
Issues to consider in price control redeterminations

1. Introduction

1.1 We were asked by the CMA panel during our presentation on 20 May 2020:

“I just wanted to give you the opportunity to expand on that if there are particular areas of your thinking, either as a result of evidence you have had since the determinations were made, or just generally having finished the process, whether from your point of view there are areas where you feel really that – I don’t want to say you are uncomfortable with your decision – there are things that you really would like us to focus on and reconsider particular elements.”

1.2 We have written this note to aid the CMA in making its redeterminations by highlighting a number of issues, being either company-specific or applying to all disputing companies, which the CMA may want to consider in its assessment. We would be happy to provide any extra information or background on the issues we have listed, should this be of assistance to the CMA.

1.3 We have previously noted that the redetermination process is not a facility for referring specific issues, but one in which companies receive a full redetermination of their respective price controls. However, the disputing companies do not have an incentive to draw attention to instances where Ofwat may have made generous decisions. On the contrary, the submissions represent **an attempt to unpick selected parts of the package without necessarily considering it as a whole**. We aim to redress this imbalance in this note, by highlighting areas in which:

- changing one element of a company’s determination **would have implications for other elements of the determination**, which would need to be taken account of to make the determination appropriate in the round;
- evidence suggests **our approach may have been conservative** and there is a credible case for increasing the challenge on the company; or
- recent evidence suggests there is a case for adjustments to the determination.

- 1.4 These considerations are important because we necessarily set our determinations ‘in the round’. By this we mean that **individual elements form part of a broader final determination package**, and have been considered as such during the price review process. At PR19, we made decisions that took into account wider evidence, including to ensure that determinations as a whole are stretching but achievable. We consider that any redetermination should take the same approach.
- 1.5 In terms of recent evidence, below we highlight where the forecasts that are necessarily required as part of the price review process will have been impacted by the Covid-19 pandemic. This includes the allowed return, labour and energy costs and growth rates. We acknowledge that many of the impacts of Covid-19 on the water sector remain uncertain including the impacts on performance commitments and wider water sector costs. As the impacts of Covid-19 become clearer, we would welcome the opportunity to make further representations on the issue.

2. Summary of issues to consider

2.1 In Table 2.1 and Table 2.2 below, we summarise the issues we would like to highlight to aid the CMA in making its redeterminations.

Table 2.1: Cross-cutting issues

Issue	Summary of issue
New issues	
Growth	There is evidence to suggest that our forecast of new connections is too high , in particular because of the likelihood of a severe economic recession arising from the Covid-19 situation. ¹
Real price effects	Analysis suggests that the case for real price adjustments for energy is weaker than at final determination , with greater uncertainty over energy prices, and that there may be a case for a negative real price adjustment for labour costs . ²
Water Industry National Environment Programme (WINEP)	Analysis suggests that all the disputing wastewater companies spent considerably less on the PR14 National Environment Programme (NEP) than they forecast in their business plans, suggesting greater scope for efficiency challenge on WINEP .
Allowed return on capital: equity beta	We consider that a lower notional equity beta than our final determinations point estimate of 0.71 could be supported taking account of alternative approaches to the delevering and relevering of beta observations, including the approach adopted by the CMA in its provisional decision for the redetermination of NERL RP3 and taking account of recent market evidence.
Allowed return on capital: outperformance wedge	New analysis suggests that a higher outperformance wedge on new debt could be supported by the evidence of bonds issued in the water sector in the period December 2019 to June 2020, where outperformance against our benchmark index has averaged 53 basis points for companies with a capital structure that is similar to the notional structure. ³
Financeability	The financial model calculates funds from operations / net debt on the basis of closing net debt. Anglian Water's modelling of downside scenarios in its latest submission calculates the financial ratio on average net debt, which increases the funds from operations / net debt financial ratio .
Per capita consumption	The third-party submission from Waterwise states that some companies are 'accepting' underperformance payments on their per capita consumption performance commitments. ⁴ The CMA should

¹ In this context, it is particularly surprising to see that Anglian Water's latest forecasts represent an increase compared to its October 2019 forecasts. See Ofwat, '[Reference of the PR19 final determinations: Response to Anglian Water's statement of case](#)', May 2020, pp. 65-7, paragraphs 3.101 to 3.103.

² Ofwat, '[Cost efficiency – response to common issues in companies' statements of case](#)', May 2020, pp. 126-7, paragraph 8.44.

³ We also addressed the issue of estimating the outperformance wedge in Ofwat, '[Reference of the PR19 final determinations: Risk and return – response to common issues](#)', May 2020, pp. 82-6, paragraphs 3.109 to 3.115.

⁴ Waterwise, '[Ofwat PR19 Final Determinations & CMA Appeals](#)', May 2020, p. 3.

	consider whether, given these statements, underperformance payments for per capita consumption should be increased.
Considerations in the round	
Catch-up efficiency challenge	Our catch-up efficiency challenge at PR19 was significantly lower than we applied at PR14 and other UK regulators have previously set more stretching benchmarks than the upper quartile. ⁵
Smart metering	A valid alternative approach to smart metering would be to provide no additional enhancement expenditure to fund the replacement of existing basic meters with smart meters, as there are cost savings companies can realise from the installation of smart meters. ⁶
Frontier shift	There continues to be evidence for a higher frontier shift allowance . If the stretch on outcomes is reduced or there is an increase in cost allowances for achieving those outcomes, there is a case to revisit whether frontier shift assumptions should be higher. ⁷
Retail controls	If residential retail controls are not disputed, we do not propose that retail controls are reopened as part of the CMA's redetermination . ⁸ However, any additional revenues above those requested should be borne in mind when redetermining controls in the round, in particular for Yorkshire Water. ⁹
Estimates of ODI risk and return and customer protections	Should the CMA adjust performance commitment levels, it would need to make corresponding adjustments to P10 and P90 estimates of performance . ¹⁰
Compliance risk index (CRI)	Should the ban on metaldehyde be reinstated during the period the CMA is conducting its redetermination, we consider the CMA should revert to the level of deadband for CRI we set at draft determinations . ¹¹
Expected performance and asymmetric information: inclusion in the level of stretch	The CMA should consider whether there should be an adjustment to reflect expected performance or asymmetric information as part of its redetermination. ¹²
Financeability	We note that various final determination assumptions made concerning the notional company in financeability testing could be

⁵ Ofwat, 'Cost efficiency – response to common issues in companies' statements of case', May 2020, pp. 73-4, paragraphs 6.20 to 6.22, and p. 78, paragraphs 6.37 to 6.39.

⁶ We explained our enhancement uplifts for smart metering for Anglian Water and Northumbrian Water in Ofwat, 'PR19 final determinations: Securing cost efficiency technical appendix', December 2019, pp. 83-5.

⁷ Ofwat, 'Cost efficiency – response to common issues in companies' statements of case', May 2020, pp. 79-82, paragraphs 7.1 to 7.11 and p. 98, paragraph 7.56. Ofwat initial presentation to CMA, May 2020, slide 46.

⁸ Bristol Water states in its 27 May submission to the CMA that it 'do[es] not dispute Ofwat's retail controls', while Northumbrian Water has correctly noted that the CMA did not examine the retail controls in its redetermination of Bristol Water's price controls in 2015. Bristol Water, 'Statement of Case', April 2020, p. 1, paragraph 4; Northumbrian Water, 'NWL Statement of Case: PR19 CMA Redetermination', April 2020, p. 5, paragraph 15, footnote 25.

⁹ Ofwat, 'Reference of the PR19 final determinations: Response to Yorkshire Water's statement of case', May 2020, p. 30, paragraph 3.7.

¹⁰ Ofwat, 'PR19 final determinations: Delivering outcomes for customers policy appendix', December 2019, p. 164.

¹¹ Ofwat, 'PR19 final determinations: Delivering outcomes for customers policy appendix', December 2019, pp. 49-50.

¹² Ofwat, 'Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case', May 2020, pp. 47-8, paragraph 4.6.

	altered, reducing the need to bring forward revenue to support financeability.
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Table 2.2: Company-specific issues

Issue	Summary of issue
Anglian Water	
Capital maintenance	There is scope for a downward adjustment by up to £55 million to reflect Anglian Water’s forecast costs associated with the transfer of private wastewater pumping stations, which is considerably lower than its reported historical expenditure. ¹³
Leakage	We consider that our allowances for Anglian Water to maintain and reduce leakage levels are generous , as the company has not taken into account the influence of enhancement allowances, in particular for smart metering, on its ability to maintain leakage levels. ¹⁴
In some areas, Anglian Water is already delivering its 2024-25 performance commitment level	Anglian Water is in line to earn significant outperformance payments for its sewer flooding performance commitments , ¹⁵ and benefits from significant resilience funding to meet its water supply interruptions performance commitment ¹⁶ . Under a company specific approach, the stretch could be increased.
Enhanced outcome delivery incentives	Should the CMA adjust Anglian Water’s standard outperformance rate for its leakage performance commitment, it would need to make a corresponding adjustment to the companies’ enhanced leakage ODI rate . ¹⁷
Bespoke scheme performance commitments	Should the CMA make adjustments to any of the parameters used to calculate ODI rates for scheme-specific performance commitments (including the allowed return on capital, cost sharing rates, RCV run-off rates and scheme totex), it would need to make a corresponding adjustment to these ODI rates . ¹⁸
Financeability	The CMA could choose to follow the approach proposed by Anglian Water in its business plan to take the beneficial effect of reconciliation adjustments for past performance into account for assessment of the financial ratios in its financeability assessment. ¹⁹
Bristol Water	

¹³ This is evident in the large difference between Anglian Water’s reported historical capex (£73.4 million) and the forecast capex for the period 2020-25 (£18.9 million); see Anglian Water, ‘[PR19 CMA Redeterminations - Statement of Case](#)’, April 2020, p. 72, paragraphs 314-15.

¹⁴ Anglian Water’s comparatively high unit cost for leakage reduction also suggests that our allowance was generous; see Ofwat, ‘[Reference of the PR19 final determinations: Response to Anglian Water’s statement of case](#)’, May 2020, pp. 107-10.

¹⁵ Ofwat, ‘[Reference of the PR19 final determinations: Response to Anglian Water’s statement of case](#)’, May 2020, p. 133, paragraphs 4.9 to 4.11.

¹⁶ We made a total allowance of £588 million for Anglian Water to ensure resilience for the longer term, over £110 million greater than for any other company, including £305 million for its regional interconnectors programme.

¹⁷ Ofwat, ‘[PR19 final determinations: Delivering outcomes for customers policy appendix](#)’, December 2019, pp. 118-19.

¹⁸ Ofwat, ‘[PR19 final determinations: Delivering outcomes for customers policy appendix](#)’, December 2019, pp. 135-40.

¹⁹ Consistent with our PR19 methodology, we chose not to adopt this approach in our final determinations; see Ofwat, ‘[PR19 final determinations: Aligning risk and return technical appendix](#)’, December 2019, p. 91.

Canal & River Trust cost adjustment claim	We made a partial allowance for this claim as part of our in the round assessment to acknowledge that the company challenged its costs considerably throughout the price review process. Should the CMA consider the Canal & River Trust cost adjustment claim in isolation, we would recommend this claim is disallowed in its entirety as it is not justified on the basis of evidence presented. ²⁰
Bristol Water's forecast performance will attract outperformance payments	Bristol Water is in line to earn outperformance payments for its water supply interruptions and per capita consumption performance commitments if it performs in line with its business plan. Under a company specific approach, the stretch could be increased.
Bespoke scheme performance commitments	Should the CMA make adjustments to any of the parameters used to calculate ODI rates for scheme-specific performance commitments, (including the WACC, cost sharing rates, RCV run-off rates and scheme totex), it would need to make a corresponding adjustment to these ODI rates. ²¹
Company specific adjustment	If the CMA accepts that Bristol Water should receive a higher allowed cost of debt on account of its circumstances as a small company, it should consider calculating the cost of debt allowance for other disputing companies excluding the impact of small company data. If the CMA accepts Bristol Water's arguments on operational gearing, the CMA should consider whether the most appropriate response is to revisit the gearing assumption for the financeability assessment rather than uplift the allowed equity return.
Northumbrian Water	
In some areas Northumbrian Water is already delivering at the level required in its final determination for 2025	Northumbrian Water is in line to earn significant outperformance payments for its pollution incidents and water supply interruptions performance commitments. Under a company specific approach, the stretch could be increased.
Enhanced outcome delivery incentives	Should the CMA adjust the standard outperformance rate for Northumbrian Water's leakage, water supply interruptions or pollution incidents performance commitments, it would need to make a corresponding adjustment to the companies' enhanced ODI rates. ²²
Bespoke scheme performance commitments	Should the CMA make adjustments to any of the parameters used to calculate ODI rates for scheme-specific performance commitments (including the WACC, cost sharing rates, RCV run-off rates and scheme totex), it would need to make a corresponding adjustment to these ODI rates. ²³
Yorkshire Water	
Wastewater WINEP phosphorus removal	The Environment Agency has moved back some completion dates for phosphorus removal schemes to beyond 2025. Our final determination allowance was for the full WINEP programme to be

²⁰ Ofwat, 'Reference of the PR19 final determinations: Response to Bristol Water's statement of case', May 2020, pp. 55-60.

²¹ Ofwat, 'PR19 final determinations: Delivering outcomes for customers policy appendix', December 2019, pp. 135-40.

²² Ofwat, 'PR19 final determinations: Delivering outcomes for customers policy appendix', December 2019, pp. 118-19.

²³ Ofwat, 'PR19 final determinations: Delivering outcomes for customers policy appendix', December 2019, pp. 135-40.

	delivered by 31 March 2025. ²⁴ We therefore consider that some expenditure for these schemes could be deferred to PR24.
Yorkshire Water's forecast performance will attract outperformance payments	If the company delivers the water supply interruptions performance levels in its September plan, it would receive outperformance payments of £18 million over the 2020-2025 period. Under a company specific approach, the stretch could be increased.
Enhanced outcome delivery incentives	Should the CMA adjust the standard outperformance rate for Yorkshire Water's leakage, per capita consumption, water supply interruptions or pollution incidents performance commitments, it would need to make a corresponding adjustment to the companies' enhanced ODI rates. ²⁵
Bespoke scheme performance commitments	Should the CMA make adjustments to any of the parameters used to calculate ODI rates for scheme-specific performance commitments, (including the WACC, cost sharing rates, RCV run-off rates and scheme totex), it would need to make a corresponding adjustment to these ODI rates. ²⁶
Moderations to our ODI rates interventions	Should the CMA make adjustments which materially change the overall balance of risk and return associated with Yorkshire Water's ODI package, it should consider whether our adjustments to mitigate the company's downside exposure are still necessary. ²⁷

²⁴ Ofwat, 'Reference of the PR19 final determinations: Response to Yorkshire Water's statement of case', May 2020, pp. 58-63, paragraphs 3.123 to 3.139.

²⁵ Ofwat, 'PR19 final determinations: Delivering outcomes for customers policy appendix', December 2019, pp. 118-19.

²⁶ Ofwat, 'PR19 final determinations: Delivering outcomes for customers policy appendix', December 2019, pp. 135-40.

²⁷ We set out the adjustments we made at final determination in Ofwat, 'PR19 final determinations: Delivering outcomes for customers policy appendix', December 2019, p. 107.