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

A Consultation Response from Dŵr Cymru Welsh Water

Welsh Water recognises the importance of the issues raised in this consultation paper and is supportive of the efforts being made by Ofwat, the UK Government and water companies to enhance the customer legitimacy of the water sector.

Many of the issues raised in this wider process are not relevant or are less relevant to the circumstances of Welsh Water, due to our unique ownership structure and governance model, and also because of the differing policy framework of the Welsh Government. However, the intention appears to be that the proposals set out in the Consultation Paper would be applied to all companies at PR19. We therefore welcome the fact that Ofwat is consulting on these proposals and we would welcome further dialogue on certain key points. Given that these changes to the PR19 Methodology are being introduced at a relatively late stage in the process, just before companies submit their PR19 Business Plans, it will be important to have an open discussion of the proposals and their detailed methods of implementation, to avoid any errors or unintended consequences being introduced.

Sharing financing gains

We support Ofwat's approach of seeking to achieve a fair balance of risk and return between companies and their customers. Welsh Water is not a highly geared company and our Board approved policy is to keep our gearing at around 60%, as we believe that this is in the best long-term interest of our customers.

However, we are concerned that a company such as ours could unintentionally be affected by the proposals as put out for consultation in the event of unexpected circumstances which require the company to borrow more in the short-term in order to maintain its essential public services in the face of an adverse cost or financial shock. Such possibilities are covered by the Ofwat consultation paper's consideration of "financial resilience" and, in such circumstances, a temporary increase in gearing is one likely company mitigation option – indeed it is the reason why our gearing is targeted to stay below a specified level, so as to allow for a margin of financial resilience in a downside scenario.

Clearly, it would not be helpful in such adverse circumstances for the company to suffer a further reduction in the financial resources available to it, because of a reduction in customer bills resulting from the temporary increase in gearing. Based on our extensive customer engagement activities in recent years, we believe that our customers would prefer to see the company better able to deal with its challenges and ensure the continuity of a high quality, essential public service, rather than receiving a temporary reduction in customer bills which would further reduce the money available to maintain the service.

We would therefore suggest that the proposed sharing mechanism should be applied only where a company plans to maintain gearing at above a level considered excessive by Ofwat, as reflected in its PR19 Business Plan submission, or where gearing increases due to financial decisions taken by the company (for example to increase leverage by way of a special dividend). It should not apply where gearing rises unexpectedly in the short-term due to adverse financial circumstances and the company is trying to take corrective action (for example, by restricting dividend payments). In addition, the proposed 60% gearing level with a 5% deadband is materially below the level that we would have considered excessive and would not allow much margin for fluctuations in financial performance, as referred to above. We would suggest that a deadband of at least 10% would be justified.

Dividend policy and executive pay

We support Ofwat's approach to seek to achieve transparency for customers in terms of the dividend and remuneration policies of water companies, since these businesses provide an essential and largely monopoly service to the public. We also believe that Ofwat are right not to want to control these matters directly, as they are key judgements for company boards to make in light of their own circumstances, in an open and transparent manner.

Welsh Water is different to the other water companies in that we do not have shareholders and so we do not pay any dividends out of our Group. All value created is returned to customers or reinvested in the business for their future benefit; we call this "Return of Value". We aim to be fully transparent by explaining our Return of Value each year to our customers in our Annual Report and Accounts and in our results announcement. We also intend to explain our policy for future Return of Value to customers in our PR19 Business Plan and how this will be informed by ongoing customer engagement (our "Have Your Say" campaign).

The Remuneration Committee of our Board seeks to achieve a very high level of transparency in our approach to executive remuneration, both with the Glas Cymru Members, who formally approve our remuneration policy, and with our customers. Our Annual Report and Accounts provides an extensive explanation of the executive remuneration policy, with full disclosure of how performance related pay is based on key metrics of customer service, environmental quality, drinking water quality and cost efficiency. There is detailed discussion of remuneration at each Annual General Meeting, with an annual Member vote on the Remuneration Report.

Financial Resilience

We support Ofwat's general approach to ensuring that PR19 delivers a water sector that is resilient for customers, including in terms of its financial resilience in the face of economic or financial shocks. This approach is very much aligned with our annual consideration of the long-term viability of our business, which we report on in our Annual Report and Accounts and in our Annual Performance Report.

However, whilst we can see the attraction of having some common downside scenarios modelled by companies as an input into PR19, we do have concerns that some of the proposed sensitivities are more extreme than we would have considered appropriate. This risks undermining the value of the exercise. For example, a 15% totex cost underperformance is more extreme than we would normally consider justified by the balance of probabilities - a 10% scenario would be more realistic. Similarly, a prolonged 3% variance in inflation from its target level looks rather higher than that implied by the probability "fan charts" included in the latest Bank of England Inflation Report (May 2018), which suggest that a 2% variance might be a more appropriate sensitivity.

Whilst the resilience scenarios clearly need to be “severe”, there is a danger that too severe an approach could actually result in our company being required to maintain gearing at a level materially lower than it really needs to be, thereby preventing us from applying financial resources to improve service and value for money for our customers in the medium term. Furthermore, such extreme scenarios, if really considered plausible, could call into question in the minds of investors and rating agencies whether the PR19 “early view” for the cost of capital is actually sufficient to offset such a degree of risk.

We would also note that the modelling of such downside scenarios will need to take account of the relevant, existing regulatory methodologies which may come into play in such circumstances, including the totex cost sharing factor, the indexation of the cost allowance for new debt and the Interim Determination mechanism for new legal obligations.