ST Classification: UNMARKED

Monitoring and reporting approach for new appointees

Consultation response

Severn Trent Water and Hafren Dyfrdwy

April 2021

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Content

1. Overall response

We welcome your consultation on the monitoring and reporting approach for new appointees. We agree with the purpose and objectives you have put forward, which should provide effective protections for water customers while applying a proportionate reporting approach to new appointees.

We agree with proportionate reporting requirements for all water companies that protect customers effectively. We note that some new appointees are growing to a point where they are close in size to some of the incumbent firms. We therefore do not think you need to distinguish between the regulation of new appointees and incumbents as a matter of principle.

We welcome the concept of a tiered approach for reporting requirements. We think your middle tier could cover smaller existing incumbents as well as NAVs that provide water and wastewater treatment. We think there is a strong case for introducing more proportionate reporting requirements and price controls for the smaller incumbents because they vary in size so much. For example, Hafren Dyfrdwy has annual allowed revenues of £26m (2017-18 prices) compared with Thames Water that has annual allowed revenue 79 times greater at £2,058m (2017-18 prices).

For performance reporting we suggest that new appointees could report on the metrics used for the common PR19 performance commitments (although we're not suggesting the common performance commitments and ODIs should apply to them). This would create some comparability between all companies and allow new appointees to move between the different reporting requirements in different tiers more easily. We would need to be careful when drawing comparisons because new appointees usually have much newer assets than incumbents and can also have their data distorted to a much greater extent by one-off events.

We provide our responses to the individual questions below.

2. Responses to individual consultation questions

Q1: Do you agree with the purpose and objectives we have set out? Should we consider other factors when developing our monitoring and reporting approach?

We welcome your consultation and agree with the purpose and objectives you have put forward.

We think that there is a good logic for taking a proportionate approach to the regulation of NAVs to protect water customers effectively. To achieve a proportionate approach, we think you could consider factors beyond the NAV's size, such as the type of services they provide (retail, water and/or wastewater services), risks to customers and risks to the environment. In addition, where you consider a NAV's size you could consider different ways of defining size beyond a financial turnover metric – perhaps customer numbers or volumes treated/supplied/delivered.

Q2: To support our purpose and objectives, do you agree with the principle of strengthening reporting requirements for all new appointees that are distinct from those for incumbents?

We agree with proportionate reporting requirements for all water companies that protect customers effectively.

We do not think you need to distinguish between new appointees and incumbents as a matter of principle. A new appointee could grow to become larger than an existing incumbent and it is not clear why, in such circumstances, different rules should apply to the new appointee and the incumbent.

Q3: Do you agree with the principle of introducing proportionate reporting requirements that are based on a 'tiered' approach? What should be the basis of these tiers?

The concept of a tiered approach is helpful in making sure that NAVs face proportionate reporting requirements as they expand their businesses.

Your proposed two tiers for new appointees and one tier for incumbents in table 3.1 raises some interesting policy questions.

First, we think it would be better to distinguish 'tier 1' and 'tier 2' by the type of service a company provides rather than size of turnover. Those companies that only buy water and/or wastewater services from incumbents, maintain local networks and provide retail services require less reporting than those NAVs and small incumbents in tier 2 that provide water and wastewater treatment services.

Second, table 3.1 also raises the issue of why the 17 incumbents should be subject to full price controls given their large disparity in size. Hafren Dyfrdwy has annual allowed revenues of £26m (2017-18 prices) compared with Thames Water that has annual allowed revenue 79 times greater at £2,058m (2017-18 prices). We think there is a strong case for introducing more proportion reporting requirements and price controls for the smaller incumbents. This is a point we made in response to your "PR14 review – call for input" in January, that the price controls could be significantly simplified for Hafren Dyfrdwy at PR24.

Third, we don't support basing the threshold between 'tier 2' and 'tier 3' on whether condition B of a company's licence is suspended. Using condition B raises the question of how you decide whether a company should have condition B of its licence applied. Such rules are likely to relate to company turnover and customer numbers, so it would probably be better to be transparent about such rules. Moving away from an approach based on whether condition B is suspended also avoids treating new appointees and incumbents differently as a matter of principle. For example, it is not clear why different rules should necessarily apply to Hafren Dyfrdwy when new appointees are reaching sizes where they will be serving as many wastewater customers as Hafren Dyfrdwy.

Fourth, if you do use turnover thresholds to define the tiers, then we suggest you set these in real terms rather than nominal values. The risk with nominal values is that these would fall in real terms over time and small steady-state NAVs could find themselves being moved up a tier, despite no material change in their business. Inflation of just 2% a year would see the nominal threshold fall in real terms by 25% in 15 years.

We've put below an alternative suggestion for table 3.1 removing the distinction between new appointees and incumbents.

Table 3.1 – an alternative option for reporting tiers

	'Tier 1' Retail-plus companies	'Tier 2' Intermediate companies (full-service NAVs and small incumbents)	'Tier 3' Large incumbents
Water company	Companies buying water and/or wastewater services from incumbents, maintaining local networks and providing retail services.	Companies providing their own water and/or wastewater treatment, maintaining networks and providing retail services. This includes NAVs and small incumbents e.g. Hafren Dyfrdwy	The large water-only companies (WoCs) and water and sewerage companies (WaSCs)

Q4: Do you have any comments on how we should approach the information we collect from new appointees?

Including NAV information in Ofwat's annual publications would be worthwhile because it would create a readily available, trusted source for such information. In doing this, it will be helpful to make sure that the NAV content is proportionate to the role that they play in the sector and the financial and operational risks for customers and the environment. We suggest that, as a minimum, NAVs provide information on infrastructure serviceability and performance, financial resilience and compliance with environmental permits and standards.

Q5: What are your views on how the quality and transparency of financial information in small company returns could be improved? How could this vary by tier?

The quality and transparency of information make an important contribution to customer trust and confidence in our sector. Therefore, we think that this is a standard that should apply equally to all NAVs, irrespective of size.

Q6: Do you agree with our proposal to introduce an annual narrative requirement for new appointees subject to a company-based assessment? Should further information be included in the small company return?

We are supportive of an annual narrative requirement to explain material differences between forecasts submitted as part of the company-based assessment and actual performance. This should help reassure customers that all services providers are being held accountable for performance.

Q7: Do you agree with the principle of a consolidated annual performance report that is accessible to all relevant stakeholders? For some measures, may another format be more appropriate?

We agree that performance data should be consolidated into a single, annual performance submission, which is available to all stakeholders. This will make sure such information is provided on a consistent basis across the sector, thereby bolstering transparency and accountability.

Q8: What should the annual performance report include as a minimum and which existing performance measures may be relevant to include?

To us, a good starting point for annual performance reporting looks to be the metrics that incumbents currently report on – mainly the metrics underpinning the common performance commitments (although we're not suggesting the common performance commitments and ODIs should apply to NAVs). Overall, we think that this approach would aid stakeholders in making appropriate comparison between the performance of new appointees with incumbent companies. We would need to be careful when drawing comparisons because new appointees usually have much newer assets than incumbents and can also have their data distorted to a much greater extent by one-off events.

Q9: How may reporting requirements differ between new appointees and at what level should performance information be reported?

As noted above, we think the quality and transparency requirements should be consistent across all new appointees, regardless of size and area of activity. We considered whether such a move might go too much against the concept of proportionality. On balance, we think these requirements are necessary given the vital public service new appointees provide to their customers.

When it comes to reporting performance, we would suggest that this is done at the company level, rather than a site-by-site basis. This will then give the best view of company performance and is largely consistent with the approach taken for incumbents. New appointees could be required to provide a narrative on performance that calls out any significant changes in performance, including explanations of the drivers of that change in performance and any remedial plans to get performance back on track.

It is also worth thinking about whether small companies should report just annual numbers or focus on rolling-averages. When companies are small, one-off events could have a significant and outsized impact on a single year's performance, without offering much insight on whether there are performance trends to be concerned about. One way to overcome this challenge might be to use rolling averages to get a clearer line of site on overall performance trends.

Q10: What should our approach be for ensuring there is sufficient assurance relating to the information provided by new appointees in their annual returns?

We think that, as a minimum, all annual returns should be signed off by a company's Board. We would also suggest that independent third-party assurance is needed for all types and sizes of NAVs. This will help make sure customers can remain confident that service providers of all types are reporting information to the same high standard. For the smallest and newest NAVs, such independent assurance is likely to prove particularly useful as it will help build and strengthen their reputations as transparent and trustworthy providers of services for customers – reputations that could otherwise take much longer to achieve.

Q11: What should our approach be in terms of the board leadership, transparency and governance of new appointees?

Overall, Ofwat's planned approach looks sensible given the need for greater transparency on NAV corporate and board structures. Having NAVs provide a narrative in their annual reports on their governance arrangements will support this transparency.

Q12: Do you have views on how and when changes to reporting requirements for new appointees should be implemented?

As an incumbent, the timing of changes to reporting requirements is not an area we are well-placed to comment upon. Assuming that the new appointees already capture much or all of the needed information and data as part of being well-run businesses, then the changes change could be implemented for the 2021/22 reporting year.