south east water

PR24 and beyond:

Creating tomorrow, together

South East Water response

22nd July 2021

South East Water

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1. Introduction

This paper sets out South East Water's (SEW) response to Ofwat's PR24 consultation.

Any queries in relation to this document should be sent to

[redacted]

2. Executive Summary

We welcome the opportunity to respond to Ofwat's initial views on the framework for PR24 and future price reviews.

We support the overall themes outlined in the document and in particular the focus on the long term. This is a crucial area that customers and stakeholders expect the industry – regulators and companies – to be focused on. PR24 represents a real opportunity for Ofwat and industry to make a long term difference to customers, communities and the environment. With this long term focus we believe Ofwat could develop this further by setting out enduring regulatory principles beyond PR24 so that there is clarity on the regulatory regime beyond 2030.

Customers

An essential part of any price determination is to ensure that investment and service is based on customer priorities, expectations and willingness to pay. We understand Ofwat's drivers to undertake centralised, collaborative research however this should not be at the expense of local, regional research undertaken by companies. We believe the scope of the centralised research should be focused on customer priorities, a limited set of common performance commitments and associated incentive rates. This will ensure an appropriate 'hand-off' to companies for any further research including societal/public value priorities, business plan acceptability and affordability.

Affordability of bills is an important area that the industry continually focuses on and ensures that support is provided to customers in vulnerable situations whenever they need it. A key factor when companies propose the level of investment required is the impact on customer bills, however the affordability of these bills is a separate element that needs to be understood. Increased investment, based on customer research, expectations and priorities should not necessarily be constrained due to affordability concerns – it should be possible to deliver increased investment and affordable bills through a wide range of support mechanisms for some customers.

Outcomes

We strongly support the retention of the outcomes framework and the inclusion of societal based outcomes within this – we believe the inclusion of these at PR24 can be one of the defining features of the price review. To enable this there will need to be a rationalisation of the number of performance commitments and outcome delivery incentives (ODIs) – this will ensure that companies are driven to perform in the areas that matter most to customers. Care needs to be taken in this regard to ensure that this rationalisation is not combined with an increasing number of KPIs or Price Control Deliverables as this would inevitably dilute this strong focus.

However, one key area that the outcomes framework needs to be further developed is to better reflect the different service types / price controls. It is clear from data published by Ofwat for 2015-2020 that the relative stretch between water and sewerage service targets is different – with the industry incurring net penalties for the water service and earning net rewards for the sewerage service. The outcomes framework should be improved to better identify these differences so that there can be a more direct link to appropriate totex allowances and/or cost of capital. This difference in risk level is also not adequately exposed in any RoRE calculations as this is carried out at aggregate level and not for each service type – therefore this distorts the true picture of the net stretch being higher for water only companies.

Ofwat should also further consider where the mechanism of ODIs is best used and how this is achieved. For example relative performance measures, financially incentivised in the ODI framework, will promote competition between companies rather than collaboration. For some

key areas of service delivery it may be more appropriate to incentivise collaboration rather than competition. We observe this has been successful in the innovation competitions in particular for environmental projects and support for customers in vulnerable circumstances.

An important component of any incentive framework is that it needs to discourage poor performance, but equally encourage good performance. Ofwat should ensure that when a company outperforms within a period this is financially recognised in that period and not make payments contingent on future performance levels – this is particularly the case when many performance commitments are set based on forward looking stretching targets, where the majority of companies will likely be incurring underperformance penalties.

Totex

We support Ofwat's approach to the continued engagement with the industry in relation to totex modelling through the cost assessment working group.

As outlined in many of our PR19 documents/responses we believe the models do not adequately allow for the appropriate level of growth costs and a new approach, potentially through the use of separate cost models, is needed. We are pleased that Ofwat has now recognised the complexity in relation to growth and developer services and is reviewing how they assess expenditure in this area and whether a separate price control is needed.

We are concerned that the long-term underfunding of growth in parts of the country that have experienced growth in recent decades, and will continue to do so in the future, will lead to an increased erosion of operational resilience in those areas.

Maintenance funding is another important investment area where we believe further review is needed. Totex allowances should not only use historic information as a predictor of future expenditure but should also include a forward looking element. It needs to be recognised that key indicators exist (e.g. age of assets) that are showing a concerning trend across the industry even if other metrics are stable (e.g. bursts). Please refer to the Water UK response to the PR24 consultation for more information on this issue.

We would encourage Ofwat to continue dialogue with the industry in both of these important areas.

Balance of risk between water and sewerage services

One issue we were disappointed not to see in the consultation document was any recognition of the risk imbalance between water and sewerage. During 2015 to 2020, the industry overspent their water service totex allowances and incurred net ODI underperformance penalties, compared to the opposite position for the sewerage service – companies underspent their totex allowances and earned net ODI rewards. Through analysis of data published by Ofwat this outcome is not driven by a difference in performance from Water and Sewerage Companies (WaSCs) or Water Only Companies (WoCs), but through a difference in the level of risk for the water and sewerage service – implicit in the price determinations. We believe this difference in risk level remains within the PR19 determinations.

For companies that provide both services, it is possible to hedge outperformance on one service with underperformance on another. However for WoCs this hedge is not possible, and therefore Ofwat should either rebalance the risk or more explicitly and transparently allow for this difference in risk – this will ensure that the balance of risk is equivalent for WaSCs and WoCs. If allowed to continue this puts undue pressure on WoCs who largely operating in the South East of England where resilience pressures are more acute especially considering the issue with the current approach to growth funding outlined above.

Risk, reward and financeability

We support Ofwat reviewing the balance of risk and reward – particularly if this is extended to capture understanding the relative risk of each service type as discussed above.

Ofwat indicate in the consultation document that it will consider an increase in notional level of indexed linked debt, and a reduction in notional gearing. Neither of these changes are supported by market evidence, which should be the basis for the notional company assumptions, and therefore we believe these proposals should not be pursued.

We are pleased that Ofwat acknowledge that the CMA's March 2021 redeterminations disallowed the gearing outperformance sharing mechanism which was introduced at PR19. As we stated at the time this mechanism is fundamentally flawed and not in the customers' interest – therefore it should not be a feature of PR24 and equally should be removed from determinations for 2020-25. We refer back to our response on this matter in our response to the Putting the Sector back in balance consultation in May 2018, where we proposed that Ofwat has other financial resilience measures in place, enforced through licence provisions to adequately address financial resilience concerns, e.g. licence conditions which require companies to have adequate financial resources and facilities to enable them to carry out their regulated activities, to maintain an investment grade credit rating.

We believe that further review is needed by Ofwat in relation to the cost of embedded debt – specifically associated with WoCs and in its determination of the allowed cost of debt, to reflect the relatively small size and issuance profile of WoCs, which has led to higher costs in a falling interest rate environment. WoCs median cost of embedded debt is 5.68 per cent compared to an equivalent WaSC cost of 4.41 per cent. Ofwat should place weight on the actual cost of debt in setting allowances.

Ofwat has suggested transitioning to full CPIH-indexation for PR24 – this will have a direct upward impact on customer bills at a time when Ofwat is trying to drive an increased focus on the long term, which will result in increased investment. We believe it would be more appropriate to allow the transition to happen at its natural pace, mitigating the impact on customer bills at PR24, and allowing this necessary investment to take place.

Ofwat has a duty to ensure that an efficient company can finance its function and financeability tests play an important role in this. Parameters such as the assumed gearing level, the assumed ratio of new and existing debt, and the assumed level of index-linked debt (and the type index) all need to be consistent with the assumptions used in estimating the WACC. Failing to do so would undermine the credibility of the financeability assessment as a meaningful and robust test.

The regulatory framework and price review process

The consultation document includes a significant amount of proposed changes to the regulatory framework and further work will be needed to prioritise these changes. Robust regulatory impact assessment should be undertaken by Ofwat to ensure all costs and benefits are understood by all stakeholders.

Overall we support a degree of simplification of the price review process, particularly where the mechanism complexity outweighs the risk it is mitigating, however it is a critical process that defines the investment of companies for a five year period and the longer term path of industry. Appropriate time for dialogue between Ofwat and companies is essential, and therefore the number of stages should be retained in the process – for example the Initial Assessment of Plans stage.

Ofwat indicate that they are considering creating a PR24 Challenge Panel to inform the price review process. It is unclear of the purpose and scope of this proposed panel, and has the potential to overlap and duplicate the work of other regulators, stakeholders and company

assurance processes. We would recommend Ofwat publish more detail on this proposal to allow all stakeholders to provide an informed view on whether such a panel is appropriate.

Ofwat is proposing that a number of key components will be set out in advance of business plans by the regulator – this includes customer research, performance commitment levels and associated incentives, totex allowances and the cost of capital. This is a substantial change from PR19, and if these proposals are pursued it is essential that this early information/guidance is provided in sufficient time to inform company plans – we would suggest as a minimum this should be supplied 9-12 months in advance of the deadline for business plan submissions.

3. Answers to consultation questions

Ambitions for PR24

Q2.1: Do you agree that the themes we have suggested for PR24 are appropriate for England and for Wales?

We support the overall themes outlined in the document and in particular the focus on the long term. This is a crucial area that customers and stakeholders expect the industry – regulators and companies – to be focused on. PR24 represents a real opportunity for Ofwat and industry to make a long term difference to customers, communities and the environment.

As part of this focus, it is important that the regulatory framework and company plans considers future challenges and intergenerational equity.

Q2.2: Do you have comments on the considerations we've identified as relevant to the design of PR24?

Overall we support a degree of simplification of the price review process particularly where the mechanism complexity outweighs the risk it is mitigating, however it is a critical process that defines the investment of companies for a five year period and the longer term path of industry. Appropriate time for dialogue between Ofwat and companies is essential, and therefore the number of stages should be retained in the process – for example the Initial Assessment of Plans stage.

We support Ofwat's approach to provide more clarity about how they will conduct price reviews in the long term. Providing more certainty across multiple price review periods will make longer term planning more effective – we believe Ofwat could develop the PR24 approach further by setting out enduring regulatory principles beyond PR24 so that there is clarity on the regulatory regime beyond 2030.

We are pleased that Ofwat has acknowledged the importance for the price review to reflect different regional needs, demography, customer priorities and socioeconomic status. This is an essential part of the price determination so that investment and service is based on local customer and community priorities, expectations and willingness to pay. We understand and to a degree support Ofwat's drivers to undertake centralised, collaborative research however this should not be at the expense of local, regional research undertaken by companies. However the overriding principle is that it is very important that customers' views are seen to have, and have, influenced the business plans and determinations in a meaningful way. This wasn't achieved at PR19 and should be the real engagement related focus of PR24.

Q2.3: How should we evaluate our progress, and how can we best develop or use appropriate metrics to do so?

Any measurement of progress needs to encompass a long term approach and care should be taken to ensure that one specific theme is pursued as the expense of any other. This is particularly relevant when considering the strategic themes from PR19 and the apparent driver for reduced bills within that price review process.

We support Ofwat's approach that any evaluation needs to include what is delivered for customers, communities and the environment – however, this needs to be both in the short and long term.

Any evaluation of the outcomes of the price review process should be measured against Ofwat's duties and clearly linked to Defra's Strategic Policy Statement, and include testing with stakeholders and customers. From this position it is more likely to create a collaborative effort to a set of meaningful objectives that can be demonstrably delivered or not.

How we regulate

Q3.1: How can we best regulate the water sector to deliver value for customers, communities and the environment? Do you agree, or have comments on, our suggestion to maintain our 'building block' approach based on outcomes, costs and risk and return?

We support the overall building block approach and the principle of markets driving efficiency. However the totex building block needs further review to ensure the flaws in developer services and growth funding is addressed. This is outlined further in our response to the questions in section 10.

We are supportive of the review Ofwat is undertaking in relation to the developer services market, and we believe the shortfalls of the totex modelling approach should be included within this review.

Q3.2: To what extent is greater co-ordination required across the sector? In what ways might we promote better co-ordination across companies and with other sectors, and how might this benefit customers?

Companies collaborate in a number of ways, through direct interaction, discussion through many different Water UK groups and through UKWIR. We believe Ofwat can also play a part in promoting best practise in a positive way and we are hopeful that the collaborative work undertaken with the industry on the Asset Management Maturity Assessment will be an example of this.

Companies are also investing significant time and resources into the development of regional resource plans that are being produced in a collaborative manner from all member companies to identify new/shared water resource solutions and produce a best value regional water resource plan.

Ofwat should give further consideration to where collaboration and competition can be best used within the industry. For example relative performance measures, financially incentivised in the ODI framework, will promote competition between companies rather than collaboration. For some key areas of service delivery it may be more appropriate to incentivise collaboration rather than competition. We observe this has been successful in the innovation competitions in particular for environmental projects and support for customers in vulnerable circumstances.

We particularly support collaboration in right areas, for example environment and vulnerability, where collaboration is absolutely necessary due to the complexity and diversity of stakeholders and the benefits that collaboration brings. It is possible to look through the building blocks of the price control and allocate the most appropriate mechanism for optimum delivery (compete, collaborate, comply) and then design the regulatory framework to facilitate this.

This exercise could be done pre-methodology stage and would suggest to Ofwat that this is done through engagement with stakeholders and companies.

Increasing focus on the long term

Q4.1: What are your views on the need for greater focus in companies' regulatory business plans on how they will deliver for the long term?

We support the focus on the long term and this is implicit in the nature of long term planning the industry undertakes – for example Asset Management, Water Resources, Water Quality and Environmental resilience etc. What comes with this is the need to be clear on what is binding either in terms of outcome or expenditure or both. Without this it is likely the process will return to a complete five year reset at each price review.

Q4.2: What should long-term strategies seek to cover and what details should we expect companies to set out in business plans? Would common requirements would help us and other stakeholders to understand each company's approach?

Common requirements could help the industry and stakeholders to understand longer term strategies. We would encourage Ofwat to engage further with the industry to assess this further, for example whether key asset health outcomes could be modelled over multiple price review periods to allow more informed discussions on base costs and enhancement expenditure needed over the same period

It could also be beneficial to have common external scenarios that companies should include in their business plans.

Q4.3: How would this build on the work completed in strategic planning frameworks?

It is important for Ofwat and EA to form a consistent view between WRMP24 and PR24. Through the development of RAPID we have seen good collaboration between the regulators and we would encourage Ofwat to continue this approach for more of the price review so that there is a consistent view between WRMP24, PR24, water quality and environmental requirements.

Q4.4: How can we allow such strategies and plans to adapt to new information at future reviews while continuing to hold companies to account to deliver expected benefits into the future?

As identified by Ofwat, each five year price control should be set with reference to a longer term set of plans, so that service levels and investment can be re-prioritised with any changing circumstances. Companies will naturally be held to account through the setting of performance targets that take into account current performance levels and customer expectations. Plans and approaches should be adaptive so that the potential course of actions are laid out over the long term using a given set of potential scenarios. If done in the right way this could facilitate a change of path to a new scenario if appropriate rather than a reset and start again at each price review.

Q4.5: Would providing our views on comparable aspects of companies' plans in advance of business plan submission streamline the price review process?

Ofwat is proposing that a number of key components will be set out in advance of business plans by the regulator – this includes customer research, performance commitment levels and associated incentives, totex allowances and the cost of capital. This is a substantial change from PR19, and if these proposals are pursued it is essential that this early information/guidance is provided in sufficient time to inform company plans – we would suggest as a minimum this should be supplied 9-12 months in advance of the deadline for business plan submissions.

Q4.6: Should we adopt a collaborative approach to developing Welsh companies' plans at PR24? If so, how should we go about doing this?

Not applicable.

Q4.7: What are your views on how we could provide clarity over the long-term regulatory framework?

We support Ofwat's approach to provide more clarity about how they will conduct price reviews in the long term. Providing more certainty across multiple price review periods will make longer term planning more effective – we believe Ofwat could develop the PR24 approach further by setting out enduring regulatory principles beyond PR24 so that there is clarity on the regulatory regime beyond 2030.

Plans and approaches should be adaptive so that the potential course of actions are laid out over the long term using a given set of potential scenarios. If done in the right way this could facilitate a change of path to a new scenario if appropriate rather than a reset and start again at each price review.

We believe Ofwat could also consider taking specific types of longer term investment outside of price reviews (i.e. a similar approach to green recovery funding) – this would enable totex allowances and deliverables to be set for more than a five year period.

Q4.8: Are there barriers to water companies changing how they deliver their core functions to deliver greater environmental and social value? How can we address any barriers?

The main barrier is there is no recognition of societal or environmental value within the current framework, the value is focused on efficient totex delivery and ODI target outperformance. If the framework recognised the value in these areas in the creation and assessment of options then it is likely that this element of value will be increased significantly and the right options overall, and in the long term, will be progressed.

Q4.9: Do you have any further suggestions for increasing the focus on the long term? If so, what are these?

All points have been covered in response to other questions.

Strengthening incentives

Q5.1: Should we undertake an initial assessment of plans at PR24? If so, what areas should we focus on in this assessment?

We believe the IAP stage of the process should be retained.

PR19 was run at what felt like arm's length by Ofwat and we would welcome more opportunities to discuss progress and approach, therefore we believe retaining the IAP should be considered as a minimum. However improvements could be made to streamlining the assessment to focus purely on the key building blocks of the price review. We also recommend that the IAP should include a review for each service type independently to ensure that there is an appropriate balance between water and sewerage services.

Q5.2: Should we consider adopting a more light touch approach at PR24 for companies with a strong track record of delivery during the PR19 price review period? If so, what factors should we consider in our assessment and why?

In principle we support this proposal, but to answer this question further clarity would be needed on Ofwat's view of a 'strong track record'. This is particularly important where more stretching targets have been set for some companies and measures, and where there is a different in stretch and risk between water and sewerage services. To illustrate, the crude use of performance commitments met as a percentage would be an inappropriate way to demonstrate track record. Absolute performance levels, in-built stretch in the measures and performance improvement rates are more relevant to demonstrate a company with a strong track record of delivery.

Q5.3: Should we streamline the price review by combining different steps in the process? If so, which of the three options outlined in this paper should we consider? And are there other options we can usefully consider?

As outlined in response to question 5.1 we believe the IAP should be retained as a discrete stage in the process. We would therefore support Option 2 or 3 from the options presented in the consultation document.

Q5.4: Is a different approach needed for the initial business plan assessment for companies in England and in Wales?

Not applicable.

Q5.5: What incentives should we provide for high quality plans at PR24? If we don't make use of early draft determinations, how else might we strengthen incentives to table high quality plans on first submission?

Incentives for high quality plans should be retained, however these need to be significant enough for the additional service deliverables a company may include in its plan or for the additional risk the company is proposing to take. The incentive needs to be calibrated against the risk in-built in a high quality plan. At PR19 it felt like companies including significant stretch in outcomes and cost faced no business plan incentive or one which was far weaker than the risk being adopted. In our view this has been the case for the last two price reviews and if it occurs again the incentive will be severely diminished due to lack of relative financial recognition.

Q5.6: How might we set cost sharing rates at PR24? Should we consider an approach based on our ability to monitor companies' asset health status?

Cost sharing rates should not be set at a punitive rate and should ensure appropriate decisions are made for benefit of customers, communities and environment – for example the current cost sharing rates strongly discourage overspending, when this could be in the long term interest of customers.

As Ofwat has not developed a consistent and reliable way of monitoring companies' asset health status we would suggest this is not linked to cost sharing rates.

The issue here is that to link cost sharing rates to performance or to business plan quality does not mean that the right sort of overspending occurs and the right amount is shared with customers. In some instances it may well in fact be the opposite and companies who should overspend are actively discouraged from doing so or that companies are overspending unnecessarily for value reasons. This is a difficult area to unpick and to not drive the wrong behaviour in either direction we would suggest a standard 50:50 share across all expenditure, with exceptions for some categories where there is greater outturn uncertainty e.g. water resource large schemes or nature based environmental solutions.

Q5.7: Which areas should we be considering targeted challenges for at PR24, and why?

Areas for targeted challenges should be based on key customer and stakeholder priorities and not pre-determined.

Q5.8: Should we use innovation specific incentive mechanisms at PR24? If so what would these be, and what would they add in addition to the other mechanisms outlined in this chapter?

Fundamentally we believe the regulatory regime already has considerable in-built innovation incentives especially as it is now supported by the innovation funds. The concept of the innovation fund is good and therefore we support the continuation of this approach. We believe this should be focused on high priority areas as identified through customer and stakeholder research and support long term investment – this may include areas that are already included with the outcomes framework.

Q5.9: In what ways might we promote the themes of EBR through PR24?

A key theme of EBR is a focus on public value. We strongly support this and believe the inclusion of societal based outcomes within the regulatory framework could be one of the defining features of the price review. Currently there is very little recognition of societal or environmental value within the current regulatory framework, the value is focused on efficient totex delivery and ODI target outperformance. If the framework recognised the value in these areas in the creation and assessment of options then it is likely that this element of value will be increased significantly and the right options overall, and in the long term, will be progressed.

We believe transparency and predictability are also both good principles of EBR and should be promoted throughout PR24.

Reflecting customers' preferences

Q6.1: What are your views on the merits of our proposals for a collaborative approach to standardised and/or nationwide customer research to inform company business plans and our determinations?

An essential part of any price determination is to ensure that investment and service is based on customer priorities, expectations and willingness to pay. We understand Ofwat's drivers to undertake centralised, collaborative research however this should not be at the expense of local, regional research undertaken by companies. It is very important that local customer research is not ignored in the price review and Ofwat must take account of this in the determinations, along with insight from everyday customer engagement (which will also identify customer priorities). A key part of the collaborative approach will be how these local priorities are captured and fed into the centralised research at the appropriate stage (and in advance of business plan submissions).

In will be important that customers and stakeholders can see a clear link between the centralised research and Ofwat's decision making and price determinations. Therefore we would welcome Ofwat having a clear plan on how to communicate with customers across all regions if a trade-off is made that does not reflect customer viewpoints.

We believe the scope of the centralised research should be focused on customer priorities, a limited set of common performance commitments and associated incentive rates. This will ensure an appropriate 'hand-off' to companies for any further research including societal/public value priorities, business plan acceptability and affordability.

Q6.2: Do you have any suggestions for how we best implement the collaborative approach to customer research for the price review?

In terms of PR24 we remain concerned about the timeline for delivery, with companies such as ourselves starting to refresh key areas of engagement and insight to support our investment planning. If the centralised research is to go ahead then this decision will need to be made and implemented quickly.

In order to achieve this an implementation team could be created by a group of companies and stakeholders representing the industry in order to kick start activities. This group would focus on the implementation requirements of the centralised research.

Once the centralised research programme is established it will be important that all relevant stakeholders and companies are involved in designing and delivering the research, and scrutinising the outputs/findings. Water companies should be included in the steering group and we would recommend an independent Chair is appointed.

Q6.3: Are there aspects of negotiated settlements that could be reflected in our price review framework?

We have no objection to negotiated settlements in principle, however this needs further investigation as to how it could work in practice, as most successful models in this area have a low number of negotiating parties.

Q6.4: What are your views on our proposals for customer challenge of business plans and assurance of customer engagement?

We support that companies should define the appropriate level and nature of challenge and assurance of their customer and stakeholder research, including the use of CCGs if appropriate. This fits more naturally with our approach to assuring other aspects of our business regulatory framework such as annual performance reporting.

Q6.5: What are your views on whether we should develop minimum standards or provide guidance in other areas?

We have no objection to minimum standards in principle, and would suggest these are discussed with the industry through the collaborative approach.

Q6.6: How well does our proposed approach to customer engagement take appropriate account of the different regulatory frameworks in England and Wales?

Not applicable.

Planning together for PR24

Q7.1: How can we ensure that companies bring together the outputs of the strategic planning frameworks in the most coherent and effective way for business plans?

Ofwat plays a key role in bringing together strategic planning in the sector, as price limits for companies will ultimately dictate what they can and cannot do in a five year period. In our region, we are particularly concerned that Ofwat's decisions at PR24 should recognise the growth pressures which we face, and the need to improve the resilience of the service that we provide to our customers.

There are a number of complex strategic choices to be made, and all the regulators and companies involved need to get themselves comfortable that the right choices are being made. In our case, this is best illustrated by the choices we must make about extracting water from chalk aquifers. We can reduce this extraction, and we have developed plans that will allow us to do so. Essentially, it is a case of replacing chalk sources with water taken from rivers during winter and stored in reservoirs. However this requires significant investment, not only in the reservoir, but in new strategic mains. Our current strategic main network is designed to move water from the sources that we use. If we change those sources, then some of the trunk main network will required less and some new mains will be required. A new trunk main network is also an opportunity to improve the resilience of our network, particularly by removing single sources of failure.

These investment decisions need to be taken in the context of the overall water resources position in South East England, and we are working very closely with WRSE. There can be no doubt that this kind of solution will have a cost associated with it, and we need to be confident that customers believe that the value of the changes to the environment is sufficient to merit the expense. We feel that Ofwat brings a particular expertise to the table with regard to cost-benefit decisions and in exerting a rigour into option choice. However it is essential that Ofwat recognises the drivers for this kind of strategic investment, as demonstrated through regional and company water resource plans, and allows funding for these schemes within price determinations.

We are particularly encouraged by the emergence of RAPID in the industry which makes schemes with regional implications easier to deliver. DPC also provides a viable mode of delivery for strategic projects and we feel that these two developments are the key to delivering a resilient future water service in South East England.

Q7.2: What are your views of our thinking on our and companies' roles in engaging with other regulators between business plan submission and our issuing of the final determinations?

We agree that it is important for companies to engage with all regulators. This is particularly important when the work of regulators inevitably interacts. This happens most commonly, but not exclusively, when a decision by one regulator, obliges a water company to make investments that need to be funded in a periodic review.

It is therefore important for regulators to form a consistent view between their strategic planning frameworks – for example between WRMP24 and PR24. Through the development of RAPID we have seen good collaboration between the regulators and we would encourage Ofwat to continue this approach for more of the price review so that there is a consistent view between WRMP24, PR24, water quality and environmental requirements.

Q7.3: How could we best involve a 'PR24 Challenge Panel' in the price review process to help ensure that our decisions best reflect the interests of customers, communities and the environment?

It is unclear of the purpose and scope of this proposed panel, and has the potential to overlap and duplicate the work of other regulators, stakeholders and company assurance processes. We would recommend Ofwat publish more detail on this proposal to allow all stakeholders to provide an informed view on whether such a panel is appropriate.

Design and implementation of price controls

Q8.1: Do you agree with, or have any comments on, our general approach to the design and implementation of controls, i.e. to retain separate controls with the same broad structure as at PR19, but with improvements to our implementation?

We support the general principle of retaining the existing controls – with the exception of developer services / growth where we believe separate cost assessment, or potentially a separate price control is required.

Q8.2: Do you agree with, or have any comments on, our proposals for specific parts of the value chain, i.e. for water resources, developer services, residential retail and business retail in Wales?

We believe the proposal to extend water resources price control needs further reviewing to determine if the potential benefits outweigh the costs of implementation. We would suggest there is further dialogue with the industry on this proposal via the cost assessment working group.

We support the review of developer services part of the value chain and would encourage Ofwat to continue engagement with the industry on the potential options.

The proposed change to residential retail seems sensible in principle.

Q8.3: Do you agree with, or have any comments on, our proposals spanning multiple parts of the value chain, i.e. for major projects and future reconciliations?

Although we are not directly involved in DPC, we consider it an improvement in the regulatory regime, improving the ability to deliver long term priorities for customers. We support the continued development of DPC as described here, and its proposed standardisation.

We support Ofwat's proposal to keep the pipeline of major projects under review, this could be a route for key schemes to be implemented without the constraints of waiting until the next price review process.

We accept the principle of simplifying future reconciliations, but note that the purpose of reconciliation mechanisms is to appropriately share risk between customers and companies. This is an important aspect of the regulatory regime to get right.

Outcomes

Q9.1: What kinds of performance commitments should we include in the price review? What outcomes require financial incentives for all companies for the foreseeable future?

We strongly support the retention of the outcomes framework and the inclusion of societal based outcomes within this – we believe the inclusion of these at PR24 can be one of the defining features of the price review. Assigning value and targets to societal and environmental outcomes will be challenging but as an industry we need to make this step or we risk never being able to meet the wider needs of our communities and customers.

To enable this new focus there will need to be a rationalisation of the number of performance commitments and outcome delivery incentives (ODIs) – this will ensure that companies are driven to perform in the areas that matter most to customers. Care needs to be taken in this regard to ensure that this rationalisation is not combined with an increasing number of KPIs or Price Control Deliverables as this would inevitably dilute this strong focus.

In the interests of regulatory consistency, the existing common PCs could be the starting point, with a move to replace some of the output measures, particularly where industry performance is strong and existing targets are at upper quartile performance, with broader societal based outcomes.

Q9.2: How do you think we should monitor outputs that are not clearly linked to the outcomes incentivised in the price control? Would it help to distinguish between PCs that monitor outcomes and PCDs that monitor outputs? What other options could we consider?

Companies should transparently report on outputs delivered so that regulators, stakeholders and customers can monitor company performance. PCDs could be one mechanism for this however we would caution against overuse of this mechanism as it inevitably will reduce flexibility for companies when looking at different investment solutions – in effect undermining the reason for moving to a totex regime. A key principle of the totex regime is giving this flexibility to companies so they can remain agile in delivery of service to customers.

If PCD are used is it essential these are accounted for in RoRE calculations and in assessments of risk.

It would also be helpful to distinguish PCs that are about customer service (supply interruptions for example) and those which are about asset serviceability (mains repairs for example). The objective for asset serviceability should be stability (unless there is a clear customer willingness to pay for something else).

Q9.3: Do you consider there are aspects of company performance where it would be better not to set expectations as part of the price control? What approaches should we consider in these cases, so that companies act in the interests of customers?

Generally it is useful for Ofwat to set out its expectations on company performance as this will be used to help to shape company business plans. However, companies should still be able to propose different performance levels if they felt that Ofwat's expectations were not representative of the customers they serve.

Where there are new or emerging areas of customer interest and priorities it may be better for these not to form part of the price control. New in-period ODIs or PCDs could use utilised to capture any new investment or customer priorities between each price review setting process.

Q9.4: What should be our aim in setting the levels of performance commitments? Do you agree with the suggestion that performance commitment levels should be set, as a starting point, at what can be achieved by an efficient company with base costs and that deviations from this are proposed in company business plans? If not what alternative proposals should we consider?

In principle, this is a sensible approach to setting service levels. However, Ofwat needs to reconsider its understanding of the relationship between base costs, efficiency and service levels. Ofwat appears to believe that productivity in the industry has stalled in the last decade, however recognises that service levels have improved at the same time. It seems to us that these two observations are connected but because Ofwat has approached the building blocks of costs and service separately and therefore this connection is being missed.

Productivity is being measured in very simplistic terms such as expenditure per megalitre of water, which does not take account of service level improvements. In reality, the productivity gains of the industry are being absorbed in service improvements that are difficult to measure, rather than cost reduction.

In reality, the industry's productivity is improving, but that increased productivity (this can be thought of as 'freed resources') is being 'spent' on service improvements. This certainly appears to be the case in the water service.

Ofwat's starting point for a periodic review should be stable service levels. Improvements in service levels should only be selected if that is a choice which customers are willing to pay for or if they prefer this to cost reductions (or a compromise of a mix of the two). This should be done considering a basket of measures or the service package overall – expecting every company to achieve every performance standard at an 'efficient cost' is not appropriate as some companies will benefit naturally in some way due to topography and demographics whereas others will be adversely affected. Therefore the overall package needs to be assessed in the round rather than at individual measure level.

Q9.5: What approach should we take to setting ODIs? How should we take account of marginal costs and marginal benefits in setting ODI rates? What are the risks and benefits of the approaches that we set out, or any others that you propose?

It is important to distinguish between ODIs that directly affect customers and those that do not. For example a supply interruption clearly affects a customer. It makes sense in this case to set the ODI rates using the marginal costs to the company of avoiding such interruptions and measuring the benefits (of an avoided interruption) based on the economic disbenefit to the customer of experiencing that supply interruption.

A mains repair, by contrast, does not affect a customer unless is causes a supply interruption, but if it does then the economics of that situation are already accounted for in the supply interruption ODI. In this case, it is not appropriate to try to measure the benefit to a customer of avoiding it (as there is no benefit).

The use of marginal cost and benefit rates at PR19 was a little rigid, and applied in some areas where it was not appropriate. Combined with inherent difficulties in accurately measuring these rates, that is why some results were not comparable at PR19. Marginal costs and benefits do have a proper role in setting some ODIs and should not be abandoned altogether, but we support the suggestion to use them more selectively and appropriately.

We recommend that Ofwat consult further with the industry on the measures where marginal costs/benefits should be applied and to set out what other methods will be used to set incentive

rates. There should be a very transparent process for determining the appropriate basis of incentive rates so that it is not left to a subjective choice.

ODI rates also need to take account of overlap between different PCs – one event can have an impact on multiple measures. For example an interruption to supply can incur penalties on that specific ODI, penalties on C-MeX and compensation under GSS, as well as extra costs to manage the incident which can be significant. These additional costs should be factored into the incentive design and calculations.

Cost assessment

Q10.1: What should be the priorities for improving our approach to cost modelling and assessment?

The creation of models to determine the right level of expenditure for a water company is an inherently difficult and complex task. The failure of the models to account for growth is the single largest problem for our region. We are concerned that the long-term underfunding of growth in parts of the country that have experienced growth in recent decades, and will continue to do so in the future, will lead to an erosion of operational resilience in those areas.

We welcome Ofwat's commitment to collect data and review this area. Obviously it is important to ensure the consistency of newly collected data before it is used.

It is also important to recognise the limitations of cost modelling, and particularly regression modelling. Such models will always be imperfect, as they are simplified versions of the real world, and Ofwat should always remember that differences between actual costs and modelled costs can arise from imperfections in the models, as well as different levels of efficiency. The search for more intricate models is not necessarily the solution to this problem and we are not convinced that totex modelling or disaggregated wholesale cost modelling is the right answer to this problem.

We welcome Ofwat's intention to share model results with companies before they submit business plans, and the more time companies have to consider these results, the better use they will be able to make of them.

We would also urge Ofwat to consider capacity, which is a very significant cost driver, particularly in relation to growth. A network with spare capacity can easily absorb the demands of new housing, but one which is operating at full capacity cannot and will require significant capital investment. Ofwat needs to be very cautious about simplistic comparisons, or averages, of the cost of offsite reinforcement costs. The average cost of offsite reinforcement, for example, will always underestimate the cost for a company whose network is operating at full capacity. In order to measure capacity, Ofwat needs to develop measures and collect appropriate data in time for PR24.

Q10.2: In what areas (both historical water sector and external) can we improve the range of benchmarks we use in cost assessment?

Benchmarking is a valuable management tool. The majority of innovations and improvements are 'imported' from other industries. There are numerous examples of this in the water industry. In recent decades we have benefitted from the development of pipe technologies in other industries (notably the gas industry) and remote sensoring and operations technology from industries as diverse as oil and gas; nuclear and even space exploration.

We are cautious however about using external benchmarks for cost assessment. Generally, benchmarking is not a sufficiently precise tool to be used in cost assessment. Small differences in industries can arise from subtly different operating conditions. For example, different cost drivers in industries as similar as water and sewerage seem to be arising from different

regulatory regimes. It is useful to ask questions and seek insights based on comparisons with similar industries, but drawing firm conclusion about what should happen in the water industry, based on the experience of other industries, is taking a step too far.

Even within the water industry, it is difficult to make firm comparisons. An example of this is leakage levels in Japan, which are much lower than England and Wales. However, this fact needs be viewed in the context of geologically unstable ground conditions in Japan, much higher mains replacement levels and very different levels of industry expenditure. Arguably, all that such a comparison tells you is that if you frequently spend money on mains renewal, you will end up with a less leaky network.

An exception to this caution might be household retail, where operations are similar to other retail operations and benchmark comparisons can be useful. Caution need to be exercised however, when looking at bad debt. Water industry bad debt levels should only be compared with other industries where the provider has no right to deny service to non-paying customers.

Q10.3: How can we take account of longer term ambitions such as delivering net zero and increasing public value in our approach to assessing costs?

We think that net zero is an increasingly urgent customer priority, and we recommend that Ofwat should test this suggestion through the collaborative customer engagement that it is proposing. We would urge Ofwat to focus on 2030 rather than 2050. As the consultation notes, this is an area of fast moving innovation, and it is possible that some, or even all, of the progress towards net zero will be made through technological innovation. If this is the case, then it is not a question of concern to regulators, as companies can be expected to achieve net zero without regulatory incentive. For example, if electric vehicles are more efficient to operate than hydrocarbon powered vehicles by 2030, then we would expect companies to adopt them at nil cost. However, it seems more likely that technological change will only get us part of the way by 2030 and if PR24 is going to be committed to net zero by 2030, this will require some investment to be funded by customers. If this is the case, it will also be necessary to have regulatory mechanisms to protect customers.

Net zero water companies are a primary example of public value and public choice, but there are many others, particularly regarding the effect that water companies have on the environment. We think that there are legitimate choices to be made by customers about what effect their companies have on the environment. However, it is important to be clear that there are costs associated with such choices, that customers will bear.

Some caution may need to be exercised around power costs. As companies increasingly invest in renewable options, different companies may be selecting different mixes of opex and capex, and this may make it difficult to compare costs. This could be overcome with appropriate transfer pricing, but in extremis, it may be necessary to exclude power costs from modelling altogether.

Identifying customer priorities, through the centralised research and company led research, will be essential to understand what is important to customers and the areas where additional investment is required. Understanding their willingness to pay for this will be essential so this can be assessed against any investment proposals.

Q10.4: Do we need to amend our cost assessment approach to take account of nature based solutions?

We are cautious of this suggestion, particularly in the water service, where the outcome of nature based solutions may be uncertain in the short/medium term. However, we are open minded on this question and would suggest this is discussed with industry further in Ofwat's cost assessment working group.

However, this does highlight a wider point that the cost assessment framework needs to be more forward looking rather than focusing on historic spend.

Q10.5: Where can we enhance our evidence base on the relationship between costs and service?

This is a difficult question to answer. It is certainly the case that some costless service improvements can be made through innovation. However, we are concerned that, in the past, Ofwat has been too quick to assume that this is the case in the absence of evidence. We note that the CMA also expressed this concern.

We welcome Ofwat's initiatives to collect more information on this subject. It is also important to understand that the relationship between cost and improvement will often be non-linear. An example of this is leakage. As a company reduces leakage, it uses up the lowest cost solutions. As this process continues, its efficiency diminishes. For example, the lowest cost solution to reducing leakage is pressure reduction. Valves and controls can be introduced to the network that reduce the pressure on mains without affecting pressure for customers, and therefore reduce the amount of water lost. However, once this has been done, the company has to move on to more expensive solutions such as physically repairing leaks. Once the larger leaks are eliminated, the company needs to seek ever smaller leaks to fix in order to achieve the same effect, and so the cost per megalitre of water saved rises. Eventually, only micro-leaks will remain and the only option will be to renew mains, which is a very expensive solution. This effect of diminishing returns is likely to apply to other outcomes too, notably supply interruptions and water quality incidents. Whilst innovation may be able to break this link, and change the shape of the diminishing returns curve, it is not right to assume that it will always do so.

Q10.6: What mechanisms should we consider for the efficient funding of performance levels, set in a long-term context, that vary from those an efficient company would deliver through its base allowance?

This will vary by PC, and it is important to understand that each PC should be considered as a choice in its own right. Customers might legitimately choose to pay for improvements to supply interruptions, but not mains repairs. An understanding of the long-term marginal cost curves is crucial to being able to guide customers through such choices.

Q10.7: Is there more that we need to do to reflect future pressure on operational resilience in our approach to cost assessment?

Alongside the broad definition of resilience we believe a defined set of common scenarios to plan against could be helpful. These scenarios would allow companies to produce comparable plans for operational resilience with an important forward looking perspective.

Q10.8: Are the most significant challenges to the operational resilience of the sector adequately captured within current strategic planning frameworks?

Current strategic planning frameworks need to include adequate local level resilience schemes (particularly WRMP) to ensure that the operational resilience of the sector is captured, rather than rely on enhancement schemes being solely assessed in the business plan. We are particularly concerned that the existing process is not capturing issues of intra-zonal resilience issues.

It is particularly crucial that any analysis of distribution requirements takes into account network capacity. Spare capacity in a network enables growth to be absorbed without difficulty and also provides resilience, as it allows redundancy and options to reroute water. As a general rule, water companies in deindustrialised regions will tend to have spare capacity because they operate networks that were designed to feed an industrial demand which, by and large, no longer exists. Housing growth also tends to be slower in these areas. In South East England by contrast, there has been very little deindustrialisation, so there is not spare capacity, and housing

growth tends to be faster. In reality there are some deindustrialised sites in our region, for example, we have been able to take advantage of the capacity freed up by the closure of a newsprint site in Kent. Similarly there are likely to be pockets of rapid housing development in northern England that put strain on those networks. This emphasises the need to understand capacity at a very localised level. A failure to account for capacity in strategic planning frameworks will tend to disadvantage those companies, such as South East Water, that are operating in high growth 'non-post-industrial' regions. This issue will also affect other areas such as cost assessment as well as strategic planning, as highlighted in our response to other questions.

Risk and Return

Q11.1: Are there areas of our risk allocation framework where mechanisms could be added, simplified or removed in a way which would benefit customers?

The companies that went to the CMA appeal process argued that companies at PR19 are bearing a disproportionate and increasing level of risk relative to PR14. We believe that Ofwat should be looking at all potential areas which could improve the overall balance of risk over the long term – not just the allocation that benefits customers in the short term at the expense of the long term.

We believe that there are merits in simplifying the cost sharing mechanism to a fixed 50/50 sharing ratio – with perhaps slightly more favourable rates for enhanced companies. Within the current asymmetric regime there is a danger (particularly in an overspend situation) that companies may be disincentivised to invest in situations where it may be in customers interests to do so.

Q11.2: How should we improve our use of RoRE risk ranges to provide insights into the balance of risk and reward, and improve comparability across companies?

We believe that Ofwat should be doing more to understand the differences in relative risk between WaSCs and WoCs. PR14 performance showed significant upside on ODI performance from the waste water area of businesses and generally downside ODI performance on the water side of the business. This is evidenced further in 11.5.

Risk methodologies for PR24 will need to include company-specific quantification of risk exposure which reflects (1) interconnectivity of risks, (2) structural breaks implied by changes in regulation, business activities/operational risks or macroeconomic factors (3) when risks are likely to occur as well as (4) scale and (5) probability of risks. Risk analysis will need to capture company specific dynamics based on the PR24 plan as well as sector wide approaches and trends, as this risk analysis will be critical to justification of core plan assumptions and regulatory engagement. Developing initial views on how this could be approached and reflected in financeability testing is important ahead of the autumn consultation on financial resilience.

Q11.3: Should we index the allowed return on equity, and if so, how ought this to be implemented?

We will need to consider which elements of the cost of equity should be indexed, if any, and the methods for estimating and updating these elements. Ofwat notes that the risk free rate (RFR) element of the cost of equity was subject to uncertainty at PR19, with the implication that the RFR should be indexed.[1] We support indexing RFR in principle but conditional on how this implemented in practice.

[1] Ofwat observes that the PR19 process was characterised by volatility in its proxy for the risk-free rate (RFR) – indexed linked gilts (ILG) – which could result in the allowed return on equity either under- or over-stating the return required by investors during the review period. Ofwat (2021) PR24 and Beyond: Creating tomorrow, together, p. XX

Indexation of RFR will need to be consistent with CAPM framework

The capital asset pricing model (CAPM) used by Ofwat and all economic GB regulators to estimate the cost of equity can be written as:

(1) $R^e = RFR + \beta*(TMR - RFR)$

Where R^e is the return on equity; β is the equity beta; RFR is the risk free rate; TMR is the total market return, and TMR minus the RFR is referred to as the equity risk premium (ERP). Re-arranging equation 1, we have:

(2) $R^e = (1-\beta)*RFR + \beta*TMR$

As can be seen from equation (2), the return on equity can be expressed as a weighted average of the RFR and the TMR with the weights determined by the equity beta.

We do not support indexation of the TMR or beta elements of the CAPM. Along with other GB regulators, the CMA assumes that the TMR is broadly constant over time[2] and its estimate at PR24 was informed by long-run historical market returns. By definition, long run historical estimates of the TMR change only slowly over time and are unlikely to change materially over any given price control.[3] Also, we would not propose indexation of the beta co-efficient given the absence of a reference benchmark index, e.g. comparable to corporate debt indices used to index cost of new debt allowance.

Thus, assuming TMR and beta elements of the CAPM are held constant over the review period, indexation of the cost of equity for changes in the RFR involves updating the allowed cost of equity as follows:

(3) $\Delta R^e = (1-\beta)* \Delta RFR$

Indeed, this is the broad approach adopted by Ofgem at RIIO-2 price controls for the indexation of the RFR within the RIIO-2 cost of equity allowance.[4]

The design of a RFR indexation mechanism will involve further methodological choices in relation to: i) the proxy for the RFR; ii) the averaging period; and, ii) the timing of the update, e.g. within period or at the end of the control period. We do not comment on these choices in this response. However, in making the choices on the proxy for the RFR it will be necessary to recognise the CMA's PR19 decision which considered indexed linked gilts (ILG) and AAA non-sovereign debt benchmarks as relevant in the determination of the RFR, and determined a RFR based on the mid-point ILG and AAA non-sovereign debt benchmarks.[5]

Q11.4: To what extent should we place weight on a) balance sheet data; and b) index data when setting the allowed return on debt?

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[2] CMA states: "*In previous regulatory determinations, the CMA has generally followed the approach set out in the 2018 UKRN report (and earlier reports by the same authors) of assuming that the total market return parameter is broadly stable and that the equity risk premium fluctuates with the risk free rate*." And: *"[...] we continue to believe that it is appropriate to place most weight on the historic TMR estimates, which should be right on average over longer time periods even if they may be too high/low at particular points in time*" . Source: CMA (2021) Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations para. 9.387 & 9.390 .

[3] For example, at PR19 CMA placed most weight on the historical ex-post and historical ex-ante measures of inflation. Source: Source: CMA (2021) Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations para. 9.393 .

[4] See: Ofgem (2018) Consultation - RIIO-2 Sector Specific Methodology Annex: Finance, para 3.46. Ofgem (2021) Decision - RIIO-2 Final Determinations – Finance Annex (REVISED), section 3

[5] Source: CMA (2021) Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations para.s 9.241-9.244

Ofwat should allow companies to recover their efficient costs of embedded debt which necessitates examination of companies' balance sheet costs. The use of a benchmark approach as per PR19 – where Ofwat relies on the historical cost associated with a benchmark index (e.g. average of A and BBB rated 10Y+ Corporate non-financial index) – does not provide a direct measure of companies' costs, and therefore should not be the basis for the cost of debt allowance. As Ofwat notes, both Ofgem and RIIO-2 and CMA PR19 FD placed weight on the actual cost of debt in setting allowances.[6]

More specifically, Ofwat should recognise the embedded cost of debt associated with WoCs in its determination of the allowed cost of debt, to reflect the relatively small size and issuance profile of WoCs. This approach necessarily involves consideration of WoC balance sheet debt costs, as we explain in our response to question 11.5 below.

Q11.5: Should we allow adjustments to the sector allowed return based on company size - and how should this be assessed?

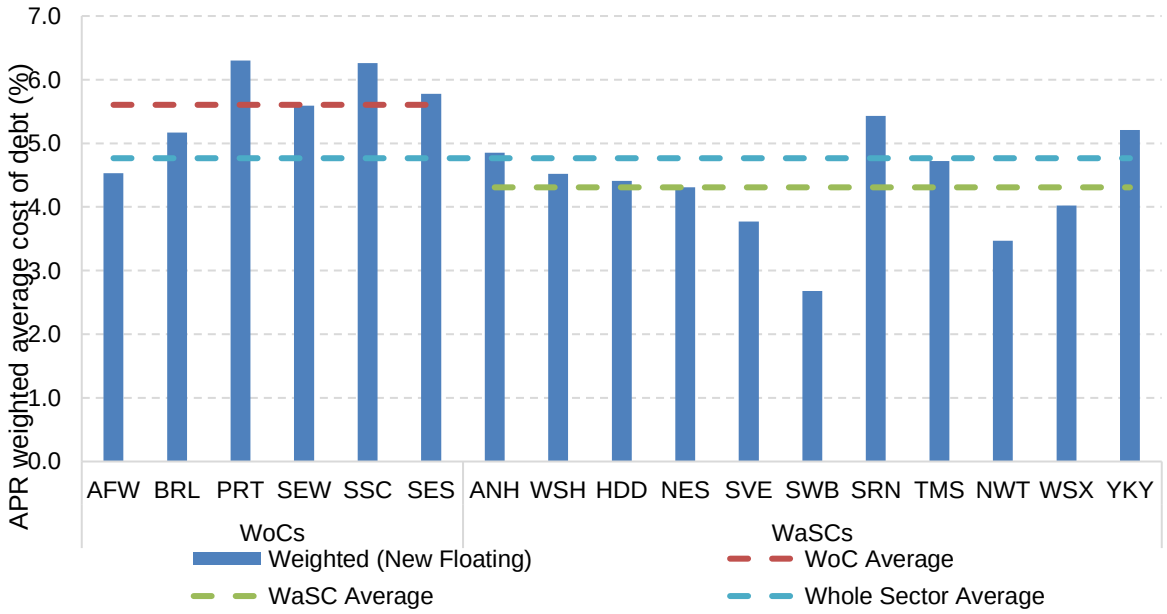
We identify two issues that Ofwat should recognise in relation to company size: the higher cost of embedded debt for WOCs and the structural downside risk in the overall regulatory framework.

<u>Ofwat should recognise higher WoC embedded cost of debt, and lower proportion of new debt issuance</u>

WoCs face higher costs than the industry average as a consequence of our relatively small scale. To achieve the minimum efficient debt issuance, WoCs access debt markets less frequently and our historically dated debt issuance has led to higher costs in a falling interest rate environment. By contrast, in a rising interest rate environment, WoC costs would have been lower as a result of our historical debt profile.

The structural difference in WoCs relative cost of debt is evident from analysis presented by CMA at PR19. The CMA reports a WoC median cost of embedded debt of 5.68 per cent compared to an equivalent WaSC cost of 4.41 per cent, i.e. around 120 bps higher.[7]

Figure 1: Ofwat should recognise higher cost of WoC embedded debt



[6] Ofwat (2021) PR24 and Beyond: Creating tomorrow, together, p. 177

[7] CMA (January 2020) Water Redeterminations 2020, Cost of debt – Working Paper, Table 2, p. 51

Source: NERA analysis of CMA (January 2021) Water Redeterminations 2020, Cost of debt – Working Paper, Table 1

Ofwat's AMP7 embedded: new cost weighting of 80:20 also fails to reflect the expected level of new debt for an infrequent issuer.[8] We expect our new debt issuance to be around 3 per cent over AMP7. Bristol Water has provided evidence that more generally WoCs will issue between 5 and 10 per cent new debt over AMP7, supporting an average weighting of 95:5.[9]

At the PR19 appeals, the CMA allowed a small company premium for Bristol Water based on its analysis of WoC versus wider industry debt costs as well as Bristol Water's own costs.[10] The allowance at PR24 should be based on balance sheet evidence of WoC debt costs at the time of the next review.

<u>Ofwat should recognise structural asymmetry in setting cost of equity</u>

Ofwat should recognise the far greater risk downside risks faced by smaller WoCs in setting the allowed cost of equity at PR24.

At the PR19 appeals, the CMA estimated asymmetry in the PR19 incentive package of between 0.1 per cent to 0.2 per cent on RORE, based on a 10 per cent weighting to a 10 per cent downside scenario for all asymmetric incentives.[11] However, evidence from AMP6 shows that there is much greater structural asymmetry in the price control for the water service (and therefore WoCs) of around 40 bps. For example, over AMP6, the sector on average underperformed by around 10 bps on ODIs, whereas the average WoC underperformed by around 40 bps. Evidence from Moody's suggests that underperformance for WoCs relative to the industry is likely to be further exacerbated over AMP7, given that the Covid crisis principally affects water as opposed to wastewater services and given the tightening of the regulatory regime.[12]

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[8] Ofwat (2019) PR19 final determinations: Allowed return on capital appendix, p. 5. Link: https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Allowed-return-on-capital-technical-appendix.pdf

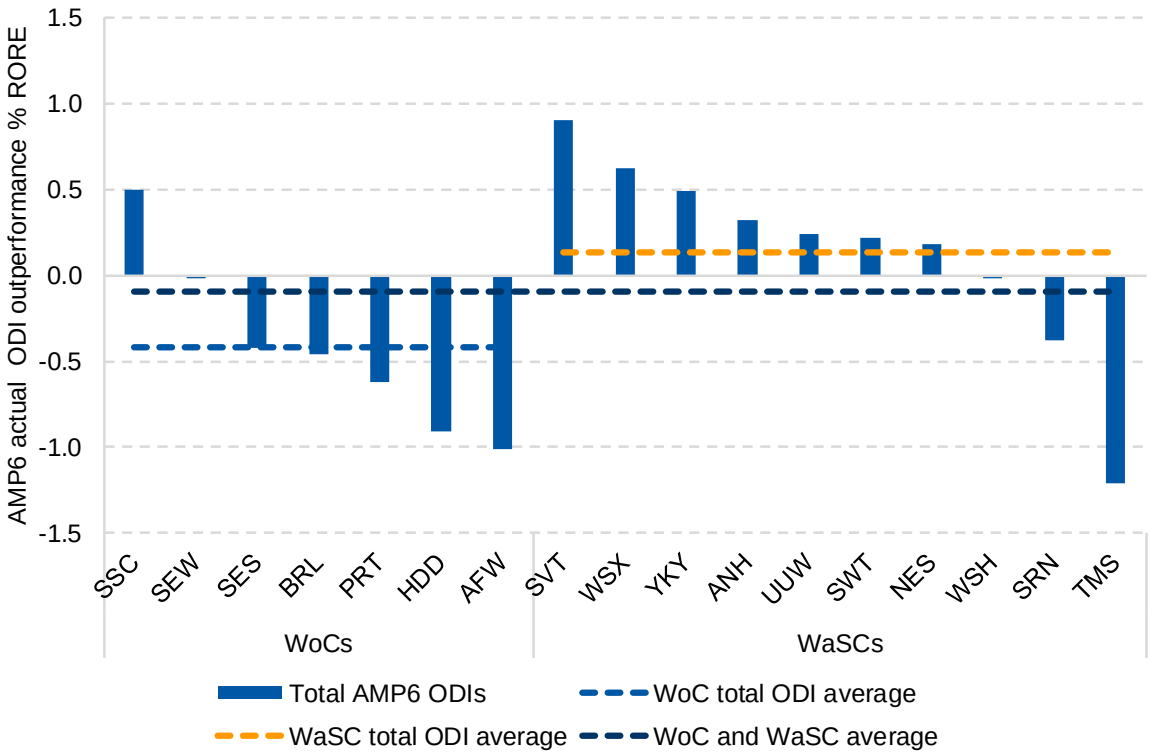
[9] Bristol Water (2020) Statement of Case, paras. 228-236

[10] CMA (2021) Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations para.s 9.1004

[11] CMA (2021) Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations para.s 9.1341.

[12] Moody's (January 2021), 2021 outlook returns to stable as companies settle into a tough regulatory period, p. 11, Exhibit 11. *"The overall penalty for the industry would be around £32 million for a 5% PCC increase across all companies and £58 million for 10% during 2020-21, but would only be paid in 2022-23. Compared with our aggregate five-year estimated penalty range at final determination, as outlined above, the* ***potential single-year impact of this one ODI is significant. As shown above, in our example the risk of materially weaker interest coverage sits disproportionally with the smaller WoCs, rather than the larger WaSCs****."*

Figure 2: Ofwat should recognise the greater risks faced by WoCs (AMP6 WoCs and WaSCs ODI outperformance %RORE)



Source: SEW analysis of Ofwat Monitoring financial resilience report 2019-20 data.

Table 1 shows ODI performance for water and wastewater services separately. This shows that WoCs and WaSCs have both underperformed on water-related ODIs whereas WaSCs have outperformed on wastewater-related ODIs. That is, the underperformance of WoCs is related to the more challenging regulatory framework for the water service, as opposed to a WoC specific issue.

Table 1: AMP6 water and wastewater-related ODI outperformance (£m)

	ODI Performance (AMP6, £M)
Water service	
WoCs	-17
WaSCs	-117
Industry	-134
Wastewater service	
WaSCs	171
Water and wastewater	
WaSC	54

Source: SEW analysis of Ofwat, "FD outcome PC and ODI database"

As well as incentives, there is also structural underperformance on totex for the water service. For example, over AMP6, Ofwat's data shows that the companies' overspent water service allowances by around 8 per cent, whereas WaSCs outperformed on wastewater services by

around 5 per cent.[13] The water service underperformance corresponds to around 60 bps on RORE.[14]

In conclusion, Ofwat should recognise the far greater risk downside risks faced by smaller WoCs in setting the allowed cost of equity. Alternatively, Ofwat needs to ensure that the cost and incentive package at AMP8 is calibrated to correct for the downside asymmetric risk associated with the water service.

Q11.6: Should we make different assumptions for the PR24 notional structure compared to PR19, and how should such a change be implemented?

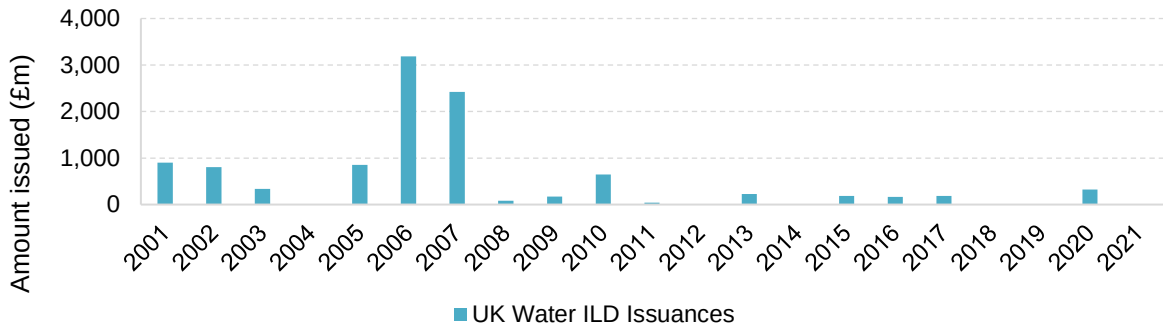
Ofwat indicates that it will consider an increase in notional level of indexed linked debt (ILD), and a reduction in notional gearing. Neither of these changes are supported by market evidence, which should be the basis for the notional company assumptions.

An increase in notional level of ILD is not supported by market evidence

Ofwat considers that one potential change could be increasing the assumed share of index-linked debt from its PR19 level of 33 per cent. Ofwat notes that as at March 2020, approximately half of the sector's total outstanding debt was index-linked debt (ILD).[15]

However, RPI ILD is relatively dated with the larger issues in the period before 2010 (see Figure 1). The transition to CPI indexation has removed the natural hedge associated with RPI ILD, while the market for CPI ILD remains immature as demonstrated by market evidence on the relatively high CPI ILD premium.[16] These factors suggest that ILD (whether RPI or CPI) will decline over PR24 and beyond from the current level. It would be wrong for Ofwat to increase the notional company ILD at a time when it is expected to decline.

Figure 3: RPI ILD is relatively dated and expected to decline as a % of total debt



Source: Analysis of RPI ILD public bond market data.

If Ofwat assumes a level of CPI ILD issuance for the notional company at PR24, it is imperative that it allows for the higher cost of issuance, as per Ofgem's approach at RIIO-2.[17]

A further reduction in notional gearing is not supported by evidence

[13] SEW analysis of Ofwat AMP6 performance data. Source: https://www.ofwat.gov.uk/publication/service-and-delivery-report-2019-20-data/

[14] Calculated assuming 50 per cent sharing factor and 6% totex to RAV ratio. Calculation: 8% underperformance *6% totex to RAV*50% sharing, divided by (1-notional gearing).

[15] Ofwat (2021) PR24 and Beyond: Creating tomorrow, together, p. 120

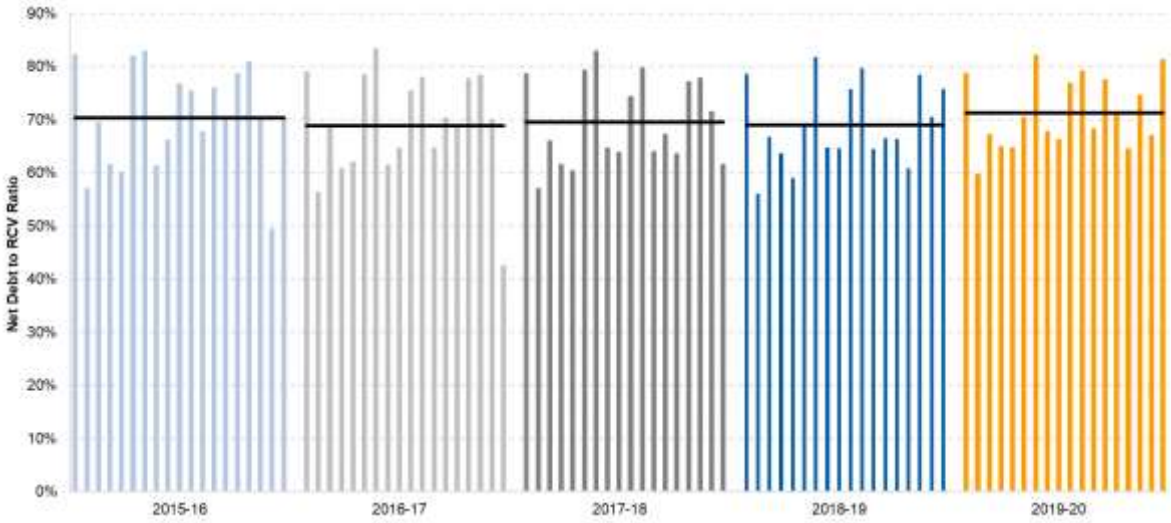
[16] A report commissioned by Energy Networks Association provides evidence for a CPI ILD premium relative to nominal debt issuance of between 30 bps and 100 bps. See: NERA (September 2020) Review of Ofgem's DD additional costs of borrowing, and deflating nominal iBoxx

[17] Ofgem (2021) Decision - RIIO-2 Final Determinations – Finance Annex (REVISED), p. 15

In addition, Ofwat will consider a further reduction to the notional level of gearing that it applied at PR19. Ofwat claims that this is consistent with proposals set out by some companies to improve financial resilience through 2020-25, and to address higher revenue risks associated with the regulatory framework.[18]

At PR19, we provided evidence that the decline in notional gearing was not supported by market evidence. A further reduction is likely to be equally unwarranted. As set out in Figure 4, net debt to RCV shows no discernible decline over AMP6 with an average sector gearing of around 70 per cent (as indicated by grey bars).

Figure 4: Market evidence on net to debt RCV does not support a reduction in notional gearing



Source: Analysis of Ofwat Monitoring Financial Resilience Report 2019-2020 Dataset, S7.
Notes: Each bar represents net debt to RCV for the following licensees: Anglian, Dwr Cymru; Northumbrian; Severn Trent; South West, Southern; Thames; United Utilities; Wessex; Yorkshire; Affinity; Bristol; Hafren; Portsmouth; SES Water; South East; South Staffs; Tideway

Q11.7: Do you have any suggestions for mechanisms which could incentivise financial resilience within the price control process?

Ofwat is concerned that current arrangements might not be enough to discourage financial structures which lack adequate levels of long-term financial resilience. It therefore proposes to consider further measures to improve financial resilience at PR24.[19]

We would welcome the opportunity to work with the industry and Ofwat on any further mechanisms to promote financial resilience. Our current view is that Ofwat's current mechanisms to promote financial resilience, enforced through licence provisions, have adequately addressed concerns around the financeability of the sector over successive price controls. For example, our licence conditions require us to provide a Ring-fencing Certificate, that certifies that we have adequate financial resources and facilities to enable us to carry out our regulated activities.[20] Our licence conditions also require us to maintain an investment grade credit rating with cash-lock up provisions if the rating requirements are breached.[21] At price control, Ofwat requires companies to demonstrate the financeability of our plans on both a notional and actual basis, and under a range of downside scenarios.

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19 Ofwat (2021) PR24 and Beyond, p. 116

20 SEW Instrument of Appointment, pp. 144&145

21 SEW Instrument of Appointment, p. 142

Empirically, Ofwat's analysis of the sector also shows that all companies are rated above the minimum investment grade rating of Baa3 and most companies are rated Baa1.[22]

Therefore, we consider the current measures to promote financial resilience of the sector are sufficient.

Q11.8: To what extent should we further increase the share of the notional company RCV which is indexed to CPIH in our assumptions for the period 2025-30, and how should this be implemented?

Ofwat states that it sees merit in further transitioning to full CPIH-indexation for PR24.[23] It also notes that by the end of the 2024-25 financial year approximately 60 per cent of the sector's RCV will be indexed to CPIH. According to Ofwat, greater use of CPIH would mean indexing with a more robust measure of inflation that has greater customer legitimacy.

In allowing for a transition to CPIH indexation whereby 50 per cent of the opening 2020 RCV is indexed to RPI, Ofwat acknowledged the need to maintain a natural hedge between the RPI RCV portion and RPI ILD, in order to mitigate basis risk (the risk that RPI deviates from CPI more than expected).[24] In the absence of the transition and where the RPI -CPI wedge outturn is greater than expected, companies would fail to recover the costs of the RPI ILD.

As set out above, we expect there to be little or no RPI ILD issuance over future AMPs. In addition, our analysis shows that very little (less than 10 per cent) of outstanding RPI ILD will be redeemed over AMP7 given the long-dated nature of the debt. Overall, we expect a slow-winding down of RPI ILD from current levels. This suggests that a substantive element of the RCV should continue to be indexed by RPI to mitigate basis risk (the risk that RPI deviates from CPI). Ofwat states that it expects around 40 per cent of the RCV to be linked to RPI by the end of AMP7, and we consider that this element should continue to be RPI linked over AMP8. If instead, Ofwat determines a full switch to CPI indexation it will be important to compensate companies for the increased basis risk associated with RPI ILD, as per Ofgem's approach at RIIO-2.[25]

Next steps for PR24

Q12.1: What are your views on the draft timetable for PR24?

Ofwat is proposing that a number of key components will be set out in advance of business plans by the regulator – this includes customer research, performance commitment levels and associated incentives, totex allowances and the cost of capital. This is a substantial change from PR19, and if these proposals are pursued it is essential that this early information/guidance is provided in sufficient time to inform company plans – we would suggest as a minimum this should be supplied 9-12 months in advance of the deadline for business plan submissions.

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[22] All companies currently have a rating at least one notch above the minimum requirement. See: Ofwat (2020) Monitoring financial resilience January 2020, p. 4.

[23] Ofwat (2021) PR24 and Beyond: Creating tomorrow, together, p.121

[24] Ofwat determined to index 50 per cent of the RCV at 1 April 2020 to RPI, with the remainder of the 1 April 2020 RCV and all future additional to CPIH. Source: Ofwat (2017) Delivering Water 2020: Our final methodology for the 2019 price review, p. 110

[25] At RIIO-2. Ofgem provided for 5 bps on the cost of debt to address "*Provision of an allowance to cover potential additional costs of CPI/CPIH new debt issuance and RPI/CPIH embedded debt basis mitigation*". Source: Ofgem (2020) Decision - RIIO-2 Final Determinations – Finance Annex (REVISED), p.15. Link:

Examining the boundary of the targeted control for water resources

Q14.1 - How can costs and incentives for the existing water resources control be targeted more effectively?

The boundary of the water resources price control is a difficult one. The industry has devoted considerable effort to getting this right in accounting terms and cost allocation. Inevitably these accounting changes take time and the data will improve over time. We think that if these efforts are continued, Ofwat will have a much better chance of developing meaningful models at PR24 than it did at PR19, where the data was relatively new and didn't have much history.

Q14.2 - Would amending the boundary to include raw water distribution or to extend it further to include water treatment improve the operation of the control? What are the issues involved?

We believe the proposal to extend water resources price control needs further reviewing to determine if the potential benefits outweigh the costs of implementation. We would suggest there is further dialogue with the industry on this proposal via the cost assessment working group.

We are not convinced about the proposal to include water treatment in the water resources control. It is very difficult to imagine an entrant into the market providing treated water, and injecting it into a water distribution network. Most networks are 'right sized' and may not be able to handle significant new water coming into the system without network investment. Unless an entrant had a works in the same location as an existing works (which seems unlikely), there could be fairly large barriers to entry. There are barriers to entry that make it difficult for an entrant to come in with raw water, but those barriers are even higher for treated water.

south east water

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