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Cathryn Ross
Ofwat
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30 August 2017

Re PR19 Methodology Consultation

Dear Cathryn,

Thank you for the opportunity to response to the consultation on Ofwat's methodology for PR19. We appreciate the early clarity provided by this set of documents as we continue with our business planning processes for AMP7. We found the consultation documents to be comprehensive and thorough and they will help to ensure that we are able to meet Ofwat's requirements and expectations while delivering an ambitious business plan that responds to the needs and priorities of our customers.

We set out below some of the key issues that we identified in reviewing the methodology consultation, while our full response has been provided to your team using the prescribed template.

1. Context and themes

We were pleased to see the prominence given to long-term planning and affordability in Ofwat's methodology consultation. It sets out Ofwat's expectation that the water industry can and should do much more to improve services for customers and deliver better value for money in the next 5-year period, while also considering resilience over the longer term. As a largely monopoly industry, it is right that water companies should be subject to this kind of rigorous challenge, and compared against the best performing companies both from within the industry and outside.

Over the last 12 months Welsh Water has been undertaking a major exercise to develop its long-term plan for the business, as a precursor to PR19. Earlier this year we published the resulting 'Welsh Water 2050' document as a public consultation. We are currently undergoing extensive research with customers on their long-term priorities in the context of Welsh Water 2050. We will feed these views into the development of our investment plans for AMP7 and beyond.

We welcome the overall approach of building on the strengths of PR14 while making changes to strengthen incentives and introduce the discipline of competitive markets into the regulatory framework where it is in the interests of customers and consistent with government policy in Wales. In particular, we are fully supportive of the increased emphasis on customer involvement. Our

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programme of customer research is well underway across a wide range of issues. Where customers have a limited appetite for or understanding of the regulatory detail on which Ofwat is expecting customer input (e.g. PAYG rates) we are seeking ways of inferring their preferences from related questioning and discussing with informed groups, notably the CCG.

In Wales we interpret the methodology within the particular context of the Welsh Government's Water Strategy and legislation. As a non-shareholder company, everything we do is driven by the interests of our customers and, with the policy emphasis on the future as set out in the Wellbeing of Future Generations (Wales) Act 2015, our focus is on ensuring high-quality sustainable services and affordability for the long-term. Ofwat's themes of resilience, customer service, innovation and affordability set the challenge for companies to set the right balance between delivering service improvements today while investing for a resilient water service to customers in the long-term.

PR19 business plans will be set against the context of a significantly lower WACC. This has benefits for customers in terms of creating financial 'headroom', but there is also a risk of lower credit ratings across the sector. Maintaining access to reliable, cheap finance is also key for long-term resilience and value for money for customers.

2. Outcomes and ODIs

The methodology acknowledges the balance that must be struck between companies defining their own business plan targets and having common metrics and targets to drive performance improvements across all companies. The industry is making good progress in harmonising the definitions of common performance commitments, but there is still work to do, particularly in certain areas. As common definitions will inevitably not perfectly suit everyone, it will be important not to penalise companies or create perverse incentives by setting targets that do not take account of each company's operating circumstances. We would propose that Ofwat commissions 'horizontal audit' work to look at compliance with performance commitment definitions and methodologies.

The methodology proposes that for four common performance commitments companies should target at least a forecast industry upper quartile level for 2024-25, and seek to achieve this in the first year of the period. While we will be seeking stretching performance improvements, guided by customer views, solutions to achieve this take time to implement and do not yield results immediately. We therefore believe that a five-year glide-path remains the most appropriate way to incentivise companies to deliver sustainable improvements.

Setting a 'day one' target for these performance commitments would also mean that even the current upper quartile company could expect to have penalties imposed on their performance during the transition to improved performance levels. The existence of widespread penalties across companies would risk undermining trust and confidence in the industry, even as performance improves, and could dilute the reputational impact of ODIs.

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Finally, Ofwat is proposing that 'deadbands' for ODIs be abolished. We suggest that this is inappropriate, given that there is inevitably some natural variation in performance, for reasons outside management control.

3. Price controls and cost efficiency.

The methodology includes a number of changes intended to incentivise cost efficiency improvements. We are supportive of Ofwat's comparative approach to cost efficiency and modelling overall, while recognising its limitations. With a small number of companies across which econometric modelling can be applied, it is likely that some factors that affect company costs will not be included in the econometric models. We strongly believe that Ofwat should take account of any such regional variables.

In justifying many of its proposals relating to performance commitments, such as incentivising companies to propose frontier shifting performance, Ofwat says that it is attempting to mimic the way that a competitive market "rewards and spreads innovation". We would point out that this is not necessarily the case, in that markets drive performance to the level where customers want them, which may not always mean better and better performance. For example, in aviation, liberalisation of air travel revealed that a significant proportion of the public preferred a lower standard of performance because the resulting price savings were deemed to be worthwhile. We believe it is important to be guided by our customers' preferences and long-term value for money.

We are pleased that Ofwat is looking to deal with input price pressure within the retail price controls. Indexation was not allowed at PR14 and continuation of this approach would have meant that companies would have to absorb 10 years of input price pressures. However, we do not agree with the proposed approach to deal with input price pressure as part of the totex allowance, rather than through indexation of the allowance. Forecasting the factors which will influence input price pressures on labour costs and wholesale charges (which drive doubtful debt costs) over a 5 year period is complex and prone to error. Any inaccuracies will be borne either by companies (in terms of unrecovered charges) or customers (in terms of higher than inflation price rises). We therefore believe that Ofwat should index the retail price controls in the same way as wholesale price controls, as this will protect customers from above-inflation price rises, as well as ensuring that companies recover their allowed retail costs.

We would like to highlight our concern over the proposal to remove 'transition expenditure'. The methodology proposes that this should no longer be required with the focus on outcomes and totex. However, we believe that 'transition' assists with the efficient planning of investment activities and helps to smooth out the peaks and troughs of the 5-year investment cycle.

Direct Procurement for Customers (DPC) is a significant innovation by Ofwat in the PR19 methodology. We recognise the value of testing investment proposals in external markets and procuring services externally to get the best value for customers. We make use of this routinely for

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design and build, and also for procuring alternative investment solutions – though this does not appear to be envisaged as within the scope of Direct Procurement.

However, we have concerns over the idea of having third-parties operating key assets in the network. Our experience with outsourcing operations between 2001 and 2010 demonstrated that it can work well in normal circumstances. But if there is a major public health incident, for example, the limitations of contractual arrangements can be an obstacle to our ability to fully discharge our responsibilities. Companies need the ability to manage the whole network in order to deliver very high standards of resilience and service, for instance by managing water production and distribution flexibly to maintain supplies to customers.

In terms of financing, we are not opposed to tendering this in principle for major projects, but third parties are unlikely to improve on the low costs of capital that are available us.

In short, companies need the flexibility to use direct procurement where it benefits customers, but not to do so, at least not in its fullest form, where it could lead to increased cost or reduced resilience.

4. True-ups and reconciliations

PR14 already included a whole series of 'true ups' intended to adjust for over- or under-recovery, to reconcile data from previous periods, or to make other adjustments linked to various incentive mechanisms. The PR19 methodology introduces a number of additional 'true ups' that will be required, affecting either revenue, the RCV or both.

The detail by which these various reconciliations are calculated and applied was already complex at PR14 and therefore prone to error or oversight. Their application at PR19 will be even more challenging, not least because of the increase in the number of price controls, and even applying them in one order rather than another could have major unintended consequences.

We would propose that Ofwat consider carefully the impact of adding further reconciliations, and engage with companies in the detailed design of how these reconciliations will be applied to understand the impact of various options.

As a related point, Ofwat is requesting considerably more data from companies at PR19 than previously. We know from experience that some low-level errors and misinterpretations in companies' data submissions are inevitable, and will increase proportionally to the volume of data requested. We therefore strongly suggest that Ofwat makes allowance for this in its post-submission planning, and continues its policy of open interaction and dialogue with companies as the best way to avoid such problems in practice.

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Finally, we would like to acknowledge the positive approach to engagement with companies on the design of the PR19 methodology to-date, through the various working groups and other forums. We look forward to continuing this engagement over the coming months.

Yours sincerely,

Chris

Chris Jones

Chief Executive