible approach to ensure the survey is being undertaken with developer representatives that have actually experienced the service. Care also needs to be taken with regards to the contact point with the developer to ensure all aspects of service are tested within the question not just the interviewees’ area of responsibility.

2.3 Chapter 5. Securing long-term resilience

Q1. Do you agree with our resilience planning principles?

We support the resilience principles proposed in the consultation document – they are in line with current industry discussions on this subject and in line with our approach to take a long term view; and consider a range of options that deliver best value to try to balance resilience across the company.

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

We support this approach, in particular system based as opposed to asset based resilience. We look forward to inputting and commenting on the September 2017 document on the subject.

2.4 Chapter 6. Targeted controls, markets and innovation: wholesale controls

Q1. Do you agree with our proposals for the form of control for network plus water and network plus wastewater set out in the ‘Wholesale controls’ chapter and appendix 7, ‘Wholesale revenue incentives’?

Overall we have commented on the form of control within the Water 2020 process and we have no further comments to make and believe the proposals are sensible. We do have some comments on aspects of detail which we outline below.

The relationship between the adjustment mechanism for developer services and the proposed revenue forecasting incentive is unclear. As revenue from developers and wholesale revenue are interrelated and there are two incentives in play (one for developers and one for the remaining revenue) the interaction on the incentives will be inevitable and needs to be further clarified.

Wholesale customer revenue lends itself more to an annual true-up away from the influence of developer services. In contrast, revenue from developer services would be better treated as an end of
period adjustment – if any true up mechanism is warranted at all. We would recommend that Ofwat consider setting up developers services as its own revenue control.

Revenue forecasting incentive (RFI)

We observe that the RFI proposals have no real change from the WRFIM from PR14 apart from the averaging impact of developer services. The penalty mechanism associated with this incentive continues to unfairly disadvantage companies with a high level of metering and the weather based variability this adds to revenue as more revenue is attributed to consumption rather than a fixed rateable amount per property. We believe there is an opportunity to correct this issue and to look at a simple adjustment to the acceptable range, depending on the proportion of households each company has metered.

Q2. Do you agree with our proposals for the form of control for water resources as set out in the ‘Wholesale controls’ chapter and appendix 5, ‘Water resources control’?

South East Water has been heavily involved in the development of this area beginning with an early contribution to the market place of ideas and subsequently on a number of working groups. We support the need for a separate price control, the proposed method of RCV allocation and broadly support the boundary of the control. We agree with the building block approach to the control and see no need to move to a unit cost approach at this stage.

We are though, again, disappointed by the balance applied in this area. There is considerable focus on the regulatory mechanisms to deal with market wide and demand utilisation risk which are now highly complex; in our view that has made them disproportionate to the benefits they generate and there is no proposed change to how the market might be incentivised or promoted – the real area customers will benefit from.

We welcome the suggestion that companies put forward risk sharing approaches on future schemes given the alternative options, but see this as an incentive that acts to reduce the ability to share and optimise resources as opposed to promoting it. Overall we fail to see how the mechanisms detailed within the methodology support the objectives of more trading, more innovation and greater collaboration. There also needs to be recognition as to the cause of the demand utilisation differences - for example, if this is because a company’s demand reduction solutions have outperformed expectations then the incentive relationships in this case are likely to be complex and need a lot of thought to understand and ensure the signals across the whole framework are appropriate.

Any consideration of utilisation needs to ensure that it is being done against the appropriate planning driver, for example against a dry year. It certainly should not look at actual utilisation or else the water available to meet customers' demand will ultimately only be available at recent historic demands; clearly this reduces resilience to a level well below the current levels of service/SOSI and is inappropriate.

We are also disappointed there is not a firm suggestion on how efficient water resource costs will be derived for inclusion in the wholesale price cap. This area was subject to much debate within the totex modelling approach used at PR14 and we would welcome the opportunity to be further involved in the approach going forward. The complexity is largely centred around costs that are incurred in this period to solve deficits in the country – in fact potentially a deficit that doesn't exist for 10 years or more - and also the use of average unit costs rates when there is widespread recognition that water resource costs vary significantly across the country due to the differing complexity of each new resource.
Q3. Do you agree with our proposals for access pricing for English water companies set out in the ‘Wholesale controls’ chapter and appendix 5, ‘Water resources control’? We have no new comments in this area as the proposal is aligned with the previous Water 2020 consultation.

Q4. Do you agree with the proposals for company bid assessment frameworks set out in appendix 9, ‘Company bid assessment frameworks: the principles’? We support the principles and approach covered in the bid assessment principles and have no points to make.

Q5. Do you agree with our proposals for the form of control for bioresources as set out in the ‘Wholesale controls’ chapter and appendix 6, ‘Bioresources control’? No comment.

2.5 Chapter 7. Targeted controls, markets and innovation: direct procurement for customers

Q1. Do you agree with our draft guidance that appointees should focus on projects likely to deliver the greatest customer value for DPC at PR19? (We ask that appointees provide a list and description of which projects, based on our guidance, they consider would be in scope at PR19.)

We would support the rationale but would ask that Ofwat reconsider the cost threshold and, in particular, how it might relate to small to medium size water resource schemes with a long asset life such as a reservoir. The £100m whole life totex might well be triggered for a relatively small enhancement scheme driven by the long life of the asset. We feel it appropriate to set both a capex (i.e. initial cost) threshold as well as a whole life cost threshold or else there is a danger that relatively small enhancements schemes with long life opex costs are captured. It is our belief that the efficiency that might arise is likely to be more attributable to the initial phase of the project as opposed to what might be considered its running costs. This is not to say that the running costs will not be a key part of any assessment - the question really is where does the DPC add the greatest value and to ensure it is being considered for the correct schemes? This view is echoed in the supporting KPMG report both in terms of the total value potentially being too low but also the expression of the contract threshold needs to be in capex terms.

Consideration should also be given to the proposals in relation to how the design and quantification of the incumbent’s ODIs should work in the future if for example a third party designs, builds and operates a significant scheme in the incumbent’s region and there are issues with the performance of that scheme.

Q2. What are your views on the type of tender model (ie an early or late tender model) appointees should use? Do you have any views on whether or not we need to specify a tender model companies should use?

We would prefer that multiple tender options are available to companies and they explain why they have chosen the one they have. Types of schemes may well benefit in different ways from the differing model types. One example might be where there is a known need but many feasible options - in this case there will be advantage in an early tender model allowing the market to develop the
options for a company. Where the options are limited or almost predefined by the need, then a later tender model might be more applicable.

We are concerned with the principle that the incumbent will be excluded from the bidding process. We understand the rationale for the exclusion and the potential for an unfair playing field, weakening of the market etc. but the exclusion of a credible delivery mechanism from the process runs the real risk of a sub-optimal outcome. We believe the issues mentioned can be mitigated via a good process and if run properly it will not create the issues, but will allow all relevant parties to enter the bidding process. This is a case where the benefits of a full competitive process should outweigh the process risks. One of the options considered by KPMG is an independent process – this solution would allow the incumbent to enter as a participant and would still retain the properties key to market confidence. Our preference would be to have an independent process that allows incumbents to bid as opposed to an incumbent run process where they are excluded.

Q3. What are your views on the overall commercial and regulatory model, including our draft procurement and contract principles set out in appendix 10, ‘Direct procurement for customers’?

The principles seem sensible subject to the comments made on the procurement model.

2.6 Chapter 8. Targeted controls, markets and innovation: retail controls

Q1. Do you agree with using a weighted average revenue control, where appropriate taking account of different costs by customer type for the residential retail price controls for English and Welsh water companies?

In principle we support this approach. However it is essential that different drivers of retail cost are sufficiently recognised in any assessment eg metered vs unmetered cost to serve. There is real risk - particularly in relation to the recognition that metered customers cost more to serve than unmetered customers - that incentives to not meter will be introduced with the obvious unwelcome impacts on driving efficient water demand management and behaviour change that creates. There is also the risk that if econometric models are used to derive costs, then the models under-estimate the cost of metering due to the extremes in metering penetration currently in play across the industry – it is unclear whether econometric models will adequately simulate required associated costs of metering. We support the proposal that bad debt impacts should be assessed separately; and that consideration should be given to the fact that, while factors such as deprivation do play a part, a significant element relates to the management of processes within companies.

Q2. Do you agree with using an average revenue control for business retail price controls for Welsh companies not subject to competition?

No comment.

Q3. Do you support price controls for business retail activities for English water companies that have not exited the business retail market?

We support this approach, however this should be proportionate in line with any guidance and protection for customers served by retailers who have exited the retail market.

Q4. Do you support price controls for water service customers of Welsh companies using more than 50 megalitres a year?

No comment.
Q5. Do you support a three year price control for residential retail activities and business retail activities?

We understand the reasons that Ofwat has proposed a three year price control. However there are potentially serious issues surrounding the Board approval of financeability given that two years of residential retail revenue/costs allowance will be unknown. While this was feasible at PR14 with the business retail element of the market, the residential retail element is of a much greater magnitude. To have such uncertainty around this level of revenue for two out of the five years of a business plan is not appropriate when company Boards are being asked to approve and assure a five year plan in its entirety.

2.7 Chapter 9. Securing cost efficiency

Q1. Do you agree with our overall approach to cost assessment?

In principle we support the overall approach. However Ofwat need to ensure that the models used are robust and are an accurate reflection of required activity and spend. For the models to have credibility Ofwat and the industry need to have confidence in them and their application.

As noted in your appendix to the consultation “cost models are necessarily imperfect and cannot take into account all relevant factors that affect cost, there may be instances where an adjustment is required to correct these imperfections”. We strongly support this view and consider there is considerable risk in moving from an upper quartile efficiency to a frontier one in this regard. In seeking a frontier level the models would need to be highly accurate, which they are not. We agree with the approach that companies should be challenged to operate efficiently, but given this risk we believe Ofwat should retain an error adjustment or a lesser catch up target to take account of model uncertainty.

A further risk of frontier challenge is the selection of the frontier company – the company selected should be efficient but also delivering a good/resilient service; it should also not benefit from an advantageous operating environment unachievable by other companies, for example, due to regional characteristics such as resource constraints, growth, PCC. It is unclear whether performance measures and cost models are completely aligned and so the concern is that a targeted frontier cost position may not be compatible with a company which is already providing good performance. The initial phases of the cost model development begun to consider this issue but it is unclear from the methodology how this thinking has been progressed and so we would welcome further consideration and clarity for the final methodology.

Cost adjustments to the models

An acknowledgement of model uncertainty is also demonstrated through the use of cost adjustments – both upward and downward. We welcome the continued opportunity to submit cost adjustments; however to calculate the cost adjustment requires knowledge of the cost models used and a process to calculate the implicit allowance provided by the models.

We believe there is an opportunity in the final methodology for Ofwat to clarify their position with regard to cost allocation by formalising the process of submitting cost adjustments through an agreed mechanism. This would allow companies to calculate the implied allowance from the models in a consistent manner across the industry.

This would also enable companies to focus on the correct adjustments – using the suggested criteria of tests and materiality as outlined in appendix 12 - to ensure appropriate funding is provided.
consistent approach to calculating the implied allowance would also help correct symmetrical adjustments.

**Publishing of Ofwat cost models**

We believe it is essential that Ofwat publishes the cost models in advance of companies submitting any cost adjustments. It is nonsensical to ask for adjustments to be made for a range of models that have not been published.

**Level of cost modelling**

The draft methodology suggests a number of models will be utilised both at an aggregate and granular level. In principle we would support independent cost models for the water resource and network+ price controls. We believe this would be advantageous since there are unique explanatory factors that would seem more appropriate to model separately.

An aggregate model is possibly a compromised approach and more difficult to unpick should cost adjustments be required.

Conversely we are, however, aware that the practical issues of developing separate price control cost models due to data consistency will make this a challenge, and therefore the best approach will likely develop following review of recently submitted cost assessment data.

We welcome the approach to mitigate the risk of cost assessment errors across a basket of cost models, but again believe Ofwat should seize the opportunity to improve and innovate upon their approach at PR14 by avoiding an overly simplistic equal weighting of models. Weaker models should not be given equal weighting.

Additionally, given the varied spread of explanatory factors that exist in the industry there is perhaps an opportunity for Ofwat to be innovative and accept that different models work for different companies and so potentially weighting could be bespoke to individual companies –avoiding the trap of aligning to the one size fits all approach, when in reality it doesn’t. This is particularly the case for potential water resource cost models – for instance companies operating in the south-east of England may suit different cost models to companies operating in less water stressed areas of the country.

**Consideration of water deficit**

It is essential that any cost models should consider, at an aggregate or granular level, water deficit. This should also allow for the fact that companies in water stressed areas will be higher up the cost solution curve than companies in less water stressed areas. Acknowledgement of deficit issues is equally important when forecasting forward i.e. deficit issues in the future will require more funding.

Currently it is also unclear how Ofwat cost models will acknowledge that subsequent solutions to resolving deficit are more expensive in existing water stressed areas, or conversely cheaper in less water stressed areas. We note that Ofwat's Water 2020 documents acknowledge the overall trend of more expensive solutions existing in some regions of the country, and we are therefore concerned that cost models are not currently able to capture this issue.

It is regarding this explanatory factor that bespoke models, as discussed previously, may provide an appropriate solution to dealing with this issue.
Q2. Do you agree with our proposed cost sharing incentive? We welcome thoughts on the calibration of the incentive.

We support the removal of the menu approach used at PR14. The impact of the cost sharing mechanism will largely depend on the final sharing rates proposed by Ofwat.

We note that the current rates proposed provide a stronger incentive to present lower costs in the plan.

Q3. Do you agree with our proposals to funding unconfirmed environmental requirements? Which of the two options do you consider is more appropriate, and why?

As outlined in the methodology we agree that option 1 carries the risk that companies will not be motivated to complete associated investment in the next period, and therefore appropriate environmental enhancement will not be completed (or not given appropriate priority). We agree this potentially defeats the overall objective of delivering required improvements. As such we favour option 2; however the approach to calculating the unit cost and related outcomes need to be developed to ensure unconfirmed requirements are sufficiently funded.

Q4. Do you agree with our approach to cost adjustment and our proposed approach to make the process more symmetric?

We support the proposal to introduce symmetrical adjustments as this creates a more level playing field and would result in different assessments being more genuinely attributable to differences in efficiency. We also support the notion this would potentially reduce ‘gaming’ of the adjustments so as to again level the playing field.

Q5. Do you agree with our proposed approach for assessing retail (residential and business) costs at PR19?

We broadly agree with the proposed approach. However we believe Ofwat should carefully consider the creation of econometric models to ensure a robust outcome is developed – this extends to ensuring data used is considered on a level playing field. For example, we are responsible for the debt of every customer - we understand other companies have arrangements where bills are facilitated by local authorities, and therefore they are also responsible for any debt. It is these types of unique arrangements that need to be fully explored to ensure the model is performing as expected.

We would also note that the industry is currently at different states of metering penetration, with the impact affecting all areas of retail activity. We would need confidence that this impact is correctly being applied for companies at all levels of meter penetration.

In summary econometric models can be a complex solution and we respect their input to the process; but, like the wholesale models, it requires a robust, understood, transparent, and consistent dataset from the industry to work effectively. By contrast the current Cost To Serve model is arguably crude but does have some merit - it provides a simple mechanism to challenge companies to be more efficient. As such we welcome its continued use as a measure of efficiency test, albeit moving away from average to efficient cost to serve seems logical.
Q6. Do you agree with our preferred approach not to index the retail controls to a measure of general inflation, and, if appropriate, deal with input price pressure as part of our totex allowance?
We believe companies should be given the opportunity to demonstrate inflation pressures are present. It is unclear to us why inflation costs should be handled within totex although we have no objection to this approach provided the hurdle for inclusion is reasonable and consistent.

Q7. Do you agree with our proposals for the transition programme?
No issues identified.

2.8 Chapter 10. Aligning risk and return

Q1. Do you agree with our proposed approach to setting the cost of equity, based on the best estimate of expected returns in the 2020-25 period?

First we consider Ofwat’s proposal to focus on short-term evidence in setting the Total Market Return (TMR). We then consider the implications of Ofwat’s proposals on the overall cost of equity and particularly the beta.

**Total market return**

SEW is concerned with the proposed approach to setting the cost of equity based on short-term market evidence. In particular, we consider that the proposed significant decrease in the Total Market Return (TMR) has not been supported by robust underlying analysis and evidence presented by PwC is far from conclusive.

We consider a shift to a short-term based approach would introduce significant regulatory risk in the form of:

- a major departure from the regulatory precedent;
- significantly higher level of uncertainty in the estimation of the cost of capital;
- introducing greater exposure to cyclical financial market risk; and
- potential for increased investors’ perception that future regulatory decisions may be opportunistic and inconsistent.

An increase in risk as a result of these factors would be accompanied by an increase in the betas for regulated water companies. In the long-term, this would lead to higher prices to customers, compared to maintaining the prevailing regulatory methodology for the cost of capital.

Furthermore, SEW would like to stress the long-term nature of the regulated water utility, both in terms of long asset lives and customers’ preferences for consistent service quality and bill stability. Linked to this, the investment in the sector is supported by long-term debt financing and a preponderance of fixed rate debt financing. An approach that shifts towards a short-term and cyclical view of the cost of...
equity does not make sense in the context of long-term debt financing and the importance of bill stability.

We expand on these points below in more detail.

Evidence on ‘lower for longer’ scenario is questionable

We consider that the evidence presented by PwC on ‘ultra-low interest rate’ is far from conclusive. We find that the same evidence presented by Ofwat and PwC for a significantly lower TMR could be equally interpreted to support a much higher TMR, and that the most recent development in the capital market is already showing signs against the conclusions made in the PwC report on low future equity returns.

The starting point for the consideration of a move to a shorter-term cost of equity approach is the view that interest rates and government bond yields will remain at historically low levels for the foreseeable future (this is the ‘lower for longer’ scenario).

PwC’s evidence on the ‘lower for longer’ scenario is primarily based on the OBR’s forecast on Bank of England base rate, the current Gilt yield and the slope of the yield curve. However, these are all short-term market indicators which can change significantly in a short period of time.

For example, the OBR forecast of the base rate was conducted in November 2016, after the Bank of England cut the base rate from 0.5% to 0.25% amid market uncertainty created by, among other things, Brexit. However, since then the UK economy has taken a turn with inflation rising to levels unseen since 2013. There have already been serious discussions within the Bank of England to raise the interest rate\(^4\). The most up-to-date OBR forecast later this year may well predict a higher base rate trajectory than the one published in 2016.

The overall issue with these forecasts and market rates is that they are prone to material revisions within a short space of time. Concluding that 2021-2025 will be a period of ‘lower for longer’ interest rate based only on the above three pieces of evidence would be speculative.

PwC’s report presents a list of six potential reasons for ‘ultra-low’ interest rates, e.g. quantitative easing, expectations of future growth, an aging population, and so on. However, the report fails to substantiate any of the above as a real reason for ultra-low interest rates. In fact PwC casts doubt on the majority of the reasons above to be categorically attributable to a lower long-term interest rate.

The PwC report also quotes studies done in recent years which support a lower equity market return for the future, such as the Credit Suisse Global Investment Returns Yearbook 2016. However, the prediction on the low equity return is no longer featured in the same authors’ latest release Yearbook 2017. Instead, the authors’ state:

> “Twelve months ago, investors were scouring history for a guide as to how to invest in times of deflation as interest rates on long-dated government bonds fell toward, and in some countries, below zero. Now, the political backdrop has altered dramatically, and so has the investment discussion.” [Emphasis added]

> “Fears of the limits of monetary policy have become hopes for the opportunity afforded by fiscal policy; fears of deflation have been replaced by discussion of resurgent

\(^4\) 3 out of 8 policymakers voted for an immediate rate rise to 0.5% during the latest rate setting meeting in June 2017
inflation; and perhaps most important of all, the debate is now not can bond yields spiral ever lower, but rather might this be the beginning of the end for the most extraordinary bull run of the last 30 years, and mark a reversal of the persistent underperformance of equities versus bonds we have seen this millennium?" [Emphasis added]

“There is precedent for moves from disinflation to mild inflation providing a favourable environment for equities that would justify a long overdue asset allocation switch in favour of equities versus bonds.” [Emphasis added]

SEW does not wish to agree with, or dispute, the above statements, or the statements from the Yearbook 2016 quoted in PwC’s report; but a crucial observation that we can make is that we operate in a highly volatile economic and political environment, where the interplay between economic and political forces is complex, unpredictable, and ultimately uncertain.

The fact that Ofwat has decided to introduce an indexation mechanism for the cost of debt is recognition of the uncertainty surrounding future financial market conditions. The data uncertainties alone prevents any indexation method for the cost of equity but it highlights the difficulty for Ofwat in relying on current short-term data to project forward financial market conditions to the period 2020 to 2025.

Switching to a short-term approach introduces regulatory risks

We consider that switching from a long-term approach to a short-term approach during the current economic environment introduces a significant level of unnecessary regulatory risks. The regulatory risk would translate to higher cost of capital in the long run, to the detriment of customers. The additional risks are attributable to the following three factors:

- Major departure from regulatory precedent;
- Higher uncertainty both in the accuracy of the estimation result and the stability of the estimate over time using a short-term method; and
- Perceived risk of inconsistent or opportunistic regulatory behaviour.

We expand on these in more detail below.

Departure from regulatory precedent

Since PR14, there have been a number of key regulatory determinations that can be considered as precedent in the context of setting the allowed return for UK water companies. Figure 1 below summarises these.

**Figure 1  Relevant regulatory precedent**

<table>
<thead>
<tr>
<th></th>
<th>Ofwat PR14</th>
<th>CMA Bristol Water 2015</th>
<th>UR GD17 PNGL</th>
<th>UR GD17 firmus</th>
<th>UR RP6 NIE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Free Rate</td>
<td>1.25%</td>
<td>1.25%</td>
<td>1.25%</td>
<td>1.25%</td>
<td>1.25%</td>
</tr>
<tr>
<td>Equity Risk Premium</td>
<td>5.50%</td>
<td>5.25%</td>
<td>5.25%</td>
<td>5.25%</td>
<td>5.25%</td>
</tr>
<tr>
<td>Total market return</td>
<td>6.75%</td>
<td>6.5%</td>
<td>6.5%</td>
<td>6.5%</td>
<td>6.5%</td>
</tr>
</tbody>
</table>

*Source: Regulatory publications*

Decisions by Ofgem for energy networks (ED1, GD1, T1) have been in line with these and in all of these determinations the primary source of evidence for the TMR has been analysis of long-term
realised equity returns. This methodology builds on the research paper produced for the UK regulators by Stephen Wright, Robin Mason and David Miles in 2003. This paper concluded that the preferred method for estimating the cost of equity for regulated utilities was to use long-term averages for the realised TMR.

In addition to financial theory, recent empirical evidence supports the view that there is a trend for movements in the ERP and RFR to show a negative relationship, particularly during major economic changes. For example, the graph reproduced below, based on Bloomberg data, shows that post the Brexit vote there was a decline in the real risk-free rate offset by an increase in ERP.

![Graph showing ERP and RFR after Brexit](image_url)

*Source: Bloomberg*

PwC recommends using the dividend discount model (DDM) to estimate the TMR. This represents a significant departure from UK regulatory precedent, as no recent regulatory determination in the UK has based the estimation of equity return on DDM analysis alone. PwC’s observation on the CMA’s 2014 determination for NIE using the DDM analysis is misconceived. In fact, The CMA has said explicitly that it did not rely on the DDM analysis for its estimate but used it as a cross check.

“We use historical approaches (both ex ante and ex post) as our primary sources for estimating the equity market return, with forward-looking approaches being used only as a cross-check on our resulting ERP estimates.”

The CMA explained why it did not rely on the forward-looking DDM approach:

“A limitation of this approach is that it is necessary to make an assumption about future long-term growth of dividends (which has a major effect on the calculation since dividends beyond year 4 or 5 account for a large part of present value at plausible discount rates). We think such approaches, since they are based on current market data and short-run forecasts, are likely to be more suitable for estimating the short-run ERP and less so for estimating the long-run equilibrium ERP. Since we are concerned with the latter, we place less weight on results derived from this approach.”

---

6 Competition Commission, Northern Ireland Electricity Limited Final Determination, March 2014, p.13.26
7 Competition Commission, Northern Ireland Electricity Limited Final Determination, March 2014, p.13.30
We note that even though the CMA’s price control for NIE ran from 2014 to 2017, the CMA still considered the DDM method to be too focused on the short-run to be relied upon for that determination. We agree with the CMA’s view and see the DDM method only as a cross-check, as DDM-implied equity returns are known to be highly volatile on a daily basis and can be considered unstable even when averaged across a number of years. It is important to note that the CMA’s decisions for both NIE in 2014 and Bristol Water 2015 considered the evidence on current and forward looking evidence on the TMR and concluded that little weight could be attached to them. The proposed approach represents a significant departure from this regulatory precedent.

High level of uncertainty and instability in the estimates

As discussed above, a forward-looking DDM-based method to estimate allowed equity return is inherently uncertain, more so than a long-term historic average approach. The uncertainty manifests itself on two levels:

- It is more prone to technical error caused by forecasting methodologies (particularly assumptions on future dividend growth rates); and
- Even if measured accurately, it is more prone to movement from one period to the next.

The first point means that the regulator is more likely to wrongly estimate the actual cost of equity. The second point means that a regime based on such method may in and of itself increase the cost of equity in the form of a higher company beta due to potential cyclical pattern created by allowed return correlating to the market return.

To see these two points, we reproduce Figure 25 in the PwC report showing monthly DDM output for the period of 2000-2016.

PwC focuses on the fact that the average of the past five years is lower than the previous five years. While that may be true, it does not imply that the rate would stay low for the next five years, judging by the volatility over the past 15 years in this chart.

As explained by the CMA, the DDM method involves a subjective assumption on the dividend growth both on the shorter term and the longer term. It is a common practice to use analyst forecast of dividend growth for the former and a representative long-term GDP growth rate for the latter (mainly due to the lack of direct dividend forecast data for the long term). The PwC’s assumption on dividend
growth is the forecast GDP growth rate for the UK, both for the short term and the long term, which is at odds with common practice:

- First, it ignores the dividend growth forecast that is available in the market, which should be more accurate than the GDP growth assumption.
- Second, the shares traded in the UK market come from a lot of global companies whose performance in dividend growth would be arguably better represented by a measure of global GDP growth rather than the UK one. It is estimated that 75% of the earnings of the FTSE-100 companies is generated overseas. According to a World Bank dataset the average GDP growth rate for the world economy has exceeded the GDP growth rate of the UK economy by 0.94% over the past 50 years. Using world GDP growth rates would make a material difference to the results.

To illustrate the sensitivity and uncertainty around the PwC DDM analysis, we have compared it with the equity market return estimated by Bloomberg, also using the DDM method, shown below.

We have two main observations:

- The level of estimated TMR is materially higher than those estimated by PwC, for example the five-year average of the 2012-2016 is 11.2%, compared with 8.8% from PwC – a difference of 2.5%.
- There is a marked increase in equity return to over 16% since May 2017.

\[ \text{Source: World Bank, accessed 14 August 2017} \]
Without arguing which method is more appropriate, the above evidence supports the argument made by the CMA against the use of DDM regarding the subjective nature of the assumptions that needs to be made on dividend growth in future and its significant impact on the estimation results.

Moreover, the recent increase since May 2017 could be interpreted as a temporary hike as seen in 2005, a long lasting rebound as seen in 2010, or indeed anything in-between.

Another example can be taken from the August 2017 Bank of England Inflation Report. The Figure below is reproduced from the report. It shows that the equity risk premium (estimated using a DDM) has increased by 1% for the UK since 2014. The same report shows that government yields are at the same level as in 2014, implying that the TMR has increased since 2014.

This reinforces the sensitivity of estimates to different methods of applying the DDM and therefore the point that there is no good way of predicting the TMR in the next five years, least of which is the average of the past five years’ estimates using a DDM method. The PwC method for applying DDM gives very different results to the methods applied by Bloomberg or the Bank of England. PwC also derives TMR from MAR data, but has not explained how it adjusts for non-regulated activities and outperformance. The non-regulated and outperformance assumptions are often difficult to estimate and therefore do not allow the calculation of implied TMR with reasonable certainty. We note that MAR analysis is also not supported by financial theory.

Future regulatory behaviour

Furthermore, there is an additional implication regarding investors’ perception of the regulatory regime. If regulators switch to a shorter term methodology when the current market return is lower than long-term average, this could generate a perception that the regulator could switch back to the
long-term approach when market condition reverses. There would be sufficient historic evidence to support such perception, shown in the chart below.

![Averages of Historical UK Real Equity Returns 1961-2016](chart.png)

This chart replicates Figure 24 from the PwC report. PwC argued based on this chart that equity returns in recent years (represented by 10-year and 20-year moving averages) are now lower than the whole-period average – and therefore setting an allowed equity return based on the whole-period average no longer represents the best estimate for a future five-year price control period. So, for example, the 10-year moving average for 2016, shown by the red line in the chart, is just below 5%.

However, this chart also clearly shows that, since PR94, the allowed TMR has always been set at or close to the whole-period average, regardless of the levels indicated by the other averages such as 10-year, 20-year or 30-year average. For example:

- both for PR94 and PR99, despite the fact that the 10-year, 20-year and 30-year averages (10%-15%) were all well above the whole-period average (7%), Ofwat’s allowed equity market return was set at the whole-period average;
- similarly, at PR04 the 20-year and 30-year averages were above the whole-period average, but Ofwat set the allowed equity market return near the whole-period return; and
- a similar story applies to PR09 and PR14 as well, although the 20-year average happened to be also in line with the whole-period average.

---

9 The underlying annual equity return data is taken from Credit Suisse Global Return Source Book 2017, as opposed to the Barclays equity gilt study. But any discrepancy does not influence the essence of this argument.
Switching the allowed market return away from the whole-period average towards the 10-year and 20-year averages at PR19, when these averages tip under the whole-period average, could lead to considerably negative investor perceptions. One plausible interpretation would be that whenever the short term market is lower than the long-term average, the regulator allows the shorter-term market rate; and whenever the short-term market is higher than the long-term average, the regulator allows the long-term average.

This perception of time inconsistency is precisely the sort of regulatory risk that Ofwat and other UK regulators have managed to minimise to date through their decisions. We understand that it is not Ofwat’s intention to introduce a method that would be applied inconsistently in the future. However, it is important to note that the detriment arises simply if investors consider that future regulatory decisions might be made on an inconsistent basis and it is difficult, if not impossible for current Ofwat policy to constrain future Ofwat decisions.

**Long-term nature of the business**

The long-term nature of the assets in the water sector, coupled with efficient long-term financing requirement, often means that the required return on equity should follow a similarly long-term pattern. Being shielded from short term market movement is considered one of the main appeals of regulated utility assets.

The long-lasting nature of the product and services provided by the regulated utility also requires a long-term perspective, as customers’ value bill stability and the continuation of good quality service.

By switching to a short-term methodology on one of the major building blocks of the allowed revenue, the regulator subjects customers and investors to economic cycles on a product/service that otherwise would not naturally need to. The benefit of the short-term gain would not outweigh the long-term cost of this approach.

**Conclusion on approach to allowed TMR**

In conclusion, SEW considers that Ofwat may be taking on unwarranted risk of underestimating the required equity market return for the period of 2021-2025 by relying on market evidence based on forward looking DDM from the past five years. One of the main lessons learned from recent history in equity market returns is that the conditions in the past five years can often be the worst predictor for the next five years.

We are concerned that Ofwat’s pursuit of the gain in the short term reduction in bills could be more than offset by longer term costs incurred to the industry in the form of higher cost of capital and lower investor confidence, due to higher perceived regulatory risks. This would ultimately lead to higher prices for customers.

**Setting water industry Beta**

The assessment of the cost of equity set out in the methodology consultation focussed on the TMR and did not consider the Beta value. At this stage we would make three observations about the Beta values:

- first, the evidence that asset Beta values have risen since PR14; and
- second, adopting the Ofwat PR19 draft methodology in the Final Determination may increase beta risk compared to PR14 in a number of areas; and
- third, the case to differentiate the Beta values between the different wholesale controls.
Industry level Beta values

At PR14 Ofwat used an asset Beta figure of 0.3. This was based on observed Betas for Pennon, Severn Trent and United Utilities over the past five years (monthly estimates) and two years (daily estimates). This was augmented with evidence from other utilities (National Grid and SSE).

Although the methodology consultation did not consider the values for Beta, the PwC report did include an analysis of recent Beta trends. These show that Betas have increased from the levels in 2012 and 2013. PwC state that¹⁰:

“Following the approach of the CMA but updated for recent data we find that the average asset beta of the listed WaSCs is now above 0.3, but on a five year average basis is approximately 0.25. For Blume adjusted asset beta estimates, the current spot figures are closer to 0.4 but between 0.29 and 0.36 on a five-year average basis.” [page 94]

“Although we find that asset betas have increased since PR14, it may be too soon into AMP6 to propose an adjustment to the 0.3 assumed industry asset beta." [page 95]

We consider that Ofwat should take account of the latest available evidence in setting the Beta values for PR19. Although we consider that Ofwat should, in general, retain a similar methodology to PR14, we note that the Beta estimates based on a daily data are generally more robust than those based on monthly observations.

Changes in Relative Risk for PR19

The changes in regulatory methodology, if implemented for PR19, are very likely to increase the investors’ risk perception, which would imply an increase in the cost of equity, most likely through beta. These risks include:

- the introduction of significant regulatory uncertainty with the adoption of a short term approach and DDM-based method to estimate the TMR (see above);
- the introduction of more competition in water resources and bioresources and the potential for stranding risk on new investment;
- the switch from RPI to CPI indexation;
- the move towards more challenging targets for efficiency and service performance;
- the increased cyclicality of returns driven by the cost of debt indexation.

Some of these changes have been discussed over the past 12 – 18 months. However the full impact of the changes will not yet be reflected in the observed Beta evidence, particularly the five year estimates.

Variations by price control

In the methodology consultation Ofwat states that it expects that companies will have the same cost of capital across the four wholesale price controls at PR19. In other words, the Beta value would not vary across the four controls.

¹⁰ PwC, Refining the balance of incentives for PR19, 2017
We do not consider that this is an appropriate methodology. The four controls (bioresources, wastewater network-plus, water network-plus and water resources) have different underlying risk characteristics and different forms of regulation proposed for PR19 and beyond. We accept that the factors that Ofwat identify in their consultation, for example, the exact form of regulation for bioresources and water resources, will have an impact on the Beta values for these controls. However, there has been no evidence presented and nor is there any reason to believe, that these factors will equalise the Beta values across the four controls.

In addition, companies will develop proposals for RCV allocation and for the extent of risk and ambition in each price control. We do not consider it appropriate to fix the costs of capital as being equal ahead of these proposals.

PwC published a report for Ofwat in 2015\(^\text{11}\) characterising the balance of risk across the water and sewerage value chain. They created a risk landscape for each business segment based on a:

- Granular risk (bottom-up) approach
- Out-turn risk (top-down) approach
- Capital intensity

They considered differences in the cost of capital through the asset beta (systematic risk) and the level of financial gearing (non-systematic risk), based on the different characteristics of each segment. Their main findings were:

- sludge (i.e. bioresources) activities are ranked as having highest value at risk compared to the other activities in the value chain: low capital intensity drives this, given just middle ranking for cost variability;
- sewerage collection has low cost risk and high capital intensity rendering it the segment with the lowest value at risk;
- water resources has higher cost risk compared to the rest of the sector, but its capital intensity is close to the average, bringing its value at risk ranking towards the middle;
- water network plus activities are ranked as having higher value at risk than wastewater network plus activities, and
- treatment activities show both higher cost risk and lower capital intensity than network activities.

\(^\text{11}\) PwC, Balance of risk: Risk and reward across the water and sewerage value chain, December 2015
Overall, and given the small size of the bioresources segment, the analysis showed that Beta and cost of capital is higher for water controls than wastewater controls. We accept that this analysis does not reflect the exact proposals for water resources and bioresources controls. However, the analysis of the relative risk of wastewater network-plus and water network-plus remains valid and we are not aware of any further, more detailed analysis, being undertaken.

We consider that Ofwat should reflect the differential risk between wastewater and water networks, reflecting this PwC analysis. To the extent that there is a difference in capital intensity between water and wastewater networks this is also consistent with the CMA decision on Bristol Water in 2015 and 2010. The uplift that the CMA applied to the asset Beta for Bristol Water was not linked to the size of the company (and therefore was not a small company premium) but reflected differences in characteristics, principally between a water company and a wastewater company.

Q2. Do you agree with our approach to indexing the cost of new debt?

SEW broadly agrees with Ofwat’s proposed approach on the indexation of the cost of new debt. However, we do not believe this is appropriate to allow for an ex ante downward adjustment to the index.

We acknowledge that no index is a perfect proxy of the cost of debt of any single company, but this is not what an index is aiming to achieve. If it was perfect, there would be no scope for outperformance or underperformance and this would be a cost pass through.

This is also true for other regulated regimes in the UK that have adopted a similar index. And we note that there is no precedent in other regimes for such adjustment.

An index presents a number of advantages and disadvantages when compared to any single company’s actual cost of new debt, given there are differences in timing, frequency and size of issuance, in tenors, in credit risk and in rating. Applying a downward adjustment presumes that these factors will be all favourable and to all companies and will be persistent. Any observed difference between water company bond yields and the index may well reflect the factors outlined above (tenor, timing of issuance etc) and may not continue at that level in the future.
The purpose of an indexation approach should be to enable the windfalls from interest rate market movements to be transferred to customers, but should retain the ability to incentivise companies to finance themselves efficiently. The loss or substantial reduction in this incentive property would result in a cost of customers and the system in the long term, as it amounts to cost pass through.

In addition, a WOC like SEW faces more risk than a WaSC that its new debt issuance will not match the index. At any point in time SEW may only have around four significant bonds issues with a gap between issuance of maybe five to seven years. This means that SEW’s actual debt costs are much less likely to match the index compared to a larger WaSC that may issue bonds every year or two.  

It is also likely that SEW will not have any major debt issuance during the period 2020 to 2025 and as such will likely be penalised assuming the cost of new debt remains lower than the cost of embedded debt. Furthermore, the less frequent and smaller debt issuance of a WOC compared to a WaSC results in higher issuance and carry costs relative to the scale of financing. While SEW does not suggest to adopt a company specific approach, we suggest that both of these factors should be considered in Ofwat’s methodology.

Furthermore, we do not think it is fair that the company bears the inflation risk and suggest that instead of using an ex-ante inflation adjustment to derive the real cost of new debt, Ofwat adjusts the nominal cost of new debt with the outturn inflation, specifically the inflation used to index the RPI-linked RCV and CPI-linked RCV over the AMP7.

We would also like to stress that the treatment of the cost of embedded debt solely on a notional level does not fairly deal with companies who have higher than average embedded debt cost, where the higher cost has arisen due to the timing of issuance (i.e. the cost of debt was efficiently incurred given the market conditions prevailing at the time).

We would like to draw attention to the CMA’s precedent on Bristol Water and NIE where the actual embedded debt cost was taken into account in the estimation of the allowed cost of debt

In the Final Determination for Bristol Water in 2010, the CMA stated:\footnote{12}{Competition Commission, Bristol Water plc, Determination on a reference under section 12(3)(a) of the Water Industry Act 1991, 2010. Appendix N, page N10}:

“There are two approaches to the cost of existing fixed-rate debt:

(a) Ofwat sets a single rate for all companies of a particular size. This has the advantage of giving companies a strong incentive to reduce the cost of their debt. However, one of the main factors affecting the cost of fixed-rate debt is the time it was taken out, and interest rates fluctuate over time. As debt issuance may be affected by company-specific factors (for instance, the timing of capex) and the cost of fixed-rate debt is affected by unpredictable changes in interest rates, there may be a danger of this approach penalizing companies that need to borrow at times of high interest rates. It might prove unsustainable if such companies are unable to finance their functions, or in order to avoid this, it might require headroom over and above the actual average to the detriment of consumers." [emphasis added]

The CMA determined the cost of embedded debt for Bristol Water using its actual debt cost, but found that this was in line with the allowance set by Ofwat using the industry average. The rationale
underpinning the CMA’s decision in that case is still relevant today and has not been affected by any changes in Ofwat’s price control methodology since 2010.

At the Final Determination for NIE in 2014, the CMA used NIE’s actual debt cost to estimate the allowed cost of embedded debt, stating\(^{13}\):

“...we followed the established regulatory approach of estimating the cost of embedded debt based on NIE’s actual debt, with appropriate consideration of whether it had been incurred prudently and efficiently through examination of the yield on NIE’s bond and comparable bonds issued by GB electricity distribution companies.”

We consider that Ofwat’s methodology should not penalise companies that incurred fixed rate debt costs during periods of higher debt costs, provided that debt was incurred prudently and efficiently. As a smaller company SEW will issue debt less frequently than a WaSC and it is more likely that its actual embedded debt costs will deviate from a notional allowance. We consider that Ofwat should make an adjustment for this.

Q3. Do you agree with our proposal to index price controls to CPIH (subject to its redesignation as a national statistic before we publish our final methodology)?

We have no new comments in this area.

Q4. Do you agree with our approach to setting tax allowances at PR19, including the proposed true up mechanism?

We agree with the approach to setting tax allowances at PR19 and the proposed true up mechanism - with the exception to the proposal to use the higher opening pool values as opposed to the notional pool value as used in previous price reviews.

We wish to highlight an inconsistency within section 6.3 that if unchanged, will result in a considerable under funding for companies in respect of taxation. The issue concerns the current and historical disclaiming of capital allowances and how this impacts the opening capital pool balances disclosed in table APP29 – Wholesale tax.

The methodology states: *In our calculation of tax allowances, we will assume that companies make full use of all the capital allowances available to them. Therefore, where companies have chosen to disclaim capital allowances resulting in a higher opening capital allowances pool balances, we will use the higher opening pool balances in our calculation of tax allowances. We will also assume that full use is made of all capital allowances available as a result of any capital expenditure in each year.*

While we accept that like previous price reviews it is reasonable that we make full use of all capital allowances available to us, it should then follow that this principle also be used when calculating the opening pool balances. For this principle to be consistent then the opening pool values for table APP29 should also assume that we make full capital allowance claims, rather than on a pool value after capital allowances have been disclaimed. This notional pool balance would be consistent with the approach suggested in the Deloitte report.

\(^{13}\) Competition Commission, Northern Ireland Electricity Limited Final Determination, 2014, p.13.58
By using the higher opening pool balances, which include allowances that were previously disclaimed in the calculation of tax allowances, it creates a situation whereby customers are benefiting twice from the disclaimed capital allowances and companies are underfunded to that degree. The allowances are used once when they are assumed to be fully utilised in the previous price control period and again when they are included in the opening balances and utilised again in the new price control period.

In order to correct this inconsistency the opening pool balance disclosed should be a notional pool balance that reflects the full use of capital allowances and ignores any deferral and therefore mirrors the standard allowance calculation and is consistent with the “stand alone” basis proposed. We believe that this is also consistent with the preferred method set out in the Deloitte report on tax accompanying the consultation.

Q4a. Should the true up mechanism be limited to change in corporate tax rates and capital tax allowances or should we extend that true-up mechanism so we can also make adjustments for other changes in tax legislation or accounting regulations which have a material impact on the amount of tax companies are liable to pay?

It would seem sensible that if a true mechanism is to be implemented taking account of changes in corporate tax rates and capital tax allowances then other material changes in tax legislation and accounting regulations should be incorporated into this review in a proportionate way. This would eliminate the change risk to both customers and the company.

Q5. Do you agree with the set of scenarios for RoRE analysis we have prescribed, the guidance we propose and to use our financial model to provide the suite of prescribed scenarios?

We are pleased that Ofwat has simplified the scenarios for RoRE analysis from those of PR14 – which we believe were unnecessarily complex.

2.9  Chapter 11. Aligning risk and return: financeability

Q1. Do you agree with our overall approach to assessing financeability?

SEW wants to stress the importance of a properly carried out financeability assessment as an integral part of a regulatory price control. The approach to assessing financeability that has been adopted by UK network regulators over the past 20 years has played an important role in establishing the credibility of the regulatory regime to investors. Specifically, the application of a test of credit metrics that acted as a material cross-check on the cost of capital assessment provided reassurance to debt investors. To preserve the attractiveness of the sector to debt investors and to continue benefit from competitive financing rates it is important that the role of a meaningful financeability assessment is preserved.

We broadly agree with Ofwat’s overall approach to assessing financeability for the notional company, and allowing companies to use the speed of money (i.e. the PAYG rate and RCV run-off rate) to address short term financeability issues created by new elements of the PR19 price control such as the switch of price index from RPI to CPIH.

One important exception is for Moody’s Adjusted Interest Cover Ratio calculation which reverses out the speed of money adjustments by increasing regulatory capital charges by a corresponding amount. (Moody’s 17 December 2014). This is applied by Moody’s across the industry and should therefore be
taken into account when using speed of money adjustments in assessing financeability for the notional and actual company.

We emphasise on the importance of a financeability test that is conducted on a notional company being strictly in line with the rest of the price control package, particularly regarding the allowed returns. Parameters such as the assumed gearing level, the assumed ratio of new and existing debt, and the assumed level of index-linked debt (and the type index) all need to be consistent with the assumptions used in estimating the WACC. Failing to do so would undermine the credibility of the financeability assessment as a meaningful and robust test.

Moody’s and S&P have both published reports following the publication of Ofwat’s PR19 draft methodology signalling the financeability risks that Ofwat’s proposals pose for water companies. They state:

“companies could see a material weakening in their cash flow based metrics”

“increased downside risk for all but exceptional performers: [...] (1) more stringent efficiency assumptions with a forecast frontier shift and a requirement for companies to be efficient from the start of the period rather than allowing a gradual improvement [...]; (2) higher-powered performance incentives, which could put a larger proportion of revenues at risk; and (3) additional cost-sharing requirements, with different pain/gain sharing rates for outperforming and underperforming companies”

“a lower allowed return will reduce companies’ financial flexibility, and coupled with measures that increase the potential for cash flow volatility, will be credit negative for the sector as a whole”

(Moody’s, 17 July 2017)

“less predictable and harder-to-forecast income decreasing the high stability of cash flows for regulated water utilities”

“proposal for lower returns will erode the rating headroom”

“[S&P’s] credit perspective on the sector could become less supportive if we perceive a shift in the balance between affordable tariffs and the stability of cash flow”

“this [...] could lead us to take a more negative view of the regulatory framework, in particular if we were to see the incentive penalties and rewards as unlimited and asymmetrical”

(S&P, 17 July 2017)

At the same time we note that Ofwat’s proposed approach to the notional cost of debt would result in an allowance for embedded debt that is below the efficiently incurred embedded debt costs that SEW faces (and would also face under a notional capital structure). Therefore the way that Ofwat proposes to apply the notional approach will make the credit metrics for SEW appear better than they reasonably would be (under a notional gearing assumption) if no adjustment as recommended is made.

Furthermore, we do not agree that it would be appropriate for Ofwat to intervene if companies use the PAYG and RCV run-off levers to address short-term financeability issues posed by actual financial structure. We agree with Ofwat’s principle that actual gearing level is a matter for the companies and customers should not bear the cost of a more highly geared structure. However, this principle is already achieved through Ofwat’s use of a cost of capital based on notional rather than actual gearing.
Using NPV-neutral levers to mitigate short-term financeability issues does not add costs to customers, but instead re-profiles the bill from future to present.

Moreover, we consider that there are material benefits to customers from a higher actual gearing level, for example:

- Higher actual gearing has led to lower tax costs in the past and has directly benefited customers, and will continue in future.
- There are other well-known benefits of high gearing structure such as management incentives, strict covenants on risk management, and so on.

If companies are not able to consider NPV-neutral options for addressing financeability issues then the only option that companies will be left is new equity injection. This could have a material impact on the cost and risk of raising finance, as new equity often comes with material costs (including equity issuance costs) and the costs can vary significantly depending on prevailing market conditions.

SEW considers that Ofwat should be open to companies proposing NPV-neutral levers such as the PAYG and RCV run-off rates to solve financeability issues for the actual capital structure as long as companies can demonstrate that it is in customers’ interest to do so. Companies could reasonably do this by for example:

- Showing the cost and benefit of a higher than notional gearing level, in terms of the cost of capital and cost of tax; and
- Showing that the use of levers on the speed of money results in a bill levels that are consistent with affordability criteria, both for present and future customers.

To apply a blanket restriction on the use of these options, regardless of the potential costs and benefits, would be over prescriptive and not in customers' long-term interests.

Q2. Do you agree the calculation of the metrics (as set out in Section 11.5 in the Financeability chapter) that we are proposing to use in our assessment?
We have no new comments in this area.

2.10 Chapter 12. Accounting for past delivery

Q1. Do you agree with our proposed approach for dealing with PR14 reconciliations and SIM? If not, please explain your alternative approach and why this would be in customers’ interests.

We support Ofwat’s proposals on the allocation of the PR14 adjustments and the proposal giving the ability to profile the adjustments in the best interests of customers.

We support the proposals for implementing SIM to 2018-19 with a pilot of C-MeX.
Q2. Do you agree with our proposed approach for reflecting how well the company is delivering for customers over the 2015-20 period in the initial assessment of business plans? If not, please explain your alternative approach and why this would be in customers’ interests.
We support this approach.

2.11 Chapter 13. Securing confidence and assurance

Q1. Are the business plan and data requirements clear and sufficiently specified?
Please see comments in relation to some data tables included in the response spreadsheet.

Q1a. Are there any areas we need to look at again?
Please see comments in relation to some data tables included in the response spreadsheet.

Q1b. Is there any data missing, or included but not required?
Please see comments in relation to some data tables included in the response spreadsheet.

Q2. Do you agree that our approach to assessing assurance can provide us and stakeholders with confidence in the companies’ business plans?
We believe the five tests are sensible and it is helpful that Ofwat have set them out in advance.

We agree with the approach that assurance in the round is appropriate and agree that the 2018 Company Monitoring Framework should be taken into account. Test 4 covers the extent that companies have a good track record; we agree that it is important that Ofwat consider the historic performance of companies around producing high quality information and the confidence this provides to the business plan and future performance.

We would suggest that one year’s categorisation should not be considered in isolation but the categorisation across the period and the ability the company has to retain or improve their position is also considered.

We welcome the additional transparency that Ofwat has included in chapter 13 on the areas that Ofwat expects the Board assurance to cover; we see these as part of our ongoing Board assurance and welcome the focus that is retained in this area.

However, Ofwat needs to consider the maturity of the data and the reporting requirements when assessing companies and to recognise that for perfectly legitimate reasons there will be inequity in how easy companies find full compliance with newer requirements.

2.12 Chapter 14. The initial assessment of business plans: securing high quality, ambition and innovation

Q1. Do you agree with our proposed approach to the initial assessment of business plans?
We agree with the areas proposed for the initial assessment and the characteristics required
Q1a. In terms of the nine test areas?

We agree with the nine test areas and the components. We do however consider that companies are highly unlikely to achieve the requirements detailed under ambitious and innovative and it is likely that companies will have areas of strengths and weaknesses. The methodology doesn’t seem to consider this balance and it would be helpful if the final methodology made reference to how Ofwat will combine the individual assessments.

Q1b. In terms of the business plan characteristics we want to see? (high quality, ambition and innovation)

Again we support these characteristics. However the level of ambition should reflect customers’ views or else there is a risk the plan lacks legitimacy and is not customer-focussed. We would recommend that ambition - particularly for performance commitments - is described in these terms.

Q1c. In terms of the business plan categories we propose to assign companies to? (significant scrutiny, slow track, fast track, exceptional) & Q1d. In terms of the financial, procedural and reputational incentives we propose to put in place?

We support the retention of incentives to produce high quality business plans as we believe this was a key driver for the improvements seen in overall business planning at the last price review.

However we are surprised that Ofwat seems have chosen to reduce the incentives in this area when it is makes clear it is seeking high quality, ambitious and innovative plans. The construct of the assessment of business plans seems to make any financial reward less likely to be achieved; and the size of the reward is not proportionate when compared to the level of ambition and risk required to achieve it. The costs, both in terms of meeting and exceeding Ofwat’s business planning expectations and the totex reductions seemingly required to achieve exceptional status, are orders of magnitude greater than the reward on offer. While there are other benefits to being assessed as exceptional, including reputational benefits, there is a risk that companies will consider striving for this classification to be too costly and too risky – and so a perverse incentive occurs, which is the complete opposite of Ofwat’s desire as outlined in its current mechanism. In addition we see very little benefit in achieving the Fast Track status other than there being some reputational element to it, as the Final Determination for Fast Track companies is no earlier than for other categories; in fact d we see the benefits of quicker Draft Determination being of limited benefit. We would recommend Ofwat examine their proposals in this area to ensure the power of the incentives are properly maintained and drive the right behaviour by a) increasing the financial incentives for exceptional plans and b) by providing greater financial differentiation in terms of the determination timing between the fast and slow track categories.

Q2. Do you agree with our proposed approach to assessing a company’s ability to deliver results for customers and the environment from innovation?

We agree this step is necessary and that companies should give confidence both in terms of innovative delivery to date, as well as garnering customer and stakeholder confidence they are able to implement the innovation they are seeking for the future. It is a valid regulatory test as long as it is pitched at a ‘level of confidence’ test - as opposed to a level of detail test – such is the nature of innovation.
2.13 Appendix 14. The initial assessment of business plans

Q1. Do you agree with the key questions under each of the test areas?
The questions all seem reasonable individually. However we again return to the potential conflict between how well has the company incorporated engagement with customers into its business plan proposals, against the regulatory expectation that company performance levels need to be stretching. Clarity is needed here on which test takes precedence if and when a conflict exists.

Q2. Do you agree with what we will look for in terms of high quality, ambition and innovation under each of the test areas?
We agree that in the categories described the expectation is fair; however we would return to our concerns about the packaging impact i.e. it is unclear how the overall plan will be assessed from a collection of individual tests as we find it implausible that any one company will reach the ambitious or innovative category in but a few test areas.

Q3. Do you agree with our high-level approach for scoring business plans into the four categories (significant scrutiny, slow-track, fast-track, exceptional)?
See Q1c above

Q4. Do you agree with our proposed schedule for the initial assessment of business plans
No issues with proposed schedule.
### 3. Reference list

The following documents have been referenced in this response:

<table>
<thead>
<tr>
<th>Page ref</th>
<th>Section</th>
<th>Document reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Page 4</td>
<td>Executive summary</td>
<td>Frontier Economics, Keeping up with the Joneses, December 2016</td>
</tr>
<tr>
<td>Page 12</td>
<td>Section 2.2</td>
<td>Artesia Consulting, Planning for future uncertainty: a review of our understanding of household consumption in the UK, draft report [unpublished], 2017</td>
</tr>
<tr>
<td>Page 14</td>
<td>Section 2.2</td>
<td>Defra, The government’s strategic priorities and objectives for Ofwat Draft for consultation, March 2017</td>
</tr>
<tr>
<td>Page 29</td>
<td>Section 2.8</td>
<td>Smithers &amp; Co, A Study into Certain Aspects of the Cost of Capital for Regulated Utilities in the U.K, 2003</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Competition Commission, Northern Ireland Electricity Limited Final Determination, March 2014</td>
</tr>
<tr>
<td>Page 35</td>
<td>Section 2.8</td>
<td>PwC, Refining the balance of incentives for PR19, 2017</td>
</tr>
<tr>
<td>Page 36</td>
<td>Section 2.8</td>
<td>PwC, Balance of risk: Risk and reward across the water and sewerage value chain, December 2015</td>
</tr>
<tr>
<td>Page 39</td>
<td>Section 2.8</td>
<td>Competition Commission, Northern Ireland Electricity Limited Final Determination, 2014</td>
</tr>
</tbody>
</table>
Contact Us

Regulation
South East Water
Rocfort Road
Snodland
Kent
ME6 5AH

southeastwater.co.uk

Follow us

Twitter LinkedIn Facebook