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BY EMAIL

Dear David

Response to PR19 draft methodology

We welcome the opportunity to comment on Ofwat's draft methodology. In general, we agree that it sets out clear expectations for companies wishing to be judged as "exceptional" at PR19 and we observe that it seeks to establish a very challenging benchmark performance for individual companies.

We are actively engaged with the Water 2020 process and remain very supportive of Ofwat's overall direction of travel - to improve the legitimacy of the sector in the eyes of customers, to increase customer engagement and participation in the services and plans delivered by companies, and to better harness the power of markets and innovation to ensure that companies are providing customers with better and more resilient services at a lower price.

We particularly welcome many of the developments in the household retail price control, especially the recognition of key drivers (such as bill size and deprivation) when assessing efficient retail costs. We welcome customer-focused developments in outcomes, such as the development of C-MeX and D-MeX, and specific outcomes for affordability and vulnerability.

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Whilst we believe that in many areas the draft methodology successfully addresses Ofwat's ambitions for the sector, we highlight a few key areas where we suggest that Ofwat considers modifying its approach. These are in relation to:

- Overall expected target performance levels
- Overall balance of risk and returns
- Estimation of the cost of equity
- Comparability of data used in comparative assessments
- Incentivising direct procurement for customers
- C-MeX design
- Further feedback on financial model and data tables

Overall expected target performance levels
Ofwat sets out clear expectations for what it considers to represent stretching performance commitments on what matters most to customers and the environment. This typically involves delivery in 2021 of a forecast upper quartile 2025 level of industry performance across all measures.

We have no doubt that such a level of performance would be very stretching, and would provide great service to customers. However, no company is currently performing consistently at industry upper quartile in all areas – i.e. on costs for each price control as well as on performance levels for every outcome individually. Therefore it appears that a notionally efficient company (as implied by the performance expectations set out in the draft methodology) is already considerably beyond the industry frontier to such an extent that it likely represents an unachievable position. This is further amplified by the expected rate at which companies progress towards this level of performance, i.e. from the first year of the next period. It is particularly the case for leakage, for which it would be virtually impossible to achieve a substantial reduction in a single year for a measure that is based on a three year rolling average.

We feel that customers' interests would be better served by taking a more balanced view as to what level of stretching performance companies can achieve in the round, across all areas of cost and performance. Given the different local and legacy circumstances which apply to different companies, it is unrealistic to expect that every company has an equal chance of achieving performance at the proposed upper quartile level, on the same timescale and whilst simultaneously achieving upper quartile cost levels. The reality is that the efficient costs of achieving the proposed upper quartile performance levels will differ between companies, as will the degree of customer support for investment to achieve such a level.

Overall balance of risk and returns
We agree that our plan should represent a reasonable balance of risk and returns. Ofwat asserts that the overall balance of risk and returns remains symmetric around the "base case" of the notionally efficient company - i.e. the level which meets Ofwat's minimum performance expectations in all areas of cost and performance.

As set out above, a notionally efficient company is already beyond the frontier of the industry, so it is difficult to see how the symmetry in expected RoRE ranges (as set out in section 10 of the draft methodology and illustrated by figure 10.1) could be achieved. This is further supported by Ofwat's expectation that an average performing company should expect to receive net penalties, which means it is difficult to see how a P10 and P90 performance range could result in a symmetric RoRE range around the assumed cost of equity.

We have engaged with Ernst & Young (EY) to produce the report “Balancing Risk & Reward at PR19” to investigate this issue in more detail and have provided it to Ofwat alongside our response to the draft methodology. In summary, EY concludes that in setting any determination Ofwat should satisfy itself that the overall risk and reward package should be balanced such that a notionally efficient company expects to be able to achieve a return on equity equal to the rate of return which equity investors in a notionally efficient company would require.

Estimation of the cost of equity

We recognise that requirements for overall returns (including the cost of debt) are lower now than they have been historically. However, we do not agree that the total market return has decreased to the extent suggested by PWC's report for Ofwat.

The total market return proposed in the draft methodology appears too low, with too much weight placed on a 'lower for longer' interest rate scenario which we feel has not been robustly evidenced. There is insufficient regard to the uncertainty and skew associated with this scenario. In addition, we feel that too much weight has been placed on the market to asset ratio and the dividend discount model - this evidence is difficult to interpret and lacks robustness. The analysis also appears to give insufficient regard to longer term data and the underlying stability of long term rates of return as well as the associated inverse relationship between the risk free rate and the market risk premium which is well documented in many academic papers.

In summary, we encourage Ofwat to consider a more holistic range of views on the total market return for PR19 to ensure that the sector remains able to attract and retain finance on the best value for money terms and in the best long term interests of customers. We have commissioned further work from EY to review the evidence base in this regard and have also provided a copy of this report (“The cost of equity at PR19”) alongside our response to the draft methodology.

Comparability of data used in comparative assessments

We agree that company targets should be stretching and that comparisons between companies should play a significant part in setting targets. However, we consider that there should be much greater recognition that local circumstances outside of management control are likely to mean that equally efficient and effective companies may deliver varying levels of performance. For example, environmental differences (such as rainfall) between companies affect the level of performance that companies are able to deliver for an equivalently stretching level of effort and cost.

In relation to the four common measures with common targets, Ofwat states that “there are no strong reasons why we should not expect companies to achieve the same level of performance”. We do not agree this is appropriate for sewer flooding given the significant influence of external factors such as regional variations in rainfall. The number of internal and external sewer flooding incidents is a reflection of sewer condition, operating and maintenance regimes and, crucially, levels of rainfall. In the North West we have industry leading performance in terms of sewer blockages, collapses and pollution incidents which demonstrates our robust approach to the management of our sewer infrastructure. However, the high levels of rainfall in our region mean that we have higher than average incidences of sewer flooding. We recognise that sewer flooding is unacceptable for the customers affected, and we will set stretching targets for AMP7. However, we strongly believe that it is not appropriate to set common targets for measures where there are regional variations in such an influential external factor. Instead, such regional variations should inform what targets companies are able to achieve for an equivalently stretching level of performance and cost.

Expecting companies to meet a frontier level of performance where this is currently being achieved by a company in a favourable operating environment may drive companies towards a balance of bills and service performance which does not reflect customer priorities or their long term interests.

We fully recognise that the onus is on us to provide compelling evidence in our business plan which demonstrates that the costs and performance targets proposed are stretching within the context of the environment in which we operate. We expect that Ofwat will be open to reviewing such evidence fairly and objectively, and will not rely on simplistic or merely prima facie comparisons between companies in forming its judgements on what constitutes stretching performance.

We also strongly believe that Ofwat should recognise that comparisons are invalid if there are inconsistencies in measurement. We consider that there are several areas where this requires further investigation and standardisation before Ofwat could reasonably rely upon measures as being comparable. One case in point is measurement of sewer flooding. We believe that our more comprehensive procedures for establishing the full extent of sewer flooding, which involve a thorough check of neighbouring properties, protects customers but distorts comparisons with other companies as these checks of neighbouring properties identify a significant proportion of the overall flooding incidents. In view of the potential impact on comparisons, we suggest that all companies should report the number of incidents which they identify, separate from those notified by customers. This information should be readily available, so it should not involve any additional costs. If this shows significant differences between companies, then we consider that these differences should be taken into account when making comparisons and when setting any targets which are based on comparative performance.

Incentivising direct procurement for customers
We agree with Ofwat that direct procurement for customers (DPC) has the potential to unlock additional efficiencies in the delivery of large projects, for the benefit of customers. We also welcome the opportunity for incumbents to have a potential role in the operation of directly procured assets. We further believe that greater customer benefit could be achieved if incumbents are able to have greater participation in a DPC process than Ofwat now envisages.

If efficiency in procurement is required, then it is unclear what advantages are gained by excluding the incumbent from the process. At worst it could result in a higher cost outcome for customers. If transparency in the procurement process is desired, then there are a number of alternatives that could be considered, none of which are presented in the draft methodology. It is therefore unclear why Ofwat has felt compelled to adopt this position, without consultation.

We are concerned that Ofwat appears to have concluded, without presenting the evidence, that a third party solution would always offer customers better value for money than could be achieved by the incumbent. We are concerned that the methodology contemplates that, in the event of a failed direct procurement process, an incumbent's allowed costs would be subject to a downwards adjustment to meet a lower expected level of costs; this appears to indicate that the approach being taken towards direct procurement is not open even to the possibility that the incumbent company may be best placed to offer value to customers for a project which is subject to DPC. In this way, there is a risk that the proposed approach to DPC is less focussed on achieving value for money for customers, but rather on excluding incumbents from delivery of medium to large schemes in their area of appointment.

We observe that the overall regulatory model proposed for DPC seems to be more focussed on an enforcement process which presumes that a third party is best placed to provide a particular service and then seeks to penalise the incumbent in the event that this is not successfully applied. The apparent reliance on a penalty-only incentive appears incongruent with the more balanced approach to incentives that Ofwat has been progressing towards in recent years.

We have been supportive of the development of a DPC process to this point, but believe that a more balanced regulatory approach is needed, particularly in taking the first steps towards commissioning projects through this method. There is scope for the DPC process to have a more balanced approach towards reward and penalty incentives. Where there is scope for a potential sharing of benefits between company and customer, this would provide a real incentive for companies to obtain the best price for a service through a DPC process.

We may have two projects which could potentially be "in scope" for DPC at PR19. At present, both of these possibilities are yet to be finalised (see details below) and therefore we cannot yet be certain of their suitability for DPC:

1. Resilience of supplies from the Haweswater Aqueduct - a component of the preferred solution (following customer engagement) may include a single large infrastructure investment (e.g. a large water treatment works) which may be a suitable candidate for DPC. We would expect such a project to be completed over AMP7 and AMP8.
2. Water trading - we may be in a position to make initial proposals for a significant transfer of water for use in the South East of England. Whilst elements of such a project could be suitable for DPC, it seems likely that the main elements of investment will take place after AMP7.

C-MeX design

Whilst we endorse the aims and objectives of C-MeX, our response to the draft methodology raises a number of suggestions for how it should be implemented:-

- Survey weightings: We believe that customer complaints should continue to carry a weighting of no less than the current 25% within C-MeX. Customers and industry stakeholders place great emphasis on complaint volumes as a measure of quality customer service. The proposal not to include complaints in the calculation of a C-MeX financial reward/penalty risks incidences of companies with high relative complaint volumes simultaneously receiving high financial rewards for customer service. This would seem to risk undermining the legitimacy of the measure in the eyes of many customers and stakeholders.

We also suggest that the non-contacting customer survey should carry a weighting closer to 25% within the new C-MeX financial incentive calculation. The introduction of a new measure for non-contacting customers is a positive move, but the industry should be careful initially in applying very strong financial incentives to it as we have limited collective understanding of how much influence company actions will have on it, and whether the new survey will drive unintended activity.

- Sample sizes: We believe that the proposed sample sizes are simply too small to identify statistically significant variations between companies, and further do not agree that this issue could be resolved by adding up results from two unrelated surveys. Current best practice in customer survey design does not support this solution. We strongly encourage Ofwat to seek independent academic advice from experts in customer survey design to identify appropriate survey designs and sample sizes.

- Survey channels: We endorse the introduction of online surveys into the survey mix. We encourage Ofwat to go further and seek to match survey channel with the customer's original contact channel, such that a customer that contacts a company by voice is surveyed by telephone, whereas a customer that initiates contact on a digital channel has a digital survey.

Further feedback on financial model and data tables

We have raised any issues we've identified so far with the financial model and the data tables along with our main response. However, we will make much more use of the financial model and the data tables over the coming months, in preparation to make our submission next September. We therefore recommend that Ofwat maintains a communication channel with companies, to receive feedback on any further issues identified in the coming months.

I hope that Ofwat finds our response helpful in concluding the final PR19 methodology in December. We remain fully engaged and would be happy to discuss further any of the issues raised.

Yours sincerely

James Bullock
Director of Economic Regulation