ST Classification: OFFICIAL PERSONAL

Draft methodology consultation response

Hafren Dyfrdwy

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1. Overview of our response

We welcome the opportunity to comment on your Draft Methodology for PR24. We're pleased to see that the planned approach is very much an evolution that builds on what went well at PR19, incorporates useful lessons learned and faces into longer-term challenges. A good example of this evolution is Ofwat's proposals for enhancement funding, which we think will act a key enabler for delivering nature-based solutions, progressing towards net zero and tackling storm overflows. Other helpful developments in our view include recognising the role of dividends in equity financing and keeping the door open for bespoke ODIs if that is what customers want.

At the same time, we're hoping that past performance will still get to play a similarly clear role in the Business Plan Incentive tests as it did at PR19. We think that it is important to assess past performance particularly where companies are (i) not investing their totex allowances <u>and</u> (ii) not delivering on performance metrics, given that such behaviour hurts us collectively as a sector. So, to our mind, increasing incentives for in-AMP performance can only be a good thing.

We also welcome the collaborative approach with key stakeholders that is being adopted in Wales. We see this as an opportunity to ensure a common understanding of the long-term challenges facing water companies in Wales as well as obtain useful steers from stakeholders on high-level outcomes and priorities. We see this as being particularly helpful given the importance of long-term delivery strategies for PR24.

In this response we focus on a small number of areas where changes to the draft methodology would help deliver a more rounded package in the long-term interests of customers and the environment.

Stretch

We are concerned that the extent of the individual stretch challenges planned across the different areas of PR24 look set to combine into an in-the-round challenge that will prove insurmountable for even the best-performing companies. This creates a risk of incentivising short-term behaviours which runs counter to the overarching aims that Ofwat has set out.

As it stands the individual challenges look likely to include:

- a more stretching catch-up efficiency benchmark than upper quartile
- a high level of frontier-shift when productivity growth across the economy has been low since 2010
- unfunded improvements in many service levels from base costs
- no inflation link for the household retail business (despite Ofwat consulting on providing the link to the non-household sector)
- no deadbands on compliance PCs, when for example, the DWI has stated publicly this is unrealistic for the Compliance Risk Index (CRI)
- asymmetric incentives, such as smaller rewards for good business plans than penalties for poor plans.

We recognise that some degree of stretch is healthy for helping push companies further and for helping drive service improvements that benefit customers without dramatically increasing their bills.

With this in mind, we would propose some moderate changes to the planned stretch including:

- keeping an upper quartile catch-up efficiency challenge
- linking frontier shift to economy-wide data since 2010

- requiring a more achievable level of service improvements from base costs
- index-linking the retail price control (consistent with the business retail market)
- providing deadbands for compliance PCs.

In-the-round, we think this would create a more realistic overall level of stretch for companies to pursue, while retaining a suitable platform for Ofwat to push hard for efficient investment in areas like storm overflows, water resources and net zero.

Proportionality

We recognise that there is a very short window for Ofwat to review all the responses to the Draft Methodology consultation, make any necessary refinements and then issue the Final Methodology before the end of the year. With this in mind, we have focussed our response on the small number of areas that are particularly material for us as the smallest company in the sector. At the headline level, we largely see this as a need for proportionality so that PR24 can work equally well for all sizes of company across the sector.

Direct Procurement for Customers (DPC)

One proportionality-related area is the extent that either specific elements of the PR24 methodology are applied to very small companies such as ourselves or the level of assessment carried out on specific parts of our plan. This is perhaps most relevant for us on Direct Procurement for Customers (DPC). At PR19, we recall that we were penalised for not carrying out a DPC analysis even though our entire wholesale totex programme was just £156m compared with a DPC totex threshold of £100m for an individual scheme. As the threshold moves to £200m for PR24 it does mean that the mismatch is likely to be even greater. Nevertheless, it also looks a good opportunity for greater proportionality and pragmatism in the extent we should be expected to carry out a DPC analysis.

Level playing field for small companies

Another way to support proportionality is to ensure there is a level playing field across the small companies. For example, this could include making sure that measures applied to us because we are a WaSC are also applied to WoCs where it is relevant to do so – such as pollutions (as these can and do happen on the water side) and the planned measure for discharge permit compliance. As it stands, we're on track to be held to a higher bar than any of the WoCs (all of which are larger than us).

A level playing field for retail

The current challenge with high inflation underscores the difficulties with the non-indexed control for residential retail. Retail is an opex-heavy business that is largely driven by wages. In a world where the retail price control does not allow for inflation, the upshot is that we face a straight-up choice between attempting to cut pay in real terms or reducing headcount each year to make room to keep wages constant in real terms. Neither of these options feels particularly palatable or sustainable even in the medium-term – especially in a high-inflation world. We note that in other similar fields (including retail non-household) the allowance is indexed linked.

We think this looks like a clear logic for updating the approach on the retail control so that inflation is taken into account. This would bring benefits in the form of:

- consistency with the wholesale controls, where it could then be combined within the Revenue Forecasting Incentive and we allow us to assess variances in revenue for each service as a whole

- consistency with the indexing applied in the Retail Exit Code protections for small non-households. Our view is that if inflationary pressures are still present in a highly competitive market like non-household retail in England, then we would expect these pressures to extend right across the retail market in Wales and England
- removing the inconsistency between the non-indexing of business retail for companies in Wales and the indexing applied in the Retail Exit Code protections for small non-households.

Normalised targets

As a small company, we're particularly aware that creating a balanced package has its challenges. On service delivery, our lived experience is that there's a small number of challenges for small companies whereby individual events can have an outsized impact on both an individual performance commitment (PC) and overall performance in any given year, even when focused on a single town. This was a challenge that Ofwat recognised at PR19 for pollutions and took specific steps to address. Our experience this AMP has also established that this challenge is not confined to pollutions – for example, the normalisation process on internal sewer flooding (ISF) turns low absolute performance numbers into comparatively poor performance with the rest of the sector.

The indivisibility of small numbers we cannot deliver the target level of performance as single event marks the difference between meeting or missing that target. In fact, to move from the penalty-side to the reward-side, this single event movement would represent a 25% reduction in the number of ISFs. In other words, we're in a unique situation whereby individual events have an impact reported performance that is out of proportion for the rest of the sector. We think that a pragmatic way to moderate such impacts would be consider targeted use of deadbands. This would then mitigate against low-level volatility in performance levels while giving room for incentives to apply in a meaningful way to more material changes in performance.

Extreme weather

The other key area that presents an outsized risk for us is the exclusion of extreme weather from performance reporting. For larger companies, such events will often average-out in their annual numbers in a way that does not happen for us. The risk for us is that a single extreme weather event can hit such a large share of our area or customers (and exacerbated by the extremely rural nature of some of our networks) that it will dominate our performance for the year – in other words it would become the story for that year's performance and the driver of an outsized penalty in return on regulated equity (RoRE) terms. This creates another unique situation; one where individual extreme weather events are highly likely to have an impact on reported performance that is out of proportion for the rest of the sector. We therefore think there is an opportunity to refine thinking around extreme weather exclusions, particularly for small companies.

Notional company

In our view Ofwat should keep the notional company assumptions used at PR19 to provide stability for investors and the sector. We also recognise the importance of moves to improve the financial resilience of the sector. To do this, we would recommend an approach that specifically discourages high gearing. To this end, we would propose penalties for high gearing as this would focus on those companies where this is relevant – rather than making changes to the notional company that would affect all companies.

At the same time, our current gearing levels mean that we could support lowering the notional gearing to 57.5% and note this would be below Ofgem's recent draft determinations for electricity distribution which used 60%.

2. Response details

2.1 Business Plan incentives

We very much support the use of incentives to encourage companies to produce high quality and ambitious plans that will benefit customers. We also really appreciated the early clarity provided in the Draft Methodology on the minimum requirements for our Business Plan – it's been really useful for communicating the expectations for PR24 more widely across the business.

At the same time, we're hoping that **past performance** will still get to play a similarly clear role in the Business Plan Incentive tests as it did at PR19. We think that it is important to assess past performance particularly where companies are (i) not investing their totex allowances and (ii) not delivering on performance metrics, given that such behaviour hurts us collectively as a sector. So, to our mind, increasing incentives for in-AMP performance can only be a good thing.

We're also concerned that the **balance** that's been built carefully into the design on the Business Plan incentives could transpire to have a heavy skew to the downside in practice. We see that there's a risk that the top category turns out to be unachievable, particularly for very small companies like ourselves. At PR19, no company achieved the top category and the three that did land fast track status were all large WaSCs. One challenge we see that small companies can have is that while their level of ambition may be proportionately large for their business, it risks looking small in totality when stood next to the total ambition of larger companies. We think an approach that makes clear it will take account of relative size, will be able to successfully overcome this challenge.

We've also welcomed Ofwat's open-mindedness to finding ways that PR24 could be simplified compared with PR19. As a small company, simplification can prove particularly useful. Having considered Ofwat's plan not to have a stage similar to the **Initial Assessment of Plans** (IAP) at PR19, we think this streamlining could be a step too far. Our logic is that we found the IAP extremely useful as it not only gave us clarity on areas of our plan that needed improving, it also gave us a good idea of what the wider sector thought was achievable. Off the back of this insight and the time afforded to us by receiving the IAP in January 2019, our teams were able to rechallenge themselves on what they thought they could achieve – ultimately helping us get to an updated plan that delivered even more for customers.

As a small, local company that is focused on serving its local communities, we are looking forward to submitting a high-quality and ambitious business plan next year and we hope the PR24 methodology will provide appropriate incentives to support us in this aim.

2.2 Base costs

As we face into the challenges of (i) delivering greater resilience in the face of climate change, (ii) delivering on our net zero responsibilities and (iii) delivering against growing customer expectations it is clear that the sector will face cost pressures in this future. Hence, we very much welcome Ofwat's intent to consider these pressures when assessing PR24 and recognising that costs from the World-as-we-used-to-know-it may not provide too much of a guide to the costs of the new World that we are moving into.

Indexing of retail price controls

One area that we consider needs looking at again is the current plan not to **index the retail price controls**.

The current challenge with high inflation underscores the difficulties that a non-indexed control for residential retail creates. Retail is an opex-heavy business that is largely driven by wages. In a world where the retail price control does not allow for inflation, the upshot is that we face a straight-up choice between attempting to cut pay in real terms or reducing headcount each year to make room to keep wages constant in real terms. Neither of these options feels particularly palatable or sustainable even in the medium-term – especially when we're set to see inflation well into double-digits. We note that this contrasts significantly with other similar fields – including retail non-household in England and retail costs in Ofgem's energy retail price cap – the allowance is indexed linked.

At PR19, Ofwat's approach to econometric modelling of retails costs included a time term, which could be said to take account of historic levels of inflation over time. The risk that inflation then deviates from this historic pattern cannot be underestimated. While the current levels of extremely high inflation were initially expected to prove transitory, the reality is beginning to look very different. In fact, there are now suggestions that higher inflation may be with us for a while yet given growing geopolitical tensions, the growing trend for near-shoring and reshoring, and the slowing of world trade. As the table below shows, differences between the level of inflation implicit in modelled cost (2% in this case) and inflation that persists at 5% a year very quickly become highly significant – almost a 20% difference by the end of the AMP.

Cumulative impact of inflation compared with constant nominal values

Year		Implicit indexing based on historic inflation of 2%	Prices index with inflation at 5%	Percentage difference
Year retail costs are set	2023/24	100.0	100.0	0.0%
Last year of AMP7	2024/25	102.0	105.0	2.9%
AMP8 year 1	2025/26	104.0	110.3	6.0%
AMP8 year 2	2026/27	106.1	115.8	9.1%
AMP8 year 3	2027/28	108.2	121.6	12.3%
AMP8 year 4	2028/29	110.4	127.6	15.6%
AMP8 year 5	2029/30	112.6	134.0	19.0%

Had inflation remained low, then the approach taken at PR19 would likely to have turned out to be low risk. Now inflation is back with a vengeance, it feels particularly risky to rely on approach that would effectively estimate future inflation based on historic values.

Overall, we think there's a clear logic for updating the approach on the retail control to include indexing so that inflation is fully taken into account so that it does not inadvertently become a new cost risk that companies have to manage even though it lies beyond management control. In addition to resolving the very real risk of a significant real-terms price gap, this would bring benefits in the form of:

- **consistency with the wholesale controls**, where it could then be combined within the Revenue Forecasting Incentive and we allow us to assess variances in revenue for each service as a whole
- **consistency with the indexing applied in the Retail Exit Code protections for small non-households**. Our view is that if inflationary pressures are still present in a highly competitive market

like non-household retail in England, then we would expect these pressures to extend right across the retail market in Wales and England

- **removing the inconsistency between the non-indexing of business retail for companies in Wales and the indexing applied in the Retail Exit Code protections for small non-households**.

Improvements expected from base

Risk of over-stretch

We are concerned that the extent of the individual stretch challenges planned across the different areas of PR24 look set to combine into an in-the-round challenge that will prove insurmountable for even the best-performing companies. This creates a risk of incentivising short-term behaviours which runs counter to the overarching aims that Ofwat has set out.

As it stands the individual challenges look likely to include:

- a more stretching catch-up efficiency benchmark than upper quartile
- a high level of frontier-shift when productivity growth across the economy has been low since 2010
- unfunded improvements in many service levels from base costs
- no inflation link for the household retail business (despite Ofwat consulting on providing the link to the non-household sector)
- no deadbands on compliance PCs, when for example, the DWI has stated publicly this is unrealistic for the Compliance Risk Index (CRI)
- asymmetric incentives, such as smaller rewards for good business plans than penalties for poor plans.

Heightened risk from the intended higher weather standards

Amongst the unfunded improvements we expect from base, one of the biggest risks that this would create for us stems from the intended higher weather standards.

For us, the exclusion of extreme weather from performance reporting area will present us with an outsized risk. For larger companies, such events will often average-out in their annual numbers in a way that does not happen for us. The risk for us is that a single extreme weather can hit such a large share of our area or customers (and exacerbated by the extremely rural nature of some of our networks) that it will dominate our performance for the year – in other words it would become the story for that year's performance and the driver of an outsized penalty in RoRE terms.

To help bring the challenge to life, the table below shows the impact on reported performance for different companies from a storm that causes a million-property-minutes event on supply interruptions. This is the same impact that Storm Arwen had on us at the backend of 2021, which added 9 minutes 43 seconds to our supply interruptions performance for the year – 2.7 times the impact such an event would have Sutton & East Surrey and 14 times the impact that a company as large as Dŵr Cymru would see.

Normalised impact of a 1m property minutes event for supply interruptions

Company	Total properties served	Impact
Hafren Dyfrdwy	106k	9 mins 43 secs
Sutton & East Surrey	285k	3 mins 37 secs
Dŵr Cymru	1.46m	42 secs

This creates another unique situation; one where individual extreme weather events are highly likely to have an impact reported performance that is out of proportion for the rest of the sector. We therefore think there is an opportunity to refine thinking around extreme weather exclusions, particularly for small companies.

Keeping the level of stretch healthy

We recognise that some degree of stretch is healthy for helping push companies further and for helping drive service improvements that benefit customers without dramatically increasing their bills.

With this in mind, we would propose some moderate changes the planned stretch including:

- keeping an upper quartile catch-up efficiency challenge
- linking frontier shift to economy-wide data since 2010
- requiring a more achievable level of service improvements from base costs
- index-linking the retail price control (consistent with the business retail market)
- providing deadbands for compliance PCs.

In-the-round, we think this would a create a more realistic overall level of stretch for companies to pursue, while retaining a suitable platform for Ofwat to push hard for efficient investment in areas like storm overflows, water resources and net zero.

2.3 Outcomes

The Draft Methodology contains a number of welcome components in the planned approach for outcomes. This includes retaining **room to put forward bespoke PCs** where customers support these and the prospect of **higher ODI incentive rates and enhanced rewards** for delivering really strong service levels for customers. The **planned symmetry principle** is also extremely sound and will help protect against the very real risk of a package that is overly focussed on penalty-only incentives.

We think there’s a need for some **tailoring of common PCs in Wales** to reflect relevant differences from England. We’ve some initial thoughts on the areas where such tailoring could be useful and look forward to working collaboratively to bottom these out at the PR24 Forum.

We note the current thinking on **Price Control Deliverables** is that these will be downside only. Whilst this is largely true for the Green Recovery schemes approved for some companies in England, it does differ from some of the delivery PCs put in place at PR19 such as metering rollouts. These have set delivery targets across AMP7, with companies penalised or rewarded against their target depending on whether they deliver fewer or more deliverables than their target. We think there is likely to be investments where a similar approach will prove prudent at PR24.

As a general principle, we think the outcomes regime should remain open to **retaining deadbands for compliance measures**. This is particularly relevant for **CRI**, where the DWI has declared in favour of retaining the deadband and reiterated this view at the July 2022 meeting of the PR24 Forum.

When setting outcomes we think it is important that these are set in a way that is **proportionate and consistent across small companies**. We think this principle should apply to make sure that measures applied to us because we are a WaSC, are also applied to WoCs where it is relevant to do so. Our view is that this should include **pollutions** – as these can and do happen on the water side – as well as the planned measure for **discharge permit compliance**. As it stands, we’re on track to be held to a higher bar than any of the WoCs (all of which are larger than us).

From our small-company perspective, we consider that the principle of proportionality is highly relevant to common PCs that use normalised measures of performance and set targets on this basis. Our lived experience is that there's a small numbers challenge for small companies whereby individual events can have an outsized impact on both an individual PC and overall performance in any given year, even when focused on a single town. This was a challenge that Ofwat recognised at PR19 for pollutions and took specific steps to address. Our experience this AMP has also established that this challenge is not confined to pollutions – for example, the normalisation process on **internal sewer flooding** (ISF) turns low absolute performance numbers into comparatively poor performance with the rest of the sector.

The indivisibility of small numbers means we cannot deliver the target level of performance as a single event marks the difference between meeting or missing that target. In fact, to move from the penalty-side to the reward-side, this single event movement would represent a 25% reduction in the number of ISFs. In other words, we're in a unique situation whereby individual events have an impact reported performance that is out of proportion for the rest of the sector. **We think that a pragmatic way to moderate such impacts would be consider targeted use of deadbands**. This would then mitigate against low-level volatility in performance levels while giving room for incentives to apply in a meaningful way to more material changes in performance.

As we noted earlier, extreme weather can have an outsized impact on our performance, because an individual weather event is likely to hit a substantially greater share of our patch or customers than for most other companies. In our view, this means that the absence of **extreme weather exclusions** is likely to hit us disproportionately across a range of PCs, such as all the sewer flooding measures and supply interruptions. Even in the case of the two smallest WoCs, such a weather event would only pose a risk to water measures and do so for areas that are largely heavily urbanised and therefore have greater in-built resilience than extremely rural networks in areas like Powys. A further aspect is that where a measure has a collar in place to mitigate against the risk of an unduly large penalty in RoRE terms, an extreme weather event in the early part of the reporting year could trigger the collar such that the incentive over the remainder of the year become purely reputational. With this is mind, **we think that there is a strong case for careful and tailored use of extreme weather exclusions**.

In the clarifications issued by Ofwat since the Draft Methodology was published, there has been a suggestion that **biodiversity** will be measured against the hectares owned. Having thought through how this measure might work in practice, our view is that it is likely to unduly favour companies with small estates relative to the number of customers served. It feels likely that a large chunk of the biodiversity gains such companies could deliver would come from third-party land and thereby give an unduly high level of reported performance. We expect that we would very much be at the other end of the spectrum as we own a lot of land relative to our customer base. With assets like the Lake Vyrnwy estate we expect we could deliver all the affordable biodiversity gains for our customers without using third-party land. The upshot of the measure as it stands is that we would need to target gains that lie significantly beyond the affordability envelope for our customers. To resolve this risk, **we suggest basing the biodiversity measure on the units of gain (irrespective of land ownership) per 1,000 customers**.

2.4 Enhancement costs

We think that Ofwat's proposals for enhancement funding are a good example of building on the approach taken at PR19 so that it adapts in readiness for challenges we now need to face into. The planned approach we think will act a key enabler for delivering nature-based solutions, progressing towards net zero and tackling storm overflows.

We welcome Ofwat's plans to expand benchmarking in its assessment of enhancement claims. Off the back of this we would expect this to speed up the pace that knowledge on best practices spreads across the sector, ultimately to the benefit of customers. We note that Ofwat also plans a level of benchmarking when it comes to securing third-party funding. We certainly support the moves to encourage take up of such funding — as a small company this is one of the main ways we can have an outsized beneficial impact on our customers and communities. When assessing the take up of such funding, we suggest the approach should be sensitive as to whether funds are universally available across the country and whether there is a limited pot that means not every high-quality scheme will always get funding.

We also welcome the greater clarity the Draft Methodology has provided for enhancement claims, including the high-level assessment criteria and the room for extra allowances to support investment in both nature-based solutions and storm overflow improvements. The extra clarity on net zero funding is similarly welcome.

One related area where we think extra clarity would be beneficial is on self-offsetting carbon emissions. We fully recognise the challenges with making sure that offsets bought from outside partners are indeed delivered over the agreed timeline — challenges that clearly push such offsets way down the pecking order, it not off the table entirely. At the same time, we think there is an opportunity for the sector to explore offsets on our own doorstep.

Many companies have sizeable estates and assets that present opportunities to deliver their own offsets, or even sell these onto other companies should they achieve their own net zero targets. If required, we also think it would be possible to create reporting requirements that would then make sure companies are fully accountable for delivering and maintaining for their entire expected lifetime.

We also recognise that it is desirable to cut carbon emissions rather than merely offset them. Alongside this, we're conscious that offsets could provide us with some of the lowest hanging fruit for tackling carbon, particularly in the near term. One idea we have is to create extra room for offsets in our early arsenal, which could be done by providing a taper on the level of funding that, each year, would lower the proportion of funding that new schemes would come through from customers' bills. We think this approach would allow the sector to accelerate its progress on carbon while maintaining longer-term incentives to keep cutting carbon emissions.

With Long Term Delivery Strategies (LTDS) being a new requirement for PR24, we think Ofwat's offer of early submission and feedback on these is a very sensible move. We think this will (i) raise the level of consistency across the sector, (ii) help ensure quality of the final submissions from companies and (iii) make sure companies' long-term investment plans are appropriately phased. The LTDS process is complex and we would like to see proportionate decision-making based on the substance rather than the technicalities of the LTDS model – this is to make sure that important investments for our customers and the environment are approved.

2.5 Risk and return

Notional company and gearing

In our view Ofwat should keep the notional company assumptions used at PR19 to provide stability for investors and the sector. We also recognise the importance of moves to improve the financial resilience of the sector. To do this, we would recommend an approach that specifically discourages high gearing. To this end, we would propose penalties for high gearing as this would focus on those companies where this is relevant – rather than making changes to the notional company that would affect all companies.

At the same time, our current gearing levels mean that we could support lowering the notional gearing to 57.5% and note this would be below Ofgem's recent draft determinations for electricity distribution which used 60%.

Allowed return on equity

There are inevitable uncertainties associated with estimating the cost of equity, which is not directly observable. These uncertainties will be more pronounced if Ofwat is considering using new data sources and approaches. Such uncertainties make it critical that Ofwat takes a balanced approach to this assessment and considers the overall cost of equity and its effects on investment in the sector, as well as looking at the individual elements in isolation. We have significant concerns the cumulative effect of the views taken on individual components use to set the cost of equity.

Calculating beta

We **strongly support maintaining the PR19 approach** and keeping to the established approach in the water and energy sectors for de-levering and re-levering beta. By contrast, we **strongly disagree with adopting a more consistent CAPM-WACC** as looks to be a very complex approach. We also **strongly disagree setting the notional gearing equal to listed companies' market gearing**. This would be a highly selective use of data that would only appear credible because the MAR gearing and Ofwat's proposed notional gearing currently happen to be similar. It would also contain significant bias because the listed companies' MAR premia are down to the high-performance of those companies – in other words they cannot be considered representative of the whole sector. Further, the approach is inconsistent with CAPM theory, whereby the market value of the (neutral performing) notional company should equal the RCV if the cost of equity is set correctly.

Risk-free-rate

While there is no theoretically definitive answer to the correct risk-free-rate (RFR) to be used in the CAPM model, the CMA did consider the yield on AAA-rated non-government bonds to have exceptionally low default rates – thereby making it a suitable input into the RFR estimate. Given this context, we support the CMA's PR19 approach of a RFR that is above the return available from index-linked gilts, but below the level suggested by the return on AAA bonds and takes the mid-point between the two. We also consider that Ofwat should take into account the ONS's forecast of rising interests in calculating the RFR – in keeping with Ofwat's proposal to use the OBR's forecast of the RPI-CPIH wedge.

Total market returns

When it considered total market return (TMR), the CMA concluded that it should place limited weight on forward-looking estimates compared with estimates based on actual historical data. We note that Ofwat acknowledges in its draft methodology that forward-looking techniques should not form the primary basis by which TMR is estimated. We therefore consider that Ofwat should continue with the CMA's PR19 approach to the TMR.

Aiming up

At PR19, the CMA identified a number of reasons why aiming up is beneficial, such as promoting efficient investment. Since then, Ofwat's financial monitoring report for 2020-21 has shown that the PR19 regulatory package has downward bias – with the sector seeing a 2.29% RoRE compared with the PR19 base return of 4.05%. With the draft methodology proposing to significantly curtail bespoke ODIs, this raises the prospect that the AMP8 ODI package will have an even greater downward bias. For example, taking out the bespoke ODIs for 2020-21 would have left the sector with a £117m net penalty for the sector – equivalent to a 40-basis-points reduction to the cost of equity. This suggests that the PR24 package will see a much more significant downward skew than the PR19 package where the CMA considered aiming up was necessary.

Overall, Ofwat's draft methodology proposals would result in a substantial reduction in the cost of equity compared with the CMA's PR19 final determination. As this would insufficiently reward companies for putting their capital at risk, the likely unforeseen impacts would include much less innovation, the stifling of efficiencies and the penalising of investment – all to the detriment of customers and the environment. Furthermore, the proposals for a lower cost of equity can be expected to work very much against Ofwat's desire to attract more equity into the sector – equity that would underpin improvements for customers and the environment. Taking this wider picture into account, it feels like Ofwat would have strong grounds for reconsidering its overall approach to the cost of equity before the final methodology is published in December.