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By email

Ofwat
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Dear Sir

Northumbrian Water response to: Green economic recovery: draft decisions

We welcome the opportunity to respond to Ofwat's Green Recovery draft determinations.

The Green Recovery process represents a missed opportunity and Ofwat could have been clearer in its methodology for the process

It is hugely positive that Ofwat has allowed some additional investment in essential water and wastewater services to support a green recovery at a difficult time for local economies. Bringing forward investment to create jobs and support environmental improvement at this challenging time must be the right thing to do. However, we remain of the view that this is a significant missed opportunity - much more could have been done across a much wider group of companies.

We note that Ofwat have agreed to make in-period revenue allowances for two companies to support financeability. We highlighted financeability as a key reason why we chose not to make a submission into the Green Recovery process. We were not confident that this would be taken into account in Ofwat's decision making. Ofwat's proposed approach to financeability as published is much clearer and broader than was set out at the time of consideration. It is now akin to the re-determined price control that we were discouraged from requesting at the time of submission.[1]

Had this been clearer at the outset, then NWL and the industry could perhaps have made more of the opportunity.

Green Recovery is different from the normal five-year price review cycle, but the proposed cost sharing rates are likely to result in customer detriment

Ofwat highlights reasonably that the Green Recovery is different because the proposals represent investments for which the need case is likely different than investments in the normal price review cycle. If these investments were as essential as others' then they would ideally have been recognised in the PR19 settlement.

[1] As set out in letter from NWL to DEFRA (Sally Randall + Ofwat cc'd) dated 6 January 2021.

In this context we note the proposed use of a 10% outperformance sharing rate on the investments. Ofwat also applied asymmetric cost sharing rates during PR19 and this was reviewed by the Competition and Markets Authority who moved the cost sharing rates back to a level much closer to symmetry (45:55). We appreciate that the Green Recovery remit is different from a normal price review and so there may be less rationale for companies to earn outperformance on these investments but the scale of these sharing rates in our opinion is probably driving customer detriment. Obviously where sharing factors are more symmetrical companies have a strong incentive to reduce costs and those savings are shared with customers. Unless Ofwat is almost 100% confident that its allowed costs are efficient and that there is no scope for efficiency then the incentive rate is not going to provide any incentive on companies to pursue those efficiencies. If Ofwat considers that these incentive rates should continue then they should be seen as a 'one-off' choice for this exercise.

The Green Recovery process proves the concept of major enhancement projects being reviewed outside of the formal five-year cycle and there is a clear advantage of early analysis and certainty over large schemes like this

The May 2021 PR24 consultation recognises the value of early engagement on material issues in advance of business plan submissions and the Green Recovery process does precisely that. One of the historical challenges with major enhancement schemes is that the clarity on scope, options, risks and costing of major projects evolves over time in line with best practise to asset management and project development. Typically, the further away from construction the project is the more risk and uncertainty is plans and costing estimates and this can make alignment with the fixed five-year price review cycle very challenging. We suggest that large, discrete enhancement schemes similar to the ones covered in this Green economic recovery proposal would be best shared and considered as early as possible in the regulatory process perhaps through a gated process which may have some similarities to the processes being developed through the RAPID/DPC arrangements. This would give more time for both companies and Ofwat to present, discuss and provide additional evidence where required outside of the formal price review submissions. We recognise that this is a broader point around the process of price controls and intend to make a similar suggestion in response to the Ofwat consultation.

Green Recovery further highlights the challenge of connecting cost allowances and service levels

Ofwat's approach highlights the challenges associated with linking cost with service improvements and determining the extent to which the latter can be delivered from base allowances and/or funded via the ODI framework.

Using the example of Ofwat's proposal to allow £75.675m of funding for Severn Trent's "Building Sustainable Flood Resilient Communities", we specifically observe that:

1. £75.675m is a significant additional allowance (VS SVT business plan proposals of £139m), against which SVT is forecasting only modest benefits in terms of reductions of 1 internal flooding incident and 6 external flooding incidents by 2024/25.
2. The ODI value (in reward terms) associated with these marginal improvements is £104,000.[2]
3. This implies that either:
    a. The marginal costs associated with this scheme are substantially outside the value that customers place on the marginal improvements (and most likely materially different from the marginal costs used to determine the incentive rates at the time), in

[2] Based on NWL calculations using publicly available FDs.

which case the business case for the scheme is not sound and funding should not be granted; or

b. The benefits associated with the scheme are expected to materialise in the longer term, i.e. through a long term improvement in flood resilience / reduction in flood risk, and hence Ofwat has concluded that it is not reasonable to expect these to be funded via the ODI framework.

4. We find the latter more likely, however it is a (welcome) departure from Ofwat's line of argument during recent CMA appeals where it stated, specifically in relation to Sewer Flooding, that:
"We are confident that our outcomes framework adequately enables companies to efficiently invest beyond the Performance Commitment Level, through adequate outperformance payments in future periods."[3]

If this is the case, then we would welcome an acceptance that it is not reasonable for companies to fund long term resilience investments via a combination of the ODI framework and base allowances, and would welcome further clarity on this as Ofwat's thinking develops for PR24. We will offer further thoughts in our response to Ofwat's May PR24 consultation.

In addition, Ofwat indicates that they are not changing any PCs at present. It would be helpful to know whether they changes will potentially be applied once the service benefits associated with Green Recovery funding become clearer. This should be complemented by assurance to ensure companies don't under-estimate any performance benefits.

Finally, Ofwat needs to consider how both additional GR funding, and associated service benefits, will be accounted for at PR24 in order to ensure that service and cost baselines are set in an equitable way across companies who do, and do not, benefit from Green Recovery funding. This will make assessments of the efficient level of cost to deliver service improvements more difficult across all companies.

Accepting some risk in innovative or different proposals and the associated investments requires a significant change in approach

The projects proposed in the Green Recovery process are described as 'innovative' and it represents an interesting test case for supporting different approaches and taking some risk. We note that Ofwat is emphasising in its PR24 consultation the importance of innovation, nature-based solutions and risk taking. This is not an issue that is unique to companies, Ofwat will also need to consider carefully its approach to cost assessment, regulating outcomes and incentives including cost sharing rates. Where innovative schemes are taken forward they are likely to have less precedent to benchmark against for costs for example and outcomes may be more risky or uncertain. Within the Green Recovery process we would observe that Ofwat appears to have sought to challenge costs very robustly, which could lead some companies to drop proposals because the allowances are insufficient and set weak incentive rates. This framework may not be consistent with supporting innovative projects and risk taking.

Yours faithfully

[3] Ofwat's "Reference of the PR19 final determinations: Response to Northumbrian Water's 27 May submission to the CMA" para 2.7

[redacted]

Andrew Beaver
Regulation & Assurance Director