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30 August 2017

Delivering PR19 – response to consultation on Ofwat's methodology by Wessex Water Services Ltd

1. Introductory comments

1.1. The Board of Wessex Water welcomes the opportunity to respond to your consultation of 11 July 2017 on the PR19 draft methodology. Having considered your proposals we are writing to summarise the key points that we believe should be incorporated into your final methodology.

1.2. The Board fully supports the importance of "trust in water" as the focus of Ofwat's strategy in recent years and in PR19. It is essential that customers retain trust in their suppliers, that consumers have trust in the regulatory regime and that companies – and their investors – retain trust in the regulatory process.

1.3. The question is, on what is trust based. At Wessex Water we take pride in the long-term, high standards, integrated approach to water management that we have built up over the last few decades. We have done much to build relationships and confidence with our customers, and to deliver an exemplary service for today's and tomorrow's citizens. But we fear that the approach put forward in the consultation will undermine trust. It is of course important to balance maintaining trust and confidence with challenging the shortcomings of individual companies; but we are concerned that the proposed Methodology will result in an unwarranted perception that the industry is collectively failing, and that the only solutions are to cut bills and deliver short term goals.

1.4. A wider loss of trust will hamper our ability to shape a sustainable operating model that includes the participation of customers to deliver resilience over the long-term. As long-term stewards of the water environment we must consider the balance of interests not only of today's customers but tomorrow's and of wider society. The proposed Methodology risks working against this by focusing companies disproportionately on short-term objectives.

1.5. The Board is also keen to understand how the proposals in the consultation, in particular the changes in your policies and approach, are compatible with the statutory framework. In particular, an incentive structure that reflects the priorities of local consumers, rather than central targets, would appear to be much more obviously in consumers' interest; we are concerned about the implications of the Methodology for long-term resilience; and the serious risk that the proposed changes in approach on the cost of capital and the balance of returns will not allow a reasonable return, which will discourage investors. We would welcome the opportunity to engage with you further on these issues before the Methodology is finalised.

1.6. In the next section, we highlight our key areas of concern and our proposed solutions. We then expand on these and explain how they impact on the PR19 themes of innovation, resilience, customer service and affordability. We answer your specific consultation questions in a separate appendix.

2. Key concerns and recommendations

The Wessex Board's key concerns and recommendations are as follows:

2.1. Incentives are inappropriately skewed to the downside. The Board recommends that Ofwat reframes incentives so that they are appropriately balanced, in particular:

- The requirement that water companies meet Ofwat's suggested efficiency frontier at the start of the charge control represents a material change in policy. The Methodology's approach to assessing efficient costs cannot capture efficiency with complete accuracy. The final Methodology therefore needs to allow for benchmark targets to be set allowing for calculation uncertainty, and in a way which allows companies to "catch-up" with what will always be an imperfect assessment.

- The consultation document sets out an expectation that the majority of companies will be fined annually for under-performance throughout the period of the price control when assessed against the four primary service metrics. The Board supports stronger incentives for improved service levels; however, targets and incentive metrics should be set at a level which do not penalise companies unnecessarily, do not unnecessarily damage public perception in the market, and work towards encouraging companies to outperform those targets where this benefits consumers. A presumption of failure is damaging to trust.

2.2. The final Methodology needs to explicitly recognise the links between expenditure, service and resilience when assessing future cost allowances. The approach taken in the Methodology to cost assessment puts at a disadvantage those companies that have already invested to deliver more resilient services, as it does not recognise that efficiency is a function of the service level already being delivered as well as cost. This is a crucial part of resilience. The proposed approach also risks damaging the incentive for companies to innovate at a catchment level in the future, to the long term detriment of customers. The cost incentive framework is also problematic for long-term resilience by incentivising low cost rather than efficient and cost-beneficial plans.

2.3. Our preference would be that incentive targets should be set by reference to local needs and agreement, reinforcing the need for high quality relationships with customers leading to solutions they recognise. The proposed method for setting some targets at a national level could lead to companies submitting imbalanced investment plans which would result in some customers receiving more/less benefits than others depending on their location. The final methodology should therefore allow companies to depart from the regulatory assumption, without fear of penalty, where good evidence shows that local priorities differ.

2.4. While the Board recognises the issues raised in the recent National Audit Office (NAO) report it considers that the proposals on tax and debt will encourage a rate of return culture by attracting passive, risk-averse investors. Our view is that the sector requires more challenging and risk-taking investors to deliver innovatively against the long-term challenges we face. We do not therefore support these changes and recommend they are removed so that these risks remain with equity, as it is best placed to manage them, rather than being passed onto customers.

2.5. The Board considers that the Methodology needs to use a longer term and forward looking analysis in setting allowed returns. The accompanying analysis of equity returns places too great an emphasis on spot evidence reflecting current market conditions rather than considering the likely returns equity will require in the period 2020-2025.

3. Delivery through innovation, markets & partnerships

3.1. Earlier this year we updated our long-term strategic vision, setting out our priorities and our preference for delivery through market-based, deregulated solutions and partnerships. This can be found at www.wessexwater.co.uk/ourstrategy

3.2. The ideas in this document underpin the plan we are building and will help to inform our PR19 submission in September 2018. They are based on an integrated, long term view of resilience, excellent relationships with our customers, a passionate commitment to a high quality environment and a framework that embraces short- and long-term goals.

3.3. Our starting point is a recognition that we are entrusted with providing services that are essential to life, public health, the well-being of local economies and the environment. We are stewards of both the assets that deliver these services and the local water environment. The nature of our business means everything we do today has an impact on the future. We must always plan for the long-term.

3.4. We strongly support more powerful incentives for companies that innovate and are ambitious in delivering the things that really matter to customers.

3.5. Retaining and enhancing trust in the industry are key to enabling our preference for innovative delivery through partnerships and markets, and the Board's concerns on the impact of the Methodology on trust are set within this context.

4. Furthering resilience

4.1. While our customers do not immediately understand the term resilience they intuitively understand that future-proofing our services is a necessary part of any business plan, and should be part of business-as-usual. Some areas of the Methodology are we believe inconsistent with this finding.

4.2. In our view the current proposals will discourage long-term resilience planning. This raises particular concerns in the light of the resilience duty, which we interpret to require a longer term view to be taken.

4.3. The current proposals do not recognise sufficiently the impact of resilience investments made by Wessex Water. For example, in assessing efficient ongoing costs through a comparison of past expenditure it is necessary to also compare the associated levels of service and resilience; the Methodology does not appear to take this into account. Maintaining our comparatively greater level of resilience in water services - including our resilience to a 1 in 200-year drought[1] and our ability to supply the vast majority of our customers from more than one source - means we must maintain and operate the investments we have made that deliver these levels of service and resilience. These include our investment in a regional grid alongside innovative land-based catchment solutions. We hope to be able to continue to work with your cost assessment team on this issue in advance of the final methodology publication.

4.4. It must also be possible for companies to look further forward and provide good evidence where this suggests a step-change in investment is required to deliver for the long-term. It is well understood that customers value bill stability, and we must not come to view PR19 as a missed opportunity to protect services for consumers of the future while also avoiding a roller-coaster in customers' bills.

4.5. Without confidence that the assessment of efficient costs will be accurate, holistic and forward looking, the proposed cost incentive framework will

[1] See Temporary Use Bans at http://discoverwater.co.uk/resilience

incentivise low cost, short-term submissions rather than efficient, cost beneficial and long-term plans. To build confidence we recommend that Ofwat commits to providing more information on the methods, models and scope of its analysis on cost assessment well in advance of companies' plan submissions.

4.6. We also note that the proposed approach may make the ongoing use of catchment-based approaches less attractive. We recommend:

- Amending the proposed assessment of asset health to exclude outages related to raw water quality as this bears no relation to the ability of our assets to deliver services to customers, but reflects a recognition that catchment-based approaches will not always deliver 365 days of the year in a way that an asset solution would

- Adjusting econometric assessments of efficient costs if they penalise companies that have already avoided asset-intensive approaches in favour of more sustainable opex-based solutions.

4.7. Delivering greater environmental resilience, particularly in wastewater, will be a key theme of our plan. We are working hard to obtain greater certainty of the quantum of work required through our environmental programme and also to ensure that the statutory requirements are framed in a way that will allow us to innovate in our delivery. Where uncertainty remains in the quantum of work required, the risks will need to be shared appropriately between customers and companies, without putting the environment at risk. The Methodology's proposed option to allow investments on a unit-cost basis best achieves this.

5. Affordability and vulnerability

5.1. Addressing the needs of vulnerable customers has been an area where we have taken a lead over the last decade, particularly in areas of affordability, with the introduction of new tariffs and work with key partners. We will continue to develop our approach in a way that is aligned with government priorities, focusing the most help and assistance on those that need it most.

5.2. Affordability is also about delivering efficiently – Ofwat's proposed approach sets the industry targets from 2020 at a forecast efficiency frontier with no allowance for a catch-up transition period. Regulatory precedent suggests that caution should be applied to assessments of efficiency, particularly if a frontier approach is taken. Without this it would be possible for a well-performing company to be penalised twice, once through an incorrect assessment of the efficiency frontier and secondly by allowing it no time to adjust to this.

5.3. The assessment of an efficiency frontier and the future scope for productivity improvements will need to be (consistently) at, or very close to, the true frontier. Given the likely significance of this proposal, the Methodology needs to provide more information on how the frontier benchmarks are to be set, and how Ofwat will allow and account for modelling error.

5.4. Without this additional information it would not be reasonable for a regulator to penalise, or threaten to penalise, companies that seek to provide additional information and evidence explaining an efficient level of costs. This could occur if a company submits a special cost factor that is rejected.

5.5. It is reasonable to make greater use of efficiency benchmarks outside of the industry, but these must be comparable. The Methodology needs to make clear the limitations of certain comparisons. In particular, we understand the challenge around bad debt, but note that the context, and scope for intervention, is often very different. For example, compared to the energy sector, which effectively manages bad debt through use of pre-payment meters; we cannot cut off or limit supplies of non-paying customers. Our plan will set out how we will continue to innovate and develop our work with partners outside our own sector to improve affordability and minimise the costs associated with bad debt.

6. Excellent customer service

6.1. We understand and support the need for companies to propose ambitious plans that deliver more of what customers want, and we expect our plan to meet this expectation. We understand that our customers' needs and expectations are changing and we are already working to deliver services in different ways, where appropriate, making greater use of technology and data to meet customers' demands.

6.2. We therefore support the proposals for greater positive incentives for the best performing companies, and, where appropriate and comparable, the use of cross-industry benchmarking.

6.3. The Board is concerned however that the Methodology will lead to a perception of collective industry failure. External stakeholders are not able to distinguish between a regulatory financial incentive and a fine for a misdemeanour. The Methodology's expectation that most companies will suffer financial penalties against the four key service metrics will in our view undermine trust in the sector as a whole and this is not in the long term interest of consumers.

6.4. The Board is also concerned that the Methodology represents a greater willingness from Ofwat to overwrite local customer priorities and demands, particularly for leakage, and that this could lead to imbalanced plans. This risk is reinforced by the associated procedural, reputational and financial incentives which are skewed to encourage planning teams to err towards the initial regulatory assumption, rather than risk arguing for a position that reflects local circumstances, priorities and demands.

6.5. An example of this is the approach to leakage. Our evidence shows that our customers' priorities around leakage are now changing. Customers are now more willing for us to prioritise approaches that will minimise their bill in return for ensuring that: the volume of water we abstract is held stable; we help customers reduce their own use of water; leakage is managed efficiently; and we invest in new ways to cost-effectively manage leaks in the long-term.

They are also willing to play their part in reducing their own use of water. While we acknowledge that the Methodology allows for companies to explain differences to the regulator's opening assumption this is accompanied by considerable procedural and financial risk.

6.6. Similarly, the Methodology allows for special factors to be claimed around company-specific costs, but implies penalties for those that are unsuccessful. Our reading of the Methodology is that, for higher levels of service resilience to be taken into account, a company would have to submit a special cost factor. It is feasible then that a company already delivering better and more resilient levels of service could be penalised twice – this seems at odds with an incentives based regime. We would welcome clarity in the final methodology around how any such outcome will be avoided.

6.7. Overall, we consider it would be preferable for the incentives regime to be set entirely based on the preference and agreement of customers at local level. Our experience suggests that this would enable both the long- and short-term interests of customers to be properly explored and addressed. This would meet the trust agenda and protect consumers with a high degree of effectiveness.

7. Financing the Plan

7.1. The long-term health of the sector needs the active participation of equity investors to sustain investment and drive greater innovation and encourage risk-taking.

7.2. While recognising the recent reports from the NAO and others that identify the historical issue of regulatory forecasting of debt and tax costs the Board does not support the proposals for debt indexation and tax pass-through. This represents a retrograde move towards a rate of return culture, encouraging more passive, risk-averse investors rather than long-term active investors that will drive the innovation that the sector needs. It will also encourage company management to be more focused on negotiating the increasingly complex regulation that surrounds this.

7.3. We note the proposal to transition to indexing the RCV using CPIH rather than RPI. As you know, the Board does not agree with the change of index. Maintaining value neutrality between customers and investors remains a key focus for the Board, and we are concerned that the change cannot be made in a value-neutral way. We would welcome a restatement of Ofwat's commitment to this principle in the final methodology over both the short term and the long term.

7.4. Maintaining the resilience of this long-term sector, where the consequences of failure are severe, requires a longer-term view to be taken around financing than currently set out in the Methodology.

7.5. We note that the approach laid out to setting the cost of equity represents a significant change from regulatory precedent, including some recent decisions, and we would anticipate further analysis of the potential costs and benefits of this change in advance of a final decision. The analysis on the likely allowance for equity returns places emphasis on spot-rates rather than long-run averages. There are good reasons to consider that the cost of equity for the period in question (i.e. 2020 to 2025) will not be consistent with the analysis of a spot rate.

7.6. PwC's analysis appears to rely primarily on the latest spot-rate output of their Dividend Discount Model (DDM). Repeating this analysis for PR19 would be akin to assuming that equity returns have the properties of a random walk, rather than the conventional view that over the long term equity returns will fluctuate around a historical mean. PwC argue that this mean has changed in recent years, but even if one accepts that this is the case we recommend that an average should be taken over a period for which the "new normal" applies.

7.7. Moreover, Ofwat will need to consider how changes in gilt yields, interest rates, QE, taxation and the impact of Brexit could impact on future equity returns. Forward looking evidence currently show expectations of a drift up in yields over the period to 31 March 2025. An increase in gilt yields should also affect expectations for returns on other assets during AMP7. Forward looking metrics such as this must be considered when setting allowed returns for the period 2020-2025.

7.8. We also note that the PwC analysis of DDM appears to be less robust than that conducted by others when addressing similar issues. If a more recent analysis of DDM is to be used by Ofwat it should be developed to take account of actual dividend expectations in the short term (as does the Bank of England) rather than be based purely around assumptions on UK GDP growth.

7.9. Any acceptance of a new normal for equity returns will also have implications for assumptions on pension deficits, in particular those that existed at the PR09 determination, which have formed part of both the PR09 and PR14 price settlements. We recommend that the final methodology recognises that the assumptions around equity returns, including those that inform the assumptions around pensions deficit valuations and their funding should be consistent.

8. The Balance of Returns

8.1. The Methodology is sometimes explicit, and elsewhere strongly implies, that the balance of likely returns is skewed to the downside[2]. This can be seen in the key incentive regimes for outcomes, for cost-sharing and cost-assessment but also in lower-order incentive mechanisms proposed around revenue forecasting, cost adjustments and bioresources forecasting. This is likely to lead to well-performing companies earning below their cost of capital.

8.2. Such an imbalance is inconsistent with Ofwat's stated trust and confidence strategy, and may ultimately increase costs to consumers. Moreover, it takes no account of all investment, performance and service to date, and strongly

[2] Ofwat (July 2017). Delivering Water 2020 p.72, in reference to Outcome Delivery Incentives

assumes the industry now requires behavioural incentives weighted to the downside.

8.3. The logical corollary of this approach is that investors will need to assume that they have a greater than 50% chance of failing to earn the determined cost of capital, and that their company will be fined for under-performance. This must imply they will require a greater central level of equity return, in order that the best performers can earn at or above their true cost of capital.[3] This could be interpreted by customers and consumer bodies as over-estimating the true cost of capital, leading to a loss of trust in economic regulation.

8.4. We would encourage Ofwat to engage with companies and be more transparent on these issues in the final methodology, showing clearly how a truly balanced set of incentives will deliver better outcomes for customers in the long-term. Our recommendation is that the incentive schemes be adjusted to allow significantly greater opportunities to meet and beat the targets, and that penalties should not apply where a company is delivering at or above the industry average level.

9. Conclusions

9.1. Overall the Board regards the current package as overly skewed to the downside and short-term issues for companies and investors, and believes that the health of the industry requires Ofwat to take a longer term, more balanced view.

9.2. The skewing of incentives towards the downside risks creating a perception that the industry will be failing to deliver, even if the reality is that continual improvements are being achieved. It also encourages submissions that are focused on short-term objectives and bill levels rather than long-term plans.

9.3. This will damage trust in the industry just at the time when we most need our customers, partners and investors to participate with us in meeting the challenges we face. A more balanced set of incentives will ensure continued financeability, further resilience in the sector and better protect consumers over the long-term.

9.4. As noted above, the Board is keen to understand how some of the proposed changes in your policy and approach are compatible with the statutory framework and we are giving more thought to this area.

9.5. As we move towards the draft PR19 methodology, the development of Water 2020 and the subsequent licence changes have been good examples of the industry and regulator working together in a more transparent manner to achieve common goals. We hope that this level of engagement will continue

[3] Ofwat makes this same point when discussing the impact of a penalty-based regime (November 2016) in A consultation on the Outcomes framework for PR19 pp. 7-8

over the coming months as the Methodology is finalised and as we develop our business plans and PR19 submission.

Yours sincerely

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