PR24 draft methodology consultation response

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7 September 2022

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1. Introduction

As the leading and largest provider of independent assurance services to the UK water sector, Jacobs has a deep regulatory insight into the issues facing companies in the forthcoming Price Review, developed through our assurance and consulting services and our wider strategic relationships within the water industry. This enables us to understand the complex relationships within a price review process, the regulatory theory that underpins it and the likely outcomes that Ofwat will expect to see delivered.

We welcome the Ofwat draft Methodology consultation and support the key theme of 'Ambition' which runs through the proposals - both in terms of new environmental requirements but also in the more familiar areas of efficiency, performance, collaboration, and competition. **However, this desire for 'ambition', whilst wholly laudable, will have to be considered against some of the biggest challenges the water industry has seen since privatisation**: input costs are rising at a rate not seen in 30 years, customer affordability pressures are properly a constraint on bills, and the PR24 draft methodology is signalling reduced financial returns across the board.

Compared to PR19, PR24 will play out against a very different customer, environment and financial context, all of which will make business plan preparation over the next 12-18 months challenging and which raises serious questions over how companies will strike a balance between the clear cost, risk/return and affordability challenges implied under the Standard and Outstanding PR24 assessments.

We also note that this consultation coincides with the appointment of a new Prime Minister and new Environment Secretary, which may have a bearing on how government responds to the forthcoming Defra Storm Overflow Discharge Reduction Plan and its potential impact on bills. In our view, more than ever with the challenges above, Ofwat, the Environment Agency, Natural Resources Wales and water companies need to be joined up and working together to manage the risks and opportunities.

We are pleased to respond to the draft Methodology consultation and have focused our comments on specific areas (signposted throughout the response). We confirm that our response can be published in full on the Ofwat website.

For queries and to discuss any of the responses, please contact (in the first instance):

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2. Chapter 2: Regulating through the Price Review – striking the right balance?

This section responds to consultation questions Q2.1 (challenges facing the sector) and Q2.3 (striking the right balance between what's in and out of the price control)

As always, the context of the short-term sets the tone of the longer-term price review. There is potential for the cost-of-living crisis to cast a shadow over the start of the price review, with any attempt to pass costs through onto bills likely to increase the numbers of customers experiencing water poverty. Similarly, the drought conditions in August will focus attention on long-term water resilience and SROs.

The emphasis on quality and ambition, while laudable, raise serious questions over whether 'Outstanding' is affordable or even achievable when set against the issues above. There is no question that the bar should be set high in terms of company performance and customer outcomes, but significant cost, risk/return and affordability challenges will need to be overcome by what is likely to be a small number of companies. We note that at PR19, no company achieved the highest rating, and only three achieved fast-track status (equivalent to 'Standard' under PR24).

The challenges above combined with the 'yet to be confirmed' methods of assessing quality and ambition raise the prospect of a round of referrals to the Competition and Markets Authority, and it remains to be seen how many companies choose to aim high (and potentially incur more risk than return) compared to the safer yet less transformative middle road of a Standard assessment.

Assessments of 'Quality' and 'Ambition' will be informed – to a large extent – by affordability considerations, yet the precise reporting requirement for affordability is yet to be published, with the suggestion that the data requirements related to affordability will be developed once the overall approach to assessing business plans is developed (Chapter 11).

Affordability has been a key priority for at least the last three Periodic Reviews. PR24 will be different from PR19 in terms of the changed context (increasing proportion of households experiencing water poverty, wider cost of living crisis) and the industry-specific challenges playing out in the late 2020s (e.g., increased cost pass-through by companies seeking to mitigate rising energy and long-term transformation costs, environmental pressures, increasing regulatory pressures)[1]

The introduction of a consistent social tariff (the single water affordability discount scheme) will make access to support fairer across company areas, but an industry wide approach will raise costs overall (see below). Given one of the objectives of splitting the household and retail markets was to bring about water efficiency benefits to non-household users, we question whether this has been achieved and suggest there is significant potential for increased support in PR24 for those intensive water sectors to use water more efficiently, particularly at a time of wider cost pressures.

[1] Looking back at PR19, the key affordability achievements (low financing costs and a strong efficiency challenge) were arguably influenced by the market conditions at the time of the PR19 FDs (e.g., affordable financing lowering costs and favourable market conditions cushioning the efficiency impact on companies). PR24 will look and feel very different to companies due to the cost of living increases and inflation, and the stalling of national economic growth (lowest in Europe, just behind Russia according to the IMF). This situation will be exacerbated by the increases in customers accessing hardship funds, defaulting on payments and taking up 'social' tariffs, a situation linked to the decline in household income and the impacts of energy costs and inflation.

Ultimately the major challenge for affordability will lie in where the balance of costs fall, recognising that water companies will need to invest more, and at the same time subsidise prices for an increasing number of households. Key to this – according to the draft methodology – will be the need to 'bring customers along' in terms of convincing them of the need to support increased charges. Long-term, this speaks to the need for a different regulatory compact (e.g., move to competitive retail markets and/or community interest company structures) but in the shorter-term robust customer engagement will be needed to support the case for higher revenues.

On this last point, it will be interesting to see if different high-level outcomes and priorities emerge between England and Wales, given the new 'whole country' Wales PR24 Forum approach and the differing legal regimes (e.g., Wales Well-Being of Future Generations Act).

3. Chapter 3: Design and implementation of price controls

This section responds to consultation questions Q3.5 (DPC), water trading and Q3.6 (Water trading incentives, developer services, retail and bioresources)

Direct Procurement for Customers (DPC)

We note that Ofwat intends to publish further guidance on DPC so the comments below should be treated as conditional on further detail.

We support the 'DPC by default' approach as an improvement to the Technical Discreteness test that has been in place to date, as this has not been consistently interpreted or applied by companies. The assumption that larger projects over lifetime £200m totex will be suitable for DPC will remove this inconsistency. However, the value for money test should remain as the definitive deciding factor and this might be better undertaken later in a projects development once market engagement has started (to better judge the market response and assess potential efficiencies).

In terms of applying the approach, the key factor will be to provide sufficient detail to avoid ambiguity and subjectivity, and drive intended outcomes. For example, there is considerable effort involved in establishing market interest (particularly given inflationary pressures and other supply chain issues) so one approach might involve multiple projects being 'bundled' together to meet the £200m threshold. Similarly, use of DPC approaches may allow water companies to transfer large-project risk to appropriate third parties, allowing the companies to focus on improving core performance through more ambitious business plans.

In terms of wider implications of adopting a DPC approach, there may also be financing opportunities to shape the payment structure on any new DPC's to 'back-end' some costs. While this approach may result in increased whole-life costs, it could help to reduce near term payments and reduce pressure on bills.

Water trading

Under PR24, the proposal is for water trading incentives for companies to be revised to support longer-term and larger-scale water trades, enabled through future strategic water resource infrastructure, and with the aim of increasing efficiency benefits to customers.

While welcome, this approach raises a number of issues not developed in the methodology, such as challenges of: information asymmetry between trading partners; the need to identify and engage non-traditional market participants such as large industrial, agricultural and hydrogen generation users; mechanisms to facilitate fair and transparent multi-party trades (including accounting rules and consideration of wider security of supply), and; approaches to streamline the regulation of the price of trading.

Bioresources

We note that Ofwat issued further guidance on the bioresources price control element of PR24 on the 2nd September, and have requested that feedback on the bioresources methodology be submitted separately. Jacobs intend to submit a separate response in this area and have therefore redacted the bioresources comments from this response.

Developer services

Our view of the Developer Services guidance at PR19 was that greater clarity was required, alongside improvements to the quality and consistency of data requested and returned. Our initial view of the PR24 DS proposals is that they are an improvement on the PR19 approach/tables.

We also note the differences in Developer Services charging rules between England and Wales. The draft methodology proposals and options (in Appendix 3) assume that Ofwat will establish new connection charging rules for Welsh companies on or prior to April 2025. If this does not happen, Ofwat will need to consider whether it can remove water and/or wastewater site specific developer services from the price control for Welsh water companies.

Additionally, Ofwat is consulting on its approach to nutrient neutrality costs. Natural England requires developments located in certain catchments, where freshwater habitats and estuaries experience nutrient pollution, to be nutrient neutral, but this requirement does not apply in Wales (Natural Resources Wales).

Retail

On Retail activities, we note the change in approach (between PR19 and PR24) to top-down models only for retail costs and the clarification that residential retail costs are part of base expenditure. Our understanding is that these changes are relatively straightforward and therefore have no substantive comment.

Net Zero

Despite the water companies adopting a common net zero target by 2030, the regulator's view is that GHG reductions should be delivered through a hierarchy of firstly base expenditure and efficiencies, then enhancements and finally a (limited) competitive net zero challenge fund for specific projects. Process emissions, which are currently the second-largest source of emissions, will become the most important area for mitigation in AMP8, and are likely to be more costly to address than the low hanging fruit of energy saving and green electricity interventions.

Operational carbon and biodiversity benefits (ref: Appendix 9)

While tracking performance and demonstrating reductions for operational energy and electricity use is relatively straightforward, there are considerable uncertainties regarding the baseline for the other sources of water company operational emissions – process emissions of nitrous oxide and methane. Existing baselines at sector level and site-by-site underestimate these emissions, an issue which has been raised in the recent Jacobs Net Zero Technology Review for Ofwat[2]. This lack of a scientifically informed baseline significantly undermines the credibility of reporting in this area and is likely to require a different approach in the final PR24 methodology.

[2] Ofwat commissioned Jacobs to identify technologies and interventions likely to be capable of reducing greenhouse gas (GHG) emissions during the investment period (2025 – 2030) covered by PR24. The full report can be accessed here: [Net Zero Technology Review - Ofwat]

4. Chapter 5: Delivering outcomes for customers – common and bespoke performance commitments

This section responds to consultation questions 5.1 and 5.2 (common and bespoke performance indicators)

We note the methodology proposes a move away from companies setting their own PCs to having a standard set of common PCs (which would result in 21 common PCs for WaSCs and 11 for WOCs), giving rise to considerable efficiency and standardisation of performance potential[3].

However, the potential - under certain circumstances – for companies to be allowed an additional 2-3 bespoke PCs would seem to militate against this, particularly if a large number of bespoke PCs are agreed. The proposed scope for the regulator to then require *all* companies to report against these bespoke measures could create added regulatory burden and may prove challenging for companies to report on the same basis. More positively, the proposed introduction of bespoke PCs recognises and supports the differing regional challenges faced by companies.

In relation to the Outcome Delivery Incentive (ODI) section, the proposals for fewer and simpler ODIs offer significant reductions in complexity and efficiency benefits, alongside simpler comparisons for the regulator. While this simplification offers benefits, it also imposes a (financial) constraint for those companies who had opted for and earnt significant rewards through out-performance on bespoke Performance Commitments. The potential shortfall in this area may lead to performance trade-offs in other areas, undermining the overall benefit of the changes.

[3] Noting that the new common PC BR-Mex for business customers and retailers will take a different form in Wales because of different market conditions

5. Chapter 6: Setting Expenditure allowances

This section responds to consultation questions 6.5 (proposed approach) and 6.8 (nutrient neutrality)

Much of what the methodology is proposing is intended to enable greater innovation and efficiency - for example partnership working, removing barriers to nature-based solutions and encouraging long-term delivery, with clear links to associated chapters on DPC, outcomes and performance commitments.

While this is to be supported, and while the methodology appears to be open to additional investment in both base and enhancement areas, the greater expectations on what is to be funded from base expenditure may prove challenging, particularly given the restricted flexibility on ODI rewards.

Differences in the regulatory and statutory framework between England and Wales also raise complexities. For example, for a small number of areas the proposed approach is either not relevant (e.g., nutrient neutrality) or is still subject to negotiations with the environmental regulator in Wales but not in England (e.g., outcomes focused NEP).

6. Chapters 7 and 8: Aligning risk and return

This section responds to consultation questions 7.3 (allowed return on equity) and 8.3 (RCV run off rates)

We recognise that in order to calculate meaningful RoRE risk ranges a number of complexities and nuances have to be considered. Additionally, as noted in the draft methodology, there are a number of different calculation methodologies.

We therefore believe that there is value in Ofwat introducing more prescriptive requirements and guidance for company produced RoRE risk ranges.

While we appreciate that the proposed PAYG/RCV run off rate bands may not be finalised it would be beneficial for Ofwat to clarify the range of the proposed bands before a fuller opinion on them is sought from stakeholders. Clarification as to whether these bands would also be applied to PAYG/RCV run off rate adjustments in the price review reconciliation models would also be useful.

END