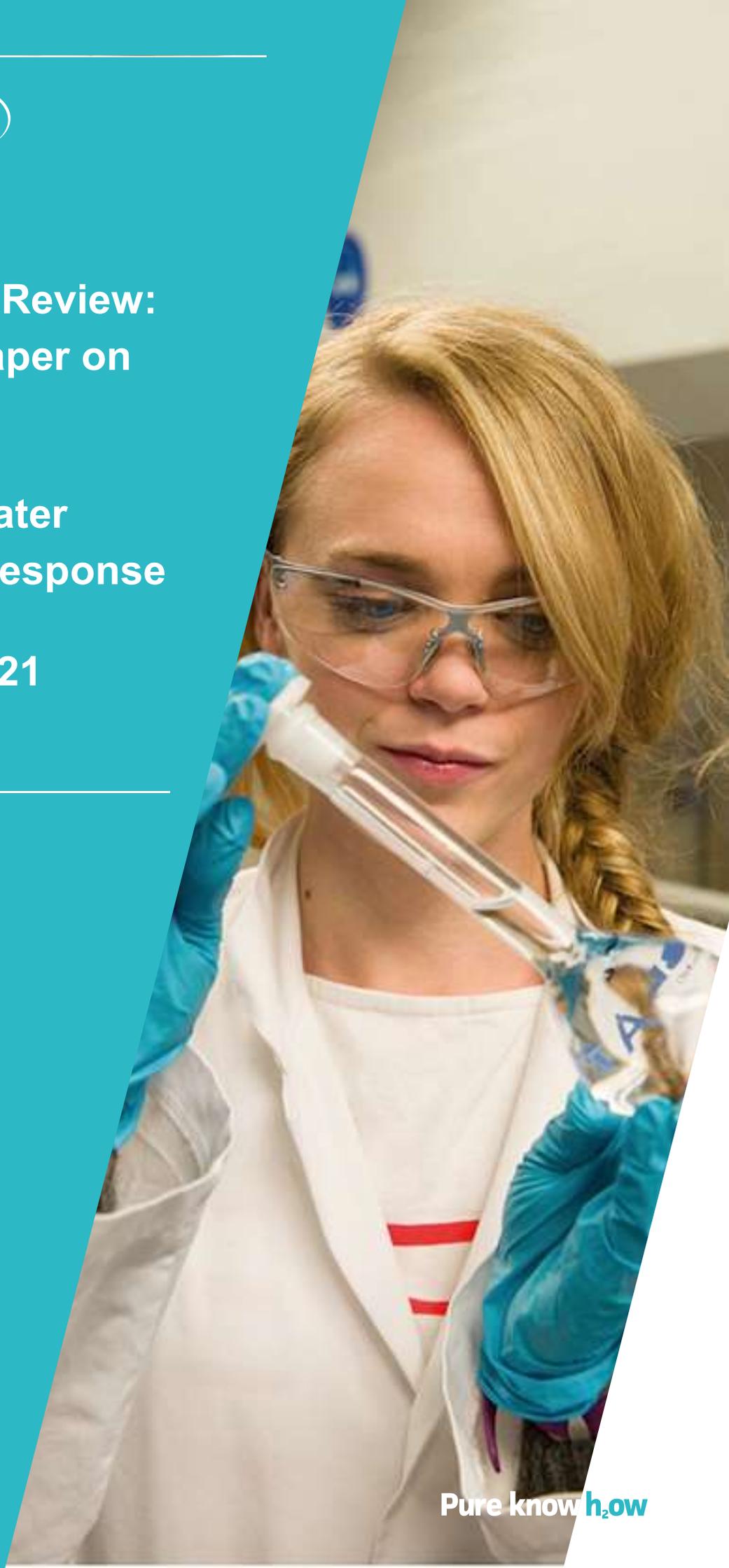

south east water

Ofwat's PR14 Review: Discussion paper on findings

South East Water consultation response

September 2021

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Pure know_how

1. Introduction

Generally we support the conclusions of this review. We also welcome Ofwat's approach to this review. The full consequences of a periodic review can only be properly understood at the end of the AMP to which it relates.

In particular, we agree that the focus on outcomes (supported with ODIs) and the focus on delivering those priorities which customers valued most, were the main successes of PR14 and have been considerable improvements to our industry.

We responded to the call for inputs in December 2020, in which we observed that PR14 was a largely balanced review which was fair to most stakeholders. We note that Ofwat seems to have taken suitable account of most of the points we made in our response. We won't therefore repeat them here.

Recent AMPs have seen a historically unusual period of falling costs of capital, including the PR14 period under review. This exceptional period has surprised many economists and confounded endless predictions. The cost of capital will not fall forever, and Ofwat should not assume that it will, even in the context of evidence that it continues to fall so far in AMP7. Ofwat should be wary of any inappropriate temptation to over-correct this at PR24.

We think that this review has overlooked one important aspect of PR14, namely the balance of stretch between water and wastewater, which we also expand upon below.

We also disagree with one particular conclusion made in the document, about productivity in the industry, which we expand on below.

Finally, we note the clear evidence that Ofwat presents that the totex regime has changed the balance of opex and capex in the industry. This is presented as a clear efficiency improvement, but this conclusion is not really evidenced. It is certainly true that the balance has changed, but the long-term effect of this change is not yet clear. We think that Ofwat should retain an open mind on this question until more evidence emerges.

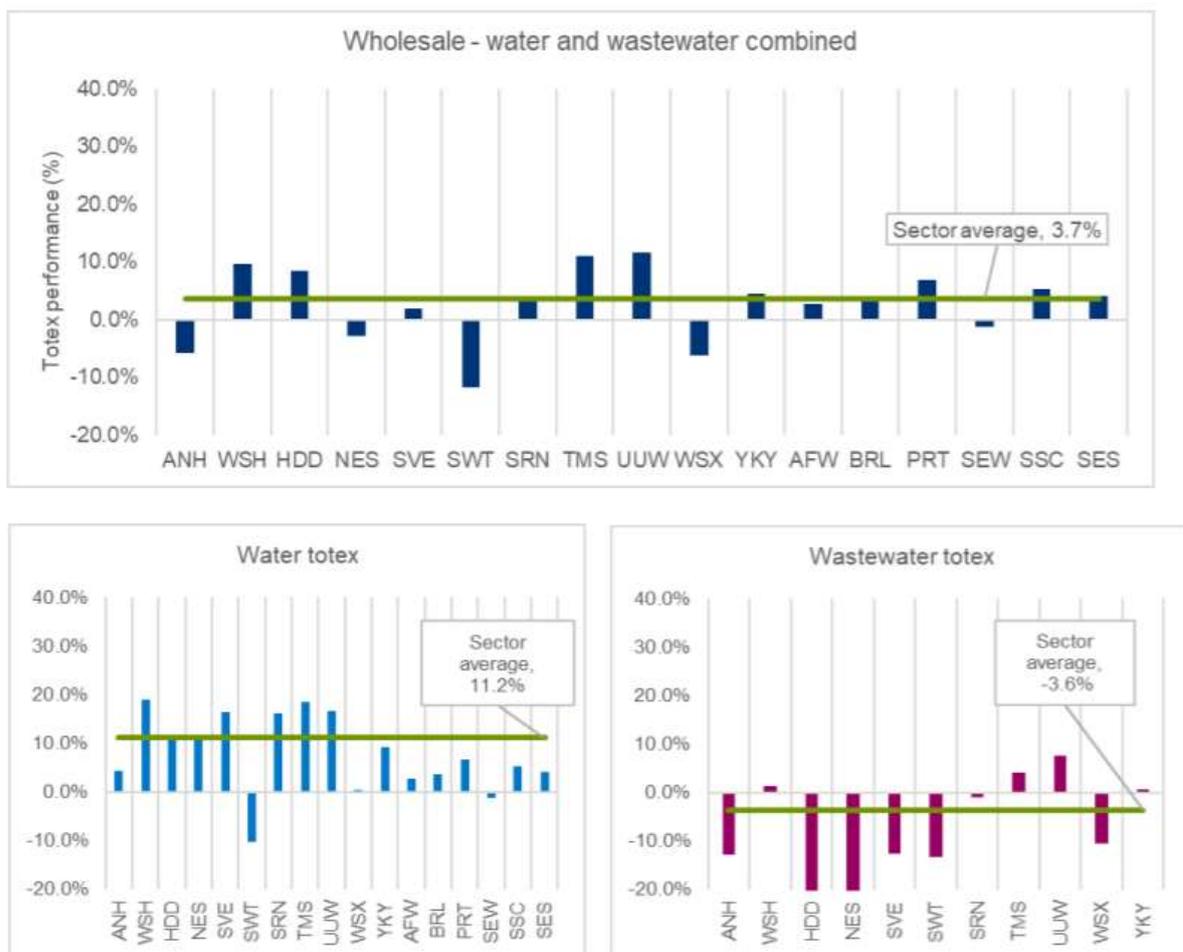
2. The balance of regulation between water and wastewater

The PR14 report claims that (p47) “Our allowances were broadly appropriate and in line with aggregated company business plans. While the sector overspent its wholesale allowances by 3.7%, this was at least partly because of expenditure brought forward in the latter part of the period in preparation for PR19”

The statement about PR19 expenditure being brought forward needs further consideration – it may be true that some expenditure was brought forward from PR19 however the statement ignores the fact that the same thing would have likely happened at the end of AMP5.

Overall Ofwat’s statement is true that they only slightly underfunded the companies at PR14 (i.e. by 3.7%). However when totex for water and wastewater are viewed separately, there is a completely different picture (p55).

Figure 4.4: Totex performance during the 2015-20 period, by company



The graphs from the report clearly show that the wastewater service outperformed the totex allowances by c3%, but that the water service was more than 11% underfunded. If we add to this the analysis in Ofwat's Service and Delivery reports, we also note that net penalties were incurred in the water service on ODIs compared to net rewards for the wastewater service.

We suggest that if the water service were looked at in isolation (which from the perspective of a WoC, it should be) then Ofwat would have concluded that it had been overly ambitious in setting PC targets, and that it had not fully funded companies at PR14.

Taken together, this shows clear disparities in the way that the water and wastewater services are regulated, with the levels of stretch in the water service being beyond that which the industry was able to deliver, but in wastewater the companies were able to perform beyond the determination. This cannot be because of differences in management because most of the companies in the industry supply both the water and wastewater service. There is no discernible difference in the performance of WoCs and WaSCs in this analysis. The only conclusion can be that the two services are being regulated in significantly different ways.

As highlighted above the majority of the companies in the industry have both water and wastewater operations, so can use one service to cross-subsidise the other. This option is not, however, available for the six water only companies (WoCs) of which we are one.

Strong evidence of this imbalance was presented to the CMA by Bristol Water, and we included further evidence in our PR24 consultation response. Ofwat's own review of PR14 clearly shows this imbalance in the period 2015 to 2020. The evidence of the first year of the new AMP, 2020/21 also suggests that this imbalance was repeated at PR19.

This is a major issue in any objective analysis of PR14 and should be specifically referenced in the final version of the review of PR14. Ofwat should continue to monitor this problem during AMP7 and take steps to ensure that it does not occur at PR24.

3. Observations on productivity

We do not agree with the following observation:

“one estimate suggests that since 2011, productivity growth across the water sector has effectively been zero” (p 6, repeated on p 57).

This observation references a Frontier Economics report. This is a highly selective interpretation of this report, which in fact says the following:

“It is acknowledged that standard approaches to productivity growth analysis, focussing on the change in quantity of outputs, may not always capture productivity improvements arising from an increase in the quality of outputs.” (p2)

“Estimates since 2015 should be viewed more cautiously as they are influenced by some data inconsistencies due to changes in reporting. Quality adjustments have also been made particularly conservatively in this period due to lack of data.” (p3)

“Our analysis of productivity growth in comparator sectors suggests that the water and sewerage businesses have outperformed materially those comparators in the decades after privatisation and leading up to the GFC in 2008. Since then, the UK’s productivity growth and the productivity growth of comparator sectors has been negative. The water sector has not been immune to this trend, with productivity growth materially slower than in the post privatisation period, but the water and sewerage businesses have nonetheless delivered modest positive productivity growth.” (p5)

“These measures (or proxies) of output for water and sewerage services do not fully capture the quality of service. For instance:

- for the water service, the safety of drinking water in terms of chemical composition, and also the reliability of service, and ‘aesthetic’ qualities such as colour and taste; and*
- for the wastewater service, the impact of sewage treatment works on the river and bathing waters into which they discharge treated water as well as the frequency with which customers experience sewer flooding.*

Capturing quality robustly in a TFP growth study is challenging.” (p6)

“Adjustments for quality present significant challenges. We are comfortable that the approach to quality adopted in this study is fit for purpose and reasonable. We consider that the approach is conservative but if time and data constraints were lifted it would be possible to develop alternatives that are potentially more accurate.” (p16)

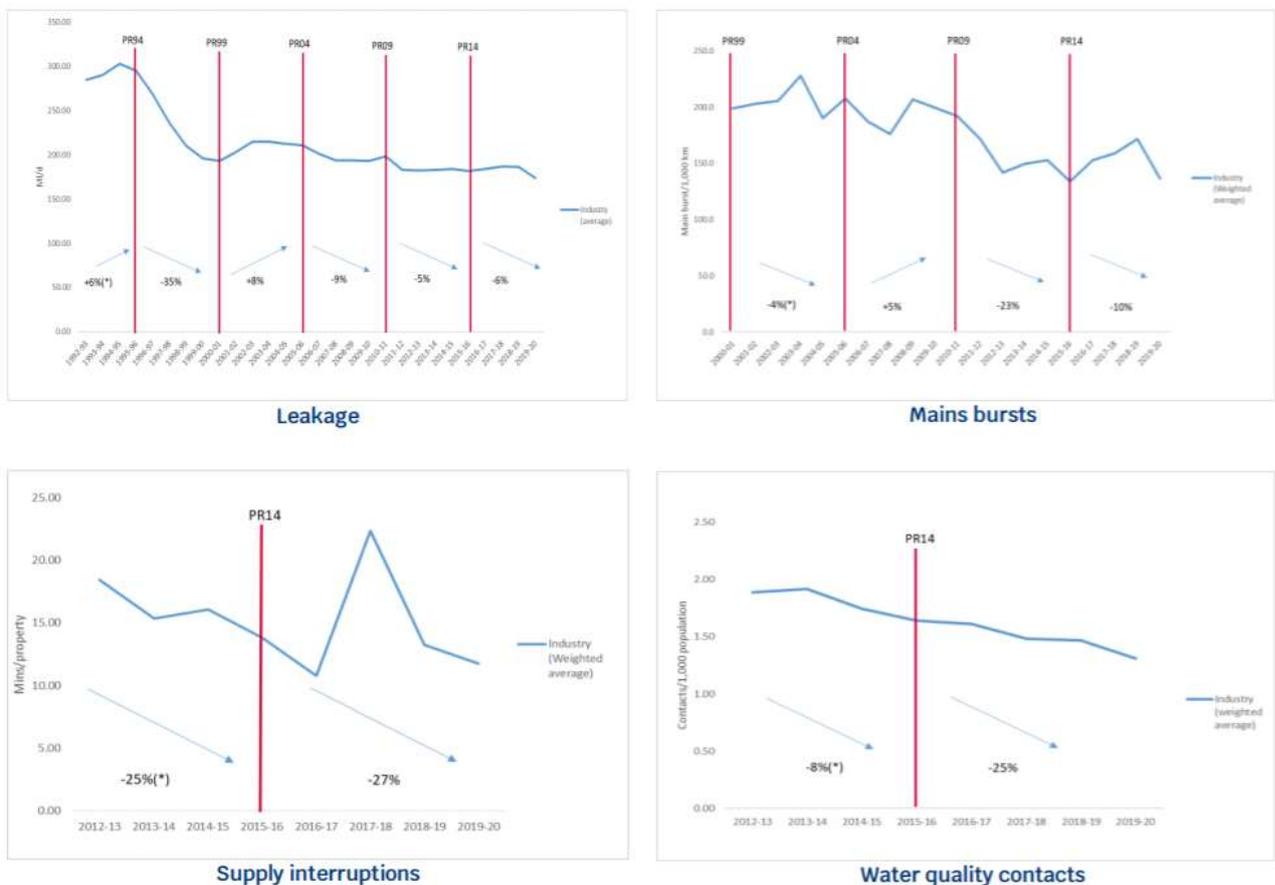
“accounting for quality of service has a statistically significant impact on the water companies’ productivity change over time.” (p69)

Productivity is classically measured as output (m³ of water) divided by cost, and this is a central problem that the Frontier report wrestles with. In water, the marginal cost of a unit is considerably below the average cost, as Ofwat often observe. In such an industry, an increase in output will lead to a fall in the average cost (by definition). A classical view of productivity will conclude that productivity has improve in this scenario. Conversely if output declines, productivity will appear to decline too.

Clearly such an analysis doesn't work, in an industry where success is being measured by a reduction in output (in this case a reduction in PCC).

This also ignores the issue of quality. Services levels have clearly improved in the water sector over the last decade. This much is made clear by the analysis in Ofwat's own review:

Figure 2.2: Performance trends in key service areas



Valuing quality improvements is always the most difficult aspect of productivity measurement and one that the NSO constantly grapples with. This was particularly a problem for the Frontier report in the post-2011 period because of the change in the quality measures employed by Ofwat. However, it cannot be ignored just because it is difficult. If we did so, it would be analogous to saying that an iphone12 in 2021 costs roughly the same as a Nokia 32210 in 2005 and therefore there has been no productivity improvement in the mobile phone industry. Clearly such an analysis would be wrong, but this is effectively what Ofwat is doing when it concludes that there has been no productivity improvements in the water industry.

In an industry with stable prices where we are trying to encourage reduction in water usage, traditional measures of productivity will not work. By such an analysis, successful companies will become less efficient (due to the reduction in output).

It is clear from Ofwat's own analysis that productivity improvements over the last decade, were delivered in the form of higher services standards, rather than lower costs. There is nothing wrong with this, and this is a direct consequence of the way that the industry has been regulated over this period. In fact the report notes on page 47:

“Companies spent £45 billion (2012-13 prices) over the 2015-20 period. This is broadly in line with PR04 and PR09 (£44 billion) however improved outcomes suggest overall better value for money for customers.”

This clearly describes that productivity improvements have been delivered in the form of improved services ('value for money' is another way of describing productivity). The document is not internally consistent on this point.

Interestingly, there is now a lot of meta-data available from PR19 valuing these improvements, which would allow the industry to make some kind of estimate of the productivity gains that have been made. This data was not available to Frontier Economics when they wrote the report referred to. The key is to properly value the improvements in service standards. For the purposes of setting ODI rates, companies collected a lot of data about how much customers valued these improvements. The following analysis is for illustration purposes only, but shows the sort of techniques that could be used:

- Ofwat's analysis suggests an improvement of about 7 minutes in supply interruptions since 2011/12
- With approximately 26m customers in the industry, this represents a reduction of about 182 million minutes of interruptions
- SEW's penalty and reward rate is £190k per minute in AMP7. This supposedly reflects the value of a service improvement or deterioration to SEW's 1 million customers
- This suggests that each minute is worth about 18p, or that customers would be prepared to pay 18p to avoid a minute of interruption
- This means that the 180m minutes of avoided interruptions is worth about £33.5m to customers in a single year.
- The water industry (excluding wastewater) spends about £4,400m per annum
- This improvement in supply interruptions has therefore (alone) delivered an improvement in productivity of nearly 1% to customers.

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