

17 May 2018

Benefits sharing consultation
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

By email: Water2020@ofwat.gsi.gov.uk

Dear Sir

PUTTING THE SECTOR BACK IN BALANCE: CONSULTATION ON PROPOSALS FOR PR19 BUSINESS PLANS

We are pleased to have the opportunity to respond to Ofwat's consultation on proposals for PR19 business plans. As we have previously indicated, we are supportive, in principle of Ofwat's regulatory reform principles and look forward to working with Ofwat on the detail supporting these principles as they are developed in order to ensure that they deliver the right long term outcomes for the water sector and our customers. It is essential for the reputation of the sector that the changes proposed in this consultation incentivise the right behaviours and keep bills as low as possible for customers in the longer term.

We strongly support the proposals as they relate to highly geared companies (above 60% gearing) and have long believed that high levels of debt are not good for the sector and do not afford customers the right level of protection.

Principles we adopted for PR14 and believe are relevant to consider given the proposals relating to highly geared companies are;

- Gains made by companies that are essentially 'unearned' and sit outside of the regulatory framework should be returned customers, not 50% but 100%
- Incentives should be appropriate and designed to achieve the desired outcomes over the long term. A proposed 50% sharing rate may yet incentivise shareholders either to retain a higher level of gearing or perversely incentivise lower geared companies to increase gearing.

We agree with the principle of sharing the benefits of new financing costs with customers and that is why we introduced our own voluntary WaterShare mechanism in PR14.

An aspect of this mechanism is that 'unearned gains' arising from rate movements in the capital markets rather than management intervention is returned 100% to customers, with management preserving the incentive to perform in this area through actual performance.

By the end of 2017/18 this has already resulted in c. £15m of cost of new debt outperformance being available for sharing with our customers. Applying the same principles to all of the other companies in our sector such that their customers also share in the benefits of such appears logical.

Retaining the incentive for management to be efficient with financing within a 'notional' regulated structure is important, as shareholders rightly bear that risk.

However we believe the principle of returning 'unearned gains' should be adopted and having voluntarily introduced that for PR14, we are again considering a voluntary position for debt costs in our PR19 business plan.

More generally, the remaining requirements that Ofwat has set out are considered broadly reasonable and we are content that these elements be introduced into the IAP process. The challenge will be to ensure a proportionate approach that provides scope for innovative responses and encourages a commitment by companies to achieving demonstrable balance within its business plan approach between the interests of customers and investors.

We believe that an appropriate approach will need to focus on:

- Companies demonstrating transparency in their proposed mechanisms and need engagement in their development
- The broad impact of a company's suite of proposals, including that they are joined up and represent a coherent strategy that has the support of its Board and its customers.

Supporting this, the regulatory approach should ensure that the company's Board provides the relevant assurances, and that the CCG report the relevant comments. Backed up by suitable rewards triggered through the IAP process and the reputational impact of the transparency of the proposals being required by the regulator, this would constitute, in our view an effective and proportionate regulatory approach to addressing the real concerns evident around balance between the interests of our two key stakeholders, our customers and our investors.

The annex to this letter contains our responses to the specific questions raised in the consultation.

We hope you find our comments helpful. Please contact us if you would like further detail.

Yours faithfully



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ANNEX – CONSULTATION QUESTIONS

QUESTION 1

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?

We support Ofwat's proposal for companies to be required to propose mechanisms for sharing financing outperformance in their business plans.

SWW has already introduced WaterShare as part of our PR14 submission. This is: our sector leading approach to sharing outperformance across a range of metrics with customers and included outperformance on the cost of new debt which was not covered by the regulatory approach at PR14. As we are intending to build on our approach for PR19 Ofwat's proposed requirement is, for us, in line, at a level of principle, with our philosophy and our Board pledges.

Although we consider there is significantly less scope for outperformance on financing going forward, given the intended indexation of the cost of debt, we agree that including financing outperformance in an explicit benefit sharing mechanisms is an important element to building trust and confidence in the sector.

Ofwat's consultation focuses on two particular areas of outperformance: embedded debt and high gearing. We have two concerns with this.

First, that focusing on these two elements of financing outperformance will distract from the broader objective, which is the achievement of an overall better balance between the interests of customers and investors. This may therefore risk some companies taking too narrow a view of how they deliver 'balance' (e.g. proposing tick box mechanisms to deal with these two issues) while also risking other companies being unrewarded for more innovative and broader proposals, designed to ensure more effective customer participation in the gains from outperformance. Our approach, building on WaterShare, will enable us to be transparent with customers about the extent and sources of financing outperformance and enable a constructive discussion with our customers about whether and how and when, taken in the context of our performance in the round, those gains should and could be shared with customers.

We therefore urge Ofwat to seek to facilitate benefit sharing in the round, rather than focusing on its proposed suite of mechanisms from ODI in period sharing, to cost of debt indexation, and specific proposals on gearing and embedded debt. The latter is less likely to take account of customer preferences e.g. for bill stability, reinvestment, bill reductions etc.

Secondly, regarding the cost of embedded debt we are particularly concerned that Ofwat does not recognise in practice (as well as in principle) that companies will need to be careful in considering their response to this, so as to sustain investor confidence. We welcome the fact that the regulator has recognised the potential incentive damage that requiring companies to share this outperformance could cause. We also note that, unlike high gearing, this advantage reflects relative efficiency in raising debt compared with other companies, with no attendant risks to customers or financial resilience.

We welcome therefore that Ofwat is proposing to leave any such proposal on embedded debt to companies to design. This will enable companies to derive mechanisms with which they, their investors and their customers are comfortable in the longer term.

Ofwat's proposal to assess companies proposed mechanisms in the IAP is not unreasonable. The objective will need to be clear, such that, for instance, it would be reasonable for Ofwat's assessment to focus on the demonstration of certain key principles such as:

- Transparency of the mechanism,
- Engagement and support of customers for the mechanism,
- Compatibility with the rest of the regulatory regime (including the proposals on financial resilience, dividends and executive pay) and with its incentive properties
- Contribution to an overall improved balance between customers and investors.

It would be inappropriate for Ofwat to second guess companies and their customers as to what appropriate sharing rates or circumstances might be, or to assume one size fits all. As indicated above, we emphasise that Ofwat's assessment should include consideration of how companies are more broadly achieving customer participation in performance, and the overall balance of risks and benefits shared with customers, as well as the evidence of customer support for a company's approach.

Left open, companies will be encouraged to innovate in this area. Any perceived threat of bespoke arrangements being overridden or the application of a 'one size fits all' being the upshot is likely to dampen this incentive.

QUESTION 2

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?

We believe that if Ofwat adopts the principles suggested above, that Ofwat should not need to intervene, as this will undermine companies' engagement with their own customers and the validity of that process. We recognise that customers (or CCGs) may not always feel comfortable with what companies are proposing in this area, or with their own expertise on this matter, in which case if CCGs seek Ofwat's advice in this area, perhaps in the report they are required to submit to Ofwat, that would be a more reasonable approach.

QUESTION 3

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 strongly support the proposals as they relate to highly geared companies (above 60% gearing) and have long believed that high levels of debt are not good for the sector and do not afford customers the right level of protection.

Principles we adopted for PR14 and believe are relevant to consider given the proposals relating to highly geared companies are;

- Gains made by companies that are essentially ‘unearned’ and sit outside of the regulatory framework should be returned customers, not 50% but 100%
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QUESTION 4

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?

We agree that it is a reasonable expectation of companies to explain their dividend policies and for Ofwat’s IAP to consider the transparency of their explanation. We think that while Ofwat’s IAP might expect the policy to take account of the listed factors, Ofwat should not try to adjudicate the best way of defining or measuring those factors, or the best method for taking account of those factors. Ofwat might wish to see a good process of engagement on the development of the policy that includes consideration of these factors, so that the Board can give appropriate assurance and the CCG can comment on the company’s engagement in this area.

QUESTION 5

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?

We agree that it is appropriate that companies should explain their approach to performance related pay (PRP). The IAP should again stick to key principles, such as transparency as suggested. In terms of demonstrating a ‘link’ to ‘exceptional performance’, it would be reasonable to expect an explanation of PRP to describe the performance which it rewards. It would not, in our opinion, be for Ofwat to determine what is a benchmark of ‘exceptional’ or what measures of ‘performance’ are adopted. This should be a matter for the Board representing investors and taking account of other key stakeholders including customers

QUESTION 6

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?

We agree with this proposal. However, in terms of the assessment which appears then broken down into 4 very specific elements, we would be concerned that the assessment may then become too compartmentalized and narrowed, losing sight of the overall objective., i.e. ‘a fair balance between the interests of customers and investors’... and ‘a high level of transparency and engagement’.

QUESTION 7

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

Given the context of PR19 and the areas identified by Ofwat and the Secretary of State as of concern, the requirement on companies to provide assurance of financial resilience is not unexpected. Indeed any responsible company will do this as a matter of course to satisfy its own Board and investors during the course of business planning for a price review.

We would however caution against Ofwat attempting to review and assess at a level of detail – risking additional complexity in its own tasks and on companies who may have to duplicate existing risk assessments in order to fit in with Ofwat definitions and approaches.

We therefore believe that more attention should be placed on ensuring Boards provide the necessary assurance of good processes and methods used to test financial viability, and assurance of effective customer engagement on these matters, rather than attempting to judge those calculations themselves.