Draft methodology for PR24: Southern Water's response

7 September 2022

WATER for LIFE

from Southern Water

1.Introduction

We are pleased to provide our response to Ofwat's draft methodology for PR24.

We welcome the overall direction of travel within the draft methodology, including the simplification of areas of the review and the greater emphasis on the long term and the creation of environmental and social value. However, taken as a whole, the proposals in the draft methodology appear to be too focused towards short-term bills, and fail to recognise the challenges and uncertainties the sector faces in a changed political and macro-economic environment.

The unprecedented level of external scrutiny the sector as a whole is experiencing currently as a result of greater data transparency, while uncomfortable, has shone a welcome light on the challenges we face, and action is now demanded to make improvements. Significant investment will be needed to meet these customer and stakeholder expectations, while addressing the challenges of climate change which are being experienced more frequently. At the same time, the wider economic climate our customers are experiencing is the most challenging in a generation.

To ensure we deliver a sector that keeps pace with expectations of today's customers is a multi-agency challenge which requires joined up solutions. It is clear that the level of environmental investment required at PR24 will be significantly greater than at PR19. Therefore, it is vital that PR24 delivers the outcomes, innovation, and resilience that our customers, community and environment require, whilst balancing this ambition with sustainable bill increases.

To meet this challenge will require creativity and innovation across costs, outcomes, and funding. We are pleased that Ofwat is keeping an open mind about how we might together meet this challenge. As a contribution to this debate Southern Water has recently published a report considering different tariff options and how water charges might be more progressive. At a time when the sector is facing existential challenges, it is critical that the final methodology for PR24 strikes the right balance between clear objectives which meet customers' expectations, and ensuring that companies can face into the current uncertainty with enough operational and financial flexibility.

We have set out below our thoughts on what we see as the key issues raised by the draft methodology. Additionally, we have used Ofwat's response template to provide answers to all of the consultation questions. We welcome the opportunity to discuss any aspect of our response further with Ofwat.

2. Key issues

2.1 Overall balance of risk and return

Ofwat's primary duties are to ensure that a company can finance its functions and to protect the interests of customers, as well as ensuring that the functions of water companies are properly carried out, while furthering the resilience of water and sewerage systems. There is inevitably a strategic choice to be made in executing these duties and Ofwat must strike a balance between setting sufficiently challenging targets – for costs, outputs, and returns – and ensuring that the package 'as a whole' is deliverable and provides sufficient funding for the proper carrying out of the water industry's statutory functions. We would welcome further discussion between companies and regulators as to how best to approach this. The increased focus on long-term delivery strategy is helpful but there remains an increasing amount of statutory scope to be delivered in AMP8. We estimate that the potential investment required to meet the Government and stakeholder's ambitions across nutrient neutrality and reducing harm from Combined Sewer Overflows could be 50% greater than our entire AMP7 WINEP programme.

At PR19 the balance of risk was excessively skewed to the downside and, based on AMP7 performance to date, has resulted in the sector as a whole struggling to meet the final determination cost allowances, to deliver common performance commitments, and earn base allowed returns. This imbalance was reflected in the fact that an unprecedented number of companies sought a redetermination of Ofwat's decisions at the CMA and received materially higher revenue allowances as a result.

The imbalance in outcomes is stark in relation to ODI performance. For the 10 common performance commitments set at PR19, companies are forecasting a net penalty for the AMP of £334m[1], with the sector as a whole earning outperformance rewards (totalling less than £7m) for just two of the 10 common ODIs. This position is masked by some companies outperforming on bespoke ODIs, which is unlikely to be the case in AMP8. At the same time, for the first two years of the AMP companies have spent £164m[2] more than allowed in the final determination.

Given the challenges faced by our sector, we remain concerned that the draft methodology fails not only to address this imbalance but adds further asymmetric risk. This imbalance risks undermining the level of investment required and the necessary resilience of such critical systems. In particular, the following features of the draft methodology give rise to significant additional risk:

- An expectation that further service level improvements are deliverable with no incremental funding, on top of those which must be delivered in AMP7. Ofwat's risk analysis fails to account for the challenge as it assumes that, on average, companies will meet these targets. As evidenced by the expected AMP7 performance described above, this is not a reasonable assumption without proper funding to meet targets.

[1] Based on data from Tables 3a and 3b of the 2021-22 Annual Performance Report
[2] Based on data from Table 4C of the 2021-22 Annual Performance Report

- Ofwat is proposing to remove a number of risk mitigants, such as deadbands, and caps and collars on ODIs (see below) which means that companies are vulnerable to the impact of outlier events, which are typically skewed to the downside. ODI targets should represent a P50 probability to maximise the incentive properties, not be an almost certain penalty. Equally the framework exacerbates the position of 'winners and losers' rather than encouraging catch up and more dynamic competition on ODI performance. Enabling ODI penalties to be reinvested into service delivery rather than discounts would benefit the sector as a whole with the same economic effect on underperforming companies (see our proposals on this aspect below).

- The proposal to continue to not index Retail costs represents a significant risk for companies, given the more volatile inflationary climate we are experiencing.

- Stretching assumptions on the level of additional productivity gains – over and above those required to deliver service improvements – which are not supported by the evidence of productivity gains delivered in other sectors. Even using Ofwat's PR19 approach to determining the level of frontier shift, which was also broadly followed by the CMA, the comparator data would suggest that the scope for productivity gains is in fact lower than at PR19[3].

- Further methodological changes to the calculation of the cost of capital which do not reflect the careful considerations of the CMA in this area (see below). This has been estimated to reduce the WACC by 80bps. This is inconsistent with Ofwat's financial resilience ambitions and licence modification proposals. This would increase the likelihood that the notional company would not sit comfortably above a Baa2 credit rating.

- A proposed approach to assessing financeability which, while it may improve financeability on a notional basis, fails to reflect the reality of companies' financing requirements, and may mask a reduction in financial resilience, particularly around the need for consistent levels of annual cashflow.

- A funding regime for capital maintenance that results in water mains replacement rates being ten times lower than the European average and the rate of sewer replacement being just a third of the European average (see below). Whilst there are positive statements within the draft methodology it is unclear whether this will ensure a sustainable rate. This is vital - our sector faces significant additional pressures from increasing customer, political and stakeholder expectations alongside climate change causing more extreme and variable weather conditions.

In the final methodology we would like to see more robust quantitative analysis of the risks faced by the sector, underpinned by realistic assumptions and evidence concerning companies' ability to deliver more for less in a world of higher service expectations and more volatile climate.

2.2 Performance commitments and ODIs

As per our previous consultation responses, we support the proposal to consolidate the number of performance commitments, which at PR19 had reached unsustainable and unmanageable levels. In our case, we currently have a total of 47 performance commitments to manage, which means that incentive properties are diluted.

[3] Frontier Shift at PR24: Response to Ofwat draft methodology Reference, Economic Insight, September 2022

We agree that many issues are best dealt with outside of the price control through monitoring and annual reporting rather than through performance commitments, but it is important to ensure that the price review deals with those matters requiring funding – or alternative in-period funding mechanisms are put in place.

Customers' preferences for the core service that they receive are reasonably stable over time and across companies, and it is right that the performance commitment regime should be focused on these areas. We also welcome the commitment to retain broadly the same set of performance commitments over multiple AMPs. This supports longer-term, more sustainable investment in service level improvements, in favour of shorter-term operational fixes. We agree that the bar for bespoke performance commitments should be high and focused on significant local priorities or areas of poor performance. However, there is also a need to look at some performance commitments and decide what target level of performance is 'good enough' given the multiple pressures on totex spend. For example, water supply interruptions has an end of AMP7 target of five minutes. This compares to the current electricity distribution network performance of 33 minutes and gas distribution network performance of 10 minutes (off a largely replaced iron network funded through customer bills over the past 20 years). Setting ever tighter standards across all performance metrics is counter-productive and should be tested in the customer research Ofwat is leading.

One of the key benefits of a smaller, more focused set of performance commitments is the ability to compare performance between companies. In this respect it is essential that these common PCs are supported by a regular and robust horizontal audit process to ensure that performance is being reported on a completely consistent basis, or else targets must be adjusted to take account for differences in reporting scope. As Ofwat is aware, we have specific concerns about the consistency of reporting of pollution incidents, where our own approach of counting both incidents identified in real time, and through additional historical spills data analysis is materially broader in scope than the approach used by other companies. We have already engaged with both the EA and Ofwat on this. In such circumstances it would be unreasonable to set a common target without taking account of these inconsistencies, and Ofwat should start collecting shadow information at the earliest opportunity to create a consistent baseline for AMP8 performance targets.

There is a case for reconsidering how performance commitments are described to stakeholders. With stretch targets which take the sector to levels of performance not previously achieved, it is unhelpful in terms of public perception to then report companies as 'failing' to meet targets, even when performance is improving significantly. In addition, as many more performance targets will be exposed to the impacts of climate change and extreme events, reconsidering how overall performance is assessed and reported is essential to retain customer trust in the sector.

Finally, we have been giving consideration to how ODIs might be re-invested in service improvements to enable lagging performers to catch up with their peers. Such re-investment would only be allowed where it was demonstrably new investment and was supported by customers, in preference to what can often be small bill reductions to an individual customer. Such a mechanism would avoid the risk that the ODI penalty regime reinforces a cycle of underperformance where the gap between the best and worst performers grows over time. Such a mechanism would also give customers a genuine say in how the money was re-invested. We attach a short note which sets out some initial thoughts on how such a mechanism might operate that ensures shareholders are no better off under the arrangement.

2.3 Removal of ODI caps and collars

The underlying purpose of ODIs is to incentivise performance improvements, not to increase or decrease ex-ante sector returns in aggregate, introduce exogenous risks or reduce financial resilience. We welcome Ofwat's stated commitment to greater symmetry in relation to ODI under- and outperformance payments. However, Ofwat proposes not to use deadbands for any performance commitments and intends that ODI caps and collars are used only on a targeted basis, such as for new or bespoke performance commitments. We do not support these proposals. We believe there remains a good case for retaining such risk mitigants (whilst preserving the incentive powers of ODIs), especially for those performance commitments that are subject to significant downside risk from weather-related events, in order that the overall package of incentives is appropriately balanced. This is required because many ODIs have a natural asymmetry. The risk of material penalties is far greater than the prospect of material rewards and these risks should be mitigated through regulatory design in order to not increase overall asset risk or create financeability problems.

Taking water supply interruptions as an example – benign weather can reduce the number of incidents that a company has to manage but is highly unlikely to result in sustained and material outperformance of stretching targets. On the other hand, severe weather events, of which we are seeing more each year, can result in significant penalties. Indeed, as service targets get tighter, we are increasingly seeing that a single severe weather event is the difference between meeting and not meeting interruptions targets. This was the case for example in February/March 2018, when the severe freeze/thaw event on its own added five minutes to our interruptions metric and resulted in a penalty which we would not have otherwise incurred.

Similar considerations in relation to the balance between the probability of out and under-performance apply to internal and external sewer flooding, mains repairs, pollution incidents, bathing water quality.

We agree with Ofwat that companies can and should strive for resilience and seek to mitigate the impact of external factors such as weather events, on customers. But companies should not be expected to manage, or for shareholders to fund, all such risks; the investment required to entirely mitigate all weather risks would be unaffordable when added to other pressures and is not reflective of customers' willingness to pay. Companies have not historically been funded to do mitigate all weather risks and it has previously been accepted that some events are outside of reasonable company control. This was reflected in weather exclusions from historical service level targets (e.g. sewer flooding which had well-defined severe weather exclusions) and in the statutory Guaranteed Standards Scheme, which contains exclusions for severe weather in respect of standards for keeping appointments, interruptions, and internal and external sewer flooding, as well as restrictions for other events beyond company control.

If caps, collars and deadbands are not retained to mitigate these types of risks, we suggest that Ofwat put in place a mechanism to exclude certain events as part of its annual in-period determinations of ODIs. In such cases the onus would be on companies to demonstrate that they had done all that they reasonably could do in the circumstances in terms of minimising customer impact. Where Ofwat was satisfied that all reasonable steps had been taken then the event would be excluded from the calculation of any in-year ODI outperformance and underperformance payments.

2.4 CRI and treatment works compliance

Closely related to the above arguments around symmetry, we are particularly concerned that Ofwat proposes that targets for both the Compliance Risk Index (CRI) and Treatment Works Compliance performance commitments be set such as to allow for zero failures – with the CRI target proposed to be set at zero and the compliance target at 100%.

While we recognise that these represent the performance that the sector should be aspiring to, it is not reasonable to expect perfect performance on average. As noted above, the sector has never historically invested, been funded nor operated on the basis of a zero-risk, zero-failure regime. This means that, unless it provides significant new funding and a glidepath to these targets, effectively Ofwat is imposing an aggregate penalty on the sector every year, using ODIs as a tool to lower returns.

To illustrate this, in Tables 1 and 2 below we show the data for each measure for the last five years and the number of companies that would have avoided an ODI penalty in each year.

For CRI, this shows that the average performance over the five years was 2.96 with upper quartile performance averaging 1.13. Over the five years from 2017 to 2021 only one company, in one year, would have avoided a CRI penalty under Ofwat's proposals for PR24.

Table 1. CRI performance 2017-18 to 2020-21*

Year	Average CRI score	Upper quartile CRI score	Number of companies avoiding a penalty
2017	3.19	1.25	0 of 20
2018	3.44	1.25	0 of 21
2019	2.67	0.83	0 of 20
2020	2.28	1.41	0 of 18
2021	3.24	0.90	1 of 17
Average	2.96	1.13	-

* Data for all large water companies (excluding NAVs) published by DWI

Similarly, for discharge permit compliance (based on wastewater treatment works compliance), in three of the five years from 2017 to 2021 all companies would have incurred an ODI penalty with a single company avoiding a penalty in each of the two remaining years.

Table 2. Compliance performance 2017-18 to 2020-21*

Year	Average compliance %	Upper quartile compliance %	Number of companies avoiding a penalty
2017	98.3	99.0	0 of 9
2018	98.8	99.1	1 of 9
2019	98.5	98.8	0 of 9
2020	99.1	99.6	0 of 9
2021	98.7	99.0	1 of 9
Average	98.7	99.1	-

* Data for the nine English WaSCs published by Environment Agency

Such blanket penalties across the sector would not only represent an unreasonable skew in the risk profile of the final determinations but would risk unnecessary and unwarranted harm to the reputation of the sector, at a time when it is under significant public scrutiny. Furthermore, since CRI is a risk-based measure and most failures result in no customer detriment, the proposal would incentivise companies to invest to deliver a level of resilience that customers do not support.

We suggest that a target of zero for CRI and 100% for treatment works compliance is retained, but with a deadband such that each company has a stretching but achievable chance on aggregate of avoiding penalties over the five-year period, consistent with the funding regime.

Alternatively, if Ofwat continues to believe that a penalty for anything other than zero failures in these two areas is essential then we would suggest that the penalty is set on a progressive basis, with a penalty rate that is modest for performance within the historical deadband levels but increases with worsening performance.

2.5 Introduction of 'DPC by default'

We support use of Direct Procurement for Customers (DPC) where it adds demonstrable value for customers and the environment, either in the form of innovative solutions and/or greater cost efficiency.

In that respect we welcome the proposal to increase the threshold for DPC schemes to a whole life cost of greater than £200m, meaning that a smaller number of very large projects will qualify. We agree that raising the threshold makes sense in terms of focusing on the higher value opportunities, given the level of fixed costs (both financial and non-financial) for companies and bidders.

However, we do not support the proposal that DPC should be considered the default solution regardless of the value for money assessment of projects. Ofwat suggests the DPC by default assumption is important as it is only possible to assess value for money by putting projects out to tender. We accept that if the value for money assessment is marginal then it would be sensible to pursue DPC to a further level of development. But where there is unambiguous evidence from a robust value for money assessment that DPC will not deliver benefits for customers, then it cannot be right for Ofwat to require customers to pay the significant costs of taking such schemes to the tender stage. Such an approach would give the impression of prioritising the means over the end.

We would suggest instead that there should be early engagement with Ofwat on candidate DPC schemes, with decisions on whether these are funded within price limits or taken forward through DPC taken in advance of business plan submissions based on the probability of the DPC route delivering material benefits for customers and/or the environment. Given the scale and bespoke nature of these projects, we also consider it would be helpful to decouple projects over £200m from the time-constrained and standardised price review process and rather assess them through RAPID (or an equivalent process). This allows for a more tailored assessment process and avoids large projects being delayed until funding is secured via the price review.

2.6 Capital maintenance funding

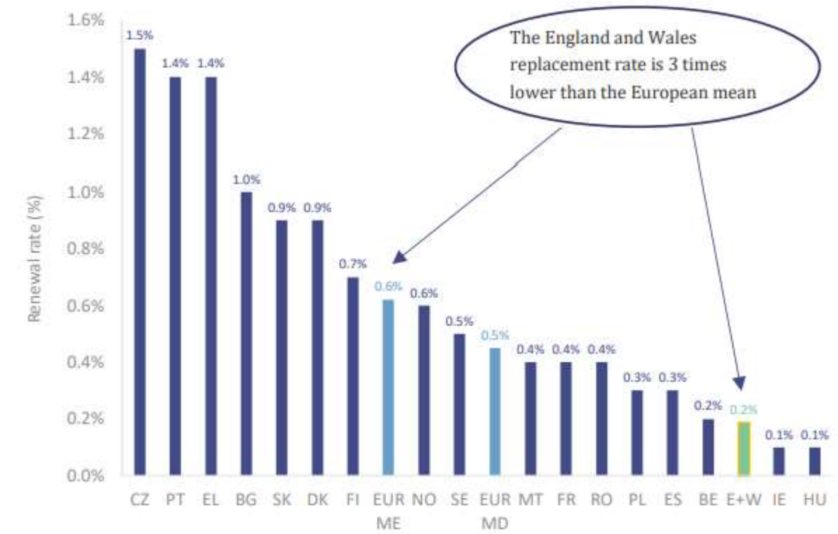
We are pleased to see that Ofwat proposes to include more of a forward-look in its base expenditure modelling and is open to considering the need for a step change in capital maintenance expenditure. We do not underestimate the difficult in estimating the 'sustainable level' of asset replacement as it is a function of multiple factors, including asset age, asset condition and replacement rates. Nevertheless, the evidence that the current rate of asset replacement is inadequate is overwhelming.

Water UK recently published a paper[4] which set out clearly the size of the challenge we face in getting to a sustainable level of asset maintenance and replacement. Figure 1 below from the Water UK paper shows that the rate of water mains replacement is just a tenth of the European average rate, while the rate of sewer replacement is only a third of the European average.

[4] Options for a Sustainable Approach to Asset Maintenance and Replacement | Water UK

Figure 1: Rate of replacement of water mains (see notes for time period)

Figure 2: Rate of replacement of wastewater mains (see notes for time period)



Source: Water UK

In the final methodology we would like to see Ofwat take a more systematic approach to getting the sector to a more sustainable level of asset maintenance, by clearly signalling that it recognises the need for change and providing a clear framework for companies to present the case for more investment. Such a framework should clarify whether asset replacement rates over the long term meet Ofwat's criteria of an 'endogenous driver in the long term' and, therefore whether this can be part of the evidence base to substantiate cost claims, calculate implicit allowances and make symmetrical adjustments. The proposed approach, which relies on the cost adjustment process and evidence of changes in exogenous factors during AMP8, is not adequate to address the pressing need for a step change in capital maintenance funding.

The Water UK paper sets out some modest, low regret proposals for facilitating the required step change at PR24, using specific asset maintenance outputs combined with Price Control Deliverables. Longer term, incorporating asset maintenance within the Long Term Delivery Strategy plans would provide a robust framework for determining long-run asset maintenance needs, including investment to manage new and increasing risks. A targeted customer protection that Ofwat could consider is whether to have totex cost sharing rates for capital maintenance of zero for underspending capital maintenance and 50:50 rate for overspending (i.e. any underspend is fully returned to customers whilst overspend is shared). This protects against the incentive to overbid and underspend, whilst still keeping an incentive to invest efficiently. Given that capital maintenance information is already reported through the regulatory accounts, there is no additional burden to introducing it.

The use of forward-looking data in base cost modelling can be a step forward towards accounting for a step change in capital maintenance. However, this depends on how the forward-looking data will be used in base modelling. In the final methodology, we would like to see clarity on how Ofwat plans to use forward-looking data.

2.7 Funding for service improvements – 'what base buys'

We are pleased to see that Ofwat proposes to consider more consistently the link between service levels and totex allowances. It is important to recognise that if productivity improvements are used to drive service quality this will reduce the scope for cost savings and that savings from productivity gains are relatively small compared to the costs of adapting and enhancing service to climate change pressures. It is not clear from the draft methodology that Ofwat recognises this important trade-off.

When setting what base buys it is important to ensure that a comprehensive assessment is provided. This needs to include the baseline for net zero commitments so that all service improvements, including delivering net zero, are transparent and their funding requirements measurable. In particular, the assumption that net zero can be delivered without significant additional funding is wrong and runs counter to the UK Committee on Climate Change and National Infrastructure Commission's analysis.

Ofwat needs to examine for each performance commitment the extent to which the assumption that improvements can be delivered without enhancement expenditure holds, and over what performance range. We consider that Ofwat should assess each performance commitment against the following set of questions:

- How are service improvements typically delivered? i.e. what are the physical interventions available to companies.
- Is incremental expenditure usually required to improve service?
- What level of service is 'good enough' relative to other priorities?
- Is there a limit to what can be delivered through process improvements without further investment?
- What is the economic level of service beyond which the costs outweigh the benefits?

Such an approach would be consistent with that taken by the CMA who recognised that leakage was an example of an area where both (i) additional funding was required to deliver improvements and (ii) consistent with the logic of diminishing returns, reductions become more costly as performance levels improve.

It also needs to carefully consider those new performance commitments, for example in relation to storm overflows, where improvements of the level required to meet Defra's targets will need to be funded principally through enhancement expenditure.

In terms of setting targets for what can be delivered from base expenditure we agree that it is sensible to take account of what has been delivered historically by the sector. In extrapolating from this historical improvement trend, given the level of uncertainty and the principle that companies should have a 50:50 chance of meeting the targets and thus earning a fair return, Ofwat should base the rate of improvement on either the median, or the upper quartile performance of a single company over a multi-year period (rather than that of the upper quartile performance data points on a single year basis). For example, at PR19, the upper quartile best performance at any point over the past 5-10 years was used set to performance targets. Given this could be impacted by unusually favourable weather conditions, it didn't represent what an actual upper quartile company could consistently deliver.

If we look at water supply interruptions from 2015-16 to 2021-22 (recognising some data gaps in the time series), the upper quartile based on all data points was 6.1 minutes, whereas the upper quartile based on the company in upper quartile position over that whole timeframe (Wessex Water) was 9.0 minutes. Looking at the multi-year performance of companies gives a more accurate view of what an upper quartile company can consistently deliver. This would eliminate any single year effects of weather (in this case 2 of the 6 years contributed around half of the data points for upper quartile based on all the data points).

Finally, it is important that, where Ofwat is switching from a company-specific target to a common target (internal and external sewer flooding and water quality contacts), Ofwat considers the need for a glidepath to the new level of performance. It would be clearly wrong for a company to hit its 2024-25 company-specific target, then have to deliver an infeasible step change in a single year to meet a commonly-derived 2025-26 target.

2.8 Approach to risk/reward and financeability

Overall, we disagree with Ofwat's approach on risk and reward. Given the challenges the sector is facing, this is perhaps the most concerning aspect of Ofwat's draft proposals.

Ofwat is explicitly proposing to put at least as much return at risk for PR24 as at PR19[5]. As such, we expect (absent observed market changes) the allowed return for PR24 to be at least equal or more than that for the PR19 determination. Indeed, as noted above, much of the regulatory framework along with the broader macro environment suggest the need for a higher return.

The approach to estimating the required returns for the sector was analysed, scrutinised, and debated in detail through the CMA PR19 re-determination process. However, Ofwat is proposing to materially deviate from the CMA's approach. Each one of Ofwat's proposed methodological changes results in a lower estimation of the required return whilst at the same time increasing the underlying asset risk through an ODI package skewed to the downside and with a larger magnitude.

We recognise that over time there may be scope for improvements to calculation methodologies. However, Ofwat is proposing approaches that adjust downwards every single parameter. This does not, on the face of it, appear to be in line with a regulator seeking to identify the most robust calculation methodology – this approach risks minimising short-term bills at the expense of longer-term financial sustainability.

The CMA's approach at PR19 provided a balanced set of returns for water companies. Given the extensive debate that took place in the CMA reaching its conclusions, there needs to be a high evidential bar for Ofwat to propose any material deviations to the established approach.

We summarise below some of our headline views on each of the key parameters.

[5] Consulting on our methodology for PR24 – Pg. 88 – *"We consider that, based on our current policy positions, our overall package at PR24 is likely to put at least as much return at risk as at PR19"*

Cost of equity
Ofwat's proposed approach will (all things being equal) lead to a reduction in the estimates for each of the following parameters feeding into cost of equity estimates:

Risk free rate
Ofwat assumes no long-term difference between the two measures of inflation after 2030 and deviates from the 1% RPI-CPI wedge in PR19; this is incorrect and not in line with market reality. Ofwat is also proposing to draw on gilt yields as the primary source of evidence for the risk-free rate and not considering AAA bonds/index and convenience yields/uplifts, which results in relatively lower estimate of risk-free rate as compared to the CMA's PR19 methodology, where a broader range of sources provide a better and more balanced estimate for the risk-free rate.

Total Market Return (TMR)
Ofwat's proposal of only using the CPIH series for deflating the historical TMR fails to consider relevant data-points from the RPI series and thus creates an unjustified bias. Ofwat also deviates from CMA's methodology in averaging, wherein the CMA used arithmetic averages and considered overlapping and non-overlapping estimators of returns over 10- and 20-year holding periods. The CMA decided on inclusion of the non-overlapping estimator after significant deliberations and discussions - "in the range of reasonable TMR estimates, rather than to exclude some of these estimates as to do so may risk 'cherry-picking' data."[6] The CMA methodology rightly considered a range of approaches, whereas Ofwat's proposed approach has just proposed a single approach.

Beta
Ofwat has proposed adopting a new method for estimation of beta to make CAPM-WACC calculation fully invariant to gearing. The approach involves back-calculating the debt beta from the actual expected cost of new debt using the CAPM formula. Ofwat's illustrative solution produces a debt beta of 0.22, which is much higher than the CMA's suggested debt beta with an upper bound of 0.10. In addition, Ofwat is proposing to use data since COVID, which may be skewed by this atypical event.

Asymmetric risk adjustment
The CMA's re-determination of PR19 provided an uplift of 25bps to account for investment incentives due to parameter uncertainty, financeability, and asymmetric risk on ODIs (including possible changes in forward-looking risk exposure). However, Ofwat is proposing to enforce a higher evidential bar to deviate from the cost of equity returns (only limited to Market-to-Asset Ratio (MAR) cross checks). This is despite Ofwat's proposals that would make the regulatory framework more asymmetrically skewed to the negative.

Cross Checks
Ofwat is also considering using MAR analysis for cross checking the mid-point estimate of CAPM derived cost of equity. MARs are driven by a wide range of factors, and very limited data points, so provide limited insight into the required cost of equity.

Cost of debt

Cost of embedded debt
Ofwat's proposed approach is unduly selective in terms of the instruments included within the sector average. Ofwat is proposing to exclude swaps and junior debt from the sector average calculation. Both represent important data-points in calculating the actual cost of debt and were previously included by the CMA within its sector average calculation (adjusting for specific elements which may skew the data). There is no clear rationale for deviating from the existing methodology.

[6] CMA (2021), PR19 FD, para. 9.333

Ofwat will also need to be more transparent on the averaging methodology for calculating the sector average cost of embedded debt (including on which companies will be included and the averaging methodology).

Ofwat is proposing to implement a full transition to CPIH indexation by the start of AMP8 which will create RPI-CPIH basis risk across the price control period. However, Ofwat has not indicated or provided for how companies can manage the mismatch between assets which will be fully linked to CPIH and liabilities which are predominantly linked to RPI. As of today, index-linked debt market for CPI remains small and for CPIH non-existent. It will be important to price in management of basis risk at PR24 to ensure NPV neutrality – particularly as a change in regulatory policy (transition to CPIH) has introduced new risk to the price control which companies cannot manage without cost.

Many companies will need to rely on swaps to manage basis risk. However, as above, swaps are not recognised in the draft methodology for setting the allowed cost of debt at all. Particularly with the accelerated CPIH transition, treasury management-related derivatives should be supported and reflected in cost of debt allowances.

Cost of new debt
In the PR19 re-determination, the CMA concluded that outperformance against the iBoxx A/BBB 10 years+ index is primarily driven by two factors - credit rating and tenor. The CMA recommended that lower tenor in isolation is not sufficient to justify an outperformance wedge. 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 more volatile interest rate environment.

Issuance and liquidity costs
Ofwat has proposed a 10bps allowance for issuance and liquidity costs for PR24. This approach does not appropriately price the RPI-CPIH hedging risk introduced by Ofwat's full transition to CPIH whilst most of the index-linked debt in the sector remains RPI-linked.

<u>Financeability</u>

We disagree with Ofwat's proposals for assuming a notional gearing of 55% (compared with 60% at PR19) for the purposes of undertaking its financeability assessment. The average gearing for water sector companies is close to 70%. The notional company would therefore be significantly departing from what is observed in the market, when there is no evidence that the notional company at 60% gearing is inefficient.

Ofwat has indicated that notional gearing might be assumed to have reduced as a result of high inflation. However high inflation also results in high cost of debt due to index-linked debt on company balance sheets. Higher accretion on index-linked debt can have a negative impact on cost of debt performance and in particular on metrics assessed by credit rating agencies – in particular S&P metrics such as FFO/net debt. As a result, high inflation in current market conditions cannot be seen as a basis for implementing changes to the notional company. It would be wrong for the regulatory framework to incentivise de-leveraging within the regulatory ringfence as this could constrain new capital available for much needed investment.

By reducing the allowed cost of capital and increasing risk in other parts of the regulatory framework, Ofwat would be reducing the financial resilience of the sector. However, by changing the set of assumptions on the notional company, Ofwat would materially offset the observation of this reduction of resilience in its financeability assessment. This undermines the purpose of a financeability assessment. Financeability challenges cannot and should not be assumed away by changing the notional company.

It is vital that PR24 has a meaningful financeability assessment. Should the sector appear to not be financeable, then this should act as a cross-check on the allowed cost of capital. This should stand both for credit rating agency metrics, and measures of equity financeability.

In September 2021, a fund managed by Macquarie Asset Management acquired a majority stake in Greensands Holdings Limited, the holding company of Southern Water, via a £1.073 billion injection of new equity, including £530 million invested as new equity into Southern Water. The injections have given Southern Water the additional funding required to accelerate improvements in both operational and financial performance. Whilst these injections have materially improved Southern Water's financial resilience, it cannot be assumed that unbounded equity injections will continue, particularly in the context of a lower allowed rate of return.

Ofwat's framework assumes equity would be raised to deliver large increases in RCV whilst at the same introducing a framework that lowers base equity returns alongside a totex and ODI package that could deliver negative returns for underperforming companies. Relying on equity injections at the scale Ofwat infers would only work if there are positive returns to equity over the timeframe of investment with a reasonable degree of certainty.

Overall, the price control framework needs to reflect an appropriate package of risk and return for investors, and that marginal equity contributions are able to achieve an appropriate positive return on equity taking into account the impact of ODIs and totex sharing.

We urge Ofwat to reconsider its approach to estimating the required rate of return, balance of risk/reward in its ODI package and its approach to assessing financeability. Not doing so could result in the sector not being able to raise the capital required to deliver against the unprecedented investment requirements that we now face.

2.9 Removal of flexibility around run-off rates

With significant new investment needs in AMP8, combined with other acute pressures on household budgets, ensuring that bills remain affordable for all customers will be one of the biggest challenges for PR24. Ofwat intends to set out in the final methodology a narrow band within which companies' run-off rates must sit. While we understand that Ofwat is concerned about the apparent wide range between companies' run-off rates, by seeking to constrain rates to a narrow band Ofwat is removing one of the key tools available to manage both customer affordability and ensure cashflows necessary to secure credit ratings.

While we agree that companies should clearly explain their proposals, given the level of pressure on AMP8 bills, we would urge Ofwat to take a pragmatic approach to this issue and allow companies greater flexibility to manage AMP8 cashflows and bill pressures.

2.10 Enhancement expenditure assessment

We welcome Ofwat's commitment to funding best-value rather than least-cost solutions, where these deliver quantifiable benefits to customers, which they are willing to pay for. However, given the level of enhancement expenditure that is likely to be required at PR24, we would like to see more detail on how Ofwat will assess the efficient level of spend and more guidance on its expectations for high quality enhancement business cases.

There may also be a need to consider additional uncertainty mechanisms in a number of areas, where the requirements may change rapidly (see for example the clear demand for action on overflows leading to new Defra targets for reducing harmful spills and the recent strengthening of requirements in relation to nutrient neutrality). It is important that the sector has sufficient agility to respond to these changing expectations without needing to wait for the next price review. Mechanisms such as the Green Recovery Fund could provide such a route, but should be fairly open to all companies with a focus on levelling up performance for those customers receiving the poorest service, rather than reinforcing extra spend for those companies already outperforming.

3 Conclusion

PR24 represents an opportunity for the sector to make significant progress in addressing the key challenges it faces. Whilst we support Ofwat's ambition and direction of travel, we have concerns that when taken together, the level of stretch applied across costs, outcomes, and risk and return could undermine this progress. We share Ofwat's desire for a resilient sector, however this requires careful calibration of the overall price review package. This is particularly pertinent when considering Ofwat's proposals to increase the licence "cash lock up" provisions to Baa2 (negative). These proposals could appear inconsistent, with the PR24 methodology and subsequent Final Determination increasing overall risk and potentially eroding financial headroom.

We would urge Ofwat to consider carefully how the final PR24 methodology can support the sector in meeting the challenges it currently faces and ensures that companies have sufficient operational and financial flexibility to meet stakeholders and customers' evolving expectations for the sector.