Affinity Water
Taking care of your water

PR24 draft methodology consultation response
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

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PR24 Draft Methodology Response

Company businesses plans for 2025 – 2030 will be developed and assessed against a backdrop of unprecedented climate challenges and increasing macroeconomic uncertainty and risk. Now more than ever, it is vital that the regulatory framework for the sector can support and incentivise the level of investment needed to meet these challenges and provide resilient and reliable infrastructure now and for the future, whilst ensuring it remains affordable for customers and balanced across current and future generations.

There is much in the draft methodology that we support, particularly the intention to encourage longer-term planning and the greater recognition of the role that nature-based solutions can play. However, there are many areas where the draft methodology falls short of providing either real clarity of ambition and purpose for the sector, or setting out well developed and evidenced-based changes to regulatory mechanisms.

It is critical that the sector works together with Ofwat on the areas of the framework that require further development. We have set out the areas of most material concern below and have provided detailed responses to the consultation questions in the accompanying appendices. We look forward to further engagement on these topics in advance of the final methodology.

Investing for the Long-Term

We are strong advocates of evolving the regulatory approach to enable long term planning and more sustainable approaches for the provision of water services. Defra has clearly set out the need to take a longer-term approach to investment, recognising that for the system to work in the enduring interests of customers, society and the environment, it cannot simply mean lower prices in the short term at the expense of future generations[1].

For Affinity Water, the twin challenges of climate change and population growth, coupled with the increasing need to protect the rare chalk streams in our area and eliminate unsustainable abstraction, mean long-term planning is a necessity to ensure a resilient supply of water into the future. Our draft Water Resources Management Plan (WRMP), developed in conjunction with other companies in the region through

[1] https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance/february-2022-the-governments-strategic-priorities-for-ofwat

WRSE and WRE[2], sets out ambitious targets for reducing water wastage from leakage and demand, along with new inter-regional water transfers and a strategic reservoir.

We have material concerns that the draft methodology fails to create the right mechanisms to translate these plans into reality. In particular, the draft methodology does not address systematic issues with the approach to cost allowances that would allow a thorough assessment of the economically efficient level of investment over a longer time horizon than the current control period.

The approach in the draft methodology to assessing base costs is still predominantly based on backward-looking views of costs which have previously been incurred. As was the case at PR19, this does not recognise that the level of asset replacement and maintenance rates will need to increase significantly to match the service improvement requirements for the sector and ensure a sustainable approach over generations. A recent report for Water UK demonstrates the sector's rate of asset replacement is well below that of its European peers[3], necessitating a more forward looking and long-term approach to asset health. Historical costs also do not reflect the growing pressures on networks resulting from climate change and extreme weather events and are likely to provide an increasingly unrealistic predictor of the level of investment needed to remain resilient in the future.

Relatedly, the draft methodology offers little support for companies in how they tackle the increased need for asset investment in a way that does not compromise the sector's ability to deliver on the commitment to achieving net zero by 2030. While it may be the case that some carbon reduction investments also reduce overall costs, this will not be true in all instances – something recognised by the Water Industry Commission for Scotland (WICS) in the recent Strategic Review of Charges for 2021-2027. Conversely, Ofwat's draft methodology provides little clarity in what the common reduction in operational carbon expectations will be (and therefore what is in base allowances) and how the 'competitive bid process' for additional enhancement allowances will operate.

The draft methodology also offers little progress on linking cost allowances and service targets over time. Leakage and mains bursts are a litmus test for company performance in public perception, as well as the legitimacy of the regulatory framework itself. A step change in performance and investment is needed across companies to meet public expectations and ensure we have a resilient infrastructure fit for the challenges of the 21st century. In relation to leakage, the recent PR19 CMA re-determinations provided for additional cost allowances for leakage in recognition that base cost allowances are not sufficient for stretching targets.

Similarly, there is scant detail in the draft methodology on how enhancement costs will be assessed, and to date, there has been little engagement by Ofwat with the sector on the development of modelling approaches. Given the scale of enhancement investment needed to support water resource and WINEP

2 Water Resources South East and Water Resources East

3 https://www.water.org.uk/publication/options-for-a-sustainable-approach-to-asset-maintenance-and-replacement/

programmes, a clear approach needs to be rapidly developed. Failure to accurately identify efficient costs will also have consequences for the proposed ‘Price Control Deliverable’ (PCD) mechanisms, which are likely to rely on these unit costs to make adjustments to account for changes to scope. We look forward to working with Ofwat on this ahead of the final methodology publication.

Affordability

Given the current economic pressure on customers, ensuring bills are affordable for those struggling to pay will be paramount over the next price control period. The number of customers needing support and assistance will inevitably increase in the lead up to PR24 as the ‘cost of living crisis’ intensifies, and the consequences of this are unlikely to be of a short duration for many customers.

It is therefore disappointing that the draft methodology does little to acknowledge and address this issue. It is unclear if the move to a national social tariff will lead to fewer customers being able to access support. As with the underlying principle of cost assessment, moving to a ‘lowest common denominator’ approach may compromise the actual service and support available to customers. While the final form of the national social tariff remains undecided, we would encourage Ofwat to set clear expectations in the final methodology for the protection of customers on existing social tariffs.

Balance of Risk and Return

We support the recognition in the draft methodology of the ‘fair bet’ principle, however we have material concerns about the distribution of risk and return for companies. If the proposals set out in the draft methodology are adopted into the final methodology without any changes being made, there is a significant risk that financial resilience and the attractiveness of the sector will be undermined as an investment proposition. Such an outcome will result in adverse consequences for customers in the form of higher borrowing costs and, ultimately, the overall sector legitimacy.

The draft methodology outlines that PR24 will expose companies to at least the same level of risk as PR19, which suggests that allowed equity returns should be no lower than those provided at PR19, prior to factoring in increased interest rates. However, the cumulative effect of the proposed approach shows this is clearly not the case.

This is further exacerbated by a partial and limited approach to assessing the risk-return ranges for the regulatory package. We consider this is an area where significant improvement is required ahead of the final methodology so that an accurate view of the risks facing companies and the sector can be completed and any excessive skew corrected.

For the calculation of the cost of capital, the PR19 CMA re-determination set a recent and clear precedent for the water sector. The draft methodology departs from this precedent and fails to provide compelling evidence for the reasons for this deviation.

- On cost of equity, the draft methodology proposals to adopt selective estimation methodologies for each CAPM parameter depart from the findings of CMA's PR19 re-determination and will result in downward-biased estimates. The proposed decrease in the cost of equity is out of line with the upward trend in market interest rates and the resulting reduction in projected equity buffer is out of line with risk exposure at PR24 and Ofwat's concerns on financial resilience.
- For cost of debt, again we disagree with the departures from the CMA re-determination on the treatment of swaps, the application of the outperformance wedge and the exclusion of junior debt from the calculation of the sector average.

We are also concerned with the perverse incentives implied by the outperformance wedge which could create short-termist capital structures which could prove inefficient in the long term i.e. to issue shorter-term debt which will lead to greater refinancing and interest rate risk. These risks will ultimately be borne by the customer when the new, shorter-term, debt matures and needs to be refinanced during future price reviews.

We consider that for the final methodology (1) an allowance should be provided for risk mitigation given that this risk is arising due to factors outside companies' control that could not have been predicted when the current debt strategies were being implemented and (2) an uplift on the cost of new debt would be appropriate to reflect our size and infrequency of issuance.

Turning to notional gearing, we note that Ofwat are proposing to adopt a gearing level for the notional company below the 60% level used at PR19. Companies were universally opposed this proposal in response to the discussion paper on risk and return in December 2021, and the draft methodology continues to fail to adequately explain why such an approach is being pursued or address the concerns raised in company responses.

We continue to disagree with this proposal as it fails to properly consider important empirical evidence, such as, actual gearing levels, rating agency criteria and regulatory precedent. Failing to properly consider the evidence available could lead to companies being incentivised to move to inefficient actual gearing levels. The cost of this inefficiency would ultimately be borne by customers.

Furthermore, this proposed change to the notional gearing continues a trend where the financeability test on the notional company is becoming less meaningful, as it cannot effectively diagnose miscalibration in the balance of risk and return. This could have significant adverse consequences for financial resilience of actual companies.

Investors in Affinity Water have already committed to reinvesting regulatory returns throughout the current period to enhance operational performance and reduce gearing. The proposals outlined in the draft methodology set an expectation that further equity will be needed to support the necessary investment in 2025-30, whilst simultaneously creating a regulatory environment that will result in lower returns than previously and a further expectation that any additional costs or asymmetric and undiversifiable risks will be absorbed. Put simply, it is difficult to see how the draft methodology proposals create an attractive investment proposition for the sector.

The design of the outcomes, performance commitments (PCs) and outcome delivery incentives (ODIs) package

We have supported the approach to streamline the package of PCs and ODIs for the price review and have been pleased with the constructive dialogue between Ofwat and the sector in refining this area. In order to ensure the incentives are meaningful and encourage beneficial outcomes for customers, society and the environment, there are a number of areas that require further careful thought ahead of the final methodology.

As outlined above, we believe there are aspects of the draft methodology that risk incentivising short term behaviour and outcomes. In particular, we do not think it is appropriate that the new PCs for operational greenhouse gas (GHG) emissions reduction and the biodiversity common PCs should be in the form of in-period/annual ODIs.

Both of these measures are new for PR24 and setting performance improvements based on a 12-month period is likely to drive inefficient and near-term thinking about measures which already have an agreed longer term sector target for 2030. We would like to see these measures incentivised as an end of control period target to encourage better planning and investment to deliver a better overall outcome over a 5-year period.

It is also disappointing that the draft methodology has ruled out the early provision of information around performance commitment targets and instead relies on companies submitting 'ambitious bids' in final business plans as to what is achievable in the totex allowances. As with cost allowances, we expect Ofwat to arrive at an independent view of what performance targets are achievable within efficient cost allowances separately to any company business plan submissions, and that the methodology for arriving at targets be systematic, transparent and evidence based.

Providing an early view of performance targets ahead of business plan submissions would also enable companies to plan appropriately and ensure an equitable distribution of costs and service between generations of bill payers. It would also avoid the potential for material changes in company plans at draft determination stage, which in turn could result in shorter term decisions and actions being taken to mitigate immediate ODI risks.

We are also concerned that ODI rates from the collaborative customer valuations work will not be available until very late in the business planning process. Any further delay in the timetable will compromise our ability to integrate the customer research into business plans effectively.

In terms of the overall package of ODIs and the balance of risk and return, we do not see sufficient evidence within the proposed design of the ODIs that the risk faced by companies is symmetrical (i.e. that there is equal opportunity to earn rewards balanced against the risk of incurring a penalty). Omitting C-Mex, D-Mex and BR-Mex from the return on regulated equity (RORE) calculation creates a partial RORE position. This omission means that it is not possible to assess the overall symmetry of the package.

Similarly, the symmetry of the RORE calculation also needs to account for the removal of deadbands that were in place for PR19. Deadbands allow for minor deviations from the 100% compliance targets that did not impact on customers, for example Compliance Risk Index (CRI). The draft methodology notes that nearly half of the companies have operated within their deadbands for the CRI during the current control period[4]. Deadbands also allow for minor deviations and circumstances that may be out of the companies' control. A move to absolute measures increases the "downside" on RORE creating an asymmetrical risk for companies. We recommend that the limited deadbands in place for AMP7 are retained for AMP8 as a method of partly alleviating asymmetrical RORE risk.

Managing uncertainty and exogenous factors

Companies are currently experiencing real and material uncertainties over costs as a result of combined supply chain concerns, legacy pandemic issues and inflationary pressures. While there are areas that are arguably within management control to a limited degree (e.g. energy hedging strategies and timing of purchases), many areas are not and will become increasingly difficult to mitigate over the course of a 5 year price control.

The existing regulatory framework does provide for 're-opener' processes in limited cases (i.e. Relevant Change of Circumstances). However, these mechanisms have high materiality thresholds, are complex to enact and are unlikely to be fit for purpose for the fast-emerging macroeconomic challenges. The draft methodology provides little to no consideration of how these material issues should be addressed - notwithstanding simplistic references to the role of more equity to deal with generic uncertainties.

The final methodology needs to include a full, detailed disclosure of how the consequences of exogenous shocks will be treated, along with greater consideration of the role of uncertainty mechanisms, to ensure a fair and appropriate allocation of risk between customers and shareholders. This includes identifying where there maybe symmetrical risk (i.e. energy prices can go up as well as down) and where the risk is one-sided.

Extreme weather events are a clear example of asymmetric risk, and again the draft methodology shows no recognition of the need for appropriate mechanisms to deal with such events. Again, whilst elements of this may be within limited management control, particularly through long term planning approaches like WRMP and long-term delivery strategies (LTDS), the increasing frequency of extreme weather events needs to be recognised in the design of performance incentives and cost allowances.

[4] Appendix-8-Outcome-delivery-incentives.pdf (ofwat.gov.uk)Page 50

We are also concerned that there is no meaningful recognition in the draft methodology of retail pressures in the retail price control, which was also raised in PR19. We estimate that inflation of 16% has already been absorbed by the retail business. We are in a high inflationary period at present, the effects of which are likely to endure into the PR24 price review and into the next control period. This is an unsustainable challenge and will materially affect the viability of the retail price control and companies' ability to provide a standard of service that customers expect. As at PR19, we continue to request that Ofwat considers that inflationary pressures in the retail price control are appropriately recognised in PR24.

Price Review Process and Business Plan Incentives

We recognise the need to simplify the price review process and are generally supportive of the approach to business plan incentives. However, there are risks inherent in the approach proposed that need further consideration ahead of the final methodology to avoid any unintended consequences.

Firstly, while the removal of the IAP stage will reduce the regulatory effort from both companies and Ofwat, it does however remove a critical interaction point in the process. PR24 will be the first price review in the history of the privatised water sector where there will be no formal feedback on complete company plans in advance of draft Determinations – either in the form of a draft business plan or through the IAP assessment.

We are concerned that there will be insufficient time to properly assess the implications of any material interventions in company plans after draft Determinations. Consequently, this will affect companies' ability to make considered and meaningful representations ahead of final Determinations. Condensing a water company's ability to respond to feedback until after the draft Determination does not reflect the complexity of the considerations that a company must balance and risks companies making "hasty" decisions that create short and long term tensions, which are detrimental to long term resilience. We do not believe that the early submissions proposed in the draft methodology alleviate this risk. We encourage Ofwat to set out how it will conduct the formal engagement and feedback process prior to draft Determinations as part of the final methodology.

Secondly, we are not convinced that the introduction of 'ambition' as the defining factor of business incentives will be a sufficiently rigorous and fair assessment criteria. For water only companies, there is limited scope to include ambitious plans relative to the scale of wastewater companies, and we would encourage Ofwat to be clearer in the final methodology about how it will arrive at a fair and proportionate assessment of business plans.

There is also a risk that companies may 'overbid' in their business plans with the intention of securing higher business plan incentive rewards. At previous price reviews, we note that one of the procedural benefits of a higher business plan categorisation was a truncated process with minimal levels of regulatory intervention in plans. However, with companies' forecasts forming the basis of the likely PR24 performance targets and cost efficiency benchmarks, we would expect a greater level of regulatory scrutiny on plans with high levels of ambition to ensure unrealistic, short-term bids are not used as the basis of sector wide targets.

We also note that 'past delivery' has been removed from the assessment of business plans, which was a key feature of the PR19 process. We would like to see a clearer justification for this change as it provides a necessary cross check on the achievability and deliverability of 'ambition' that a company may propose in their business plan.

Finally, in relation to the 'quality' assessment of business plans, we note there is a worrying tautological logic in the approach. Put simply, companies who do not accept Ofwat's view of key parameters, such as WACC, and who do not provide complete assurance of financial resilience on that basis, will not pass the quality assessment. Not only does this preclude the possibility that regulatory determinations themselves are a causal factor in any financial risks, but it also limits legitimate and important debate around key evidence for the price review.

Direct Procurement by Default

While we recognise a desire to promote markets and to attract investors, we see potential for the introduction of 'Direct Procurement by default' to have unforeseen and significant consequences for the sector. The concept of DPC has had limited testing in the industry to date and, at a minimum, such a fundamental change to the regulatory approach needs to be accompanied by a fully evidenced impact assessment quantifying the risks and benefits.

Affinity Water investors, Allianz Capital Partners and DIF, have experience in investing in one of the only successful DPC projects to date in the sector (Thames Tideway Tunnel). Projects of this nature are extremely complex and unique to each set of circumstances and require significant upfront capital and resources. The draft methodology contains little consideration about the practical aspects of implementing DPC and it is not clear if the potential benefits to customers assumed in the draft methodology can be delivered consistently, if at all, at the scale implied by DPC by default proposal.

For example, it is not clear if DPC will affect the ability for a project to obtain a Defined Consent Order (DCO), as currently only water undertakers are able to obtain permission for developments categorised as Nationally Significant Infrastructure Projects (NSIPs). DCOs are intended to simplify and speed up the development of NSIPs, such as reservoir developments or water transfers, by streamlining the planning process and allowing the benefits to be delivered to customers as soon as possible. It is likely that any financial benefits to the DPC approach would be completely overshadowed by lengthy planning delays and additional costs arising from the loss of DCO status.

More fundamentally, the DPC by default approach will radically change the delivery model for all projects above £200m and that are sufficiently separable, as incumbent water undertakers will no longer be eligible to be potential bidders in DPC projects.

This effectively rules out the current providers from competing in the market when this may actually be the most efficient delivery method.

Not only could this create adverse consequences for customers in terms of the cost and timeliness of delivery, but it also fundamentally changes the future RCV growth potential for the sector. This is a very different proposition for investors compared to the current market and could potentially increase future borrowing costs and possibly negate any value gained by customers by the use of DPC.

It is also not clear if the £200 million threshold is a realistic or viable threshold to attract significant new investment into the industry. As the draft methodology does not contain any meaningful analysis or evidence, the choice of threshold appears arbitrary and ill-conceived. While there will be some investors who may be willing to engage in small investment propositions, size constraints will drive out a significant proportion of cheap institutional demand, which in turn will imply higher cost of capital, and higher costs for customers. The draft methodology contains no evidence that there is sufficient investor interest to make the market viable. Without this essential evidence there is a significant risk of a supressed market which will drive up price (a "bidder's" market) that fails to deliver true value for customers.

We are not opposed in principle to the increased use of DPC across the sector, as it is a viable option for very large, operationally discrete projects, particularly those that span multiple company regions. However, the final methodology needs to set out clearer evidence and analysis of the impact of the proposals, along with practical consideration of DPC in operation and how it interacts with other regulatory and planning mechanisms.

Conclusion

We have provided our response to the draft methodology with the aim of supporting Ofwat's development and finalisation of the PR24 approach. We have set out our response to each question in the consultation in the excel template provided and have also included three additional annexes outlining our detailed response to the specific proposals on aligning risk and return, financeability and promoting financial resilience. We look forward to working with Ofwat ahead of the final methodology publication and would welcome the opportunity to discuss our concerns on the specific areas of the draft methodology over the Autumn.

Yours sincerely,

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Liv Walton

Director of Regulation and Strategy, Affinity Water