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Dear David,

PR19 Draft Methodology – South Staffs Water Response

Thank you for the opportunity to respond to the consultation on the draft methodology for PR19, continuing the constructive engagement with the industry.

We welcome and will work towards the aspirations of PR19, namely great customer service, affordability, innovation and resilience. We believe that there will be real choices to be made between lower bills and higher service and it is our intention that our plan will fully reflect this balance based on what our customers want.

We support the drive towards a greater differentiation of returns between high and low performing companies. To this end, the Board are determined that South Staffs Water (SSC) should be a high performing company at the forefront of service and cost, whilst continuing to have one of the lowest bills in the country. The achievement of this requires the company to be fully responsible for delivering ever higher levels of efficiency and innovation, and for the regulatory approach and assumptions to be robust and sustainable. To facilitate this, we believe that Ofwat should reflect on the following three key issues before the final methodology is published in December:

- **Cost assessment must be robust**
  Cost assessment has in the past been seen as potentially unreliable. At PR14 there was a great deal of uncertainty in how TOTEX was assessed which was demonstrated in the CMA's assessment of cost in the Bristol Water referral. If such uncertainty continues, an approach of setting cost allowances at the absolute frontier determined by a particular model or having models that do not properly reflect the most appropriate cost drivers may well undermine incentives for companies to take full responsibility for delivering to customers, and may well lead to challenge.

- **Companies must be placed on level playing field**
  In assessing cost allowances, due account should be taken of the levels of service being delivered, and there should also be recognition that not all companies have been able to take advantage of the portfolio effect when creating their debt capital structures.

- **There should be a long term approach to determining the cost of equity**
  Whilst the current cost of equity is at a historic low it should not be assumed that this will continue for a prolonged period. In such a long term industry, doing so could act as a disincentive to invest and result in volatile prices, neither of which is in customers' long term interests.

As you would expect from such a comprehensive consultation, we do have some other specific points which we set out below.

Embedded Debt
The methodology sets out the proposed approach for assessing an allowance for the cost of embedded debt which will use benchmark data (for example, indices of bonds for companies with similar credit ratings) and information contained in company balance sheets. We have a particular challenge on embedded debt and are exploring ways in which we can look to mitigate this, including for example considering the potential to extend the tenor of our index-linked debt to reduce the coupon we pay which may partly reduce this impact. We have also commissioned Oxera to report on possible regulatory remedies which we have already made available for your consideration. We would be pleased to discuss this in advance of the publication of the final methodology in December.

Cost of Equity
The likely downward movement in cost of equity indicated by Ofwat's current thinking is a cause for concern. We think that the balance of risk and return has been significantly shifted with the combined impact of totex efficiency and step changes in performance with no glide paths or deadbands for PCs. This doesn't seem to be reflected in the proposed range for cost of equity. A further concern is the statement that the average company will be in ODI penalty. We can understand not getting rewards for being average but this again seems inconsistent with the quoted range for the cost of equity.

It would also be useful for Ofwat to confirm that the assessment of both the cost of debt and cost of equity will be done over a consistent time horizon, using the same mix of forward and backward looking evidence.

In analysing the variables that drive the cost of equity (e.g. asset beta) we ask that Ofwat gives consideration to the suggested degree of risk being introduced by competition, directly as in Water Resources, or indirectly through some of the common ODIs within Network Plus.

Leakage
We agree that companies should be able to make the case for specific optimal performance commitments (PCs) given their unique engineering challenges, affordability constraints and the degree of customer support obtained. We support the overall intent for there to be a step change in leakage; however we think it is important that the leakage PC is practically achievable such that it functions as an effective incentive. The South Staffs region has higher than average leakage that reflects local conditions, for example a more dense

population and the water resource position, and therefore significant reductions in leakage are not expected to be economic and specific funding (with customer support) will be needed if such targets are to be set.

Wholesale cost modelling and power

As mentioned above, it is important that the wholesale econometric totex modelling is robust and takes account of all the appropriate drivers in assessing cost allowances. In particular, power is a significant expense for South Staffs due to our high pumping head (compared to the rest of the industry). Therefore, we believe that pumping head is a key cost driver that should be represented appropriately in the modelling of power costs. Furthermore, although we believe this has already been considered by Ofwat, we would like to make sure that industry power cost data is compared on a like for like basis; for example that power generation from sludge should not offset power costs in the water network-plus price control, as WoCs inherently do not have this generation option.

Residential Retail Price Control

We understand the benefits of a three year price control for residential retail which will allow evidence from the business retail market to benefit residential customers earlier. It may also allow more flexibility in the timing of a potential opening of residential retail to competition. From our experience of the business retail market, significant cost was incurred within the wholesale price control to ensure market compliance. It would be useful to know how Ofwat would deal with the potential introduction of residential competition during the next price control period where the wholesale control remains at five years.

Assessing Retail Costs

We believe econometric modelling should only be used for residential retail if it can be demonstrated that robust cost drivers exist that capture the majority of spend.

In respect of using other sectors as a benchmark, we think that it is important that it should take into account differences that may exist. For example, a comparison of bad debt should allow for the fact that in the gas and electric industry, customers can be placed onto a pre-payment meter if they have a poor payment history. In other sectors, customers sign up to a contract which can be terminated if payment is not made.

Common PC for Resilience

We recognise the importance of a common PC for resilience and the difficulty in developing this; however we believe that the current suggested PC focusing on drought risk may be too narrow compared to a broad view of resilience. We also have some detailed comments on the design of this PC if it is retained which are set out in the technical appendix.

Financial Model and Data Tables

We have raised some technical points on the draft financial model and data tables which are set out in the template provided with the methodology. We have also attached a separate note for more specific comments around questions raised in the appendices.

We trust that our comments are constructive and will assist in finalising the methodology in December.

We would be happy to meet to discuss the methodology and our response with you when you have had chance to review.

Yours sincerely,

Phil Newland
Managing Director
South Staffordshire Water PLC