

Via email: OfwatPandO@ofwat.gov.uk

Ofwat
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21st October 2021

Dear

Draft determination of Affinity Water’s in-period outcome delivery incentives for 2020-21

We have reviewed the 5th October draft determination for in-period adjustments. We believe that our draft determination includes an incorrect assumption on tax, and we have certain concerns about inclusion of ‘repairs on repairs’ in the mains repair commitment. We provide further detail on these items in the sections below.

Tax

We note that the draft determination uses a default assumption, 19% marginal rate of tax. This is significantly higher than the annual average effective tax rate of about 5.5% assumed in our Final Determination 2019.

Having recently reviewed our forecasts, our expectation is that the company will make a loss in 2022/23 for corporation tax purposes. This loss, which will be carried forward and offset against taxable profits in future years, is increased by the ODI adjustment. Therefore, the marginal tax rate in 2022/23 should be nil because no tax will be due.

Further ahead, we expect our forecast taxable profits for 2023/24 to be insufficient to utilise losses carried forward from 2020/21, therefore the earliest year in which the additional loss created by the ODIs in 2022/23 will be utilised is 2024/25. The tax benefit resulting from the ODI adjustment will therefore not be realised until 2024/25 at the very earliest.

To illustrate the effects of correcting the draft determination default tax assumption, we attach a revised version of the in-period model. In this we have entered the value 0% for Marginal Rate of Tax, reference A3023 on the ‘Input Expected’ tab. The effect of this change is summarised in the table below which compares the previous determination, Ofwat’s draft determination and our response having re-set the tax rate to zero.

| Price Control | | 2021/22 | 2022/23 | 2023/24 | 2024/25 |
|--------------------------------|---------------------------|---------|---------|---------|---------|
| Water Resources (K factors) | Previous Determination | 10.58 | 14.67 | 9.29 | -2.46 |
| | Ofwat Draft Determination | 10.58 | 14.77 | 9.20 | -2.46 |
| | AFW Draft Detn. Response | 10.58 | 14.75 | 9.22 | -2.46 |
| Water Network Plus (K factors) | Previous Determination | 1.40 | 0.59 | 0.96 | 3.27 |
| | Ofwat Draft Determination | 1.40 | -1.94 | 3.50 | 3.27 |
| | AFW Draft Detn. Response | 1.40 | -1.46 | 3.00 | 3.27 |
| Residential Retail (£m) | Previous Determination | 27.875 | 28.573 | 29.306 | 30.044 |
| | Ofwat Draft Determination | 27.875 | 26.502 | 29.306 | 30.044 |
| | AFW Draft Detn. Response | 27.875 | 26.895 | 29.306 | 30.044 |

Mains Repairs

We acknowledge the draft determination's adjustment to the penalty incentive on mains repairs although we also note that the guidance does not make reference to 'repairs on repairs'. Further, the following guidance paragraph does not clarify the position on whether a repair to the actual clamp itself (through replacement of bolts) should be included as a repair to the main.

'Any work that is not undertaken on the main e.g. solely on a ferrule, hydrant or valve and clamps associated with these ancillaries, which does not involve a repair on the main shall be excluded. Clamps used to repair the main shall be included.'

We would add that the inclusion of repairs to clamps and clamp bolts and the wider term 'repairs to repairs' moves this metric further from its intended position as an asset health measure because the efficacy and durability of repairs is not the same thing as the condition and performance of our mains. Their inclusion provides more of an indication of disruption to our customer base through road disruption. The customer impacts of road disruptions are already incentivised through C-Mex and the Interruptions to Supply commitment, so we consider its inclusion in the main repair metric could be double counting.

The new terminology 'repairs to repairs' also raises the question how intended temporary repairs to return supply to customers should be treated. There may be scenarios where a temporary clamp fix is initiated (to ensure a continuous water supply) with the intention of carrying out a cut out or similar job later in the day or at a quieter time. Under the umbrella term 'repairs to repairs' this would imply the temporary fix would count as an additional repair and risks a perverse incentive to concentrate on repairs rather than return to service.

Therefore, we suggest that the guidance requires review and clarification. As it currently stands, it is open to interpretation and risks being applied inconsistently across companies with consequences for comparability. At the time of the common performance commitment workshops, mains repairs was given little time for discussion and we would welcome company-wide collaboration to review, ensuring a greater understanding and fair application of guidance.

Yours sincerely,

Nicola Fomes
Interim Director of Strategy and Regulation