**Northumbrian Water response to the Ofwat consultation: 'Putting the sector back in balance: Consultation of proposals for PR19 business plans'**

Northumbrian Water Limited (NWL) welcomes the opportunity to respond to the consultation, and we trust that the important issues raised in it can be considered over an appropriate period of time. Given the significance of the proposals and that many represent a fundamental change of established regulatory policy, we would be very concerned if decisions were taken in haste. In particular, the three week consultation period in our view is inadequately short to properly consider such fundamental changes to regulation, even if all relevant empirical evidence was independently prepared in advance and made available by Ofwat, which has not been the case. We are also concerned by statements made by Ofwat on 14 May that its decision paper could be issued as early as June 2018.

We fully support the aim of further enhancing trust and confidence in the sector and continuing to deliver for customers, as previously confirmed. Our concerns, as set out in the responses to the questions below, are that we believe the proposals are unreasonable, unacceptably far reaching, creating significant uncertainty and that collectively this uncertainty is not in the interests of customers or the broader sector, and as such we believe it would be remiss of us not to challenge these proposals.

We are very concerned by the distinct lack of supporting data and evidence, as well as the absence of any impact assessment for many of the fundamental changes proposed. The imposition of explicit restrictions on companies' capital structures and dividend policies represents a fundamental and highly significant change from the well-established and proven regulatory practice that has favourably served customers to-date.

We are concerned that the warning issued by the credit rating agency Moody's Investor Services (Moody's), in February 2018, that *"changes to regulation to restrict companies' financing arrangements would be a departure from past practice and could undermine the regime's track record of stability and predictability"* may now occur, and in turn undermine the long-held confidence in the water sector.

Ofwat's emerging preference for companies to propose individual and varied regulatory policies, rather than there being a clear mandatory regulatory system, also creates significant and unnecessary ambiguity.

**The importance of stable, transparent, and incentive based regulation in the UK**

The impact of Ofwat tightening the allowed cost of capital in its existing PR19 methodology, and the capture for customers of past and future cost efficiencies, will already deliver considerable customer benefits through falling bills. This clearly shows that customers benefit from stable, transparent and incentive based regulation. We strongly believe that if a company adopts an ambitious business plan, that delivers great service for customers at an efficient cost, invests sufficiently in resilience to enable such service and cost to be maintained long into the future, and then outperforms that plan, then customers benefit and companies should be rewarded. Equally, if a company fails to deliver great customer service or invest adequately in long-term resilience, then it should be penalised accordingly.

Any development that threatens to reduce regulatory objectivity, or to make regulatory decisions less transparent and more unpredictable, will undoubtedly increase risk in the sector, which will ultimately flow through to an increased cost of capital. Of particular concern would be any move away from 'rules based' regulation, which sets out the regulatory contract in clear and unambiguous terms, towards 'discretion based' regulation, which relies upon decisions that are difficult to predict in advance. In particular, any move towards 'ex-post' regulation where, for instance, decisions on appropriate returns are taken after the event, would be seen as highly retrograde.

**Northumbrian Water response to the Ofwat consultation: 'Putting the sector back in balance: Consultation of proposals for PR19 business plans'**

## The importance of targeted, risk based regulation

We believe strongly in predictable rules based regulation, and in particular that any changes to established regulatory practice should not be retrospective. Such changes should be made explicitly through Licence amendments or changes to the price setting methodology, which then establish very clearly what the rules are from that point onwards, after detailed, evidence-based consultation. In that regard we have been very concerned at recent use of public castigation as an ad hoc regulatory tool.

We remain strongly of the view that any changes must preserve the incentive based nature of regulation, which has been proven to work well for customers. It has helped sector leading companies like NWL, where we aim to always deliver unrivalled customer service, to drive standards higher, deliver on our customer promises, invest resiliently for the long-term and improve environmental performance over many years. We believe it is important to maintain the incentive for companies to strive for greater performance, which is key to making the regulatory system work for customers.

***Q1: Do you agree that companies should be required to propose mechanisms for sharing financing outperformance in their business plans, and that we should assess such mechanisms in the IAP?***

No, we do not.

For the reasons we set out in Q3, we do not believe that Ofwat has set out any clear evidence that higher gearing actually creates financial outperformance. Ofwat has already set out a common approach to the indexation for the cost of new debt and, as per Q3, we believe there is already an established mechanism for sharing industry performance on embedded debt, which works well for customers, resulting in over 50% sharing of any outperformance already with customers.

Due to this established mechanism, we strongly believe that Ofwat's new proposal for sharing financial outperformance will lead to unintended perverse outcomes, specifically:

- Higher leverage could be viewed as actually in the customers' interests as their bills would be lower than would otherwise be the case; and
- Customers of a water company with actual leverage in line with the 60% notional level would be penalised, as they would pay more for their water than customers of a water company that has leverage above 65%.

Any attempt to differentiate for the gearing level in the cost of capital would require a significant amount of academic study and lengthy consultation.

We strongly believe that if customers were actually consulted on whether they would welcome a company increasing its gearing, within certain parameters, so as to be able to deliver a reduction to customer bills, then most customers would welcome such an outcome due to the positive impact on their bills.

***Q2: Where adequate mechanisms are not offered in business plans, do you agree we should intervene to impose a sharing mechanism, to ensure customers will receive an appropriate level of benefit from companies with highly geared structures?***

No, we do not.

As per Q1, this illustrates in our mind the perverseness and complexity of the approach proposed. If despite all the clear evidence invalidating Ofwat's proposed approach, some form of mechanism was still introduced, and Ofwat intervenes with an imposed mechanism for some companies, there will be a mixture of regulatory and non-regulatory approaches. Ofwat would have to devise multiple reporting and assurance approaches to confirm sharing mechanisms were maintained and used appropriately. Our response (covered in specific detail in the response to Q3 below) highlights the sharing scheme specifically cited by Ofwat as one which does not actually appear to deliver additional benefits for customers beyond those being delivered by other companies as 'business as usual'. In our view this clearly evidences how the discretionary sharing concept is flawed and unenforceable in practice across the sector.

***Q3. Do you have views on our proposals for the design of the outperformance sharing mechanism for highly geared structures? Do you agree that the calculation should be on a nominal basis and take account of the actual, rather than notional, cost of debt?***

We believe Ofwat's suggested design is impractical for the reasons already outlined above.

If despite all the evidence contrary to Ofwat's proposed approach, some form of mechanism was introduced, we agree that using a nominal basis would be simpler and avoid the complexity of the interaction between RPI and CPIH. If a real terms approach was taken, the figure deducted for inflation would have to be the same for the cost of equity and the cost of debt, leaving the difference the same as the nominal approach.

Using actual company cost of debt for the calculation also risks undermining the incentive for companies to seek efficient financing. It does not seem right to us that if two companies have the same level of gearing, the one with the lower cost of debt would then also face the larger outperformance adjustment. Similarly if a company has a cost of debt higher than Ofwat's notional allowance, would that be used in the calculations?

**(i) Sharing outperformance associated with high gearing**

Ofwat has failed to provide clear evidence, beyond a short reference to a UK utilities dataset, for its choice of 60% for the level of 'high gearing' (or 65% if the 5% deadband is adopted). In addition, we don't believe Ofwat is better positioned to comment on gearing than established credit rating agencies such as Moody's, Standard & Poor's or Fitch Ratings, who have assessed trillions of pounds of debt that has successfully been raised around the world over many decades. Furthermore, we don't believe Ofwat's view aligns with those published by the credit rating agencies, in the context of whether greater than 60% gearing should be considered as 'high' for a UK water company.

In addition, any kind of arbitrary gearing level would also require very tight definitions, particularly with regards to inclusion or exclusion of swap and other derivative positions, as well as other accounting liabilities such as pension deficits, given the material impact these can have on net debt calculations.

In our view this is an area where further economic research study would be required to assess and quantify further before any suggested mechanism could be formally considered.

In terms of calculating financial outperformance, Ofwat state that *'finance theory implies that equity returns increase in linear fashion with gearing but, typically, such theories do not reflect the benefits of securitisation arrangements.'* There is no evidence provided to support such an assertion, which seeks to overturn fundamental finance theory (Modigliani & Miller) that has been generally accepted by all parties for decades. For example, in the 2017

Firmus Energy appeal, the CMA confirmed that returns to equity varied with gearing, and so we are very surprised by this sweeping comment in the consultation document.

It is imperative that any major departure now from the well-recognised economic principle of the cost of capital being independent from gearing levels, should be accompanied by a reputable published study rather than this principle being dismissed.

**(ii) Sharing outperformance of the cost of debt**

We agree with the separation of the cost of new debt from embedded debt and the indexation of the cost allowance for new debt. This was well trailed and evidenced in the PR19 methodology consultation.

For embedded debt, we agree with Ofwat's statement that *'sharing mechanisms may weaken company incentives to manage financing risks and could expose customers to risks associated with companies' actual financing structures'.* As a consequence, we do not understand why Ofwat then goes on to say that *'where companies outperform the notional cost of debt that underpins our cost of capital, we reiterate that we expect companies to consider adopting their own outperformance sharing mechanisms.'* This implies that either Ofwat expects variations in the cost of debt performance to be shared asymmetrically or that companies with costs higher than the notional cost of debt would be allowed to pass a proportion of those onto customers. Either approach has significant consequences that require careful consideration.

Finally, and crucially, reductions in the cost of embedded debt are already shared with customers. Embedded debt typically has a tenor of 20-25 years. The industry might keep outperformance for up to five years, before the reduction is passed on to customers. In this way, the debt cost outperformance sharing proportion for customers is already significantly greater than 50%.

**(iii) Forms of debt outperformance sharing**

We believe Ofwat's debt outperformance sharing concept is flawed for the reasons already outlined.

Ofwat state '*we would also expect companies to provide assurance that any mechanism for benefit sharing, other than lowering bills, is genuinely delivering extra for customers, beyond what they are already required to deliver to meet statutory and licence obligations that should be provided from the regulatory cost allowance.'*

As covered in Q1 response, we note that Ofwat specifically cites in the consultation the Watershare scheme as an appropriate form of benefit sharing, which states:

https://www.southwestwater.co.uk/about-us/watershare/earning-and-sharing-benefits/

*In 2015/16, the first year of our five-year regulated business plan, we performed better than expected and earned a £3.1m benefit which is being passed back to customers as reinvestment in improving services.*

- *The benefit was earned largely because we managed to borrow money for investment more cheaply than predicted when we submitted our business plan to Ofwat in December 2013. Customers therefore directly benefit from our success in being ever-more efficient.*
- *The £3.1m reinvestment is already delivering a better and more responsive service to customers, on top of previously planned investment. The extra improvements include:*
- *The creation of 22 new jobs in the Exeter call centre to respond to and resolve customer inquiries more quickly and fully*

- *Extra assistance for vulnerable customers, particularly those in social housing*
- *Extra measures to encourage customers to save money and water by having a free water meter installed in their property*
- *Working with communities to reduce sewer blockages in hotspot areas by raising awareness of what not to flush or pour down toilets and sinks, and working with the Environment Agency and Cornwall Wildlife Trust to reduce the risk of pollution*

As we see it, the outperformance reinvestment noted above seems to be targeted at improving levels of customer services and delivering increased levels of existing services. It is difficult to see how this is any different to the services and strategies that other companies like NWL already provide as part of their core functions. Further the company makes no mention of the arrangements for sharing 2016/17 outperformance on its website, and we therefore believe this example chosen by Ofwat clearly evidences how the discretionary sharing concept is flawed and unenforceable in practice across the sector.

In our view, this is a clear example of how a company devised voluntary benefit sharing approach could actually undermine customer trust in a regulatory regime rather than increase it. Customers must be assured that benefits shared are not those that would have been delivered anyway, through the normal company actions. This is the reason we prefer a sector wide approach to any benefit sharing based on rules that are consistent and transparent, though we do not believe one is required for gearing for the reasons already outlined.

**Q4: Do you agree that companies should explain their approach to dividend policy in their business plans and that our IAP assessment should assess both transparency and how the policy takes account of factors which include obligations and promises to customers, delivery of service to customers, financial resilience and employee interests?**

When considering the level of dividends, company boards already have a range of prescribed factors that they must consider under the UK Corporate Governance Code (The Code) as well as required under the Listing Rules (LR) under LR 9.8.6 R in relation to going concern statements that directors are required to make. These state that directors should give due consideration to matters such as business performance, prospects of the company and principal risks *"including those that would threaten its business model, future performance, solvency or liquidity"*. As such, when declaring any dividend, company boards consider as a matter of course operational performance, affordability, prevailing risks and future prospects. We are unclear why Ofwat considers these current requirements and obligations to be insufficient for the water sector. Is there evidence to suggest that dividend policies in the water industry have been more risk-taking than those in other sectors?

We are deeply concerned that Ofwat's guidance amounts to an attempt to regulate company dividends, akin to rate of return regulation. The de facto imposition of a prescribed dividend policy is unacceptably intrusive and overrides Ofwat's previous long-held assurances and published position that capital structures and dividends are a matter solely for companies.

These proposals move us from revenue regulation to regulation of company balance sheets and go far beyond the remit of stable, predictable and well thought through economic regulation.

The consultation sets out the licence conditions that companies must comply with and we accept.

Page 26 of the consultation then sets out an extra series of extremely broad conditions, none of which are in the licence. Many of these conditions simply create uncertainty – for example, the suggestion that companies should consider whether obligations and promises have been met before paying dividends is extremely vague. Similarly the comment regarding pension deficits is ambiguous, and companies require much more detail of what this statement in the consultation document is meant to actually mean in practice.

Under the PR19 methodology, Ofwat has already created a scenario in which tightening the allowed cost of capital, and capturing past and future efficiencies, will already deliver considerable customer benefits. In addition it has created an outcomes regime which is designed to be very challenging, but still allow high performing companies to earn an overall incentive reward. As a consequence of these proposals it is now unclear whether that reward could now flow through into dividends. If not then this regime has clearly been nullified.

We believe that the creation of any quasi-legal 'obligations' could adversely affect the credibility of the UK regulatory regime as it can, and has in the past, resulted in public disagreements between companies and regulators over what companies are required to do and whether the regulator has the powers to make that happen.

With intervention in company returns of this scale and consequence, there is a real risk to the sector that equity and debt investor behaviours, and appetite for investment, are likely to be significantly affected. With very low base returns, limited upside and potential for significant penalty, this may also severely limit the potential for discretionary investment with this accompanying degree of uncertainty. We also have concerns that these new proposals are likely to act as a constraint on innovation, and penalise and restrict good companies with sector leading efficiency and great customer services such as NWL.

One of the benefits of the established and proven incentives based regulatory regime over rate of return regulation is that companies can be confident that additional risks taken though successful innovation or extra investment will be compensated for through additional returns. If these returns are in effect trapped in the company, then companies will become risk averse and innovation will suffer. In addition, we are concerned that the proposals could result in trapped cash on company balance sheets, leading to inefficient use of corporate capital for companies and investors alike.

**Q5: Do you agree that companies should explain their approach to any performance related element of executive pay in their business plans and that our IAP assessment should assess both transparency and that policies for awards of any performance related element of executive pay demonstrate a link to exceptional delivery for customers?**

Water company licences ensure that all companies have due consideration to The Code. NWL therefore already fully complies with the remuneration disclosure obligations of The Code where relevant, and we explain fully any areas of The Code which are not relevant to us as a private company. We are happy to embrace the suggested disclosure of the ratio of CEO pay to the average, and be an early adopter of this proposed future revision to The Code, alongside our already comprehensive and transparent executive pay and remuneration disclosures.

Significantly more information is required by companies to understand how any further obligations or possible IAP assessment criteria could align with the existing and future Code guidance, which we note is purposely designed for listed companies. Without additional clarification we cannot assess whether it would be appropriate to extend our already comprehensive disclosures or whether it would be appropriate for Ofwat to extend the current IAP assessment criteria.

**Q6: Do you agree with our proposed revisions to extend the confidence and assurance test area to include trust and with the revised wording of question 3 of this test area?**

No, we do not agree with the revisions.

The revisions introduce uncertainty over how Ofwat will assess what appropriate measures are and what a fair balance between customers and investors is. They will encourage complexity and incoherence across the industry.

The approach proposed will produce a multiplicity of policies across the industry that will be unenforceable by Ofwat. As we have noted earlier, if Ofwat believe that a regulatory issue needs addressing, it should be clearly consulted on and mandated across the industry rather than encouraging a range of unenforceable policies that could be changed at any time.

**Q7: Do you have any comments on the additional clarification of our approach to financial resilience in the IAP?**

We feel that the additional financial resilience tests now being proposed are simply unnecessary and furthermore the scenarios as set out in Section 6.2 do not align to those in the Business Plan guidelines per table App26 – RORE scenarios. There is no guidance on how the results of these stress tests would need to be considered by company boards, presented or whether Ofwat believes it wishes to see the financial results of such additional stress tests.

If Ofwat wishes to change the stress tests from those set out in App26 this should be incorporated into the Tables and Business Plan guidance and fundamentally ensure that these are based on sensible plausible scenarios.

We do have a specific concern over the proposed inflation stress test. It is not clear whether the test is for inflation to be 3% below Treasury forecasts (2% pa for CPIH) for one year or every year. To have five full years of deflation seems to us to be extreme if not unprecedented. A more realistic stress test would either be a single year of deflation or five years of inflation at 1% below Treasury forecasts.

The totex overspend scenario proposed is also unrealistic for all but the most inefficient companies. In particular, companies which are able to demonstrate Upper Quartile or better efficiency should be able to use more realistic assumptions reflecting the lower risk of underperformance. This is the approach we intend to take in our business plan, alongside our intention to assess downside scenarios that are appropriately tailored to our business, rather than taking a 'one size fits all' approach that Ofwat appears to now be proposing, in particular in relation to the combined downside case.

**The Board of**
**Northumbrian Water Limited**
**May 2018**