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Dear David

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

We welcome Ofwat's approach to engagement throughout the PR19 price control process. In particular we welcome the early consultation on its framework for setting price controls for 2020 and fully support the general approach set out in the proposed methodology.

We strongly believe Ofwat's key themes of great customer service, resilience, affordable bills, and innovation are the right themes to focus on - both in terms of shaping the price review and, more generally, in how water companies should provide services.

We are pleased to see a clearly defined suite of common ODIs in Ofwat's draft methodology and believe a push to promote competition in new water resources and bio resources markets has the potential to drive stronger performance and innovation in the sector.

The strong focus on customer participation (using the Tapped In 'FACE' principles) will genuinely challenge companies to go further and be more creative in the way in which they engage with customers to understand their desired outcomes, co-create solutions and actively involve customers in the delivery of our services.

While the proposed methodology inevitably and rightly presents some challenges for the sector, we welcome the all-inclusive approach to company resilience and support Ofwat in seeking to create a step change in both efficiency and service.

A simplified approach to scenario analysis and the early publication of business planning tables is also a welcome addition which, alongside the introduction of a secure data capture system, will be very helpful in streamlining the business planning process.

We are excited by the challenge of producing and subsequently delivering the best possible business plan for our customers. We understand that to achieve this we will need to demonstrate that we are not only improving our company performance at pace but also capable of delivering an ambitious business plan that sets the foundations for the long-term transformation of our services.

We also need to continue to work hard to ensure that our plan reflects our customers' changing priorities, whether expressed directly through research, identified through business as usual contacts or our own and third party data. We have continued to engage with our customers throughout the delivery of our PR14 business plan – for example ensuring customers had a strong voice in the selection of which bathing waters we improve to 'excellent' status. We have also begun our more focused research and analysis to support the development of our new plan. We recently published the first outputs for consultation (<https://beta.southernwater.co.uk/lets-talk-water/>), using both social and traditional media to ensure as many of our customers as possible have the opportunity to help shape our plans.

Meeting the challenges of our region

Ofwat is right to highlight that the South-East is an area of water stress, where high levels of population growth and development are forecast alongside greater environmental protection. We are focussing our future strategy on developing systems which allow our existing water resources to go further, through increased leakage reduction and incentives for water efficiency. At the same time, we will be pursuing opportunities to reuse valuable wastewater to supplement supplies, increase resilience and support the environment, particularly at times of drought. Taking a more integrated approach to catchment management and actively contributing to interventions which will enhance the quality of the natural environment we rely upon, aid its regeneration and increase its resilience to both short term shocks and long-term trends is also central to our future strategy.

Alongside securing high-quality, resilient sources of water we recognise the integral role our wastewater network plays in providing a vital service to customers, protecting the environment, facilitating new housing and development and supporting economic growth across our region. We realise the opportunities for partnerships that will allow us to deliver better outcomes for our customers. For example we are working with Ebbsfleet Development Corporation and have identified the Garden City as a project where there are opportunities to develop innovative solutions to provide resilient and sustainable services within the context of a large, new development.

We are also keen to build on our industry-leading projects, such as the UK's first universal metering programme, which has seen a sustained reduction in customer demand. When combined with our leakage performance, which is leading the sector, it has resulted in the lowest level of abstraction per head from the environment in the UK, with the amount we put into supply now lower than in 1976, despite the significant housing growth across our region. Our ambition is to drive this down further, and use it to increase customer participation in the delivery of our service and increase long-term resilience.

We are an active part of Water Resources South East (WRSE), which is carrying out regional modelling work to identify additional opportunities for transfers and the development of strategic resources that will benefit the whole of the South East region and increase the connectivity between companies. We are committed to reflecting the outcomes of the WRSE work in our draft Water Resources Management Plan and working with our neighbouring companies to develop a more integrated and resilient regional network. In addition, we are looking to develop partnerships across sectors, such as agriculture and energy suppliers, which will signal a new approach to regional infrastructure and resource planning.

Our customer transformation programme is well advanced and we have seen complaints decrease dramatically over the past eighteen months. However, we recognise we have not performed well in this area and more generally we are working hard to improve our services.

Ensuring bills are affordable is a critical issue for companies, regulators, government and, above all, customers. As such, we welcome the clearly defined theme of affordable bills in the PR19 draft methodology. We are committed to providing good value, affordable and accessible services for all of our customers, now and in the future and to date have provided additional help when needed to over 190,000 of our customers.

Areas of specific concern

While we are supportive of the key themes of the proposed approach, we do have some reservations regarding the draft methodology. These are captured in the detailed responses to the consultation questions, but we would emphasise the following three areas:

1) The overall balance of cost, performance, and risk

We embrace Ofwat's challenge for companies to improve in both efficiency and performance. As the methodology stands however, we do not think that the links between costs, performance, and risk have been suitably balanced. By taking an (at least) upper quartile approach to performance, and a frontier-based approach to costs, Ofwat is treating inputs and outputs as largely distinct from one another. Delivering a step change in performance may require costs to be incurred. Therefore, it is our view that Ofwat will need to carefully consider evidence from companies that will authenticate the relationship between cost and service, and recognise the interplay when setting targets.

We also note Ofwat's statement that an average performing company will earn penalties under the proposed incentives framework. At an industry-level, this would logically result in expected returns below the cost of capital. We believe Ofwat should ensure that there is no such systematic inconsistency – and that high-performing companies should expect to earn the allowed WACC. If the current approach is maintained, Ofwat would need to consider adapting the WACC to reflect the increased risk of sector-wide underperformance. Otherwise, when combined with greater revenue volatility from within-period incentives, this could reduce the financial resilience of the sector.

We note that Moody's considers that the methodology as it stands will be credit negative for the sector as a whole¹. It is important that the sector can maintain access to, and customers are able to benefit from, low-cost finance.

¹ Moody's (2017) 'UK Water Sector: Ofwat signals challenging price review'

2) Cost assessment

The proposed frontier-based cost challenge is a potential shift in the regulatory standard and relies on Ofwat's cost models having a high degree of reliability. This is unprecedented in the regulated utility sector in the UK. We note that the Competition and Markets Authority (CMA) found a number of material issues with the cost models used at the last review, and opted for an average-based cost challenge to reflect the lack of confidence in the modelling. While we consider the engagement to date through the cost assessment working group to be very positive, complex econometric models will always be subject to normal errors and uncertainty.

We suggest that, should the frontier-based cost benchmark imply a level of efficiency significantly greater than companies' plans, Ofwat should consider either:

- using a benchmark that is less stringent than the modelled frontier, recognising the inherent margin or error in the modelling;
- allowing companies to catch up to the modelled frontier in a phased manner; or
- seeking to make use of a wide-range of cross-checks to ensure that it does not set an unachievable efficiency challenge, including further statistical tests of models used.

3) Total market returns

Ofwat's proposed range of total market returns (TMRs) is materially below recent regulatory precedent, and places little weight on historical data prior to 2000. This represents a major departure from the way in which regulators have typically used long-term averages to inform the capital asset pricing model (CAPM) in the past. We propose that the arguments in support of a longer-term approach, along with broader issues of regulatory consistency, should be given greater weight.

Summary

In summary, we welcome the direction of travel set out in the methodology consultation. We recognise that Ofwat's proposed methodology presents a significant challenge to the sector, and we are committed to stepping up to this challenge.

We hope our response to the consultation reflects the small number of areas where we have concerns, in particular how Ofwat is proposing to calibrate the overall price control package. We are grateful for the open, engaging approach so far and look forward to working further with you as the methodology develops.

If you would like to discuss any of our consultation responses further, please do not hesitate to contact either me or a member of my team.

Yours sincerely,

Craig Lonie
Director of Strategy and Regulation