

To: David Black, Chief Executive, Ofwat

By email: PR24@ofwat.gov.uk

7 September 2022

Dear David

We appreciate the opportunity to provide feedback to Ofwat on its Draft Methodology for the PR24 price review. Given the current focus on the water industry, on the impacts of climate change, and on the economic outlook, PR24 will be absolutely critical both in terms of maintaining trust in the sector and ensuring the sector is fit for the long-term.

In our view the draft methodology for PR24 provides a sound basis overall for reaching settlements with companies for 2025-30 that will tackle these challenges. It builds on the approach taken at PR19, which is to be welcomed, whilst also introducing changes that address some of the lessons of past reviews, notably seeking in some areas to simplify and streamline the process and the regulatory framework. There is a potentially significant change to the regulatory approach to bioresources, but the details are not yet clear. We will be responding in detail to the Ofwat consultation on that topic in due course.

Ofwat will retain a significant degree of discretion as to how it applies the approach in terms of the decisions and judgements that are made across a range of areas. In order to get these decisions right, in the best interests of customers and the environment over the long-term, we would urge Ofwat to ensure there are opportunities within the process for companies and Ofwat to exchange views and information on key issues. This will be particularly important in the absence of the IAP stage, which provided valuable feedback for companies at PR19.

We support the four themes that Ofwat has set out for PR24, particularly delivering greater environmental and social value, which, together with climate change adaptation, are perhaps the most prominent challenges for us in Wales. We welcome the proposals on nature-based solutions, resilience, and reducing greenhouse gas emissions. We also believe it is right that companies should have performance commitments to underpin commitments to improve river water quality and reduce the impact of storm overflows.

We are acutely conscious of how the current cost of living crisis, combined with the economic downturn, is likely to affect our customer base, particularly given the relatively high prevalence of economic deprivation in Wales. This, set against the challenge of investing to deliver

environmental improvements against the background of climate change, poses an acute dilemma for the PR24 business plan to achieve the right balance between bills and appropriately prioritised investment. This is why the PR24 Forum and the collaborative process in Wales offers such a valuable opportunity to build a consensus around the way forward, while ensuring stakeholders work together to deliver the best possible value for people and the environment in Wales.

The uncertainty that exists with regard the implementation of the Single Social Tariff is a particular concern for Welsh Water given the large proportion of our customer base that rely on a social tariff to make their bills affordable. At PR19 Ofwat recognised the obligation the company had to continue to support our existing social tariff customers by increasing the RCV run-off rate to allow the company to make a company contribution whilst maintaining financeability. In the absence of detail on the scale of support and transition arrangements of any Single Social Tariff, if implemented, it will be important to recognise in our determination the ongoing obligation on Welsh Water created by our existing social tariff provision.

We set out in the template our answers to the detailed questions, as well as our comments on the proposed set of common Performance Commitments and the draft tables. We would like to highlight here a few of the more significant points.

Business Plan Assessment

In terms of the price review process, we were disappointed to see that the Initial Assessment of Plans stage is being dropped. We can see some advantages of a more streamlined process, but we risk losing the opportunity to have feedback from Ofwat on our plans before they are finalised, and also to have visibility as to how other companies have responded to the challenges posed by Ofwat in the methodology. The proposed approach could work if there are robust mechanisms to support engagement of companies with Ofwat between the Business Plan submissions and the Draft Determinations. (At PR19, while the IAP provided useful feedback, this was only one-way feedback, and the opportunity for dialogue with Ofwat on substantive matters came very late in the process, following the Draft Determination.) An Ofwat-company engagement process is only hinted at in the Draft Methodology. We suggest that companies should be provided with more detail on this, and the process must be open and fair. The Draft Determination should be a truly 'final draft', such that there are no further changes in Ofwat's decisions, judgements or methodologies that cannot be considered by companies and stakeholders before the Final Determination.

Retail indexation

Our view is that the lack of inflation indexation for the retail expenditure allowance imposes an arbitrary efficiency challenge that lacks economic justification. While inflation remained low, this was something that companies could live with, but as inflation rises above 10%, this approach is both unreasonable and unsustainable. We believe a better approach would be to allow for CPIH

indexation of retail, and then pose an efficiency challenge based on a 'catch up' efficiency and a reasonable 'frontier shift', supported by sound evidence.

Relationship between RPI, CPI and CPIH

The previously stable relationships between movements in the RPI, the CPI, and the CPIH have broken down in the current inflationary environment. This has implications for the calculation of components of the WACC, but the consultation is largely silent on this. As Ofwat is planning to publish an early view of the WACC with the final methodology in December we recommend a further informal consultation on this area during the autumn.

Common performance commitments

In our detailed response we make a number of points concerning the proposed common performance commitments, mostly those relating to the environment, owing to the different policy and/or legislation in Wales. In particular, the proposed common industry measure counting absolute numbers of CSO spills does not align with the approach being taken by the Welsh Government and the Better River Quality Taskforce here in Wales, and we are already working with stakeholders and regulators to put forward an alternative. We also propose to retain our current measure of river water quality, 'KM of river improved', as the most appropriate measure for Wales, instead of focusing narrowly on Phosphorous discharges. These and other common PCs will be a topic of discussion at a forthcoming PR24 Forum meeting.

Outcomes and ODI framework

We remain of the view that Ofwat's approach to efficiency and performance improvements effectively 'double counts' productivity improvements. Ofwat's approach looks at the Total Factor Productivity (TFP) trends in the wider economy, which considers both inputs (costs), and outputs (performance). It uses this to determine an appropriate productivity 'frontier shift' for the water industry, and applies it in full to companies allowed costs, without allowing for the fact that companies are also improving their performance. That is, Ofwat takes a TFP calculation based on both inputs and outputs, and applies it to just company inputs while ignoring changes in company outputs.

It appears that the ODIs framework will be significantly skewed to the negative side, partly due to the nature of the performance commitments, and partly due to the removal of deadbands. This was a concern at PR19 and some changes proposed for PR24 reinforce this. Many performance measures are naturally limited on the scope for 'upside' performance (for example, you cannot do better than zero on CRI, supply interruptions or pollution incidents), but have no natural limit on the 'downside' (where extreme weather can have a big impact). The ceiling/floor on ODI outperformance or underperformance payments, at an overall level, is too high/low to be provide any significant mitigation at the level of individual measures. We would expect the stretching

nature of performance targets to provide further limits on the 'upside' scope for companies. The removal of deadbands for compliance measures also skews the framework towards the negative. Taken together, the overall negative asymmetry on ODIs is likely to be significant for companies, and if these features are retained, should be recognised and corrected for elsewhere in the regulatory framework, such as in the determination of the required return on capital.

Performance and productivity

The methodology sets out that Ofwat generally expects companies to be able to improve performance from base expenditure. While some incremental improvements may be possible from a tighter management focus and adopting best-practice operational methods, in general the assumption of 'free' improvements is appealing but may prove optimistic. Any significant 'improvements from base' will not be possible unless the level of base expenditure increases. We would therefore suggest that the focus in the price review should be on setting base allowances sufficient to be able to maintain performance over the long-term, while providing efficient enhancement funding to increase capacity and resilience against the threats of climate change.

Customer engagement

Finally, we welcome the shift in the approach to customer engagement and the principles Ofwat set out on this area of the price review in its earlier publications. In our view the methodology for the collaborative ODI rates research relies on some major assumptions and has not been used before, so we would urge suitable caution in interpreting and applying the results of that study. Our concerns with the ODI rates methodology include its reliance on just two 'anchor' valuations from which all other valuations are derived. We are following with interest the ongoing work on the development of the common approach to affordability and acceptability testing of business plans. We think it is important to keep an open mind as to how the approach is applied, and how the results are interpreted and applied in the price review, in view of the fundamental difficulties in applying a single approach fairly across the industry.

Again, overall we found much to welcome within the draft methodology and look forward to further engagement with Ofwat as it finalises the outstanding issues and considers responses to the consultation.

Regards



Eleri Rees

Strategy and Regulation Director