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7 September 2022

Dear Aileen,

SEVERN TRENT'S RESPONSE TO THE DRAFT PR24 METHODOLOGY CONSULTATION

I welcome the opportunity to respond to Ofwat's consultation on the draft methodology for PR24. This is an important step towards delivering the investment the Midlands needs to secure its water and wastewater services for the long-term.

In our response we have highlighted some changes we think would help achieve a better outcome for customers and the environment, starting with the inclusion of past performance in the business plan incentive tests.

The sector is facing unprecedented scrutiny, with an enormous focus on the use of storm overflows, the ecological status of our rivers and more recently the use of hosepipe bans and leakage performance – all occurring at a time when the country is facing the biggest reduction in real pay in over a century.

If the sector is to restore trust, it is critical that companies not only focus on the 2025-30 period but also their performance today.

At Severn Trent we have stepped forward with ambitious pledges on rivers, a £30m package of affordability support and a commitment to below-inflation bill increases next year. At the same time we are displaying responsible financial behaviours and delivering excellent service for our customers and the environment – evidenced by our top ranking on the Environmental Performance Assessment (EPA) and in Ofwat's service delivery and financial resilience reports.

We note that a number of companies, such as Anglian Water, have also stepped forward, setting out ambitious commitments to support the environment and customers. However there remains a significant gap in performance across the sector, which needs to be narrowed if we are to restore trust. We therefore think it is critical that Ofwat deploys all its tools to drive performance today – namely the PR24 framework and in particular the inclusion of a past performance test in the business plan incentive.

The incentive power of the price review is one of the strongest tools Ofwat has available to it. We urge Ofwat to **include past performance in the PR24 business plan incentive**. Not to do so would be a huge, missed opportunity and could, depending on the outcome of the PR24 business plan assessment, potentially embarrass the sector. It does not seem credible that Ofwat could reach an overall assessment of a company's business plan without considering past performance. We consider Ofwat could reinstate the test on past performance simply, using metrics Ofwat already captures, for

example, the proportion of PR19 performance commitments (PCs) a company has delivered, the Environment Agency's EPA ratings and the financial resilience metrics Ofwat considers in its annual financial resilience report. We suggest Ofwat should also consider companies' pledges to improve river quality and their delivery of them as part of a past performance test.

We think Ofwat could go further and innovate in relation to the past performance test. Ofwat could create a separate pathway through the PR24 process for those companies that are doing the right thing, creating a large procedural incentive for companies to improve current performance. This pathway could involve, for example, an early and accelerated process for considering cost adjustment claims and bespoke PCs.

Alongside the inclusion of past performance in the business plan incentive test, we think there are other areas where the PR24 methodology could be amended to deliver better outcomes for customers and the environment over the long term:

- We consider there would be large benefits to customers from **reinstating the fast-track process** from the previous two price reviews. The draft PR24 timeline means that Ofwat will receive business plans on 2 October 2023 and provide its first views on the business plan incentive alongside the draft determinations in spring 2024, which could be as late as May. As a result, it could be seven to eight months before Ofwat communicates its views to companies on their business plans compared with just over three months at PR14 and just over four months at PR19. The fast-track process, with early feedback from Ofwat, enabled the fast-tracked companies to start delivering on their business plan commitments for customers and the environment much more quickly than would otherwise have been the case.
- In our view Ofwat should **keep the notional company assumptions the same as at PR19** to provide stability for investors and the sector. In relation to **notional gearing** we recognise Ofwat is trying to improve the financial resilience of the sector. In our view, a much better approach to discourage high gearing would be to have penalties for high gearing rather than making changes to the notional company, which affect all companies. We consider Ofwat should continue with 60% notional gearing for PR24, which is consistent with Ofgem's recent draft determinations for the electricity distribution companies. However, if Ofwat is going to reduce notional gearing, we think 2.5 percentage points should be the maximum reduction, in keeping with the reduction made at PR19 that took into account the costs of reducing gearing.

We do not support an increase in **the proportion of index-linked debt assumed for the notional company** from its current 33% because we think it will increase costs for the sector. Index-linked debt markets tend to be less liquid and more expensive than nominal debt markets, with investors usually requiring a "linker premium", which can be at least 10-15 basis points. In addition, we consider that by increasing the proportion of index-linked debt for the notional company, Ofwat is encouraging lower interest payments in the short term and deferring the cost of servicing debt onto future generations of bill payers.

Moreover, our analysis of index-linked debt ratios at 31 March 2022 shows that the weighted-average ratio of index-linked debt for water companies, after excluding those companies with whole business securitisation (WBS) structures (who carry higher ratios of index-link debt in order to secure better credit ratings at elevated levels of gearing) is around 39%, close to the

level assumed at PR19. Given Ofwat's concerns about WBS structures we consider Ofwat should take the average for non-securitised companies as its reference point, which suggest no change is needed from the current 33% assumption. We also note that Ofgem used 25% recently for electricity distribution companies and 30% in 2020 for electricity and gas transmission companies.

If Ofwat does decide to increase the proportion of index-linked debt in the notional company we suggest that Ofwat moves it moderately (say, by at most 5 percentage points) to preserve the stability of the notional company assumptions over time. We consider Ofwat should provide an allowance for the cost to companies of increasing their index-linked debt. We note as well that the efficient way to increase index-linked debt is very likely to involve swaps; the index-linked debt market is simply not big enough for companies to maintain a higher proportion of index-linked debt higher without the use of swaps. The use of inflation swaps will introduce new risks which will need to be carefully managed.

- In our view Ofwat should **make the proposed degree of stretch across the whole of PR24 more realistic and make incentives more symmetrical**. The level of stretch in company efficiency Ofwat is proposing across all elements of PR24 combined looks unachievable, even for the best performing companies. Ofwat is considering: a more stretching catch-up efficiency benchmark than upper quartile; a high level of frontier shift when productivity growth across the economy has been low since 2010; unfunded improvements in many service levels from base costs; no inflation link for the retail business (which becomes a particularly unreasonable and arbitrary efficiency challenge at times of high inflation); and no deadbands on compliance PCs, when for example, the DWI has stated publicly this is unrealistic for the Compliance Risk Index (CRI). Combined with asymmetric incentives, such as smaller rewards for good business plans than penalties for poor plans, the overall degree of stretch could put even the best performing companies into persistent penalties.

To provide a more realistic overall stretch on company performance we suggest Ofwat should keep to no more than an upper quartile catch-up efficiency challenge, link frontier shift to economy-wide data since 2010, require only a reasonable level of service improvements from base costs, index-link the retail price control (which Ofwat is doing for the business retail market) and provide deadbands for compliance PCs. This would still enable Ofwat to push hard for efficient investment in areas like storm overflows, water resources and net zero. We also suggest Ofwat should make its incentives symmetric, for example D-MeX and the business plan incentive.

- We consider Ofwat should **increase the scope for customer influence over companies' business plans and PR24**. We recognise that Ofwat wants to standardise more aspects of the price review across companies but we strongly disagree that all companies should only have up to three bespoke PCs. We suggest a simple improvement Ofwat could make would be to increase the number of bespoke PCs to three per service (i.e. six for a water and sewerage company and three for a water only company) to give the customers of water and sewerage companies the same influence over business plans as customers of water only companies, whilst still delivering on

Ofwat's ambition to reduce the number of PCs overall. It will also allow for more innovation to inform Ofwat when it is developing PR29.

Having focused on the areas where we are suggesting change, we also want to express our support for a number of areas in the methodology. For example:

- We support Ofwat's **four themes for PR24** of: focusing on the long-term; delivering greater environmental and social value; reflecting a clearer understanding of customers and communities; and driving improvements through efficiency and innovation. These align well with our company purpose of "taking care of one of life's essentials" and provide a welcome emphasis on securing services for the future.
- We support **the continuation of the outcomes framework**, which has delivered large benefits for water customers. A [report](#) we sponsored by Fast Track Squared estimated that Ofwat's outcome delivery incentives (ODIs) have delivered net benefits of between £850m and £1.3bn to customers and the environment over its first six years. This is equivalent to £32-£54 per customer.
- We support companies placing their five-year delivery plans in the context of a **long-term delivery strategy (LTDS)**, which should ensure companies' long-term investment plans are appropriately phased. The LTDS process is complex and we would like to see decisions based on the substance rather than the technicalities of the LTDS model. This is needed to make sure important investments for our customers and the environment are approved.
- We applaud Ofwat proposing more certainty on the funding of **nature-based solutions** over the long-term, although we are providing more detailed comments in the annexes to this letter.
- We broadly welcome Ofwat's proposals on funding to deliver efficiently on the government's **net zero** targets.
- We welcome Ofwat proposal to allow companies to request additional enhancement allowances to go further than the Water Industry National Environment Programme (WINEP) on reducing the average number of spills from **storm overflows**.
- We support the **open challenge sessions** Ofwat is proposing for January-June 2023 and October-November 2023. We think they will encourage more engagement on companies' business plans from stakeholders and customers, which is important for a vital service. We consider they will be most effective if they are held in person, with executive team attendance from companies and Ofwat to show senior-level ownership of the business plans and commitment to the PR24 process.
- We welcome Ofwat recognising the **important role of dividends** in equity financeability. We support Ofwat's approach that companies are responsible for their dividend policies and that companies' dividends should reflect how well they deliver for customers, communities and the environment over time.

We hope Ofwat will consider the improvements we are suggesting (we have summarised them in annex 1). As a leading company Severn Trent is looking forward to submitting a high-quality and ambitious business plan next year and we hope the PR24 methodology will provide appropriate incentives for us to do so.

There are three annexes to our response:

1. Annex 1 is attached to this letter and summarises the main improvements we are asking for in the PR24 methodology.
2. Annex 2 is the Ofwat spreadsheet response template. Ofwat has asked us to say whether we strongly agree / agree / neither agree nor disagree / disagree / strongly disagree in column I. Our spreadsheet contains a lot of disagrees because the questions cover complex and wide areas and it is hard to agree with every element.
3. Annex 3 covers comments we are making on the draft PR24 methodology in more detail, that are not covered in annex 2.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Shane Anderson', written over a light grey horizontal line.

Shane Anderson
Director of Strategy and Regulation
Severn Trent Water

Annex 1 – Changes we are proposing to the PR24 methodology

Our main proposals to improve the PR24 methodology are:

1. Include a current / past performance test in the business plan incentive tests.
2. Introduce a fast-track process into the PR24 business plan assessment process.
3. Maintain notional gearing at 60%.
4. Maintain the notional proportion of index-linked debt at 33%.
5. Use no more than upper quartile for the catch-up efficiency challenge.
6. Link frontier shift to economy-wide data since 2010, rather than previous years.
7. Require only a reasonable level of service improvements from base costs.
8. Index-link the retail price control.
9. Make the business plan incentive symmetric.
10. Provide deadbands for compliance PCs.
11. Allow six bespoke PCs for WaSCs and three bespoke PCs for WoCs.