

PR24 Draft Methodology

South East Water response

September 2022

South East Water
Rocfort Road
Snodland
Kent
ME6 5AH



1. Executive Summary

We welcome to opportunity to comment on the PR24 draft methodology and include in our response a number of areas where we believe the methodology can be improved to benefit customers and the environment both now and in the future.

Overall we strongly support the focus on the long term and the specific ambition Ofwat has included in this regard. We are hopeful that PR24 will be recognised as delivering the much needed investment for the sector, at a time when future challenges are increasing in complexity and impact and there is ever-growing public scrutiny of companies and of regulators. PR19 was a missed opportunity in this regard and we now have the opportunity to ensure PR24 does not follow the same outcome.

Affordability is a key concern for all of us, particularly at a time when there is a cost of living crisis, however this should not translate to a simple focus on the level of the average bill but look to ensure instead that companies are offering a wide range of support mechanisms to ensure all customers in vulnerable situations are supported. Affordability is wider than the average bill it needs to consider whether the business plans strike the right approach between all groups of customers and makes provision for those customers who will have affordability challenges as a result of any proposed investment.

We support the continuation of the overall building blocks of price control – outcomes, costs, risk and return. These are fundamental pillars of the regulatory framework that are intrinsically linked. For example cost allowances are a key determinant of service performance, and therefore any assessment of expenditure and performance targets needs to be across all of these building blocks.

We believe it is appropriate that the PR24 cost models are an evolution of the PR19 models – however as identified in previous price reviews urgent change is needed for the approach adopted by Ofwat in relation to growth and future looking costs in relation to asset maintenance and replacement where a step-change is needed at PR24 to ensure that the sector is on a long-term sustainable path. We are pleased that Ofwat has acknowledged this and are investigating these areas further and potential for alternative cost drivers and ways to model growth costs – we strongly recommend that Ofwat need to ensure new and appropriate cost drivers are included in the base models for growth costs and if this cannot be achieved then separate deep dive assessment is needed for this area.

For South East Water, Ofwat's current approach to growth and resilience funding has resulted in shortfalls against our submitted business plans over a number of reviews and has resulted in an erosion to our operational resilience, network capacity and headroom. This issue combined with how resilience is dealt with at a regulatory level, and the risk decisions we were then required to make, has been a contributing factor that has led to direct impacts for our customers during extreme external events such as Storm Eunice and the summer drought. Our concern with how Ofwat proposes to assess resilience at PR24 is centred on one key issue. This issue is that as an industry, and unlike other utility providers we don't assess the capacity of our systems to deliver service levels. Capacity is the key factor in a systems ability to deal with and recover from stress including climate change.

For a resilient supply we need to produce sufficient water, have enough storage, and have a network with connectivity to be able to move water around to where it is most needed. These three areas need to work together during peak demand periods, so issues can be resolved before storage is used up and there is sufficient supply capacity to enable rapid recovery. The network should be designed to provide flexibility utilising all available resources so that customers can rely on more than one source of supply. We are concerned that there are no national minimum standards for capacity, and over time, with ongoing growth and development, capacity has reduced leaving water systems fragile to sustained issues and events. This is especially an issue with climate change increasing the likelihood of extreme events.

We believe it is important to establish capacity metrics at this sub-zonal level, to identify areas at risk due to capacity constraints so companies can then include plans to increase capacity, storage and connectivity to improve resilience. We do not have fully tested and embedded capacity metrics but suggest metrics such as “percentage of customers on single storage/source of supply” and “hours of water at peak demand” may be appropriate. These would require engagement with other companies to see if there are other suitable metrics and to enable testing.

Customers’ needs and expectations should always be at the heart of any price control determination and we are hopeful that with the centralised engagement approach being adopted for PR24 this will be the case. We are keen that the voice of the customer is being heard and is seen to be heard at each stage of the process, from setting performance targets, penalties and rewards to the balance between overall investment and bill levels.

Whilst there is a role for innovation, it is important performance commitment levels (PCLs) are based on customer priorities and for areas of service where customers feel improvements are valued and need to be made, otherwise key resources will be diverted to areas of service that are not the highest priority for customers. PCLs need to be set at a sustainable level and not assuming ever-improving performance levels at no additional cost. They should also recognise the differences and local circumstances of individual companies – this is particularly important for areas such as asset health and per capita consumption. For example, we operate two non-contiguous areas and despite the geographical proximity of these two areas we see significant differences on how challenges that relate to weather, growth and overall system resilience effect service in these areas.

Although we advocated at the last review performance commitments across virtually all our funded activity given the importance of the industry refocusing on fundamental priorities, we support the rationalisation of the number of performance commitments and outcome delivery incentives (ODIs). 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, we have significant concerns in relation to the proposed changes Ofwat has suggested with the removal of many caps, collars, deadbands and exclusions for extreme weather events. These mechanisms are a sensible feature of the ODI framework and ensures that risk is appropriately shared between companies and customers. However we are very concerned that potential penalty sizes will result in inappropriate investment choices being made due to a disproportionate impact of ODI penalties on some PCs. We provide detail in our response on how the proposed approach could create really perverse penalties and drive unwanted but necessary

mitigation from companies using real world examples. Specifically we are very concerned with two aspects:

- The removal of the under-performance collar and exclusion for extreme events for supply interruptions. Ofwat need to consider the overall cost of such incidents which go beyond the value of any ODI under-performance payment. Removing the collar for this ODI simply increases the risk to companies and will risk creating an unbalanced ODI package where too much focus is placed on any individual measure, to the detriment of other service levels. In relation to the current exclusion for extreme events, a regulatory regime where there is ex-post adjustment of efficient costs incurred in responding to an extreme weather event and a suspension of the incentive regime during that extreme weather event is likely to provide the best value to customers by ensuring that 1) in the event of such an extreme weather event, companies can focus on restoring supplies to customers (while avoiding high costs of full risk mitigation for events with a low likelihood) and 2) that the incentive regime remains focussed on what matters to customers across the entire regulatory period rather than being distorted by one extreme event that companies are not funded to deal with. Ofwat also need to take into consideration the impact and incentives that are already included within the regulatory framework, for example the impact on C-MeX (immediate and longer term) and the cost of any significant operational incident – for South East Water the incident cost in relation to Storm Eunice was in excess of £2m (excluding any ODI penalties).
- The proposal to remove the deadband for the Compliance Risk Index (CRI) as this would lead to the inevitable result of every company incurring under-performance payments for this measure. This would significantly undermine the public's trust and confidence in the most fundamental measure for the water sector. We note that this proposal is also not supported by the DWI where comments recently made by the DWI's Chief Inspector recognised the need for an appropriate deadband.

In relation to risk and return, it is not clear that Ofwat's draft methodology, combined with the subsequently published financial resilience licence modification consultation – taken in the round across both consultations – will support improving resilience and performance in the sector.

In particular we are disappointed that there appears to be a disconnect in the draft methodology between:

- a desire to improve the financial resilience of the water sector
- the risk and return proposals in the draft methodology, including the ODI regime, which all else equal will result in a material reduction in returns and reduce our financial flexibility to manage risk

The balance of risk and return underpins financial resilience in the sector but this key inter-dependency does not appear to have been explored – we do not consider this to be in the interests of our customers.

We replied to the December discussion papers on risk and return and financial resilience, making detailed submissions due to the significant implications of what was being proposed – however we are concerned that a number of the points made in these submissions do not appear to have been

taken into account in the draft methodology. On the contrary, Ofwat's proposals seem to result in higher risk exposure for a lower return, without proven benefits for customers and with negative impacts on financeability.

We are concerned that, as it stands, Ofwat's recent financial resilience licence modification proposals do not consider the potential implications of the calibration of risk and return at each price control and the financial resilience of the sector. We strongly recommend that Ofwat considers these two consultations together prior to finalising the financial resilience licence modifications. This will ensure that (1) the financial resilience consultation considers all relevant inputs to the resilience of the sector; and (2) that the price control is calibrated such that risk exposure is consistent with returns and hence supports financial resilience requirements.

Relatedly we consider that it will be critical to design robust tests for the assessment of financeability and financial resilience at PR24. The draft methodology on the one hand sets out a series of proposed changes to the approach to the allowed cost of capital which are likely to reduce allowed returns, whilst on the other hand the proposed approach to the specification of the notional company risks marginalising the role of financeability as a robust and meaningful cross-check of risk and return. The proposed changes to the assumed level of gearing and debt mix – combined with the draft methodology position that there is no link between risk exposure and return calibration – mean that the test will not serve as an input to price control calibration and protect customers.

Overall the changes proposed in the finance sections of the draft methodology are not in the long-term interests of customers. The combination of lower returns implied by the draft methodology, increasing risk and changes to the notional company are likely to reduce the attractiveness of the sector to new investment at precisely the time when significant investment is required to meet climate change and environmental challenges.

We also emphasise that it is not appropriate to use sector-wide mechanisms, such as a one-size-fits-all cost of capital, for a diverse group of companies – in particular mechanisms which do not take into account different characteristics for companies which are not within companies' control, such as size. Such an approach risks penalising companies for factors which they cannot control and allocating higher risk to those companies. This is a material consideration and we welcome Ofwat's position that it will consider company specific adjustments.

Overall, the price review process is necessarily complex, however we would urge Ofwat to ensure a holistic view of company plans and determinations is undertaken. There is always a risk in creating a framework for a price review that individual assessments of each building block (costs, outcomes, risk and return) has been thoroughly undertaken but the overall package these elements create has not, for example the clear link between cost and service.

It is essential that any regulatory price determination has appropriate incentives in place so that the plans put forward by companies seek to achieve a rounded set of well-balanced outcomes. We welcome that Ofwat has reviewed the mechanisms in place at PR19 to ensure these incentives drive the best outcomes for customers and the environment, however the proposals included in the draft methodology consultation do not achieve this.

It is our view that the business planning incentives and the proposals around some of the performance measures when viewed in the round disincentivises investment. The penalties for reaching a different position on totex and some of the key building blocks included within the risk and return elements are punitive. It seems to us that the economic choice and the one created by the incentive framework looks to lead companies to under invest and over promise. This seems at great odds with the long term approach that forms an essential part of the remainder of the framework.

We would encourage Ofwat to work collaboratively with the industry to re-design the business plan assessment criteria to ensure it is focused on the ambitions that the PR24 draft methodology is trying to achieve.

We would also urge Ofwat to consider re-introducing the Initial Assessment of Plans (IAP) stage of the process as this provides a valuable opportunity for formal dialogue between companies and Ofwat where further evidence can be provided and assessed.

One final point is from the perspective of a water only company. Since privatisation the industry has been regulated as largely a single population of companies. We believe it is time to reassess this position. Over recent reviews we have seen a different risk profile in terms of both totex expenditure and of opportunities to earn rewards between sewerage and water services. More recently we have also seen considerable bill pressures and investment requirements arising in the sewerage service. We have raised these concerns in the build up to the PR24 methodology but see no evidence of any steps to ensure the single model is still fit for purpose to cover these ever diverging service challenges and costs. We fear without remedy this issue may lead to an inappropriate set of incentives at the water service level potentially combined with investment in sewage services being prioritised over the needs of the water service at an industry level.

In summary, there are many areas where we support the draft methodology and the ambitions identified by Ofwat. However, we believe only with the key changes identified above being made will the necessary investment be able to be made to benefit current and future customers, wider society and the environment.

We welcome the opportunity that PR24 can bring to customers and the environment, now and in the future, and look forward to working constructively with Ofwat throughout the process.

2. Summary – risk and return

We provide overarching comments on key changes implied by the draft methodology in turn, structured as follows:

- Cost of equity
- Cost of debt for a notional company like SEW
- Risk analysis and quantification for a WoC
- Financeability and the notional capital structure

Cost of equity

Ofwat’s approach to the cost of equity is inconsistent with the CMA’s approach recently applied at PR19 and omits relevant evidence which results in a downwards skew for each parameter. The scale of the reduction implied in allowed returns will all else equal result in pressure on financeability and the ability of the notional company to manage increasing risk at PR24.

Extensive analysis was performed on the methodology for setting the cost of equity for the water sector as part of the CMA’s PR19 re-determination. Ofwat’s proposed approach for PR24 implies material departures from the CMA’s approach and places weight on Ofgem’s RIIO-2 decisions in energy which were recently challenged at the CMA, without any clear justification. There are significant differences between the energy appeals and water re-determination regimes. The PR19 CMA re-determination was based on a sector specific, bottom up approach to estimation of the cost of equity. Under this re-determination framework the CMA determined the cost of equity it considered to be ‘right’ for PR19 (which replaced in full Ofwat’s decision). By contrast the RIIO-2 CMA appeal was based on an appeals standard whereby CMA assesses whether Ofgem’s decisions were ‘wrong’, providing Ofgem a greater degree of regulatory discretion and margin of appreciation.

The table below sets out the cost of equity parameters and details the change in methodology from the CMA at PR19 to Ofwat’s draft methodology.

Table 1: Cost of equity parameters – changes since PR19 CMA

Parameter	Change since CMA PR19	Comments on Ofwat’s approach	Impact on WACC
Risk free rate	Ofwat has indicated that it will not apply a convenience yield adjustment or forward rate uplift. Ofwat will also not take into account AAAs as part of its estimation of the risk free rate. Ofwat is minded to move	The correct approach for the estimation of the RfR should be supported by corporate finance literature as well as CMA’s PR19 precedent. The methodology should take into account the convenience yield. An approach which excludes AAA corporate bonds	↓

	away from the 1% RPI-CPIH wedge used at PR19 to a lower value that incorporates a 0 wedge from 2030 onwards.	and relies solely on ILGs is likely to be downwards biased as the UK government can borrow at rates considerably lower than those /that can be achieved by even higher-rated non-government issuers.	
Total market return	Ofwat is minded to rely on arithmetic range derived using the overlapping estimator, which results in lower values relative to the case where non-overlapping estimator is also included (a further, new departure from CMA). Ofwat is also proposing not to take into account the RPI back cast series when setting TMR.	There is no rationale for Ofwat's change in the averaging methodology from the approach taken by the CMA at PR19. We disagree with the proposal to disregard the RPI series for deflating historical TMR on the basis that both CPIH and RPI have relevant strengths and weaknesses which means that weight should be placed on both.	↓
Beta	Ofwat is clear it will not attach bespoke weights to Covid-affected data. Ofwat proposes to change its approach to de-levering (a variant on one of Mason & Wright's methodologies).	Ofwat's approach is inconsistent with the CMA's methodology at PR19. Ofwat does not take into account structural breaks to account for the impact of Covid-19 on UK water company betas and the assumption that these impacts will be temporary.	↓
Cross checks	Ofwat proposes to use Market-to-Asset-Ratios (MARs) to cross check the overall cost of equity which the draft methodology indicates may be applied through selection of a point estimate below the mid-point.	The use of MAR as a cross check has significant limitations due to the range of assumptions used when valuing a water company – it is very difficult to derive meaningful information to cross check allowed returns from MAR data.	↓
Selection of a point estimate	Ofwat does not propose to aim up and may select a point estimate below the midpoint of the range due to the MAR cross check.	An aiming up adjustment should be included to account for asymmetry of the overall package and also to account for the inherent uncertainty in calculating the cost of equity.	↓
Cost of equity indexation/forward rate adjustment	Ofwat is proposing neither to index the cost of equity nor include a forward rate adjustment to reflect changes in rates over AMP8. This is consistent with the CMA.	Given the current macroeconomic volatility it is crucial to include a forward rate adjustment or cost of equity indexation to ensure companies and customers are not unduly exposed to changes in market rates.	?

Each of these proposals might contribute to a significant downwards adjustment to the cost of equity overall from the recent CMA re-determination at PR19, driven by changes in *methodology* rather than changes in the *market*.

We do not consider this approach to be robust based on a balanced assessment of market evidence and methodology, and are concerned that this could lead to allowed returns significantly below required returns, as well as material pressure on financeability. Ofwat's proposed methodological changes to the cost of equity are not supported by robust evidence that the proposals are in the customer interest.

Cost of debt for a notional company like SEW

We welcome that Ofwat has signalled that a company specific adjustment will be allowed if there is evidence that the notional company faces a higher cost of debt due to its size. However, we are concerned that Ofwat does not appear to have drawn on or engage in detail with the methodologies we proposed in relation to company specific adjustments within our response to the PR24 risk and return discussion paper in January.

We set out below key approaches which we consider need to be captured in the PR24 methodology in relation to company specific adjustments.

Infrequent issuer

Small, relatively infrequent issuers of debt like SEW have a smaller asset base relative to the sector and smaller implied debt requirements in each year (sub-benchmark) which means they have to 'build up' to benchmark size before raising debt. As a result, they have more limited control over factors that affect cost of debt (e.g., maturity concentration, timing of issuance and debt composition) and each issuance more materially impacts upon the cost of debt.

As recognised by Ofgem in its recent ED2 Draft Determination, the specific characteristics of small, infrequent issuers can result in risk differentials for these issuers relative to large, frequent issuers that are out of management control:

- Greater exposure to point in time risk: Issuers which issue infrequently are more likely to raise debt at points further from the mid-point in the evolution of the yield curve and credit spread.
- More limited ability to match the sector average: Small, infrequent issuers have less flexibility to manage factors outside of their control.
- More limited ability to influence the sector average: Issuers with a small RCV have less ability to influence the allowance given it is not clear that WoC costs will be captured in the average of sector debt costs.

Ofwat should recognise the characteristics of small infrequent issuers in its approach to cost of debt in the PR24 methodology.

This effect can be observed in cost differentials between small issuers (WoCs) and large issuers (WaSCs). In general, WoCs issue debt less frequently, have access to fewer sources of finance, exhibit a higher cost of carry, and face higher issuance and liquidity costs.

Accordingly, Ofwat should differentiate between WaSCs and WoCs when setting the cost of debt allowance.

Company specific cross check on cost of debt

Closely reflecting the costs incurred by a company can reduce variance between costs and allowances and improve financial resilience for the sector. The CMA at PR19 performed a cross check to Bristol Water's actual cost of debt following the inclusion of the company specific adjustment. We consider that Ofwat should perform a similar cross check to SEW's actual cost of debt at PR24.

We have previously set out company specific circumstances that justify a tailored cost of debt for SEW. We would welcome further discussion with Ofwat on how best to reflect the differences in the underlying characteristics of companies in the sector when setting the cost of debt allowance.

Risk analysis and quantification for a WoC

We welcome Ofwat's increased focus on risk analysis for PR24. However, Ofwat's approach to RoRE ranges does not accurately reflect the risk exposure for companies in the sector, relies too heavily on backward looking data, does not capture company specific characteristics which may have implications for risk exposure and does not take into account the risk differential between water and wastewater services.

Ofwat has provided limited guidance on how to treat the risk differential between water and wastewater services which has been observed over recent price controls. It is important that the RoRE risk ranges represent the risk faced by each company and appropriately capture the risk differential on totex and ODIs between water and wastewater.

The omission of company specific risk analysis by Ofwat ignores key risks that a notional company like SEW is likely to face at PR24 due to regional characteristics such as population growth, a higher number of people working from home post pandemic, water resource challenges, the impact of extreme weather events – which are not within management control. These risks include the significant costs and ODI penalties incurred due to climate change including storm Eunice and the summer heatwave, population growth and resilience challenges in the south east of England.

Ofwat's risk analysis for PR24 needs to consider how risk is evolving over time and consider company specific risks to appropriately capture the exposure we face and ensure that the price control is calibrated appropriately to mitigate risk. This calibration could address risk at source through totex allowances and incentive design or be priced within the cost of equity.

Financeability and the notional capital structure

The specification of the notional structure underpins a meaningful financeability cross check on the overall price control and allowed return. The notional company should be set based on appropriate industry benchmarks and corporate finance theory. Ofwat's proposed changes to the notional structure - including a reduction in notional gearing, increase in the proportion of index linked debt, retention of RPI linked debt within the notional structure alongside a full transition to CPIH - undermine financeability as a robust and meaningful cross check.

In our response to Ofwat's December discussion paper on risk and return we highlighted a number of inconsistencies in Ofwat's approach to setting the notional company. Overall we consider that there is no clear evidence to support reducing the notional gearing figure below the 60% at PR19. In recent years the gearing of the water sector has been above 70%. Moreover the target gearing level for the investment level BBB grade is 55%-70%, and current notional gearing of 60% is at the stronger end of the rating band. The proposed changes to the notional company, which do not correspond to market evidence, undermine the notional financeability test as a meaningful cross check on returns and risk allocation.

3. Specific Consultation Questions

Q2.1: Do you agree with the challenges facing the sector and the ambitions for PR24 we have identified?

We strongly support the focus on the long term. PR19 was a missed opportunity for necessary investment within our region – most noticeably in relation to growth and network capacity. For us the main challenges are increasing resilience to achieve a level that is in the public interest and to make us more able to maintain a good standard of service in an ever more volatile and warming meteorological environment, in which storms and heatwaves that were once exceptional will become commonplace.

We support the four ambitions proposed by Ofwat. However these ambitions cannot overlook the importance of providing a stable, sustainable and wholesome water supply to our customers – this is a fundamental requirement and the regulatory framework needs to ensure there is appropriate funding and incentives to do this. In a year when we have experienced two ‘highly unlikely’ weather events in the form of a sustained drought and unprecedented storm disruption, we are increasingly acutely aware of the risk to customers supplies that is coming with climate change, and the need to increase investment to maintain existing levels of resilience, let alone achieve higher levels.

The ambitions should be set more explicitly in the context of customer and environmental priorities driven from the research. We think there is clear customer support for increasing the level of resilience that water companies have and PR24 creates an ideal opportunity to deliver on this, indeed the issue of resilience is key to the legitimacy of the sector.

Q2.2: Do you agree that continuing to use our three building blocks helps push companies to meet our ambitions for PR24?

We support the continued use of the three building blocks as this is an established regime which is generally well understood. Of course, the detail of how the three building blocks are executed is all important. In particular, it is important that the three cannot be considered in silos. This is particularly the case with the cost assessment process and the outcomes regime. Efficiency can be delivered in one of two ways – reduced costs or improved service. It is not possible to achieve both (of course a compromise with some cost reduction and some outcome improvement is possible). Ofwat should not consider these building blocks in isolation and needs to work to understand the trade-offs involved between them.

Q2.3: Do you agree that we have struck the right balance between what's in and what's outside of the price control?

Generally speaking Ofwat should try to keep everything within a price control, as this provides certainty and a stable investment environment. It is generally a matter of regulatory judgment what should be inside, and what should be outside of the price control. Currently we don't have any major concerns about the way in which Ofwat exercises its judgment in this respect, but would like to highlight an emerging concern that Ofwat is proposing to make more use of licence changes to make significant changes to the regulatory regime. This approach runs the risk of decoupling further obligations and performance expectations from price setting. This is not appropriate as changes required in this way should be prioritised within a basket of priorities costed, risk assessed, and tested with customers and other stakeholders. The price review process is designed to tackle these issues. Matters that could be settled outside of a price review should therefore only be in situations where this kind of assessment is not required i.e. they have no material cost or risk impact either on companies, customers or the environment.

Q2.4: Do you have any comments on our approach to evaluating progress? What specific evaluation questions (based within the four key ambitions) do you think an evaluation should look to answer?

It would be useful if Ofwat developed a clearer quantitative method or impact assessment for determining if priorities are achieved. This could deliver greater clarity on how trade-offs and the balance of priorities will be made. This evaluation could also extend to other regulatory tools and mechanisms such as proposed financial resilience licence changes and customer protection licence changes

This evaluation should be carried out at each stage of the process such as the publication of the Final Methodology, the Draft Determination stage, and the Final Determination stage. It should include a review against the objectives set out in the SPS and whether these are being achieved.

Q3.1. Do you agree that in our final methodology we should commit to introducing either an adapted water trading incentive or a new water trading incentive at PR29? If you have a preferred approach, please provide reasons, including any thoughts on how the options we set out in Appendix 2 could be improved.

Yes, we do agree. We prefer Option 1– it builds on the existing water trading arrangements which we are familiar with, the proposed amends are understandable, and there is a low regulatory burden.

Q3.2. Do you agree with our proposals to: a) Continue to include network reinforcement in the network plus price controls? b) Remove wastewater site-specific developer services from the wholesale wastewater network plus price control?

We agree that network reinforcement should remain in the network plus price control. As identified in our response to question Q6.1, our preference is that network reinforcement should be modelled separately from base. We have no comment on (b) as we are a WOC.

Q3.3 Do you agree that the inclusion of network reinforcement in cost sharing would be enough to manage uncertainty around the volume and mix of network reinforcement work to be delivered?

The cost sharing mechanism looks at Totex as a whole and as such network reinforcement should be included and part of the overall discussion about cost versus benefit and management of the network. There may be more cost effective ways of delivering water to those areas rather than a large and costly main as well as including options into the larger strategy of network management.

However, whilst the cost sharing mechanism has a role in dealing with uncertainty around volume and mix, it is not a catch-all to compensate for the systematic underfunding of growth relating network reinforcement, which we have experienced in recent AMPs. The cumulative effect of the underfunding of growth related network reinforcement is putting our network under extreme strain. It has effectively been gradually reducing capacity in a way which we don't think many, if any other water companies have experienced. This is a fundamental problem within the regulatory regime that needs addressing at PR24.

Q3.4. For water site-specific developer services: a) Do you agree with our proposal to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24, but with transitional arrangements for companies with low levels of competition? b) Do you think that new developments of 25 properties and fewer should remain in the wholesale water network plus control or be removed? If they were removed from the price control, what alternative protections could we introduce to protect new connection customers from monopoly power?

- a) If there are concerns around the level of competitive market for one off connections to existing mains we are not sure that the 25 property cut off is the correct criteria for excluding work from the wholesale water network plus price control. For example a block of 30 flats with a single connection to an existing company main (not part of a large development) would be excluded, however, it is currently unlikely that there would be a competitive market for this one off connection. In general all self-lay/NAV activity has a related onsite main, it might be that you exclude any new developments with a related main – this seems to be the defining factor for whether there is a market for work.

The transition arrangements need more clarity and we need to understand what level of competition (or growth of competition) would mean they need to be implemented. Transitional arrangements (increases by CPIH) for these customers could mean that incumbents are the choice of last resort and would likely make losses on these developments. It may also inhibit competition if companies are not able to charge customers cost reflective prices, i.e. self-lay providers trying to break into this area of the market could be undercut by incumbent companies because prices are no longer cost reflective. This is particularly topical at the moment when the market has seen significant price increases in materials, fuel, energy and labour costs etc.

- b) For developments where there is a low level of competition, such as one-off connections to existing mains, it seems pragmatic to keep these within the price control, at least in AMP8. The data Ofwat has provided has shown that there is currently not enough protection for these smaller developments in the open market. We believe it is important that our charges are cost reflective and that this needs to be considered when building any transitional arrangements.

With the information provided we cannot see a way that you could fully remove these customers from some kind of regulation, be it back stop regulation or price control.

Q3.5. Do you agree with our proposals: a) To raise the size threshold above which companies should deliver schemes through DPC to around £200m lifetime totex? b) For companies to deliver schemes through DPC by default above this threshold?

We welcome the clarity provided by the new approach and a clear size threshold, which is linked to perceived and documented benefits over the life of the contract. However, we have concerns about Ofwat's suggestion that they reserve the right to put other schemes in at their discretion, based on size compared to overall capital programme. This introduces uncertainty and causes companies additional work, as far more schemes now have to be assessed for DPC, and goes against the original rationale that set the threshold of £200m. We believe that Ofwat should keep the £200m threshold and remove this caveat, or provide clear criteria for when it might deviate from this threshold. We are also unable to understand why relative size to the remaining programme is relevant to the majority of the benefits associated to DPC so we don't support this element of the criteria.

We are always willing to explore new options for engaging with the market, where they provide demonstrable benefits to customers, through cost effective delivery of good quality water to

customers. It is important that these benefits are demonstrable and will occur across the life of contract. Therefore our assumption for DPC projects is that SEW will undertake work up to and including obtaining planning and consents, before a tender occurs, and therefore these costs, along with the contract development are critical for a successful tender and for ongoing contract management. We are concerned in the methodology that Ofwat appear to be taking set costs and percentages from other infrastructure sectors as a way of setting the level of these early costs and we would like more visibility on analysis to show that these are equivalent and appropriate for water schemes, as we believe they cannot be directly read across and should be subject to deep dive assessments. For example, our experience particularly for water resource schemes, is that one element of planning that is likely to be water industry specific is the unique impact of needing to divert existing water bodies and the environmental impact of this, which will form a significant part of the planning process.

The DPC as default approach is reasonable, subject to two caveats:

The first is that post tender, if the market does not demonstrate that this is a value for money approach, that companies still are able to deliver the original scheme (which will have passed the need test), and the mechanism for this is absent from the methodology. Ofwat should clarify how a key enhancement scheme will be delivered in this case.

We still believe it is critical to have a discreteness test, and that this needs to be applied robustly to schemes. We welcome that this test remains within the PR24 methodology, as we need to ensure clarity of ownership and responsibility so we can continue to manage our network and water systems efficiently and effectively. We propose to develop a clear set of tests for discreteness that we will then apply systematically to our material enhancement schemes, and would welcome a discussion with Ofwat to ensure that these align with Ofwat's methodology.

Q3.6. Do you have any views on any other aspect of our proposals [in relation to price controls]

Consistency is important in a long-term asset management business and we think that Ofwat has maintained the structure of PR19 where possible, and looked to introduce changes where it can bring improvements.

Q4.1. Do you agree with our approach to making sure that companies' price review submissions and our determinations reflect an understanding of customers', communities' and environmental concerns?

We strongly support the need for Price Review Submissions to reflect these understandings.

Our own research recently has identified that customers priorities have changed significantly over the last 5 years since PR19 with growing expectations of the service that not only they expect but also a heightening awareness of the challenges that companies face over time regarding the environment, biodiversity and carbon reduction. These elements will be published shortly with our qualitative research with our customer panel (the 'Water Horizon Forum').

Despite this understanding from consumers a key area of concern for many is the impact of costs in the short term, particularly in relation to the current cost of living increases and this will undoubtedly be reflected more strongly in our insight programme over the coming 18 months and we consider that these will need to be considered alongside other consumer concerns.

Our most recent concern from customers relates to sewerage pollution. Whilst not directly relating to our activities our ongoing insight sees that reflection of concern growing and growing and customers and consumers struggle to differentiate between a water only and water and sewerage company. This problem is directly impacting us in measures such as C-Mex. We are therefore keen that in this process Ofwat find ways to enable Water Only Companies such as ourselves that enable our services, impacts and outcomes to be differentiated from Water and Sewerage Companies.

This again demonstrates the needs for greater separation in the regulatory framework between water and wastewater. We have repeatedly pointed out to Ofwat that there have been very significant differences in outcomes for water services (including the water elements of WaSCs) and wastewater services in both the last AMP and, on the early evidence, this one too. Ofwat needs to ensure this difference in risk is addressed within the final methodology, as it has not done so in the draft methodology. This would be through recognising these difference when setting cost allowances and performance targets/incentive rates, or through an appropriate uplift in the cost of capital for the water service.

Q4.2. Do you agree with our proposal to conduct open challenge sessions?

The proposed approach to 'Open Challenge Sessions' is something that in principle we agree with. However it is important to recognise that these will form only one part of a company's engagement with customers and stakeholders and therefore any findings from these sessions will have to be triangulated with other research and engagement undertaken.

For example we have an ongoing stakeholder programme based on our stakeholder mapping which includes:

- an overarching stakeholder group ('Think Tank') made up of key stakeholder representatives that will meet along the roadmap to business plan creation to provide an ongoing challenge

mechanism, along with identifying conflicting stakeholder views and areas where trade-offs are needed

- Ongoing stakeholder challenge to specific themes i.e. customer vulnerability and affordability through stakeholder forums – designed to challenge our design and approach to service and outcomes in these areas
- Design Sprints with stakeholders to understand needs, opportunities and co-develop solutions and delivery plans

Open challenge sessions are in line with our ongoing Engagement Strategy that can be found at <https://www.southeastwater.co.uk/about/our-plans/our-engagement-strategy/>

It also complements our ongoing approach to stakeholders but we remain keen to be able to better understand:

- How Ofwat and / or CCW will utilise the outcomes of these findings, many of which should reflect the ongoing stakeholder insight being established by companies?
- How these sessions will be facilitated, to provide constructive and valuable discussion?
- How the groups output will be reflected around trade-offs established?
- How stakeholders across regions such as ours, with multiple water companies, will be specifically motivated to attend multiple sessions in addition to ongoing Stakeholder engagement activities of the companies?

Q4.3. Do you have views on open challenge sessions can align with the collaborative approach in Wales?

Not applicable.

Q4.4. Do you have views on how the outcome of collaborative customer research can contribute in the context of the collaborative approach in Wales?

Not applicable.

Q5.1. Do you agree with our proposed package of common performance commitments? Is water demand best incentivised through separate performance commitments on business and household consumption and leakage or through a performance commitment measuring total demand?

We are generally supportive of the selection of PCs, however we are concerned about making water companies financially accountable for the behaviour of customers. We recognise the desirability of giving companies incentives, but that there is a danger of losing sight of the fundamentals of per capita consumption (PCC). It is worth reminding all stakeholders that water companies can influence, but not control the behaviour of their customers. Covid was perhaps the most relevant reminder of this, when PCC increased for all companies due to factors beyond their control – in this case an increase in working from home.

We are not opposed to PCs for customer demand, but it is worth stating that what is true of domestic customers is doubly true of non-household customers. These are customers that we are actually prohibited from having retail relationships with, and over whom we have even less influence than we do for domestic customers. If water companies become financially responsible for the consumption levels of non-household customers they will be exposed to events which are completely beyond their control. For example, the closure of a factory that was using a lot of water would lead to a reward, whereas a similar factory relocating from one area to another might cause a reward for one company and a penalty for another.

Having said that we understand the logic for including non-household customers in a PC, be that total demand or non-household demand. We are not opposed to this. We struggle to imagine a world in which our stakeholders accept that leakage is no longer reported, so even in a regime of a total demand PC, we assume leakage will continue to be reported. To the extent that this will lead to any total demand measure being broken down into its component parts, it seems that the additional overarching PC will add complication and reduce transparency rather than the other way around. However recent experience suggests that further consideration is given to which leakage number is used with the leakage PC, it seems now is the time to separate customer side leakage from the company leakage to improve the legitimacy of the sector and ensure companies are only held accountable for what they can control.

Q5.2. Do you agree with our proposed guidance for bespoke performance commitments?

The smaller role for bespoke PCs which Ofwat is suggesting is reasonable in itself, and we understand how they have arrived at this position. To the extent that it will promote simplicity and clarity in the PC regime, we welcome it. However, we are concerned that the reduction in bespoke PCs will reduce innovation and reduce ownership. In our own case, we have introduced vulnerability and environment related PCs at PR19 which we think have been of value to our customers and the industry.

Q5.3. Do you agree with our proposed approach to setting standard rates?

In principle we are supportive of centralised research that leads to the setting of standard rates for ODIs and have been an active member of the group in relation to the Ofwat Research Steering Group.

It is important that rates as well as targets and ambition are derived from stakeholder and customer engagement if the framework is to have wider legitimacy and we would therefore expect the rates to be derived and clearly linked to the customer research as companies did for PR24. We note that it is likely that customer priorities have changed since Pr19 and therefore there should not be any over reliance on the research carried out as part of that process.

Q5.4. Do you agree with our proposed approach to the measures of experience performance commitments, including to increase the size of C-MeX?

We are concerned by the influencing factors that have been outlined in QA6.2 which we do not feel have been yet subject to transparent company discussions. These factors are likely to have an impact on certain companies' performance and risk in this area, in the event of increasing the revenue at risk with this ODI.

We are particularly concerned that the customer experience measures, of which three are now proposed, are to be excluded from the RoRE assessment. This makes the real risks faced by companies greater than the RoRE analysis would imply. We therefore don't believe it is appropriate to increase the size of C-Mex.

Any decision to change the size of the C-MeX incentive should also be reviewed within the overall ODI package and RoRE range. Whilst we believe the C-MeX measure has real power as an incentive, it has known flaws which we have pointed out in many previous consultations. The main flaws relate to how the sewerage and water elements are combined to produce an overall score and the second relates to a proven south east satisfaction bias. Whilst these kind of flaws still exist we don't believe it is appropriate to increase the size of the incentive.

Q5.5 Do you agree with our proposed approach to estimating marginal benefits for common and bespoke performance commitments?

We support the estimation of marginal benefits, but they should be used unaltered in calculating PC rewards and penalties. If we think of any number of free markets, we can see that companies do not fully compensate customers for the disbenefits of products that they sell. For example, the maximum a broadband company will ever compensate for an interruption, is the monthly bill that has been paid. The economic disbenefit may significantly exceed the value of the bill, but the customer shares the cost. In the case of physical goods we can think of cars, laptops, phones, building products or televisions. When these products fail, it is the customer that bears the costs of repairs and

maintenance, not the producer. Whilst these are not monopoly providers the logic of maintaining the mechanisms that exist within these kind of markets is a really important check on the sizing of incentives or there is a real risk that disproportionate actions are taken that are not in the interests of customers.

Q5.6. Do you agree with our proposed approach to incentivising asset health performance?

We broadly support the roll forward of the two existing water related performance measures, mains repairs and unplanned outage, within the context of the progression of the Operational Resilience approach set-out in Ofwat's discussion paper in May of this year. There is confidence in the methodology, and consistency in its application so results can be compared across companies.

However, there are some limitations with the coverage these measures provide. In particular they do not take any account of the asset health of service reservoirs, booster stations and other critical assets, and both measures have factors that limit understanding of underlying asset health. This needs to be recognised and linked to incentivisation and overall long term ambitions for performance going forward.

We would also like to see Ofwat develop measures of 'headroom' and 'capacity' in water networks. Networks with lots of spare capacity are far more resilient than those without any. Networks with capacity can absorb housing growth and can use that capacity to supply customers in the case of asset failures such as a trunk main burst or a pump failure. There are significant differences in the level of aggregate capacity between different water companies, that Ofwat's regime is not taking account of, and it is crucial that Ofwat should develop a measure to effectively measure capacity.

Historically Ofwat required companies to manage stable serviceability, and ensure no degradation in asset health, which links closely to the definition for base expenditure. Since PR19, Ofwat has abandoned this approach, and now believe that improvements should be made within base allowances, despite compelling evidence that base expenditure is not providing sufficient long term replacement rates. It is important, therefore, that long term ambitions on asset health metrics are achievable and appropriate and drive the most cost beneficial long term investment decisions.

We welcome the proposal to balance these PCs by associating them with rewards and penalties. This is appropriate for measures, particularly mains repairs, which fluctuate naturally with weather. This natural fluctuation also justifies a deadband. If Ofwat carries out a correlation of mains repairs performance between the companies, it will see that there is a strong correlation each year, reflecting the effect that weather has on performance.

Mains Repairs

For companies with upper-quartile leakage performance, 30-40% of mains repairs are driven from proactive active leakage control and, with Leakage being a key customer priority as well as being critical for overall supply/demand balance, it is important that this is not dis-incentivised through the PCL incentive mechanism.

There is clear evidence that mains bursts, and resulting repairs are significantly impacted by extreme weather, both extreme cold, and extreme heat. Looking at our performance over the last 12 years, the difference in performance can be directly linked to these extremes, and the bursts that arise from the resultant ground movement. During the current dry period the industry has reported 50-100% increase in repair rates, underlying the impact of weather on this measure.

The incentives and penalties need to be fairly balanced to ensure that these weather impacts, which are likely to be more frequent due to climate change, do not unfairly penalise companies, otherwise Ofwat should reconsider the lack of a collar on this metric.

As a UK industry we are not currently funded sufficiently in Infrastructure Renewal Expenditure to undertake sustainable levels of mains replacements, and the interruptions target disincentives more efficient mechanisms, such as cleaning and relining of mains. Without an appropriate uplift in base IRE, or a separate planned interruption target, that is measured and monitored separately, then the long term ambition for mains repairs performance improvements will be limited.

Unplanned Outage

We are now several years into measuring and reporting unplanned outage (including the shadow reporting years), and have identified an unexpected consequence to the measure around borehole maintenance. SEW has a large number of small groundwater sites, and loss of output from boreholes is impacting our unplanned outage number. Borehole output naturally reduces over time, and this is addressed through periodic cleans (until such a time as the borehole needs replacing) which are undertaken at set frequencies, unless there is a sudden step in reduced output. This loss is factored into our day to day operation and is therefore planned failure, but is considered as unplanned in the PC. This PC therefore encourages repeated, inefficient and unnecessary cleaning, driving additional base costs and disruption to our operational sites, or encourages a write-down of overall output through the WRMP. We believe this type of local, company specific drivers of outage % are ignored by the common PCL approach, and that the methodology should be amended to prevent this.

Q5.7. Do you agree with our proposal to retain, expand and streamline enhanced incentives?

We don't have very strong views on this. We can understand the logic that enhanced incentives encourage innovation, and we are supportive of this. We have not seen any examples of this happening, largely due to the level of performance required to trigger the incentive, for it operate as an effective target it has to feel achievable and therefore a calibration should be performed if these are retained.

Q5.8. Do you agree with our proposed approach to selecting performance commitments for enhanced incentives?

Yes, these seem like a good selection and reflect the PCs where innovation is both more likely and would be beneficial if it occurs. The criteria set out on page 62 of the main document seem like good

criteria to select upon. However, we note that in the appendix (p28) only one of the proposed PCs is a water PC. We think this is unbalanced. In particular leakage is an area in which innovation may have transformative effects and could be of considerable consequence, so we therefore propose that leakage should be included. We understand the argument made about perverse incentives, but this could be resolved by adjusting targets for enhanced incentives.

Q5.9. Do you agree with our proposed approach to setting enhanced thresholds, rates and caps?

We find this a little difficult to comment on given the lack of real world examples of companies earning enhanced incentives. Given this, the proposed Option 2 (double rates) seems like a sensible and pragmatic approach, perhaps to be reviewed in the light of experience at PR29.

Q5.10. Do you agree with our proposed approach to knowledge sharing?

Yes, this is an important part of the enhanced incentives 'system' and the mechanism for delivering benefits to customers, so we support it.

Q5.11. Do you agree with our proposal to set caps and collars on a targeted basis, and apply a two-sided aggregate sharing mechanism to all companies?

We support the two-sided aggregate sharing mechanism, which seems like a good way of balancing risk between customers and companies. However, we are concerned that the approach to caps and collars exposes companies to excessive risk.

Recent experience has shown that companies are particularly vulnerable to supply interruptions events which are beyond their control. In our case, Storm Eunice, a 1 in 100 year event, caused widespread power outages, overwhelming our back up power facilities. There are already many incentives in place to incentivise water companies to avoid interruptions, and where that is not possible, to minimise disruption.

Interruptions generate significant internal activity and cost, including:

1. Bottled water and tanker provision
2. Extra plan hire for example generators
3. Manning bottle water sites, largely by support areas of the business e.g. Finance Dept.
4. 24 hour incident teams
5. Operational overtime and resource being stretched
6. Retail overtime and resources being stretched
7. Supply chain costs
8. Media activity
9. Increased customer contact

10. Decreased customer satisfaction
11. Significant distraction for in some cases months
12. Customer compensation and continued contact again over months

In the example of storm Eunice these activities, excluding lost productivity costs, impacted SEW to approximately £2m. Clearly there are significant incentives that operate outside of the ODI framework that influence how we think both operationally and strategically about interruptions. The proposal to increase the size of penalty and effectively remove any limit to this penalty will move the incentives on this particular ODI to a level that won't be justifiable on any assessment whether that be via willingness to pay or a traditional cost benefit assessment.

To illustrate, for Storm Eunice under the proposed regime the ODI penalty would be £12.6m on top of the above. 85,000 properties were affected for between one and 126 hours, and that means for each customer affected we would be paying on average £148, the equivalent of nearly a whole year's water bill.

The added impact is that financially we would need to ensure we avoid or mitigate this uncapped disproportionate risk and would undoubtedly need to divert financial and human resources away from other areas to do so. This also is not appropriate as we will have sized our programme to ensure we were targeting all key outcomes and outputs and that inevitably we would fall short elsewhere. You will see that there is a real risk of setting ODI targets and levels inappropriately and this area needs to be re-examined and changed for the Final Methodology, as a priority.

It is worth reflecting here on the purpose of utility regulation. Ofwat, Ofgem, the ORR and other similar regulators were set up as an alternative to state ownership, to protect customers in industries where a natural monopoly was the optimal way to organise the industry. As such the purpose of the regulator is to replicate, as much as possible, the disciplines of a free market, and to try to afford customers the same protection that they might expect in a free market.

However, companies do not bear all the risk in a free market. To understand this we need only look at the world around us. We are living in a global economy that has been hugely disrupted by Covid, war in Europe and political instability. This has resulted in massive disturbances to carefully equalised supply chains and a string of problems for various companies. We might look at the example of car manufacturing, where global shortages of silicon chips has led to delays in production and failures to fulfil customer orders. However, customers have generally not received financial compensation for these failures. Certainly car companies have borne some costs in lost margins and reputational damage, but the reputational damage is limited by the widespread nature of the problems (like C-Mex it is a relative measure).

ODIs are a good idea, but transferring excessive risk to companies is neither sensible due to the perverse incentives generated, nor does it replicate the discipline of a free market. Penalties should be limited (collared) in order to maintain a sensible risk profile. Companies already have plenty of incentives to perform well, exposing them to highly risky downside scenarios will serve only to promote instability in the industry at a time that the industry is under close public scrutiny and requires stability, and long-term thinking.

Q5.12. Do you agree with our proposal to not set deadbands on any performance commitment?

We strongly disagree with this proposal. We are particularly concerned about the proposal to remove deadbands for CRI. The measure was not designed by the DWI to achieve scores of 0 as this is not achievable, and the DWI has publicly stated that a deadband for CRI should be retained. There is a real risk that removing deadbands will undermine public trust, as it could lead to headlines that all companies have failed to deliver wholesome water to customers which would not be a true reflection of the service. The proposal is also inconsistent with Ofwat's stated objective to bring balance to the upside and downside risks.

We are already seeing signs in this AMP from the first two years' data that the companies will be in penalty over the AMP. This is particularly true for the water service (both WoCs and WaSCs), and is starting to look like the case for the wastewater service too. The removal of deadbands will simply further increase the downside risks which companies already face. This sort of change would require a compensatory adjustment to the WACC.

Q5.13. Do you agree with our proposed approach to estimating ODI risk?

Estimating ODI risk using RoRE is an appropriate approach however it should be recognised that this does not cover all risks that exist within the price control or those that are beyond it (e.g. imposed by licence conditions or statutory duties). Also we do not see any justification for excluding the customer experience measures from this analysis as mentioned above, particularly given the limitations of the methodology and that the satisfaction measures are relative and do not represent customer experience but relative customer experience. The methodology has guaranteed penalties even if the water industry represented overall excellent customer service. With the proposed addition of another experience measure (BR-Mex) at PR24, the level of risk that companies are exposed to will increase again. We support the principle of an aggregate sharing mechanism as illustrated on p64, however it should include the customer experience measures in its scope.

At PR19 there were differing views between companies and Ofwat in relation to P10, P50 and P90 PC levels. In the final methodology these were set by Ofwat and there were industry concerns that these were not done in a balanced way and optimistic assumptions were used that replaced an evidence based assessment of what is realistic. If Ofwat repeats this exercise at PR24, risk will be further understated. When these values are set at PR24 consideration needs to be given to current experience and forecast performance to ensure PC targets are stretching but achievable and risk is appropriately quantified.

Ofwat could also consider the use of an independent panel to set P10, P50 and P90 levels for PCs at PR24.

Q5.14. Are there instances where providing greater clarity over our intended approach to incentive rates in PR29 would clearly be in the interests of customers? Please explain why and provide supporting evidence.

Stability of the regulatory regime is a desirable objective. Ofwat has been as clear about its approach to PR29 as it can be reasonably be expected to be.

Q5.15. Do you have any comments on our proposed approach to implementing and streamlining payments at PR24?

This seems to be essentially the same as the PR19 approach, which seems to be working well, so we have no objections to this. We support the proposal to allow companies to defer ODI payments between years, where it helps to smooth bills or improve affordability.

Q5.16. Do you have any wider comments about the ODI framework at PR24?

We are concerned about the overall level of risk which the ODI regime might pose to companies at PR24. As we have discussed above, we are concerned about the exclusion of customer experience measures and that the approach is not consistent with Ofwat's purpose, to offer customers a level of protection which they might expect in a competitive market.

Of course, the detail matters here, and Ofwat have not provided it at this stage. If the PC targets are reasonably set, with appropriate weight given to historical data (perhaps by an independent body as we suggest above), with appropriate use of caps, collars and deadbands, then the framework will have an appropriate balance of incentives. The aggregate sharing mechanism provides a level of aggregate protection for both customers and companies which seems to be appropriate.

It is important that water and wastewater are treated separately in this analysis (and in the RoRE assessment) in order to ensure that the risk imbalance between the two services that has existed in the past is not perpetuated. If this does not happen, then the resulting risks will need to be accounted for in the setting of the WACC.

Q6.1. Do you agree with our proposed approach to setting efficient expenditure allowances at PR24?

We agree that the PR19 approach for cost modelling provides a suitable starting point for setting efficient expenditure allowances at PR24. We also understand that the PR24 draft methodology is limited to setting out a broad scope and timeline, with the majority of the detail to be discussed as part of the spring 2023 consultation.

We welcome the opportunity to continue to engage with Ofwat to enable the PR19 approach to evolve appropriately – we acknowledge the opportunity to provide modelling options for Ofwat's consideration and we will undoubtedly contribute.

Our main area of concern remains growth expenditure allowance, or rather its inclusion within base modelling. The funding of growth expenditure has always represented a challenge over many price reviews. This is highlighted by the fact that the same approach has never really endured for more than one 5 year cycle and indeed was changed by Ofwat multiple times during the PR19 process.

Our network would have been installed initially with some spare capacity, but continued population growth means that this has been used to meet additional demand from new development, to a point at which there will be areas where it may not be able to sustain any more without compromising our levels of service. Network reinforcement does vary from region to region, and also over time even for the same company. It is entirely plausible that one company could add many new connections but still spend relatively little on network reinforcement if it happens to have spare capacity in the area. Conversely, one company could add a relatively low number of new connections, but still require a relatively high amount of reinforcement if it does not have spare capacity in the area. For PR14 we provided details on the areas of our network already nearing maximum capacity. And due to the forecasts over the next 25 years, we have to reinforce a high proportion of our network to accommodate the extra demands. Furthermore, in addition to increasing population growth, our operating area also provides support to agricultural activities through irrigation.

This is therefore a crucial area to get right in that growth inevitably places resilience challenges on existing infrastructure, and if not handled appropriately will lead to a continual reduction in resilience.

We note from your methodology document that you remain open to separating growth expenditure from the base expenditure modelling, but is dependent on robust and available data that can lead to separated growth cost modelling. As part of the continual cost assessment engagement along with new data we look forward to assisting to determine an appropriate solution. History shows that the Ofwat backstop of keeping growth expenditure as part of base maintenance modelling, will again provide companies insufficient expenditure to provide for growth.

We continue to have concerns that base cost models do not truly deliver sufficient funding for sustainable long term capital maintenance, particularly for mains renewals and longer life civil assets, such as service reservoirs and boreholes, where significant numbers of assets are coming to the end of life, and have not been replaced at that frequency previously, and/or need to be modified to deal with future resilience requirements. We are also concerned that the current suite of models does not sufficiently reflect the likely increase in deterioration of asset health from climate change and other

external factors, and that the removal of base from the long term delivery strategy approach does not provide a suitable place in the methodology for this case to be put forward.

Equally, for enhancement it is noted and accepted that PR19 remains the foundation but appreciate that Ofwat are seeking to expand the use of modelling to infer funding. As per the methodology we appreciate the econometric modelling can be instructive, however data/modelling needs to be proven to be robust. The draft methodology sets out clear criteria for enhancement cost business cases – where there are notable difference between modelled and an evidenced business plan we would expect Ofwat to go beyond their modelling via deep dive analysis to determine appropriate funding allowances. The deep dive approach recognises the different challenges that companies face and the level of in built resilience with the systems they operate. Models cannot capture this unless they contain all relevant drivers such as capacity and interconnectivity.

Also noted is that the level of catch-up efficiency is broadly deferred to the cost assessment Spring 2023, thereby allowing the analysis of latest economic modelling to be taken into account as part of Ofwat's consultation. We broadly agree with this approach, however we remain cautious and share the CMA's PR19 view that efficiency beyond upper quartile is not appropriate, placing too much faith on near perfect econometric modelling assessment for the industry, the result leading to insufficient funding rather than properly sized efficiency incentives.

As per previous responses we highlight the issue that efficiency should not be at cost of providing quality service and therefore look to Ofwat to ensure this alignment is not misjudged. That is, Ofwat needs to take account of this relationship when setting Performance Commitment targets, Outcome Delivery Incentives and totex allowances.

For frontier shift efficiency, defined as the efficiency improvements that it is possible for even the most efficient firms to make over a period of time, Ofwat has set out the following criteria (*Ofwat, Appendix 9: Setting Expenditure Allowances, July 2022*) to consider to inform their decisions:

- *on-going efficiency improvements in the economy that the water sector should be able to emulate;*
- *efficiency improvements driven by the £200 million innovation fund; and*
- *additional efficiency improvements that might be possible as the water sector 'catches up' to the productivity in competitive sectors.*

An additional criteria for consideration is the time period for consideration and correlating this analysis by taking account of the UK economic outlook for the PR24 period. This issue is highlighted by Economic Insight within their paper "*Frontier Shift at PR24*" (August 2022). By the measure of most UK forecast agencies it is broadly agreed that the UK is entering a period of high volatility characterised by low growth and high inflation. The Economic Insight paper outlines the significance with the following two reasons:

"(i) productivity growth is lowest during economic downturns, which forecasters predict will occur at the start of PR24; and (ii) the high degree of volatility the economy is currently experiencing creates uncertainty, which makes it harder for firms to take the investment decisions required to achieve future productivity increases." (Economic Insight, "*Frontier Shift at PR24*", August 2022)

In conclusion we agree with the report that unless this issue is addressed with greater weighting to the more recent period then the frontier efficiency could be inappropriate. Furthermore we also highlight in our response other considerations highlighted by Economic Insight regarding frontier efficiency, namely: 1) the importance of ensuring there is no duplication of catch-up efficiency which can be mitigated by ensuring correct comparators are utilised; and 2) the inclusion of allocative efficiency within total factor productivity (TFP), again mitigated by ensuring comparators used in the analysis have resemblance to the water industry.

Consequently, we believe data should be prioritised that most closely matches the characteristics predicted over the forthcoming time period. In our view, this means greater weight should be placed upon more recent data; and the final frontier shift challenge should not be overly ambitious.

We also have continuing concerns that Ofwat intend to continue the PR14 and PR19 approach not to index retail controls to CPIH. This is not an economically rational approach. It effectively sets efficiency targets at whatever level inflation is. With inflation currently in the region of 10%, that simply sets an unrealistic target. We will take this issue under advisement as part of engagement and response to the cost assessment process and consultation. However, given the notable recent increases in CPIH we consider that Ofwat should make the retail price control indexed to CPIH at PR24.

We note that Ofwat is suggesting for PR24 that there should be a step change in efficiency, a continued ramp up in service performance, and the introduction of more clawback mechanisms, alongside removing caps and collars on PCLs, and a narrowing of the resilience definition. Yet Ofwat also recognise that the future is uncertain and will cause more extreme events. This does not seem to be realistic or internally consistent. If Ofwat carries a set of unachievable assumptions into PR24, it will cause long-term harm to both the industry and its investability.

We welcome Ofwat's move to long term planning and looking at AMP8 within a 25 year adaptive strategy and context, which will enable companies to demonstrate long term investment plans, how they are preparing for and addressing future challenges, and how plans balance intergenerational affordability. However, we have a few concerns with the approach as currently proposed in the methodology:

- 1) By separating and not including base expenditure within the Long Term Delivery Strategy approach and the adaptive plans does not enable a true picture to be drawn on the impact of scenarios on base performance, asset health and demonstrate existing limitations that may exist but will only now be exposed by more extreme external events.
- 2) We do not believe Ofwat's 'plausible extremes' scenarios go far enough, as the lower levels for climate change are already below what will be expected, and the higher levels are not reflective of advice we have received of a plausible future. We will therefore include a further third scenario that we believe is plausible to test our ambitions and schemes.
- 3) We understand and support Ofwat wanting companies to show how affordability has influenced extent and timing of schemes. It is important to demonstrate that we have identified the correct schemes, correct options and correct timings based on when issues materialise, and we are comfortable with the no regrets, low regrets approach, but this suggests that if there is a justified need to increase enhancement expenditure, we should actively defer needed schemes to meet an affordability criteria (which may be driven by a cost of living crisis, that may not happen at the time the funding is needed). We are therefore concerned that, rather than be used as a tool to understand how plans can be adaptive and put in a wider context they will instead be used

inappropriately as comparative cost benchmarks and to expose possible delay opportunities to the investment proposed. If the challenges we are all agreed exist, then this is the price review to begin to deal with these challenges.

- 4) Ofwat states we need to present improvements to PC levels from enhancement expenditure, provide a bespoke PC or put in place a PCD. We believe a lot of our schemes will reduce an expected erosion of PCL performance caused by external factors or will put companies into relatively similar positions with regard to resilience, system capacity and interconnectivity. To assume enhancement expenditure should require an ODI target adjustment also assumes that all companies are equal before the addition of this investment, clearly an incorrect assumption.
- 5) This issue is something omitted from Ofwat's approach and the methodology needs to recognise these necessities.

We welcome Ofwat's willingness to fund preparatory work in PR24. We would expect preparatory work to include measurement, monitoring and hydraulic modelling type activities but would like this to be confirmed in the final methodology.

Q6.2. What are your views on how we can best align the treatment of third-party costs and revenues?

We concur that a continuation of the PR19 approach with regard to third party costs and revenue seems prudent.

With regard to the potential that third party costs could differ to forecast and allowing the ability for companies to recover this, we do consider this to be reasonable. Broadly third party costs can be uncontrollable (e.g. third party damage) and we believe it correct that customers should bear some of the variance (risk).

Q6.3. Do you agree that companies that submit the most stretching and well evidenced business plans should receive the most favourable cost sharing rates at PR24?

This is a reasonable principle with regard to well evidenced, but the context on stretching is important. Ofwat should not just use industry rankings to assess stretch as this assumes that the only difference between companies is their ability and management skill and there are no performance difference driven by other factors, such as demographics, capacity and interconnectivity.

Stretch needs to be examined in this context, and targets should be set in this context. We have demonstrable evidence of this difference within our own Company where the western area of our company, formerly Mid Southern Water until a merger in 1999 has in built capacity and interconnectivity as well as a different demographic profile, yet has been under the same management and ownership approach as the rest of the business. It is our estimation that this area, if still operating as a separate company would rank in the upper quartile for many of the current ODIs including low pressure, leakage, burst mains and interruptions the ODIs most affected by these factors.

This clearly shows stretch should be defined in terms of improvement and not against an unachievable comparator unless it can be shown that these other drivers of performance are in fact equal i.e. data is gathered on capacity and interconnectivity and used within the models or assessments.

We also note that the CMA expressed some discomfort with the approach to cost sharing rate at PR19 due to the wide variation of rates that were set. We support the introduction of a limited set of cost sharing rates as suggested in the draft methodology.

Q6.4. Do you agree that resilience enhancement should be used to fund companies to manage increasing risks to specific hazards that are beyond their control and not covered by base expenditure and other enhancement areas?

We have already experienced examples of these external threats, and the way they have impacted our operation is causing us to rethink our current network configuration, storage, and headroom capacity. We have also seen that those utilities that we rely on (primarily electricity providers) also appear fragile to these extreme events, and that we are likely to have to put in place higher levels of resilience to loss of power and telecoms, than we have had to do in the past. We are still working through exact needs and solutions, and are reaching out to these companies to understand their plans and make sure our plans are aligned.

These impacts do not lend themselves to modelling assessment particularly given the absence of key comparative data on capacity and interconnectivity and therefore represent a set of interventions that should be included as resilience enhancement expenditure and looked at on a case by case basis,

As mentioned in our response to Q5.6, we do believe that external threats and hazards can impact speed and deterioration of assets, through increased extreme weather events impacting ground movement, for example. This deterioration of performance will put pressure on resilience, and is likely to outstrip any improvements companies can make through base expenditure, and the exact mechanism to capture this is unclear. We believe this is a gap in the methodology and will mean that PCL ambition will be limited, and/or more schemes will be needed in resilience enhancement to counteract this performance deterioration.

Q6.5. Do you agree with our proposed approach to setting performance commitment levels at PR24?

It cannot be assumed that performance commitments can be continually improved through efficiencies in base costs. Of course innovation may theoretically make this possible, but to assume such innovation in advance is not realistic, and not consistent with what has happened in the past. The reality is that performance improvements for some PCs will require additional base and/or enhancement expenditure. This is particularly true of leakage and mains repairs.

Enhancement expenditure will in some cases reduce an expected erosion of PCL performance caused by external factors such as climate change leading to the increased frequency of extreme weather events. This does not seem to be recognised in the draft methodology

Performance commitment levels (PCL) need to take account of forecast performance levels at 2024/25 not current FD targets. This is particularly the case where forecasts from PR19 have proved undeliverable. Otherwise Ofwat risks setting increasingly unattainable targets, with consequent reputational damage to the industry and loss of trust from consumers, even where there is a continual improvement in industry performance.

Q6.6. Do you agree with our view on what performance commitments should be set using common or company specific performance commitment levels?

As identified in other consultation question answers, common PCLs need to take into account company specific circumstances that reflect their region and impact of external events. We understand why simplistic comparison is an attractive option for a regulator, but it is too simplistic to assume all companies can achieve the same level of performance. It would clearly be useful if Ofwat could rely on this sort of simple comparative regulation, but the reality is that companies do not all operate in identical environments and that this does affect PC performance. Factors such as network configuration, soil types, historical investment, topography and even local variations in climate are too significant to ignore completely.

Q6.7. Do you agree with our proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows?

We welcome Ofwat's encouragement to reduce GHG emissions in the sector. We accept there are reductions in operational GHG emissions to be achieved through base expenditure during 2025-30. With regard to Ofwat's approach to incentivise further reductions via net-zero enhancement investments we understand the proposal is a hybrid of achieving performance commitments and net-zero bidding competition.

With regard to net-zero, the methodology is unclear to what GHG boundary is being applied. The draft methodology's proposed approach needs to clarify whether the intention is limited to reducing operational GHG emissions, or whether the approach includes further scope 3 / capital (embedded) emissions. Whilst we agree that for the 2025-30 approach that GHG emissions should be targeted separately for operational and embedded emissions the draft methodology often appears unclear what GHG emission incentive is being targeted.

It is clear that industry companies and regulator are aligned to reducing GHG emissions, however the approach outlined in the draft methodology should be refined for the final methodology to clarify how incentive approaches should target reductions for both operational and embedded emissions. For instance, enhancement expenditure could be proposed to significantly reduce operational emissions, but potentially with a notable increase in embedded emissions.

In the first instance companies and regulator should agree reporting guidance to cover both operational and embedded emissions. At a broad level this could be achieved by expanding scope 3 emissions in the current GHG reporting to cover embedded emissions as a consequence of our capital investment projects. Expanding this reporting should still allow operational and embedded emissions to be identified as separate sub-totals (thereby allowing operational performance commitment reporting), but would also ensure the carbon footprint of each company is understood as a whole and avoid an incorrect balance (and focus) of reduction across the two streams of GHG reporting.

We consider a workshop between Ofwat, and companies to agree this reporting would be worthwhile and provide clarity ahead of 2022-23 reporting.

With regard to the hybrid approach – aside from a lack of clarity around boundaries identified above – we can see the advantages of the approach in theory. In practice, however, there is the concern that larger companies have an advantage in that they have more resources to call upon to seek innovative solutions than smaller companies. Consequently the scheme may inadvertently favour larger companies, and smaller companies may be expected to catch-up to align with these solutions through base expenditure 2030 onwards. Potentially, this may be appropriate given the larger companies have more challenges associated with the wastewater side, however it could hinder smaller companies to align with larger companies on appropriate net-zero investment across the water-only side.

Q6.8. Do you agree with our proposed approach to implementing nutrient neutrality in the PR24 regulatory framework?

This question is about wastewater, so we haven't answered it.

Q6.9. Do you agree with our proposed approach to encouraging companies to deliver best value through our cost assessment?

We support the assessment of costs considering best value metrics including natural and social capital – in particular for large enhancement schemes. We share Ofwat's ambition to deliver best value solutions. We recognise that there are some difficulties in quantifying non-financial measures of value, but we would like to work constructively with Ofwat and the wider industry to find workable solutions.

Q6.10. Do you agree with our proposed approach to removing the potential disadvantage that nature-based operating expenditure solutions may face in relation to the treatment of enhancement operating expenditure?

The proposed solution looks appropriate.

Q7.1. Do you have any comments on our approach to the overall balance of the PR24 incentive package, our proposed guidance on producing risk ranges, and our view of the balance of risk facing the notional company?

The proposed RoRE risk ranges do not represent robust analysis considering the SEW specific risks arising from population growth, climate change demand, environmental factors, calibration of water incentives and macroeconomic volatility. Ofwat's methodology for PR24 should capture:

- Company specific characteristics and risks
- Differentials between water and wastewater wholesale controls
- Importance of forward-looking risk analysis to capture changes in risk exposure
- Pricing of asymmetric risk exposure

Company specific risks are not captured

Ofwat delineates between notional and actual risk analysis for PR24, however this approach may not capture key risks that a company like SEW will face over PR24. Whilst we welcome a renewed focus on risk at PR24, we are concerned that Ofwat's sector-wide proposals may not reflect specific company characteristics including *inter alia* (1) its region and how demand and climate change risks could impact on operational risk; (2) the implications of operating a water service business only (rather than both water and wastewater services – see below); (3) its relatively small size; (4) company specific risks associated with operating as a water only company located in one of the most water stressed area in the UK; and (5) the increasing risk of breaching ex ante ODIs and of material pressures on costs.

Our location is a primary driver of our risk. Our supply area is a designated area of serious water stress and is densely populated¹. Weather events such as droughts put pressure on stressed raw water resources, demonstrated by the ongoing temporary use ban in SEW's area as a result of the driest July on record since 1935. The location of our business and the implications of climate change impact on SEW differently to other companies in the sector. It is important that risk analysis at PR24 captures these risks.

Storm Eunice was the worst storm to hit our region in a generation. Despite significant planning for storm events, including the provision of alternative power sources, unprecedented power outages left us in a very difficult position. In the aftermath of the storms, over 100 assets were inoperable due to lack of power. This represented the most significant loss of power in our company's history. It is pivotal that Ofwat considers the potential drivers of this type of risk, and the impacts on ODI performance and costs incurred within its assessment of risk for PR24.

Our financial performance and resilience are also linked to external macroeconomic risk factors. The global and UK economies have been significantly affected by the consequences of the Covid-19 pandemic (including as a result of China's continuing zero Covid-19 policy) and more recently by the invasion of Ukraine by Russia which have led to high energy, commodities and food prices,

¹ Environment Agency, Water stressed areas – 2021 classification <https://www.gov.uk/government/publications/water-stressed-areas-2021-classification>

disruptions to supply chains and transport systems, high inflation, lower growth expectations and financial markets volatility. SEW has limited ability to mitigate these risks given our size and therefore ability to negotiate and achieve economies of scales similar to other larger WaSCs, our 'lumpy', infrequent debt issuance profile which may result in issuance during periods of relatively high interest rates, and our inability to diversify and insulate part of the impact through a portfolio effect arising from provision of wastewater services in particular on ODI performance.

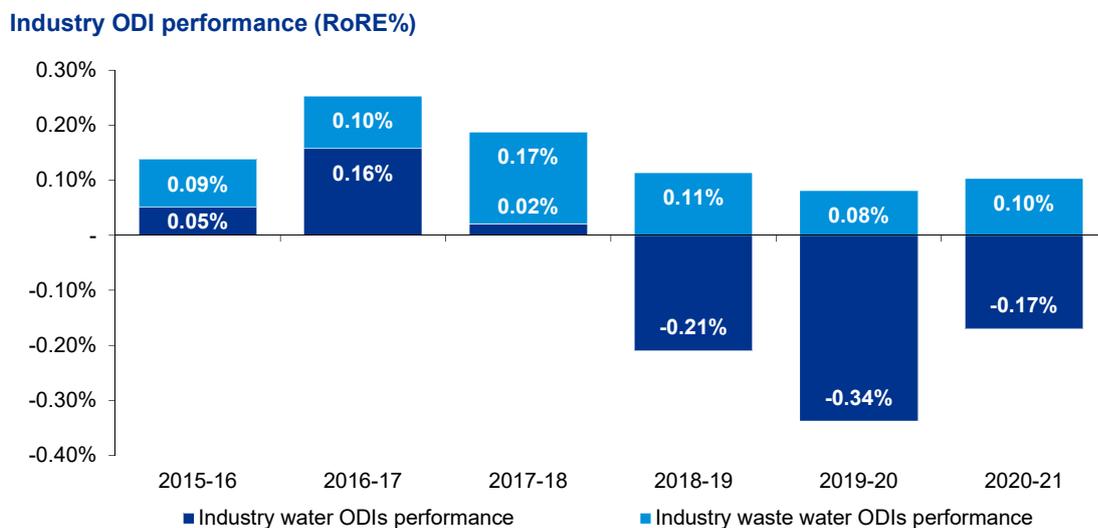
Risk differential between water and waste

Within its risk and return discussion paper Ofwat stated it would seek to understand any differences in risk and performance between WoCs and WaSCs. We consider that the more relevant assessment will be to understand the differences in risk and performance between the water and wastewater wholesale controls, and in the provision of a single (water) service versus dual service.

There are performance differences between water controls, and hence risk differentials which need to be priced through the allowance.

Our response to the risk and return discussion paper set out the difference in performance between water and wastewater ODIs over AMP6. We have expanded this analysis to capture the performance in AMP7 to 2021.

Figure 1: AMP6 water and wastewater ODI performance



We consider that this issue should be addressed at source, with adjustments to totex allowances for water services and ODIs to address this imbalance.

Importance of forward-looking risk analysis

The macroeconomic, commercial and regulatory environment has evolved in recent price controls and it is crucial that Ofwat captures the change in risk exposure within its risk assessment for PR24. Ofwat has indicated that it intends to project risk exposure for PR24 based primarily on historical performance across the sector. This approach inherently assumes mean reversion of risks and may not capture changes to risks in future. This is particularly important as forward-looking risks and

uncertainty implied by the regulatory framework might be increasing, as recognised by Ofwat in its Long-Term Delivery Strategies papers.

Relying primarily on historical risk exposure will not capture the evolving risk exposure at PR24. KPMG performed relative risk analysis as part of its analysis of risk and beta for PR24². This analysis included an assessment of the evolution of the risk landscape at PR24 which highlighted a number of industry, environmental, business, regulatory and competition drivers of risk³ which are increasing going into PR24, including *inter alia*:

- **Transition to Net Zero.** Substantial investment requirements required to meet Net Zero targets and environmental commitments.
- **Abstraction reduction and drought resilience.** Adaptation of infrastructure and improving operational resilience in response to environmental commitments and climate change. Failure to do so would lead to an inability to meet statutory duties and water demand in the future and is not in the customer interest. It would also lead to additional costs that could affect the financial resilience of the company in the long-term. A failure to adapt to climate change is not in the interests of our customers.
- **Reforms to Outcome Delivery Incentives.** Changes to the calibration of incentives, including (1) the removal of incentive deadbands, caps and collars; (2) fewer financial performance measures; (3) removal of exclusions for events outside of companies' control.
- **Bad debts.** The current high inflation environment has resulted in a cost of living crisis for many of our customers. It is unclear whether this may lead to a higher numbers and prolonged periods of customer default on water bills.
- **Full transition to CPIH.** Prior to PR24 there has been a natural hedge between our RPI linked assets and RPI linked liabilities. However, the full transition to CPIH will result in a mismatch between CPIH linked revenues and assets and RPI linked debt. Given the current volatility in the wedge between RPI and CPIH this could expose companies like SEW with a high proportion of RPI linked debt.

Pricing of asymmetric risk exposure

In the draft methodology Ofwat presents RoRE risk ranges which have symmetrical upside and downside.

This presentation of risk for PR24 does not appropriately reflect the calibration of individual components of the incentive package and how changes to the deadbands, targets and caps and collars proposed could impact risk exposure. Overall as we highlight in our incentives response we are concerned that changes to deadbands and removal of caps and collars will increase our exposure to downside-only risks and result in an asymmetric range of potential outcomes on incentives.

² KPMG (2022), Relative risk analysis and beta estimation for PR24

³ Ibid, section 4

Q7.2. Do you agree with our proposals on the regulatory regime for managing companies' exposure to uncertainty over 2025-30?

We support risk being allocated to the party best placed to manage the risk. The risks allocated to companies should be priced in through the allowed return.

We have faced increased pressure on our input costs driven by severe weather events and increases in energy costs over PR19. As a water company we are not able to control changes in energy costs, we therefore suggest Ofwat includes Real Price Effects (RPEs) for energy costs in PR24 with a true up at the end of the price control, similar to the mechanism used for wages at PR19. RPEs are widely used by regulators in the UK with Ofgem including RPEs for labour and materials at RIIO-2.

We would also welcome adjustments to the interim determination of K (IDoK) threshold at PR24 to either reduce the threshold or consider different thresholds for different costs. This would allow companies to revisit allowances before undue pressure is put on costs due to factors outside of management control.

Q7.3. Is there value in introducing more prescriptive requirements and guidance for company-produced RoRE risk ranges?

More prescriptive guidance on RoRE ranges for PR24 would improve comparability of methodologies to quantify risk across the sector but it is important that the principle of consistency does not preclude capturing the risk exposure that individual companies face.

A common framework for developing risk analysis should be set by Ofwat which allows companies to incorporate their principal risks and company specific considerations, as well as company specific evidence and data. Imposing guidance which for example limits the variables which can be considered (e.g. excluding the cost of embedded debt from the RoRE risk ranges, or the impacts of severe weather events in our area) risks not capturing robustly the risk exposure which companies face.

Building on the risk analysis we have performed for our annual viability statement testing we would approach risk analysis for PR24 in the following way:

- Analysis of sector and company specific performance over previous price controls on totex and ODIs (at the appointee level but also by service type).
- Analysis of macroeconomic parameters based on central forecasts from the Bank of England and volatility based on historic data.
- Consideration of the primary drivers of historical performance for SEW. For example, more detailed analysis on specific ODIs which have driven performance in the past.
- Review and analysis of risks which could be new or increasing in PR24 due to changes in the regulatory regime, macroeconomic environment or operational pressures.

a. How might this be implemented for interactions between performance on cost and service?

Companies across the sector have different levels of previous enhancement allowances and therefore investment in the network. These differences will result in material variances in the condition of the network and consequently the relationship between cost and service for future price controls. We therefore do not think it is appropriate for Ofwat to make sector wide assumptions on the relationship between cost and service.

b. How might this be implemented for interactions between performance on different ODIs?

External factors outside of management control can impact on PR24 incentive performance – and the correlations between different incentives are complex. It will be necessary to map risk drivers for each ODI and understand the interaction between these risk drivers across the incentive package as a whole. For example, under dry conditions we would anticipate our performance on flooding would improve but we would see a reduction in performance on per capita consumption.

We suggest that the starting point should be a conceptual mapping of the relationships between risk drivers and how risk drivers link to different incentives and costs to build a map of key interrelationships between risks and incentives. Each significant interrelationship will need to be translated into specific measures of correlation based on either past performance data or tools which can capture expert evidence from the business on relationships between risks.

We consider it more appropriate at this stage to focus on individual scenarios which could create exposure rather than stochastic modelling to map the interactions between all ODIs. This could be based on common principles and guidance around evidence which could be used to corroborate and quantify exposure.

Q7.4. Do you agree with our proposed approach to setting the allowed return on equity?

Ofwat's proposed approach to setting the cost of equity at PR24 is based on a number of significant changes from the methodologies employed by the CMA at PR19. Ofwat appears to selectively apply methods that are likely (on their own and in combination) to introduce downward bias to the cost of equity estimate. We have included below our commentary on each parameter and cross reference Water UK work on the cost of equity where relevant.

There is a clear juxtaposition between Ofwat's focus on water company financial resilience and the proposed unjustified methodological changes to cost of equity which, all else equal, will reduce returns and projected equity buffer available to manage risk.

The estimation of the cost of equity was the topic of extensive consideration during the recent PR19 CMA appeal, and the CMA evaluated a wide range of information in its re-estimation of the cost of equity. The appeal's conclusions are current. Since the CMA would again be the body that would re-examine any decision of Ofwat's for PR24 according to the same procedure, we consider it is incumbent upon Ofwat to attach paramount weight to the evidence and methodologies upon which the CMA based its PR19 re-determination. There is no reason to consider that the CMA would reach

any other views than those expressed in the PR19 re-determination if it were to examine these issues afresh in the water context.

As noted in our response to Ofwat's *PR24 any beyond consultation*, the CMA at PR19 estimated an asymmetric adjustment due to the incentive package of 0.1 to 0.2%. There is much greater structural asymmetry for water services and therefore WoCs, which will (depending on final calibration of incentives) require a premium to the cost of equity⁴.

Beta

KPMG has carried out a detailed assessment of beta for PR24. We agree that exposure to risk is likely to increase based on the draft methodology. Based on this beta as a measure of systematic risk would be expected to be flat or increasing, assuming that risks implied by PR24 represent a good proxy for exposure over the investment horizon. The relative risk analysis also indicates that a number of changes to risks at PR24 are likely to increase exposure to asymmetric risk.

A key question for estimation of beta at PR24 is how to treat the impacts of two significant recent events which have had a very material impact on the global and UK economies, as well as water company betas – namely Covid and the Russia-Ukraine war.

We consider that very low weight should be attached to these events as (1) cost of capital is being set over a long-run (15Y+) investment horizon and (2) returns are being set based on an unconditional CAPM which does not factor in time variation in betas.

We agree with the unlevered beta ranges estimated by KPMG (set out below for reference):

- Assumed Covid19 weightings to simulate a 1 in 15 and 1 in 100-year frequencies of pandemics in future price controls (0.28-0.29)
- Beta estimates based on water company portfolio, in particular the equally weighted average for the spot betas as at 28 February 2020 (0.296)
- Beta implied by structural breaks (0.28-0.33), based on window from PR14 to February 2020 as the start date for Covid19.

We consider that particular weight should be attached to the equally weighted average for the spot betas, as this closely reflects the approach applied by the CMA at PR19 and we do not believe that there is any change to the long-run unconditional betas since that decision.

KPMG has also considered treatment of de and re-levering.

KPMG considers whether parameters implied by the Mason and Wright options meet market tests and market evidence, and hence are plausible and make economic sense.

While assuming the Modigliani-Miller (MM) principle – that WACC should be invariant to gearing – is reasonable for the purposes of estimating cost of capital in a regulatory context, in practice as long as deviations are not very large, trying to strictly enforce MM is:

⁴ South East Water (2021), CMA cost of capital consultation South East Water response, pages 4-5

- Difficult to apply objectively, including which parameter should be adjusted and by how much. An approach which forces invariance to gearing is trying to arrive at a combination of parameters that is ultimately not known.
- Can introduce new distortions (because it is not clear which level of WACC it might be correct to hold constant at different levels of gearing). Variance in gearing could be driven by a methodology for a different parameter which has been set too low. This does not appear to have been considered in the draft methodology at this stage. In this case hard-wiring debt beta – which all else would result in lower returns – could compound an existing issue which is already resulting in under-estimation of required returns.
- Does not recognise that there might be various other factors affecting the cost of capital that might cause departures from MM

To avoid compounding or introducing additional distortions into the WACC parameters, – as variance to gearing is endogenous to the methodology applied for each parameter – focus should be on the calibration of each parameter which all have margin for of error which could be significantly larger than the variance to gearing highlighted in the draft methodology. This is consistent with the methodology applied by the CMA at PR19, which noted small increases in WACC in gearing – which is in line with expectations that WACC at different gearing levels would be broadly unchanged.

First Economics show that, if the regulator uses a too-low risk-free rate, this leads to a WACC that is increasing in leverage. If the risk-free rate is calculated correctly, then the WACC is no longer increasing in leverage. Thus, to the extent that the regulator considers that it is a problem that WACC is increasing slightly in leverage, a superior solution is to ensure the risk-free rate is calculated correctly. First Economics show that, if the regulator uses a too-low risk-free rate, this leads to a WACC that is increasing in leverage.⁵ If the risk-free rate is calculated correctly, then the WACC is no longer increasing in leverage. Thus, to the extent to which the regulator considers that it is a problem that WACC is increasing slightly in leverage, a superior solution is to ensure the risk-free rate is calculated correctly (see below).

The calculation of beta for PR24 should take into account the following considerations, as set out in KPMG's report⁶

- Increased systematic risk exposure from PR19 to PR24.
- Analysis of structural breaks to account for the impact of Covid-19 and the war on UK water company betas and the assumption that these impacts will be temporary.
- The Gregory et al analysis from the PR19 CMA appeals which sets out that data from 2014 onwards is most relevant to cost of equity estimation at PR24.
- PR19 CMA precedent to not place any weight on the Covid period data.

⁵ First Economics (2022), The Risk-free Rate Prepared for a Group of England & Wales Water Companies, section 3

⁶ KPMG (2022), Relative risk analysis and beta estimation for PR24, para 8.4.1

KPMG's analysis gives a notional equity beta range of 0.687 to 0.750 for PR24, in line with the CMA's PR19 re-determination⁷

Risk free rate (RFR)

We do not agree with Ofwat's approach to setting the RFR as outlined in its Draft Methodology. The CMA's PR19 methodology is the most relevant precedent for estimating the RfR at PR24. An artificial reduction in the RFR is not in the long term interest of customers, which we explain in more detail below. Additional considerations related to the methodology for determining the RPI-CPIH wedge to deflate ILGs is included in the response to question 7.6.

Additional analysis and evidence are included in Oxera's report on RFR methodology and First Economics paper on RFR, both commissioned by Water UK.⁸

RfR proxy and convenience yield

As determined by the CMA at PR19, we agree that the RfR is a representation of the return required on a 'zero beta' asset within the Capital Asset Pricing Model (CAPM). This is a hypothetical value and needs to be estimated using a proxy.

The CMA has noted that the near 'risk free' nature of ILGs closely matches the requirements of the RfR. However, government bonds have special properties that create additional demand for these instruments, which in turn lower the bond yield below a market-clearing price based solely on the risk-free cash flows. This phenomenon is known as the 'convenience premium'.

There is a large body of academic literature supporting the existence of a convenience yield, which is presented in Oxera's report for Water UK. The evidence suggests that:

- There is evidence of the existence of a convenience yield. Authors have estimated that the convenience yield sits within a range of 30-90bps.
- The cost of capital computations that use the CAPM should use a higher RfR than the treasury rate.
- The observed convenience yield arises from, *inter alia*, the role of government bonds for hedging interest risk, regulatory requirements requiring financial institutions to buy Gilts, and high liquidity (or money-like features).

A key contention of the suitability of ILGs is whether market participants can borrow at rates that are as low as the ones accessible for governments. Part of the discussion has been focused on whether the marginal investor in water companies is a 'net lender' or a 'net borrower', however these arguments are misplaced as they are irrelevant for assessing the use of a convenience yield.

⁷ Ibid, Table 11

⁸ Oxera (September 2022) RFR methodology for PR24

Acknowledging the evidence supporting the existence of a convenience yield, the CMA also considered the use of AAA rated bond yields to inform an estimate of RfR, concluding that these are not 'risk free' in the same way as government bonds are, due to the existence of liquidity and default risks. However, the CMA recognised that the default risk of these bonds is exceptionally low, concluding that AAA-non government bonds are suitable inputs to RfR estimation⁹. In the round, the CMA concluded that the evidence suggests that the yield of AAA bonds would be slightly above the 'true' level of RfR¹⁰. This view is supported by academic literature as shown in Oxera's report¹¹, which shows that:

- Corporate bonds rated AAA by Moody's have exhibited a 0.0% default rate.
- Estimated cumulative default probabilities of AAA-rated corporate bonds are c.0.87-1.71% (which translates into a 0.03-0.05% default premium).
- Actual default rates and bankruptcy recovery rates would imply that a risk-neutral investor would require at most 5bp default premium to invest in 10-years AA-rated corporate bond.

Oxera's assessment (following the approach applied in the literature) concludes that a downward adjustment to AAA-rated bonds of approximately 5 bps to 10-years horizon and 5-20bps to 20-years horizon would be justified by the evidence.

Oxera also estimates the liquidity premium of AAA-rated bonds, estimating a liquidity premium of 12bps, which is in line with the academic literature. As Oxera notes, this evidence suggests that the premium on AAA-rated corporate bonds is small.

SONIA cross-checks

The Bank of England has categorised SONIA OIS market as deep, liquid and transparent, but despite this, the evidence suggests that long-term SONIA swaps rates are inappropriate cross checks for the RfR.

As Oxera notes¹², there is a wide body of academic literature that shows that capital markets imperfections and supply-demand imbalances distort swap rates downwards. The literature shows that swaps play an important role in hedging, and that swap rates are primarily driven by excess demand. Since limits to arbitrage prevents the market from correcting these imbalances, negative swap rates continue to persist. These distortions distort swap rates as a suitable proxy for the RfR, consequently, we do not consider 20-year SONIA swap rate to be a valid proxy for a cross-check of the RfR.

⁹ CMA (2021), PR19 FD, para. 9.162.

¹⁰ CMA (2021), PR19 FD, para. 9.151.

¹¹ For a complete review of the literature see Oxera (September 2022) RFR methodology for PR24.

¹² For a complete review of the literature see Oxera (September 2022) RFR methodology for PR24.

Risk-free Rate, Debt Premium, Debt Beta and the Effect of Gearing

As set out in the Beta section above, if the regulator uses a too-low risk-free rate, this leads to a WACC that is increasing in leverage.¹³ Using Ofwat's PR19 methodology the debt premium, calculated as the difference between the cost of new debt allowance and the risk free rate, has widened from 190bps to 270bps.¹⁴

We agree with First Economics conclusions¹⁵ that Ofwat has misdiagnosed the problem by amending debt betas and instead the solution is to calculate the RfR in line with the CMA's PR19 precedent. This approach would give a more accurate representation of the debt premium paid by companies.

Estimation of RfR

We consider that the correct approach for the estimation of the RfR should reflect the points raised above, which are supported by corporate finance literature as well as CMA's PR19 precedent. In particular, the correct approach:

- Sets the bottom of the RfR range as the 6-months trailing average of the UK 20-year ILG.
- Sets the top of the RfR range as the 6-months trailing average of the iBoxx £ Non-Gilt AAA 10+ and 10-15 years.

Transforms RPI ILG yields into CPIH equivalents using RPI-CPI wedge implied by swaps and evidence of the existence of a non-nil CPI-CPIH wedge.

Total Market Return (TMR)

We disagree with the proposal to disregard the RPI series for deflating historical TMR on the basis that both CPIH and RPI have relevant strengths and weaknesses which means that weight should be placed on both.

RPI actual values are available for a longer proportion of the historical window, but the formula is known to have varied over time and it is not the best measure of inflation going forward. CPIH is a more reliable measure of inflation, however, the quality of the CPIH back series published in May needs to be reviewed. We note that the modelled CPI series required revisions¹⁶.

As a result, weight should be placed on both RPI and CPIH series; to do otherwise risks introducing a bias through omission of relevant data. This is consistent with the approach adopted by the CMA at PR19 appeals.

On averaging, there is no rationale to diverge from the approach adopted by the CMA, which focused on arithmetic averages and considered overlapping and non-overlapping estimators of returns over

¹³ First Economics (2022), The Risk-free Rate Prepared for a Group of England & Wales Water Companies, section 3

¹⁴ Ibid, Table 5

¹⁵ Ibid, section 3.3

¹⁶ [Consumer Prices Index including owner occupiers' housing costs \(CPIH\) historical series - Office for National Statistics](#)

10- and 20-year holding periods. We note that the CMA carefully considered the arguments for and against the inclusion of the non-overlapping estimator and concluded that these should be included “in the range of reasonable TMR estimates, rather than to exclude some of these estimates as to do so may risk ‘cherry-picking’ data”¹⁷.

Ofwat also proposes to retain the use of a direct transformation of the whole-period geometric average return to its arithmetic equivalent as a cross-check. We note that CMA PR19 appeals revealed challenges in estimating the appropriate uplift to the geometric mean¹⁸, so this approach would need to be applied with caution and may be of limited usefulness.

Inflation

We agree with Ofwat’s approach in the draft methodology to continue to use long run inflation assumptions to estimate the real cost of capital. Inflation exposure is a key attraction for investors in the sector and the use of long run inflation to estimate the cost of capital exposes investors to symmetric risk where outturn inflation varies from the long run assumption.

The approach demonstrates regulatory consistency, which requires long-term predictability on the approach for price reviews and provides certainty for investor support during a time of significant uncertainty and development in the sector.

Cost of equity indexation

There is material uncertainty around the macroeconomic environment, with highly volatile inflation and rising interest rates, and this may continue into PR24. We consider it is appropriate to include either (1) cost of equity indexation or (2) application of a forward rate adjustment to take into account outturn macroeconomic conditions within PR24.

Market consensus continues to indicate that interest rates rises in the medium term are possible in response to the record high inflation seen in the UK. The Bank of England has increased the base rate gradually since December 2021 and most recently increased the rate to 1.75% in August 2022 and future increases are expected.

Cost of equity indexation would improve financeability over PR24 as the risk of increasing interest rates would be mitigated, reducing the downside exposure to companies over the price control.

Ofwat states that risk should be allocated to the party best placed to manage the risk. Companies and investors are not more able to manage market risks than customers. In fact, when deciding to index the cost of new debt, Ofwat noted that “*companies have struggled to manage the forecasting risk in the past, which has potentially increased either the Cost of Equity or the allowed Cost of Debt*”¹⁹. As a result Ofwat should include cost of equity indexation or a forward rate adjustment to mitigate the risk of market movements within the price control.

¹⁷ CMA (2021), PR19 FD, para. 9.333

¹⁸ Ibid. para. 9.334 – 9.338

¹⁹ CMA (2021), Cost of debt working paper, Table 2

Aiming up

Ofwat has not followed the CMA's approach at PR19 to incentivise investment in the sector and tackle asymmetries within the incentive package through 'aiming up'. Ofwat states that it has tackled the asymmetries at source, and therefore there is no need for aiming up. We consider that asymmetry of the package needs to be evaluated carefully based on the final specification of the PR24 framework for SEW. More generally asymmetry is only one of the reasons why aiming up is important – we note that CMA rightly also factored in wider uncertainty in estimating cost of equity and financeability as reasons for aiming up, which will also need to be carefully assessed for PR24.

Cross checks

We disagree with Ofwat's proposals to use Market to Asset Ratios (MARs) as the primary cross check on the cost of equity. MARs have significant limitations as indirect benchmarks and are generally unreliable as market sources to inform estimates of required returns on capital. As set out in the KPMG report²⁰ prepared for Water UK, a high degree of judgement and a number of assumptions are required to decompose a MAR such that it is incapable of providing any clear insight as a cross-check for the calibration of allowed returns.

KPMG set out the following criteria²¹ for assessing cost of equity cross checks:

- Transparent
- Targeted
- Objective
- Incentive compatible
- Consistent

We agree with KPMG's conclusions that the MAR cross check fails to meet or only partially meets all of the criteria above as the use of a MAR as a cross check includes non-regulated activities, are biased towards a bidder's aims and contradicts market evidence that MAR cannot be used to observe the cost of equity without controlling for other factors.

Alternative cross checks should be used to ensure the cost of equity set by Ofwat at PR24 is at an appropriate level. These cross checks could include the notional financeability assessment, as used by the CMA at PR19 or multi factor model analysis.

Q7.5. Do you agree with our proposed approach to setting the allowed return on debt?

Ofwat states that a company specific adjustment will be allowed if there is evidence that the notional company faces a higher cost of debt due to its size. We are concerned that Ofwat

²⁰ KPMG (2022), Use of market-to-asset ratios (MARs) as a cross-check in the context of regulatory price controls

²¹ Ibid, section 2

does not appear to have drawn on the methodologies we proposed within our response to the PR24 risk and return discussion paper in January.

Ofwat has adopted an approach which is consistent with the CMA's approach to setting the cost of debt at PR19 at the highest level but a number of departures in the detail could result in omission of relevant costs and a material reduction in the cost of debt allowance.

We do not agree with Ofwat's approach to exclude index-linked swaps and junior debt from the sector average methodology, lack of clarity around how the sector average will be calculated (including averaging methodology and the companies which will be included) and the inclusion of an outperformance wedge.

Cost of debt for a notional company like SEW

Small, relatively infrequent issuers of debt like SEW have a smaller asset base relative to the sector and smaller implied debt requirements in each year (sub-benchmark) which means they have to 'build up' to benchmark size before raising debt. As a result, they have more limited control over factors that affect cost of debt (e.g., maturity concentration, timing of issuance and debt composition) and each issuance more materially impacts upon the cost of debt.

SEW's embedded debt was raised efficiently at the time of issue in line with market benchmarks. This historical debt should be remunerated through the cost of debt allowance as it was raised efficiently, however was subject to the interest rate prevailing at time of issue – which alongside subsequent evolution of interest rates were outside of SEW's control.

These differentials have a number of impacts on our debt profile in terms of frequency of issuance and exposure to market movements.

Issuing at benchmark size but less frequently

To achieve benchmark issuance size (£250m), WoCs access debt markets less frequently. This gives rise to a number of risk differentials relative to a frequent issuer:

- Greater exposure to point in time risk: Issuers which issue infrequently are more likely to raise debt at high (or low) points in the evolution of the yield curve and credit spread i.e., point in time risk. The allowance assumes a daily issuance profile which implies an equal spread of issuance and equal exposure to underlying rates. Hence, infrequent issuers have a higher risk of mismatch with the allowance due to point in time risk.
- More limited ability to match the sector average: Small, infrequent issuers have less flexibility to manage factors outside of their control, such as regulatory policy and the macroeconomic environment over time, given they have more limited control over the factors which affect cost of debt. 'Lags' in their responses to such events relative to large issuers could widen variances with the sector average and thus the allowance.
- More limited ability to influence the sector average: Issuers with a small RCV have less ability to influence the allowance given it is not clear that WoC costs will be captured in the average of sector debt costs (if Ofwat takes the CMA precedent then large WoCs only will be included in the sector average). Hence, small issuers are more exposed to mismatches with the allowance and underperforming the rest of the sector. In addition to the risks set out above, the small, infrequent issuer may also be exposed to

additional costs. In particular, the infrequent issuer may be exposed to either (1) the direct costs of hedging and managing risk differentials for an infrequent issuer; and (2) additional costs of borrowing where small issuers have limited ability to manage liquidity and secure that funds are available to meet financial liabilities as they fall due.

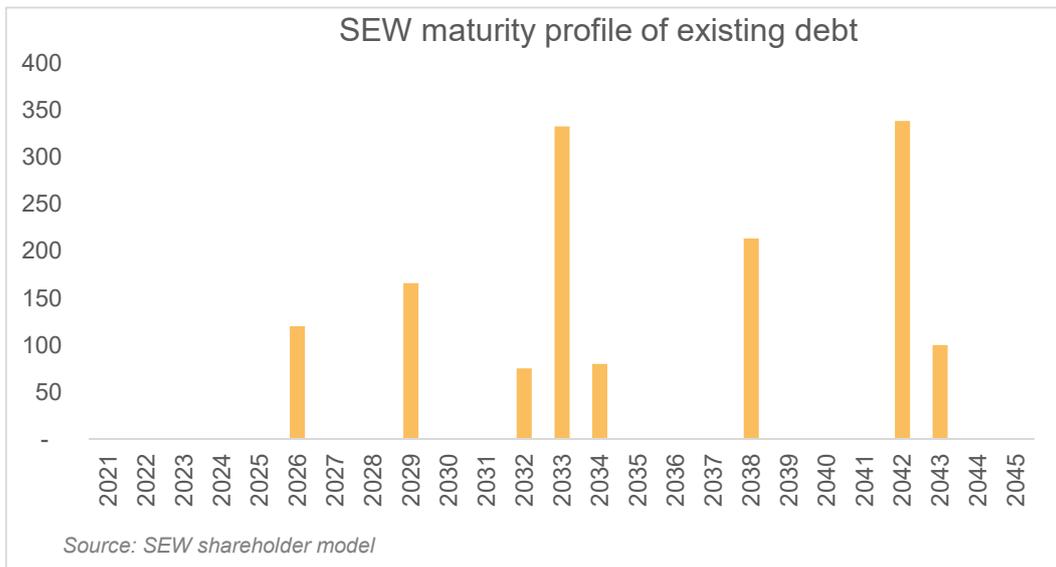
SEW's RCV balance at 31 March 2022 was £1.49bn. If we consider a notional company the size of SEW, with 60% gearing, this RCV size and level of gearing equates to c. £895m of debt (or lower if Ofwat reduces notional gearing).

Given a benchmark issuance size of £250m, SEW would only be able to hold three to four instruments of benchmark size. Assuming an average tenor of 15 years (in line with the sector average), this would imply debt issuance every four to five years, or once per AMP.

This issuance profile exposes a company like SEW to movements in market rates more so than a larger company which is able to issue at benchmark size more frequently.

Another consequence of less frequent issuance is increased volatility in refinancing requirements in each AMP. This is reflected in SEW's 'lumpy' debt maturity profile as shown in Figure 2. This profile is in contrast to the overall sector and in particular the average WaSC which has a more continuous maturity curve.

Figure 2: SEW maturity profile



The variance between SEW's maturity profile and the sector's results in a risk differential for SEW as it is exposed to significantly higher 'point in time' risk. As more expensive legacy debt matures at the sector level, the cost of embedded debt allowance will reduce but SEW's actual cost of debt will not reduce at the same rate.

Ofgem recognised in its recent ED2 Draft Determination that the specific characteristics of small, infrequent issuers can result in risk differentials for these issuers relative to large,

frequent issuers that are out of management control. Ofwat should also give recognition to infrequent issuers in the PR24 methodology.

Pricing the risk differential

There are various methodologies and regulatory precedent which could be drawn on to price the differentiated cost of debt observed by smaller companies.

The proposed lower notional gearing by Ofwat will be a challenging transition for SEW and WoCs, which cannot easily adjust their capital structure, given the more limited issuance opportunities and additional costs during issuance. Should Ofwat pursue the change in notional gearing, this should be priced accordingly through the cost of debt allowance.

Infrequent issuer premium

An infrequent issuer premium would allow a Company Specific Adjustment (CSA) for companies that issue less frequently. This would require an assessment of additional risk from small issuers that issue benchmark size debt but less frequently.

There is regulatory precedent for such a premium such as Ofgem's RIIO ED2, which included an allowance of 26bps for infrequent issuer premium on new debt based on Constant Maturity Swaps (CMS) pricing²². An estimate using the CMS methodology would imply an overall adjustment of at least 26bps, if applied to new and embedded debt, for infrequent issuers such as SEW.

Our embedded portfolio comprises of debt which was issued pre-merger with Mid Kent Water. The size of SEW and Mid Kent Water individually were smaller than SEW's current size, which resulted in even higher risk of point in time exposure as infrequent issuers. It is therefore important that Ofwat includes a CSA for both new and embedded debt at PR24. We have estimated an uplift of 6 bps for embedded debt based on the Mid Kent Water novated debt.

Another potential way to address this risk would be address the pre-merger SEW and Mid Kent Water as two distinct businesses and bifurcate the debt portfolio for the notional company to consider (1) Mid Kent debt and (2) other SEW debt separately. Given that Mid Kent was significantly smaller than SEW when it was raising Artesian finance, it could be considered as a separate notionally structured WoC which would require a company specific adjustment.

WoC-average cost of debt clearly highlights risk differentials

There are fundamental differences in WoCs and WaSCs characteristics which should be reflected in Ofwat's methodology for setting the cost of debt allowance. As a smaller company, we *inter alia* issue debt less frequently and face higher issuance and liquidity costs.

In the water sector there are two distinct groups of companies (WaSCs and WoCs) – the fundamental differences between these two groups mean that a one-size-fits-all approach to

²² Ofgem (June 2022) RIIO-ED2 Draft determinations – Finance Annex, p. 17

the cost of debt is not appropriate. During the PR19 re-determination the CMA calculated that the WoCs median cost of embedded debt is 5.68 per cent compared to an equivalent WaSC cost of 4.41 per cent²³.

Ofwat should consider the average cost of WoCs debt and use this to develop a WoC-specific cost of debt for PR24. This methodology would provide market-based evidence of the differential in the cost of debt for WoCs compared to WaSCs.

It will also be important for Ofwat to specify ex ante the basis on which the WoC average cost of debt position will be calculated in terms of (1) treatment of different instruments; and (2) the averaging methodology.

Weighting of new to embedded debt for WoCs

Ofwat has proposed to set the proportion of new debt with reference to the sector's refinancing, new investment requirements and in the context of potential changes to the notional gearing. We disagree with Ofwat's approach, as these assumptions are unlikely to reflect the actual scale of refinancing for an infrequent issuer like SEW. The weighting should more appropriately reflect SEW and WoCs issuance profiles. SEW's specific characteristics result in infrequent issuances and 'lumpy' maturity as can be seen in Figure 1, compared to other companies in the sector. The proportion of new debt during the AMP8 would therefore be materially lower than other companies. We propose Ofwat includes a SEW or WoC specific new to embedded debt ratio when setting our cost of debt allowance in AMP8.

Specification of the cost of debt based on sector average

In addition to company specific considerations we consider that Ofwat does not calibrate the sector cost of debt allowance such that companies' efficient costs are remunerated.

Balance sheet approach – methodological considerations

Multiple aspects of the methodology for calculating the sector average are unclear within Ofwat's draft methodology. We welcome Ofwat's approach to publish the model used for the calculation in due course however the lack of clarity over how the balance sheet approach will be applied, generates uncertainty. We consider that the CMA's PR19 methodology is appropriate for the calculation of the sector average and can inform the ex ante principles required, before the application of the CSA for SEW.

We would welcome further engagement with Ofwat on the principles and factors which require ex ante specification including:

- Companies included in the sector average calculation – particularly important in light of the different characteristics of WaSCs and WoCs above

²³ CMA (2021), Cost of debt working paper, Table 2

- Averaging methodology – the CMA, for example, argued that using median values across a broad range of companies would ensure that the allowance is not skewed by the performance or risk decisions of outlier companies²⁴.
- Treatment of different instruments – for example, identification and assessment of outliers, treatment of swaps and Class B debt.

At this stage, Ofwat has provided limited detail on the calculation methodology for the balance sheet approach as well as the specification of cross-checks. This lack of detail means significant uncertainty remains which makes incentives unclear. Ofwat's methodology should ensure companies can recover efficient debt costs over time.

Outperformance wedge on new debt

The CMA determined at PR19 that there is no evidence of a material halo effect and concluded that outperformance against the iBoxx A/BBB 10+ index is driven primarily by two factors (1) credit rating and (2) tenor. The CMA considered that lower tenor in isolation is not sufficient to justify an outperformance wedge. We consider that adjusting the cost of new debt in PR24 for outperformance driven by tenor would incentivise shorter debt tenors, which transfers risk to customers in a rising interest rate environment. An ex-post adjustment increases uncertainty and could preclude recovery of efficient costs over the life of each instrument.

Issuance costs

Ofwat proposes to follow the CMA PR19 approach and retain 10bps issuance and liquidity cost allowance. Given Ofwat's approach of a full transition to CPIH, the 10bps allowance does not appropriately remunerate companies for hedging the basis risk between RPI and CPIH, as the majority of the sector currently holds RPI linked debt.

There has been regulatory precedent pricing the basis risk in the cost of debt allowance in Ofgem's recent RIIO-2 Final Determination. Ofgem provided a 25bps uplift for additional borrowing costs which included an explicit 5bps uplift for CPIH issuance and basis risk mitigation costs²⁵. The 5bps was split between 3bps for embedded debt and 2bps for new debt, where the risk was mitigated through swaps²⁶.

Within this 25bps uplift, Ofgem also provided a 10bps cost of carry allowance, where debt has been issued ahead of when it is required to ensure sufficient cashflows. The approach taken by Ofwat does not factor in the cost of carry.

We note that given the current macroeconomic environment the market to swap between RPI and CPI/CPIH exposure has been highly volatile. This may result in an additional allowance

²⁴ CMA (2021), PR19 FD, para. 9.635 (b)

²⁵ Ofgem (February 2021) RIIO-ED2 Final determinations – Finance Annex, p. 15

²⁶ Ofgem (June 2022) RIIO-ED2 Draft determinations – Finance Annex, p. 15

being required to swap between RPI and CPIH and further analysis is required from Ofwat to arrive at the correct allowance.

Q7.6. What are your views on the options we have set out for estimating the RPI-CPIH wedge for converting RPI-linked yields to a CPIH basis?

In light of the planned RPI to CPI transition scheduled for 2030, an estimate of the RPI-CPIH wedge is required for PR24. We disagree with Ofwat's proposed approach to estimate the RPI-CPIH wedge. Ofwat has proposed to rely on the official OBR's RPI and CPI forecasts before 2030 for estimating the RPI-CPIH wedge. This approach significantly underestimates the true RPI-CPIH wedge, which could in turn lead to an underestimated CPIH-real RfR.

There is considerable uncertainty with respect to the RPI transition, notably after some pension funds were granted judicial review of the case that challenges the RPI reforms and Chancellor's decision not to compensate ILGs holders for the change. If compensation was to be paid, ILG prices would increase, resulting in lower yields. This in turn would impact the breakeven between RPI inflation implied by nominal gilts and ILG yields, translating into a wider RPI-CPIH wedge.

The relevant inflation expectations to estimate the RPI-CPIH wedge is a market-based estimate, which reflects the expectations that ILGs buyers have when they invest. Market-based evidence indicates a clear divergent behaviour of ILGs and nominal gilts – this means that market expectations are diverging considerably from “official forecast” figures.

Consequently, we propose the use of an alternative methodology to estimate the RPI-CPIH wedge at PR24, which relies on the use of zero-coupon CPI and RPI swaps. As Ofwat notes, both CPI and RPI swaps are affected by inflation and liquidity risk, however the levels of distortion are reduced when estimating the RPI-CPI wedge, as this is effectively a difference of both indices. Therefore, the use of CPI and RPI swaps provides a more accurate picture of market expectations of the RPI inflation during AMP8. Following this approach, Oxera's estimation indicates that the RPI-CPI wedge, implied by 20-years swap rates, is c.46bps.²⁷

Furthermore, the resulting estimation has to be adjusted by the CPI-CPIH wedge, which has widened considerably since mid-2021 (to levels over 120bps as of July 2022). Oxera observes that in the past, after an episode of wide CPI-CPIH wedge, it took nearly five years to revert to zero. Therefore, assuming a wedge of zero at PR24 would considerably underestimate the actual wedge, which would under-estimate the CPIH RfR required across AMP8.

Oxera estimates that the 20-year average CPI-CPIH wedge is approximately 17 bps as of July 2022. This, in conjunction with the swaps estimated RPI-CPI wedge above, indicates an RPI-CPIH wedge of c.63bps which differs from the implied Ofwat's official forecast approach of c.42bps.

²⁷ Oxera (2022), RFR for PR24, section 4.1

Q7.7. Do you agree with our proposed approach to the notional structure and setting allowances for corporation tax?

We disagree with Ofwat's proposed changes for the specification of the notional company. The changes are not supported by market evidence and are internally inconsistent. Changes to the notional company should be subject to a robust assessment taking into account regulatory consistency over time, internal consistency with other parameters, market evidence and corporate finance theory.

Approach to setting the notional structure

The notional structure has not been set on a consistent basis and the changes proposed by Ofwat are not based on clear principles or market evidence. Any changes to the notional structure should be carefully considered and assessed against criteria including:

- What is the problem which the change is seeking to address?
- Is this change consistent with market evidence?
- Is the basis of the change consistent with the rationale for other elements of the notional company?
- Are the changes made in the logical sequence for assessing financeability?

Changes which are not based on clear principles applied consistently over time will undermine the notional financeability test.

Notional gearing

We do not agree with Ofwat's proposals to decrease the notional gearing. The notional gearing should be set using market evidence as a primary basis and is not in line with the recent CMA PR19 determination. As a result, companies cannot both achieve optimal gearing and debt cost minimisation and meet ensure financeability which requires de-gearing to the notional level.

There are several considerations that can inform an adequate range of notional gearing, such as the minimisation of pre-tax WACC, sector risks, economic policy, and financial market conditions. However, in practice, these considerations are numerous and have complex interactions between them making it is too complex to accurately estimate the optimal gearing range from first principles²⁸. This fact is recognised by Mason and Wright report, which stated that "*there is no consensus about privately optimal levels of gearing, never mind the socially optimal ones*"²⁹. Consequently, as argued by Frontier Economics, there is no reason to believe, in principle, that the social optimum gearing is below the private optimal, and therefore, the assessment should be focused on the empirical evidence, on the regulatory framework, and on Ofwat's regulatory duties.

Ofwat's decision on the notional gearing level is not value neutral, as it underpins both the allowed returns and the financeability assessment, acting as an important signalling mechanism to companies

²⁸ A complete assessment of the factors that determine an efficient level of notional gearing can be found on: Frontier Economics (August 2022), notional capital structure report, p. 10

²⁹ Mason R, Wright S. (2021) [A report on financial resilience, gearing, and price controls](#)

when considering their own capital structure. An analysis of the regulatory framework performed on behalf of Water UK by Frontier Economics supports the concept that, under the current regulatory framework and guidance, the notional gearing should be assessed on an independent and objective basis. Adjustments to the notional gearing level away from this objective level in order to address financeability issues would not be consistent with Ofwat's financeability duties.

As shown by Frontier Economics, Ofwat has not provided evidence on the balance of risk to suggest why a notional gearing of 60% is considered too high. If this was the case, we would expect to observe, *inter alia*,

- Credit rating criteria indicating that 60% gearing is too high for BBB+/Baa1 (Ofwat's target credit rating).
- Companies with higher gearing than 60% unable to borrow efficiently at their current gearing levels.
- Other regulators of infrastructure sectors adopting considerably lower levels of notional gearing.

Indeed, there is no significant market evidence that suggests that the current notional gearing level of 60% is too high.

Credit rating agencies have a target level for regulated water companies of up to 70% gearing for a BBB/Baa credit rating^{30,31}, for example, Moody's target for regulatory gearing is the range 55%-70%. Hence, a notional gearing level of 60% provides a considerable headroom for Ofwat's target rating for the notional company of BBB+/Baa1. These target level range has remained unchanged over recent years, despite the sector going through recent periods of volatility and uncertainty.

On the other hand, when considering the water sector evidence, the majority of firms have gearing ratios in excess of 60%, with an average gearing level of c.66%, considerably above the notional gearing level³². These levels have been approximately constant since AMP6 (as shown in Figure 3). Frontier Economics notes that there appears to be no clear correlation between gearing level and credit ratings. Furthermore, market evidence shows that a level of gearing of 60% is in line with regulated infrastructure assets. For example, companies in the energy sector, during RIIO-1, had an average of 63%, which does not differ considerably from the water sector. 7

³⁰ Fitch Ratings (2022) [Sector navigators. Addendum to the Corporate Rating Criteria](#), Page 204

³¹ Moody's (2022) [Moody's 2022 updated assessment on United Utilities](#) which was carried out based on its 2018 methodology.

³² Water companies - 2021/22 Annual Performance Reports

Figure 3: Total gearing across the water sector over time



Moreover, recent GB regulatory precedent for energy (RIIO GD&T2 and RIIO ED2) and aviation (CAA H7) have used 60% as the notional gearing. While business models differ, these regulated industries face similar challenges related to the decarbonisation of the economy (which requires considerable capital investment), as well as risks arising as a result of the Covid pandemic and consequent changes in consumers’ behaviour. If Ofwat views increasing risks arising from climate change and severe weather, for example, best practice would be to tackle these risks directly at source. This is the approach that Ofgem has taken in its draft determinations for RIIO-ED2 which includes a severe weather funding mechanisms that allows companies to recover efficient costs incurred directly as a result of severe weather. Ofgem has also considered ‘use it or lose it’ allowances and re-openers related to severe weather shocks.

In the aviation sector, as Frontier Economic analysis shows, the case of Heathrow, that faced an unprecedented demand shock as a result of Covid lockdowns, while having at the time a higher level of gearing than water companies (c.86.5%), does not support Ofwat’s view that lower gearing levels are required to address uncertainty. Accordingly, the CAA’s approach to address uncertainty through a Traffic Risk Sharing mechanism rather than simply assuming that reducing the notional gearing would solve financeability and uncertainty concerns is an example of thorough considerations of the full range of options to mitigate risks.

Moreover, regulators have recognised the role that gearing has in aligning managerial incentives, indeed, a report by the Department of Trade and Industry on the gearing levels of utilities recognised that mature cash-rich firms, like water companies, that impose a capital structure with a greater proportion of debt can increase managerial focus on profits, and hence raise firm value³³.

Finally, a change in the notional gearing level, without compelling evidence of its need, risks undermining investor confidence and goes against regulatory best practice. Investors in the water sector value significantly the stability of the regulatory regime, this is recognised by the Government’s

³³ DTI, The drivers and public policy consequences of increased gearing, A report by the Department of Trade and Industry and HM Treasury, October 2004.

Principles for Economic Regulation³⁴, which includes predictability as one of the main principles, and by BEIS's recent consultation paper³⁵ which states that a key element to encourage investments is providing stable and predictable environment for investors. This factor plays a critical role at PR24 due to the significant long-term investments required in the sector to support a transition towards Net Zero and climate change-related risks.

On this basis, as Frontier Economics report shows, the historical change on notional gearing levels since PR99 does not constitute a valid argument to rule a reduction of gearing by 5% as not unprecedented. This is because notional gearing levels at any point in time must be considered in the context of the financial and regulatory environment. Indeed, total expenditure as percentage of RCV has dropped considerably since PR99, demonstrating a change in overall risk profiles of water companies.

Proportion of index linked debt (ILD)

Ofwat is proposing to increase the proportion of ILD for the notional company based on observed companies' balance sheets. We do not agree with this increase in the assumed proportion of ILD for the notional company. The proposed change could undermine the predictability and stability of the notional financial structure assumed across successive price reviews.

The CPI market is still immature, as evidenced by high CPI linked debt premiums. From a cost perspective, this would suggest the proportion of CPI linked debt would decline, unlike Ofwat's proposals to increase the proportion of CPI linked debt.

It is important to note that higher levels of ILD are commonly a feature of securitised structures with higher gearing, therefore it is not internally consistent with other parameters of the notional company such as gearing where there is a proposed reduction. Ofwat should apply the methodology consistently across the different elements of the allowed return. Therefore if Ofwat bases the proportion of ILD on market data it should also increase notional gearing from 60% to 66% in line with market data.

Mix of ILD for notional company

Ofwat is proposing to use a mix of RPI and CPIH linked debt for the notional company but does not detail the exact mix or the rationale for its approach. This represents a fundamental divergence from the approach to fully transition revenues to CPIH and undermines the financeability assessment.

A mismatch between CPIH linked revenues and RPI linked liabilities will artificially improve the notional financeability test as cash interest costs will be lower in AMP8. This mismatch, coupled with the proportion of ILD for the notional company will result in distortions to the financeability assessment. If Ofwat applies CPIH indexation to the RCV, index linked debt should also be indexed to CPIH.

³⁴ Department for Business, Innovation and Skills (2011) [The Principles for Economic Regulation](#)

³⁵ Department for Business, Innovation and Skills (2022). [Economic regulation policy paper](#)

Full transition to CPIH

Ofwat is proposing a full transition to CPIH from the start of PR24. However, Ofwat has not included additional allowances to cover the basis risk arising from RPI-linked debt and CPIH linked revenues.

A phased transition to CPIH based on the natural rate would be in the customer interest. An immediate transition to CPIH would result in material basis risk for companies which are exposed to CPIH linked revenues and RPI linked liabilities as well as costs for hedging basis risk which would be either incurred by companies or paid by customers, to ensure the transition is net present value neutral.

There is significant uncertainty in the market around the ability for companies to fully hedge CPIH exposure, which is similarly reflected in the lack of liquidity in the CPI and CPIH swap markets. There is a risk that companies when trying to swap their RPI exposure post transition will be unable to do so due to lack of bank bandwidth, lack of demand from investors or is cost prohibitive. In all instances there is a real risk of additional costs to customers.

A phased transition would allow companies to manage the basis risk over time through to the RPI Reform in 2030. Should Ofwat implement a full transition, there would need to be careful consideration and detailed discussions to ensure the risks are priced.

Corporation Tax

We agree with Ofwat's revised approach to calculating tax allowances and welcome the simplification through using a single geometric uplift to replace the iterative tax calculation. We caution that assumptions will need to be made to apportion balances between the water resources and water network controls and it will not be possible to reconcile the actual tax charge to the tax allowance at a control level.

We note Ofwat is yet to clarify the methodology for the PR19 tax reconciliation mechanism, specifically the treatment of super deductions. We await clarification on how the true-up will be calculated and how the super deductions pool will be treated in the opening capital allowance balances for PR24.

Q8.1. Do you agree with our approach to assessing financeability?

We do not agree with Ofwat's approach to assessing financeability. The approach is neither in companies nor customers interests. The specification of the notional structure should underpin a meaningful financeability cross check on the overall price control and allowed return. The notional company should be set based on appropriate industry benchmarks and corporate finance theory. Ofwat's proposed changes to the notional structure - including a reduction in notional gearing, increase in the proportion of index linked debt, retention of RPI linked debt within the notional structure alongside a full transition to CPIH - undermine financeability as a robust and meaningful cross check.

The underlying financeability of a company like SEW is likely to be more constrained at PR24 in the context of Ofwat's proposed reduction in allowed cost of equity, limited scope to recover efficient debt costs, increasing operational risk and an uncertain macroeconomic environment. However, Ofwat's notional financeability test is likely to be less constrained given the proposed changes to the notional company (which are not supported by market evidence).

Impacts of notional structure on financeability

Ofwat is proposing to:

- Reduce the level of notional gearing;
- Increase the proportion of index linked debt;
- Fully transition revenues and RCV indexation to CPIH;
- Include RPI linked debt for the notional company; and
- Reduce the cost of debt allowance.

Each of these changes to the notional company will undermine the notional financeability cross check at PR24.

Ofwat should include counterfactual analysis to evaluate financeability using the PR19 notional structure to highlight the drivers of financeability at PR24. Crucially if notional financeability is contingent on the changes to the notional structure, this undermines the financeability test.

Approach to actual financeability

It is important that Ofwat assesses both notional and actual financeability at PR24. Ofwat's approach in the draft methodology focuses solely on notional financeability and does not give due consideration to companies' actual costs and structures. Ofwat has a duty to ensure efficient companies can finance their functions and this will include consideration of actual capital structures.

This approach to financeability, which focuses solely on the notional assessment, is inconsistent with Ofwat's financial resilience consultation document which includes Ofwat's interpretation of the finance duty based on actual structures.

Link between financeability test and financial resilience

The allowed return set by Ofwat is a primary driver of financial resilience in the sector and the financeability test has an important role as the primary cross check on the allowed return.

The allowed return on equity represents the cash available to the business for the management of downside risk and ensure efficient capital raising. If the financeability test does not provide a cross check on the allowed return, companies will be more vulnerable to downside scenarios in the future which could result in additional risk to customers service levels.

Q8.2. Do you agree with the focus on the metrics outlined in section 8.4 for the assessment of financeability?

The metrics outlined within section 8.4 represent a good starting point for the assessment of financeability at PR24. It is important that these metrics are calculated in line with the relevant rating agency methodologies and the corresponding rating agency thresholds are used for the assessment of financeability. In addition, equity financeability metrics should be considered to ensure the assessment captures both debt and equity financeability.

Rating agency methodologies are publicly available and Ofwat should use these to assess financeability at PR24 to ensure a robust assessment. Rating agencies also publish thresholds for the different ratings which should be used by Ofwat. The assessment should consider both the scorecard approach and also the primary metric for each rating agency, which can act as a binding check on the rating.

When assessing financeability at targeting a specific rating level, Ofwat should maintain headroom against the minimum thresholds to ensure companies have headroom to manage downside risks without becoming immediately at risk of a downgrade.

Equity metrics should also be considered within the financeability assessment. We suggest that the following metrics are evaluated for the assessment of equity financeability (1) dividend yield (2) payout ratios (3) hedge ratios (4) equity buffer vs risk exposure.

These equity financeability metrics should be considered against the following benchmarks:

- Dividend yield: The FTSE All Share index and dividend yields for listed UK water and energy companies could be used as a relevant benchmark for the water sector.
- Payout ratios: The payout ratios in the European market could be used as a benchmark. This benchmark was set out by Ofwat in its PR19 consultation process *“The average payout ratio over 2011-17 for the European market as a whole was around 60%, within a range of around 40-70%. As water utilities are typically considered to be income stocks, the upper end of this payout ratio range is likely to be more appropriate to guide the maximum level reasonable for the base dividend, equivalent to a nominal base dividend yield of 5%.”*³⁶
- Hedge ratios:

³⁶ Ofwat (2018), 'Putting the sector back in balance: Consultation on proposals for PR19'. April, p25

- Equity buffer vs. risk exposure: Analysis of equity buffer compared to the risk exposure over historic price controls.

Q8.3. Do you agree with our proposed approach to cost recovery, in particular that we set a narrow range for RCV run-off rates within which companies will be required to evidence their choice of rate which best achieves a fair balance between current and future customers?

We agree with Ofwat's approach not to apply run-off and PAYG adjustments to move revenues forward from future price controls to address financeability constraints. Any financeability constraints should be addressed through a higher cost of equity. There are multiple methodologies for calculating the natural run-off range and these should be taken into account rather than introducing a prescriptive range at the sector level.

The approach to cost recovery at PR19 seemed to mostly work. The PR19 framework gave companies the flexibility to justify their cost recovery parameters on an economic basis appropriate to the individual company. It is not clear to us that there is any need to change from the approach used at PR19.

We are not fundamentally disagreeing with Ofwat's proposals but we would like more clarity on what Ofwat is proposing – particularly around the treatment of opex and capex IRE expenditure in PAYG and RCV Runoff cost recovery. At PR19 we included capitalised IRE with opex in the PAYG ratio – reflecting the overall treatment of IRE since privatisation. We were not the only company to take this approach.

It seems that Ofwat is more prescriptive for PR24 of what constitutes PAYG expenditure and that it excludes the capitalised component of IRE, however this is not explicitly stated anywhere.

'We consider the most appropriate starting point for calculating PAYG rates is operating costs as a proportion of totex. This was the approach that the majority of companies took at PR19.'

(Ofwat - PR24 Draft methodology Appendix 10.5 p31)

We would like more clarity on how Ofwat proposes that the IRE component of assets is recovered within the 'narrow range' of RCV run-off rates if it is not allowed in the PAYG ratio. We would like Ofwat to be more specific for these cost recovery elements in the final methodology.

We have some more particular comments to make on the mechanics of the setting of the PAYG ratio at PR19 and its implications for PR24, and on PR24 proposals for restricting the RCV run-off rates.

RCV runoff rates

Ofwat's proposal to set a narrow band for RCV run-off rates seems to be based on the premise that all companies have a similar spread of asset stock in terms of engineering and remaining lives. We do not believe this to be the case – each company has its own history and makeup of assets. The numbers of very long life assets (e.g. impounding reservoirs) and very short assets (e.g. meters)

varies significantly across companies. We do not believe that there is a need to restrict runoff rates where they have been determined on a company specific and economic basis. We note our run-off rates were the lowest in the sector at PR19 and Ofwat included an uplift to address financeability concerns.

The PR24 methodology is also focused on the comparison of proposed base maintenance costs vs cost recovery from RCV run-off.

'Typically, over the longer term we would expect the amount of revenue generated from customers in respect of the RCV run-off to be close to that required to be reinvested in new or replacement regulatory assets.'

(Ofwat - PR24 Draft methodology main document p103)

This is similar to the old 'broad equivalence' test of above ground asset expenditure versus current cost depreciation from PR99 to PR09.

Again this analysis is very company specific and difficult to generalise across the industry. For PR04 and PR09 we demonstrated that there are good reasons why this premise does not hold. We have long life, low risk assets which are being depreciated and are not due or programmed for replacement in the following 30 years. For example long life assets (boreholes, service reservoirs and structures of 60-80 years asset life) will attract depreciation over the comparison period but may not require MNI expenditure.

We have estimated the variance between regulatory run-off in line with AMP7 and the effective statutory depreciation rate based on (1) depreciation charges (4.54%) and (2) statutory asset lives (3.48%) for fixed assets as a cross-check. The statutory depreciation rate of 4.54% indicates that there is scope to increase the run-off rates to align with the statutory depreciation rate.

Setting PAYG ratios

There is uncertainty regarding the composition of our costs over time and it will be important to capture any changes within the natural PAYG rates at PR24. For example, we have seen a significant increase in our power costs over PR19 which will need to be captured. We are currently reviewing the make-up of our cost stack and will provide analysis to support any changes to our natural PAYG rates at PR24. Over the last two price reviews we have identified an issue with the setting or revision of PAYG ratios between our PAYG proposals in our business plan and the ratios used by Ofwat in the draft/final determination stages.

The PAYG ratios presented in our business plan are based on a specific programme of expenditure to deliver best outcomes for customers. When Ofwat varies the overall expenditure allowance at DD/FD stages we may need to review the split of opex and capex that would be required to allow us to achieve the outcomes we are committed to providing for our customers. It is unlikely to be a pro rata allocation of opex/capex as per the business plan. Ofwat's approach tends to underestimate the PAYG ratio at the DD stages – particularly if significant enhancement expenditure has been

disallowed. It may be that further correspondence is required with the company at that stage to better understand these implications and to refine these parameters.

Q9.1. Do you agree with the proposed standard set of scenarios for testing financial resilience?

Ofwat's proposed scenarios for testing financial resilience represent a good starting point for analysis of financial resilience and allow for comparability across the sector. However, it is critical that the risk analysis performed for financial resilience takes into account company specific risk drivers.

Our financial resilience testing will build on the analysis we perform for our annual viability statement testing which takes into consideration our principal risks which are reviewed and discussed with the Board.

We note that Ofwat has not included actual capital structure functionality within the PR24 financial model. This functionality is required to allow us to test our financial resilience in a manner which appropriately captures Ofwat's updated methodology at PR24. In addition, we note that comparability of analysis across the sector will be limited if different companies are using different models to perform the analysis.

Q9.2. Do you agree with our approach to how the board of the company should approach its board assurance statement?

We agree with Ofwat that financial resilience is an important consideration to inform the calibration of the price control at PR24. Financial resilience will be dependent on the level of risk exposure implied by the PR24 framework and the remuneration of this risk through the allowed return.

Our board reviews and assesses the impact for financial resilience for the long term viability statement and going concern statements each year. We agree boards should consider and assess financial resilience in the context of PR24 but note that financial resilience will be dependent on the allowed return and design of the price control.

For the notional structure assessment it will be critical for the specification of the notional company to be robust as highlighted above.

The additional requirements that are referred to in the consultation document that the board assurance statement should also relate to the period "beyond" 2025 to 2030 and that boards should consider "risks associated with any potential variance from its business plan" are open ended and therefore unrealistic.

They do not appear to be consistent with the approach suggested by Ofwat (with which we agree) to define common scenarios or parameters (to be complemented by companies as appropriate), an approach which seems to recognise that an objective assessment of the financeability of a business plan can only be carried out within a reasonable period and within a range of reasonably predictable parameters.

Companies' boards will carry out an analysis similar to that carried out for their annual viability statements which typically covers a 10 years outlook period. The outcome of this assessment would

be one of the relevant factors taken into account that boards would refer to in their board assurance statement.

However, a board assurance statement relating to longer and undefined future periods or any possible variance would not provide useful insight into the financeability of the business plan for the purpose of the price review due to the assumptions that would need to be made and the level of uncertainty.

Boards should only be required to provide a board assurance statement that relates to financeability over 2025 to 2030, the period to which their business plan relates and within a range of reasonable parameters. The suggested additional requirements referring to “beyond” and “any potential variance” should be removed.

Q9.3. Do you agree with our proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance?

We consider company performance, among a range of other factors, when setting our dividend and executive pay policies. We do not consider that it is necessary to introduce a change to the regulatory contract to reflect these policies. We also do not set out proposals for voluntary sharing of outperformance.

Dividend policies

Our dividend policy states that dividends should provide a suitable return to shareholders for their investment whilst ensuring that the company is able to finance its functions and meet its obligations as a water undertaker without impairing its long-term financial resilience.

When assessing the appropriate level of dividend, considerations will include the company’s actual and forecast level of gearing, the need to maintain its credit rating, the allowed cost of capital, any outperformance achieved or forecasted, as well as the level of any equity injections received.

Dividends are considered in the context of the overall performance and financial resilience of the company, which also depends on our performance under outcome delivery incentives and any reward or penalty. Dividends are also considered by reference to forecast financial and operational performance to ensure that they would not compromise the future performance of the company.

The dividend yield set out by Ofwat in the Final Determination is also considered. Ofwat acknowledges the role that dividends play for equity financeability³⁷, however at this stage has not set out an expected notional dividend yield for PR24.

The appropriate level of dividend yield for the water sector could be based on an analysis of market benchmarks for (1) the FTSE All Share as a proxy for the wider market and (2) yields implied by listed

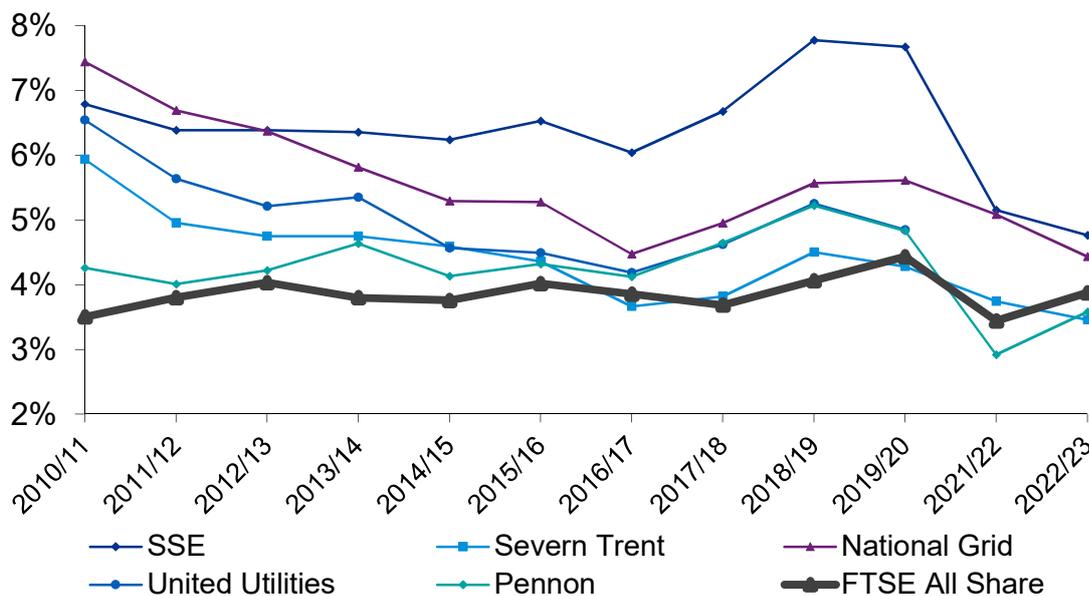
³⁷ Ofwat (2022), Draft methodology – appendix 10, p. 29.

utilities as these comparable companies have similar business characteristics and investor expectations to SEW.

Figure 4 below sets out the dividend yields for the listed UK water and energy companies. These have generally varied in the range of c.4-6%. Specifically, the average UK dividend yield for the listed UK utilities shown in Figure 4 has been c.5.3% for the past 10 years. This is about c.100bps higher than the average yield for the FTSE All Share, which on average implies a dividend yield of c.4%.

Figure 4: Dividend yield in the UK market (Utilities vs FTSE All Share)

Dividend yield - UK Utilities vs. FTSE All Share



Executive pay

Our policy incentivises strong long-term performance, linking executive pay to successful business performance and customer service levels and benefits. This policy ensures that long term customer interests are prioritised. Our policy is kept under regular review by a remuneration committee, which has a majority of independent directors,. Consequently, we do not consider additional regulation in this area to be necessary.

We updated our remuneration policy for PR19 and this was approved by the remuneration committee for AMP7. Our remuneration policy for executive directors and senior managers is based on the following key focus areas:

- Outcome Delivery Incentives (ODIs);
- Responsible business;
- Financial performance;
- Appointed cash receipts and opex;
- Non-appointed operating profit; and
- Personal objectives.

The pay of our executive directors includes a variable component which is based on actual performance against our performance commitments.

Voluntary sharing

New regulation should address a specific market failure. Ofwat has not identified a market failure and as such we do not propose to introduce any voluntary sharing mechanisms at this stage.

Q10.1. Are the PR24 submission requirements clear and sufficiently specified?

Yes, and the guidelines are helpful.

Q10.2. Is any data missing, or included but not required or areas we need to look at again?

This is a broad question. We refer to other answers given in this response document for areas of the methodology where Ofwat need to revise the approach or make changes.

Q10.3. Are the limits on the number and size of documents workable? Should we be more prescriptive in terms of file and folder structures etc?

The limits are workable. This prescription is already greater than in previous reviews. We think this is helpful, but we don't think there is a case for going any further. We are concerned that as "well evidenced" is a much used term in the methodology it is not defined. This has been an issue at previous reviews, where companies have responded to this challenge with volumes of information as there was no limit on this volume. Now the volume has been limited the need to be more specific on the requirements of a well evidenced plan is even greater.

Q10.4 Do our expectations for company board's assurance and governance arrangements provide enough guidance to ensure that boards have sufficient level of 'ownership' and so ensure a high quality submission? [see appendix for details]

We are concerned that there might be a conflict between the required statements and the business plan assessment incentives.

An example of such a conflict might be that Ofwat is insisting that companies should either use Ofwat's assumptions, or to provide "compelling evidence" to support an alternative. The suggestion is that if companies do not do so, then they will fail the quality assessment and be classified as 'inadequate'. However the Board might take the view that Ofwat's assumptions are not within the bounds of what is financeable. If so, then the company will be forced to change Ofwat's assumptions in order to allow the Board to provide the necessary assurance. In such a case, the company might end up failing Ofwat's quality test as a result of trying to comply with the Board assurance requirements.

Q10.5. Do you agree with our proposal to continue to apply revenue adjustments for past performance across all years of 2025-30, after the financeability assessment?

Yes, this is the established methodology, and we are not aware of a strong case for change.

Q11.1. Do you agree with the framework we propose to encourage the best business plans? Specifically, do you agree

- **that we should first assess 'quality' followed by 'ambition'?**
- **with our proposed allocation of rewards and penalties for performance on each?**

In principle, having an assessment process that reviews quality and ambition is reasonable, however this approach only works in practice if the list within the quality assessment represents genuine minimum standards that all companies should reasonably be expected to deliver. The proposed approach does not do this, as it has very prescriptive list of aspects of the price control that companies need to accept, some of which could be considered “quality” and some of which go beyond what could be considered as minimum standards with an inappropriate focus on agreeing to Ofwat’s assumptions. Our significant concern is that this approach forces companies via incentives to adopt Ofwat’s key assumptions removing ownership from companies and restricting their ability to construct a plan in a certain way and in the best interests of their customers. This seems to be counter to previous reviews where innovation was welcomed and we believe has been seen and delivered.

Both quality and ambition are important, but it’s not clear why they need to be assessed separately in a two tier process, unless it is intended to be a mechanism to force companies to accept Ofwat assumptions that it fears will not pass the CMA test.

Q11.2. Do you agree with the proposed scope of our 'quality' assessment? Specifically, do you agree:

- **we should have minimum expectations in the six areas described above?**
- **with the minimum expectations we specify in each of the six areas?**

The six categories are a reasonable scope. We have some concerns about the application of these tests as described above. There is not anything in the minimum standards that are set out, although there is a lack of detail on how exactly these would be implemented – this should be clarified in the final methodology.

Q11.3. Do you agree with the proposed scope of our ambition assessment?

It is not clear why Ofwat have felt the need to be so prescriptive on areas for ambition and quality. In constructing a plan we will always seek to stretch our ambition in the context of the challenges we know we face. We will also seek to ensure the quality provided is sufficient to justify the position we have taken and the level of quality be proportional to the materiality of the issue. Prejudging which elements need to be quality assessed and also excluding some altogether (like approaches to vulnerability) seems to us not to be the right approach. Whilst clarity on the assessment is helpful we prefer less clarity in the knowledge that Ofwat will do an assessment in the round examining costs, outcomes, ambition, and innovation, rather than this somewhat prescribed incomplete list of elements that are likely, if followed by companies, to produce odd assessment outcomes.

Q11.4. Do you agree with our proposed reputational, financial and procedural rewards and penalties, including the overall package of reward and penalty?

The choice of wording for the categories is not well considered, as they are overly critical of the companies and should be considered from the lens of customers and stakeholders in a world where together we need to look to improve the legitimacy of the sector. Over aggressive categorisation and inappropriate wording of that category serves no useful purpose other than to allow Ofwat to look like it's being tough on companies. There are wider more important issues at stake for our industry and that should be considered, both in the area of business plan assessment, but also more widely - as mentioned above in, for example, the CRI deadband.

We don't agree with the idea of featuring the Ofwat category in company literature such as bills and websites unless the categorisation is a fair description arrived at objectively and is appropriately described, which as they stand they are not.

Q11.5. Do you have any other comments regarding our proposed approach to business plan incentives at PR24?

On a procedural point we recommend that the IAP and Draft Determination stages should be separated as this enables a business plan process that allows more dialogue between companies and Ofwat, and is likely to lead to a better outcome for customers.

On sizing of incentives we don't believe there is any need to increase the penalty/reward sizing in this area. Ofwat underestimate the other incentives that are driven just through the categorisation process itself. It is also not appropriate that to achieve the rewards companies must agree with Ofwat's core assumptions (or pass what feels like an almost unachievable compelling evidence test). This feels inappropriate as a regulatory mechanism and puts too much onus on Ofwat being right in its own assessment, as this process in effect significantly reduces the likelihood of a challenge to these assumptions. This doesn't feel healthy as a key component of a regulatory mechanism and we would suggest it be reconsidered, either within the categorisation process, or in the size of the business plan assessment penalties.

QA6.1. Do you have further views on whether the proposals laid out for C-MeX are appropriate?

We have outlined our key concerns in QA 5.4

We are supportive of the retention of the C-MeX methodology and the proposed approach generally. We would like to take this opportunity to continue to remind Ofwat of our concerns in the following aspects:

- The influence of Waste on the overall C-MeX calculation

Whilst Ofwat has reinforced in the methodology that no influencing can be identified in the calculation we feel that any component part of a calculation that relates to a product that we cannot participate in (whether to be influenced positively or negatively) should not be included in the all company calculation and ranking.

Sewerage providers do have the opportunity to change their position, ranking or overall score through the waste component and therefore this will be impacting the overall scores of those companies.

- Impact of local factors

It is clear that regional impacts potentially exist across a number of aspects including;

- Affluence – there is a strong indication across a range of research that the more affluent the customer the more likely to score lower (meaning that the same level of service spend for customers cannot equate to the same satisfaction levels)
- Meter penetration – we believe that the higher the meter penetration the more likelihood of customer dis-satisfaction exists. Metered customers compared to unmetered have a higher likelihood of experiencing a problem transaction e.g. Internal leaks, mis-reads, faulty meters and more complex payment plans compared to unmetered customers – this is a factor not reflective in the current method.

We also have concerns over the proposed removal of Check and Challenge stage of the process.

We continue to hear scores being attributed by customers to the performance of overlapping sewerage companies rather than South East Water and we continue to have these removed on the basis of the customer not actually scoring the water company.

We would be supportive of a more robust approach to quality that will remove the check and challenge process but whilst we continue to see the current level of challenge we would suggest that this be something that Ofwat and the supplier become more engaged with through discussion with companies following check and challenge reviews. This will enable us to remove this process after a focus over the next 2 years.

QA6.2. Do you agree that C-MeX needs to adapt to provide better service to vulnerable and worse served customers?

In terms of vulnerable customers we are supportive of Ofwat's ambitions in this area to better understand satisfaction for this group. South East Water has for several years undertaken a full range of Customer Satisfaction Performance Commitments targeted at such groups and our current surveys provide us a focus on our service delivery for the following customer groups;

- Customers experiencing payment difficulties
- Customers on the companies Priority Services Register
- Customers on the companies Priority Services Register who have had a supply disruption greater than 3 hours

The targeted surveys that we do have been useful to help improve and define our service delivery for these customers and to track improvements. We would therefore raise with you two key difficulties with inclusion within C-MeX that we have found to exist.

- 1) Through establishing standalone surveys we have been able to ensure that a robust sample size is undertaken to represent the voice of these customer groups.
- 2) The second relates to participation for vulnerable customers. Having undertaken these surveys for some time we have identified significant issues with vulnerable customers wishing to participate in these surveys compared to more generic surveys. This is felt to be primarily because of the concern held by many around scams or the desire to enter into conversations with researchers that are not trusted by customers. This can create difficulties in achieving target numbers.

QA6.3. What are your views on our proposal to introduce a single, combined common performance commitment ('BR-MeX') capturing the experience of both end business customers and retailers as intermediate customers?

We are happy with this proposal. This an important part of the regulatory and industry supply chain. It is appropriate for Ofwat to try to capture performance in this area.

QA6.4. Do you consider evidence suggests that the current water supply interruptions performance commitment is inhibiting innovation? If so please provide it.

The interruption performance commitment in our view doesn't hinder innovation. There may be some instances where planned interruptions need to be considered differently to avoid interruptions over 3 hours, but in our experience, this in itself helps drive innovative thinking rather than hinder it.

QA6.5. Do you agree with our proposed definition for the biodiversity performance commitment?

The Biodiversity metric chosen we don't believe is appropriate for this application, as it has been devised for development projects only and therefore has limitations in its coverage of existing assets, we would like Ofwat to consider the use of our own bespoke biodiversity metric (devised in conjunction with Natural England) which builds upon the Defra metric and sets out habitat and species net gain at a level more suited to the purpose of this ODI

We also challenge the assumption that biodiversity net gain is possible on every site, for our sites this is not the case as they have been managed proactively for decades.

It is our view that Ofwat should consider the track record and starting position on biodiversity for each company. Ideally we would like to see a measure which sets out a target across all company land ownership to enable all companies to set out change across the whole estate rather than the use of net gain units which will not take into account work undertaken over many decades, and where companies have very little net gain available on their estate i.e. the metric should be absolute biodiversity no net gain

We request that Ofwat re-considers the use of independent assessors for net gain, we cannot see how this would benefit the customer or environment. Instead, the use of competent/accredited ecologist in combination with assurance is more likely to lead to improved internal expertise, consistency, cost efficiency and improvements to biodiversity over the long term.

Why make changes?

- To ensure that companies who have innovated in this area already are not put at a disadvantage
- To ensure it is recognised that some companies have a low number of biodiversity net gain units per hectare available to them (due to 20+ years of proactive conservation work). Measuring change at both habitat and species level should be considered.
- Allow use of **internal** 'competent and qualified' ecologist as they are more likely to drive innovation, are cost effective and likely to drive wider changes across businesses thus providing a wider environmental and societal benefit

Potential solutions:

- Measure could focus on maximum biodiversity units across a water company estate at a set baseline date
- Potential to then measure % of biodiversity units delivered across estate in hectares – with aim of 100% biodiversity unit delivery over x time.
- Allow ecological staff to undertake assessments provided they are 'competent to do so' and a member of CIEEM. Also ensure that all work is externally assured with Board assurance.

South East Water is a leading performer in this area and has invested in a proactive biodiversity programme for over 20 years. The current metric as devised will put us at a disadvantage as there is little net gain available

QA6.6. Do you agree with our proposal to have separate operational greenhouse gas emissions performance commitments for water and wastewater, which are based on a normalised measure?

Overall, we are minded to agree with Ofwat's approach to separate the PCs.

QA6.7. Do you agree with our proposal that the performance commitment on serious pollution incidents should only apply to water and wastewater companies?

Whilst the EA are now using this measure, in the draft guidance this is only used for wastewater companies (we are a WoC)

QA13.1. Do you agree with our proposed approach to mechanisms at PR24?

On the whole the Price Review mechanisms adopted for PR19 worked well although there was a significant increase in reconciliation mechanisms from previous Price Reviews. We support Ofwat's endeavour to reduce the number of reconciliation mechanisms for PR24.

With respect to the draft financial model we are pleased to see that the inputs section has been rationalised and organised in a more logical design. The overall model looks to be well laid out and should facilitate better understanding of the component processes. It is inevitable that there will be errors, omissions and clarifications needing correction throughout the PR24 process. As part of the final methodology Ofwat should be clear on the channels to be used for this feedback to be circulated and on the timetable of when updates will occur.

RCV feeder model

SEW Closing RCV at March 2025

The projected value of the closing RCV at March 2025 (before midnight adjustments) is an important input to the RCV feeder models and should be sourced from the PR19 outputs, updated for actual inflation where available. As reported in our two recent APR submissions we are concerned that Ofwat is not calculating the RCV correctly when converting from its year average calculation to a year end position.

Ofwat has published its view of Companies RCV taking into account the actual inflation figures for RPI and CPIH. From the calculation file published by Ofwat it is apparent that the RPI component of the RCV has been uplifted from year average to year end using CPIH instead of RPI. Given the difference between RPI and CPIH up to 2021-22 this leads to an understatement of our RCV of c£6m.

We believe that Ofwat should revise their calculation of the published RCV in time for the calculation of the March 2023 RCV which is a key source input for PR24 modelling.

Opex/capex split model/ PAYG model

In our response to Q8.3 on costs recovery we highlighted issues with the calculation of the PAYG ratio at the DD/FD stage. The Opex/capex split model does not always reflect the correct split of the proposed totex allowance, particularly when significant enhancement schemes are disallowed. We believe that closer consultation with companies is required in these circumstances.

DSRA – inconsistency in treatment of NAVs

Ofwat is reviewing the use of the DSRA mechanism which corrects for actual vs allowed numbers of new connections. However the mechanism will be in use for the PR19 reconciliations and we are concerned with the inconsistency of definitions between PR19 documentation, the PR19 Rulebook

and APR Tables. The PR19 documentation³⁸ clearly states that the number of new connections in the mechanism should include NAVs:

For our final determinations, we refine our definition by including the properties connected by NAVs.

Section 2.4 Implementation of that document (p 16) is also clear that NAVs are included in the definition.

The PR19 rulebook references data from the APR tables for use in this field:

#	Input	Description	Source	Units
2	Actual number of connections (AC)	The actual number of new properties connected for the relevant service occurring in charging year	Company's APR. Table 4Q, RAG 4 reference 4Q.3	Number

The APR Table 4Q.3 is clearly labelled to exclude NAVs and the number of NAV connections is not collected in the APR Table 4Q data.

Pro forma 4Q
South East Water

Developer services - New connections, properties and

Line description	Units	DPs	Water	Wastewater	Total	RAG 4 reference
Connections volume data						
New connections (residential – excluding NAVs)	nr	0	8403	0	8403	4Q.1
New connections (business – excluding NAVs)	nr	0	324	0	324	4Q.2
Total new connections served by incumbent	nr	0	8727	0	8727	4Q.3

We believe that Ofwat should correct this mechanism within the PR19 Rulebook when reviewing their final methodology.

RFI mechanism

We believe that the penalties within the current RFI mechanism unfairly disadvantage highly metered companies. A variance of 3% in revenue is much more likely to occur in a company which is almost entirely consumption driven compared to a company which is predominantly unmeasured. It would be a simple addition to the mechanism to have different penalty thresholds for companies over a certain level of meter penetration.

³⁸ PR19 final determinations: Our approach to regulating developer services, p14.

Contact Us

South East Water
Rocfort Road
Snodland
Kent
ME6 5AH

southeastwater.co.uk

Follow us

