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24 May 2019

David Black
Senior Director
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Dear David

We welcome the opportunity to make representations to Ofwat on the Draft Determinations for the Fast Track companies: Severn Trent Water, United Utilities and South West Water. The three principal areas of concern are:

1. the approach to the determination of efficient expenditure – cost assessment;
2. the calculation of 'upper quartile' targets for three common performance commitments; and
3. matters related to risk and return.

While these methodological areas need to be logically scrutinised one by one, the Draft Determination is in the end a 'package', and therefore we also comment on the combined impact of Ofwat's draft decisions.

Cost assessment

We have welcomed Ofwat's open and consultative process in developing its cost models. On the wholesale side, the final models appear successfully to have delivered on the principles and aims agreed with the industry for the cost modelling process. We pointed out some flaws and errors in the models in our IAP response and we think that given the difficulties in modelling base expenditure, the results need to be treated with caution. However, our main concerns are not with the models themselves, but with associated issues such as the assumptions on the applicable ongoing productivity gains, the allowances (or lack thereof) for Real Price Effects, and the impact of the 'totex and outcomes framework'. On the frontier shift, specifically:

- The assumption of a 1% per annum total factor productivity shift for the water industry is at odds with current evidence and the views of institutions such as the Bank of England and the Office for Budget Responsibility on the trend in the wider economy;
- Even if 1% was the generalised rate of productivity growth in the wider economy on *average*, it is far from clear that this same rate can legitimately be applied to the *frontier* in the water industry;
- Historical evidence that might support a 1% ongoing efficiency factor relative to RPI would in any case not support a 1% ongoing efficiency factor relative to CPIH, which is what Ofwat appears to have suggested;

- In proposing a 1.5% efficiency frontier shift, Ofwat does not have regard to the expected improvements in service that Ofwat is expecting at the same time, suggesting that the effective efficiency frontier shift is significantly higher than 1.5%;
- Ofwat has decided to make no allowance for Real Price Effects, which in effect pushes the 'efficiency frontier' out further; and
- The assumption of a 0.5% efficiency 'gain' from the totex and outcomes framework is not backed by sound evidence.

We also take issue with Ofwat's approach to business rates. Ofwat does not take account of any business rates revaluations in AMP7. We believe that the impact of these can be reliably forecast and should be included in Ofwat's assessment.

On the retail side, while the proposed models are an improvement on a simple unit cost approach, they are objectively less robust than on the wholesale side - the cost models have a large range of residuals, particularly on the bad debt models, and may be influenced by differing accounting practices between companies. As a result, we would urge caution in the way Ofwat applies the models. Further, we believe that Ofwat's approach to forecasting the efficiency frontier using forecast business plan data is unsound (Oxera suggest that the data used is not supported by Ofwat's own cost models) and contrary to regulatory practice (Ofgem tested whether historical cost models supported the use of forecast data in RIIO-ED1, and chose in the end to consider only a historical benchmark).

Ofwat have made no allowance for expenditure required to improve performance commitment levels to the improved targets allowed in the plan. This approach is inconsistent with other aspects of Ofwat's methodology. Enhancement 'spend' is not included in the historical base costs used for cost modelling, so Ofwat's approach to one aspect of the price review (cost modelling) is at odds with its approach to another (enhancement expenditure allowances). It is also at odds with Ofwat's promotion of cost-benefit analysis and customer engagement (including Willingness to Pay) as a means of determining the appropriate targets, and does not give appropriate regard to both companies' different 'starting positions' and different historical patterns of allowed enhancement expenditure.

Performance commitments

In common with all companies at the IAP stage, the draft determinations expect companies to work to standard 'calculated upper quartile' targets for supply interruptions , pollution incidents and internal sewer flooding , plus a common deadband for tap water quality (CRI). While comparative benchmarking can be used as one of a range of tools for assessing companies' performance commitments, this should be done in conjunction with other methods to help make meaningful and appropriate comparisons. Indeed, Ofwat's PR19 final methodology asked companies to take into account considerations such as customer priorities and valuations, historical performance trends, and the maximum achievable improvement.

There are two principal weaknesses in Ofwat's approach to this part of the price review: the logic of using companies' business plan targets as the basis for setting the 'upper quartile' targets, and the rationale for applying a common target to all companies regardless of circumstances.

On the first of these, Ofwat has not taken sufficient account of the differing bases on which different companies set their business plan targets. Companies took different stances with regard to Ofwat's guidance requiring companies to set targets at 'at least forecast upper quartile levels'. Ofwat also did not make an assessment of the deliverability of companies' proposed targets, nor of the differing levels of enhancement spending included in companies' business plans on which the targets were based. It then calculated the 'upper quartile' of these business plan numbers as the basis for a common industry target.

Secondly, unlike in the field of cost assessment, Ofwat has not reflected the fact that companies are located in different operating environments, are subject to different constraints and trade-offs, and have had very different patterns of historical expenditure. It has also been shown that there are significant differences between customer priorities in different regions. Further, we continue to argue that it is inappropriate to give the anticipated performance of a small company such as Portsmouth (with very particular operating circumstances) the same weight as Yorkshire or Thames when determining the 'upper quartile' for the industry.

This approach therefore risks setting targets which, in some company circumstances, are not *stretching yet deliverable*.

Crucially, these two issues of cost assessment and performance targets have largely been addressed separately by Ofwat, and then combined in the draft determinations. Given that the upper quartile companies on cost are not at the upper quartile on performance and vice versa, the determinations in effect set companies the challenge of going beyond 'combined upper quartile' performance when taking the two elements together. We do not believe that this gives a sustainable result.

Risk and return

As a consequence of Ofwat's approach to assessing cost assessment and performance as discussed above, the draft determinations have significant implications for the way that companies are financed and assessed in terms of the risk and return for shareholders. Ofwat's analysis (see page 14-15 of Severn Trent Water draft determination, for example) shows that the RORE range is skewed asymmetrically, with the downside risk significantly higher than the likely upside. This is unsurprising in the light of Ofwat's approach to setting targets and expenditure allowances, as discussed above. Ofwat has not yet updated its view of the allowable WACC but this 'downside asymmetry' of the RORE range means that the required WACC that would render companies notionally financeable will be higher than would otherwise be the case. Allowed returns influence credit ratings, and credit ratings in turn influence companies' ability to access capital from financial markets. There is a real danger that further credit rating downgrades would increase borrowing costs, which in the medium term could mitigate against the bill reductions for customers that Ofwat is seeking.

In sum, considering each of the three areas discussed above *separately*, Ofwat has chosen extremely 'challenging' positions. What is more, when extended across *all* elements of the price review and viewed in the round, the approach as applied to the draft determinations runs the risk of producing results that may not be achievable or sustainable in practice.

Yours sincerely,

Mike

Mike Davis

Director of Strategy and Regulation