

November 2020

# Reference of the PR19 final determinations: Introduction to our response to provisional findings responses

**Ofwat**

## 1. Introduction

- 1.1 This short introductory document is accompanied by two papers setting out our responses to the submissions made by the disputing companies in respect of the CMA's Provisional Findings. The two papers cover: Risk and Return; and Costs and Outcomes. In introducing these submissions, we wish to draw the CMA's attention to four key points.

### 1. The Scope of the Submissions

- 1.2 The CMA has asked that we address only the new issues and evidence raised in other parties' responses to the Provisional Findings. This is what we have done.
- 1.3 Some of the issues raised by companies in their response to the Provisional Findings are not new, but merely repeat arguments that they have previously made. The CMA has already received our submissions and evidence in response to these representations, and we do not repeat them here.
- 1.4 We have not responded to all of the issues raised by third party respondents, although we consider it is important to set out our response to the Energy Networks Association submission (and the accompanying Annexes by Oxera) given the level of detail they have provided.

## 2. New Claims by the Parties

- 1.5 The disputing companies have submitted a range of new evidence and argument to argue for a substantial increase in cost allowances and even higher returns than proposed by the CMA in the Provisional Findings. They have also made some entirely new claims, or advanced claims in ways that we have not previously seen. Elements of the approach by the companies appear to us to be very surprising.
- 1.6 **First**, as set out in our response to the Provisional Findings, the allowed return and incentive package proposed by the CMA materially alters the overall balance of risk and return in the companies' favour. The CMA's proposed allowed return is above the level that was proposed by the companies for the sector in their original business plans, which underpinned Board assurance by the companies that their plans were financeable.
- 1.7 It is surprising therefore that each of the disputing companies continues to claim that the determination proposed by the CMA is challenging and proposes more amendments

that would further skew the risk and return package further to companies at the expense of customers.

- 1.8 There is strong evidence that the PR19 allowed return incentivises investment. As part of the green recovery, in July we, together with Defra and other regulators, invited companies to accelerate AMP 7 investment, bring forward AMP8 investment or to bring forward specific new innovative ideas, which would benefit current or future customers.<sup>1</sup> So far companies (both disputing and other companies) have proposed more than £2 billion of additional expenditure in this control period. This includes around £500 million of proposals from Anglian Water and Northumbrian Water **before** they were aware of the CMA provisional findings on the allowed return.<sup>2,3</sup> This is in addition to companies strongly supporting taking forward almost £2 billion of contingent amber WINEP proposals included in the AMP7 settlement. We therefore do not consider that an increase on the PR19 allowed return is required to incentivise investment.
- 1.9 **Second**, each of the disputing companies is advancing claims for allowances that are new or presented in ways that we have not previously seen. For instance –
- **Anglian Water** asks the CMA to make up a totex ‘gap’ of £630 million. However, it has now shifted its focus to alternative ways to increase its totex, most notably by advancing new cost adjustment claims for the costs of large wastewater treatment works (£53 million)<sup>4</sup> and the use of average pumping head (£36 million).<sup>5</sup> In addition, Anglian Water argues for a move to average rather than upper quartile cost efficiency that would increase its cost allowance by £122 million (or £328 million if this were applied to all the disputing companies).<sup>6</sup>
  - **Northumbrian Water** includes claims for the CMA to allow £234 million more totex than in the Provisional Findings, which includes £121 million more for base cost allowance and £113 million more for enhancement expenditure. Of these amounts, a total of £77 million relates to entirely new claims that are being made only after the Provisional Findings were published.<sup>7 8</sup>
  - **Bristol Water** has consistently asked the CMA to close the c. £30 million gap between its business plan and our final determination throughout the process. However, the cost elements that it relies upon to bridge the gap have varied in the company’s submissions (albeit with leakage and service level adjustments as

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<sup>1</sup> Defra, Ofwat, EA, DWI, CCW, [‘Green economic recovery – the water industry’s role in building a resilient future’](#) July 2020.

<sup>2</sup> Peter Simpson, letter to Rebecca Pow, Rachel Fletcher, Marcus Rink, Harvey Bradshaw, Emma Clancy, 17 August 2020

<sup>3</sup> Heidi Mottram, letter to Rebecca Pow, 10 September 2020

<sup>4</sup> Anglian Water. ‘Response to provisional findings’, p.11

<sup>5</sup> Anglian Water. ‘Response to provisional findings’, p. 11.

<sup>6</sup> Anglian Water, ‘Response to provisional findings’, p. 23. And Ofwat calculations.

<sup>7</sup> Northumbrian Water, ‘Response to provisional findings’, table 2, p. 9 (NB. our calculation excludes £6m for the RPE chemicals adjustment to base which is no longer requested)

<sup>8</sup> Northumbrian Water, ‘Response to provisional findings’, table 9, p. 34

repeated themes). For example, the £6 million base leakage allowance Bristol Water now asks the CMA to give<sup>9</sup> is significantly lower than the £13 million it originally asked the CMA to consider in its statement of case.<sup>10</sup> Conversely, the £25 million service level adjustment it now asks the CMA to make<sup>11</sup> is significantly higher than the £14–15 million it requested in its statement of case.<sup>12</sup>

- Even though the provisional findings would provide **Yorkshire Water** with a comparable average bill to its April 2019 business plan (at £379), Yorkshire Water is arguing for an additional £79 million that it has not asked for previously in the CMA process in order to address internal sewer flooding.

1.10 **Third**, the disputing companies are now asking that the CMA use 2019–20 data in its modelling. The effect of this is to request much higher allowances at the same time as reducing the stretch on performance commitments than anticipated in the Provisional Findings. The inclusion of this data alone would allow what the companies themselves claim to be £145m more in cost allowances. This is composed of: Anglian Water, £26m; Northumbrian Water, £39m; Bristol Water, £26m; and Yorkshire Water, £54m.<sup>13</sup>

1.11 For the reasons set out in our response to RFI 019, we consider that the CMA should not revise cost allowances to take account of 2019–20 data. In short, the data are unreliable for modelling purposes because:

- they reflect an unprecedented rise in wholesale water costs in the final year of a price control period, entirely out of line with historical trends and with the position in respect of wastewater costs;
- all of the evidence strongly suggests that this is driven by companies bringing forward spending on leakage reductions from the current price control period; and
- the data are therefore highly distortive of the true cost position in the last price control period.

1.12 Use of the 2019–20 data would therefore allow the disputing companies allowances that are disproportionate to actual need and unjustified in the light of the costs properly attributable to the last price control period. It would also require a reassessment of other areas of the control, e.g. cost adjustment claims, catch-up efficiency challenge and performance commitments.

1.13 In light of the forward looking information companies submitted in August 2019 – once the performance commitment levels for AMP7 were well understood – the base cost

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<sup>9</sup> Bristol Water, '[Response to CMA provisional findings](#)', October 2020, p. 39, paragraph 179.

<sup>10</sup> Bristol Water, '[Statement of case](#)', April 2020, p. 98, paragraph 395.

<sup>11</sup> Bristol Water, '[Response to CMA provisional findings](#)', October 2020, p. 39, paragraph 179.

<sup>12</sup> Bristol Water, '[Statement of case](#)', April 2020, p. 85, paragraph 341.

<sup>13</sup> Bristol Water, '[Response to CMA provisional findings](#)', October 2020, table AN1.4, p.68. Oxera, 'On the use of 2019/20 APR data in econometric modelling', October 2020, table 4.3, p. 9.

allowances we set at our final determinations, and those provisionally set by the CMA in its Provisional Findings, remain reasonable.

- 1.14 **Fourth**, the aggregate effect of the claims now made by the disputing companies on top of the CMA's Provisional Findings, together with other repeated claims on both cost allowances and the allowed return, is that the disputing companies are seeking more revenue than they sought in their April 2019 PR19 revised business plans. This is both inappropriate as a matter of procedure, and undermines the credibility of the claims.
- 1.15 The table immediately below compares average household bills from the Provisional Findings to the company April 2019 revised business plans. In response to the Provisional Findings, each of the disputing companies now claims a higher allowed return and substantially increased cost allowances. The combined impact of these proposals would drive bills higher than those that would have flowed from those business plans even if we had accepted them in full.

Company	Revised business plan	CMA provisional findings
Anglian	£418	£400 (~£407 including Anglian proposed PAYG rates)
Bristol	£174	£166
Northumbrian	£343	£335
Yorkshire	£379	£379

- 1.16 For example including Yorkshire Water's additional cost allowance requests would increase bills by around £5 above the level in the provisional findings and their business plan. For Anglian Water including its totex allowance proposals would increase bills to around £4 above its revised business plan, and including its allowed return proposals would increase it by further £8, i.e. £12 above its revised business plan. Claims from Bristol Water and Northumbrian Water would similarly result in bills above their revised business plans.
- 1.17 **In summary**, we suggest that these matters should give the CMA pause for thought. In particular, the CMA is entitled to ask why new and reformulated claims are being advanced at this late stage of proceedings. Such claims advanced only after the Provisional Findings have already been made – at the same time as the companies are inviting the CMA to truncate the re-determination process by not using the time available to it under statute – ought to require a high standard of justification by any company seeking to advance them. We therefore encourage the CMA to apply a high bar before even considering these new and reformulated claims. It is entirely reasonable to put the companies to strict proof of the necessity of any such claim at this stage.

- 1.18 We also invite the CMA to view with scepticism any arguments that would, if accepted, skew risk and return further in favour of the companies, especially where this would lead to the companies benefiting from a higher return than they requested in their business plans and which their boards provided assurance were financeable.
- 1.19 In short, the CMA should be astute, in our opinion, to avoid the disputing companies seeking to take advantage of this re-determination process to obtain benefits beyond those that they need or have previously claimed. That would involve a highly questionable use of the current process. It would risk creating severely distorted incentives on companies in relation to their handling of future price controls.

### **3. Requests beyond the Scope of the Process**

- 1.20 Some of the disputing companies have invited the CMA to make various recommendations or observations as to the future. Some non-disputing companies, in their role as third parties, have invited the CMA to make recommendations as to Ofwat's actions in relation to their own price controls.
- 1.21 Both of these requests concern matters that go beyond the CMA's remit in these proceedings. They seek to persuade the CMA to come to conclusions or express views on matters in respect of which it unavoidably does not possess all of the relevant information and on which it has not been fully sighted. We respectfully suggest that this is a position which the CMA should avoid.
- 1.22 In the same way, in the Provisional Findings, the CMA did not consider it would be appropriate to provide views or set out principles in relation to how Ofwat should approach Covid-19 impact, nor did it consider it was clear that it fell within its powers to do so.
- 1.23 As to the non-disputing companies, their price controls must ultimately be matters for Ofwat in circumstances in which those companies had the opportunity to seek a referral to the CMA, but decided to accept the controls that we had determined. We will consider their price controls in future as we always do – in the round, in accordance with our duties, and based on the full spectrum of information available to us.
- 1.24 With regard to wider matters of future regulation, these are of course work in progress. As the CMA knows, we have carried out a lessons-learned exercise in the light of PR19 with a wide range of our stakeholders, including all the companies. We will continue to evolve our price control setting process so that it remains fit for purpose in the future,

having regard also to wider developments.<sup>14</sup> It would be inappropriate, as well as beyond the scope of the current exercise, to pre-empt these issues now.

#### **4. Focus on Key Matters**

- 1.25 Finally, bearing in mind the points made above, we wish to emphasise a point as to procedure.
- 1.26 The CMA is aware that we have made a number of representations about the work that still needs to be done in order to bring the re-determination process to a fair conclusion that delivers the right outcome for customers. We need not repeat these points here. We note only that we recognise there remains a lot that the CMA needs to do and – even with the additional time that the CMA has now decided to take. As we said in our submission on the CMA’s proposed revised timetable, it would not be appropriate or prudent to narrow that window further. We do not consider the arguments put forward by the companies on this issue have any merit and their views as to the potential impacts and legal or practical barriers to address them, should that be appropriate or necessary at the time, are either incorrect or overstated.
- 1.27 We therefore invite the CMA to focus on issues of central importance to customers of the disputing companies, and to use its time judiciously to address the issues that have been identified as being of fundamental concern.

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<sup>14</sup> In December we intend to publish our PR24 launch document engaging the sector on the future challenges for PR24. In addition, we have already begun to consider our approach to reflecting customers’ preferences in future price reviews. We expect to publish a discussion paper which outlines a set of proposals in this area shortly. This has been informed by our lessons learnt from PR19, as well as a number of preliminary discussions we have had with companies, CCG chairs, academics and regulators from other sectors. We have also started considering asset resilience and held our project kick off meeting involving various stakeholders earlier in [November](#)

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