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Summary

Water UK is the representative body and policy organisation for water and wastewater service providers across the UK.

We recognise the significant effort that Ofwat has expended in the PR19 process, and the improvements in transparency and engagement compared to previous reviews. The open and inclusive process taken to developing the PR19 methodology was appreciated by companies, including the invitation to the industry to put forward thinking via the marketplace for ideas¹.

This submission considers a number of issues raised in the References from Ofwat and the Main Party Submissions. In doing so, we are conscious that these issues are relevant not only to the four price determinations which have been referred to the CMA, but also to the future price determinations for all water and wastewater service providers in England and Wales, to their customers, and to the environment.

An overarching point is the need for a long-term orientation not just in strategies but also in implementation and decisions in price reviews. The need for this approach to infrastructure sectors such as water is widely recognised. The UK Government², Welsh Government³, National Infrastructure Commission⁴, National Audit Office⁵ and the Chair of the Environmental Audit Committee⁶ have all highlighted the need for actions to be taken in the context of a long-term approach. Ofwat's strategy⁷ has a long-term orientation, and this is also seen in other nations of the UK, for example in recent decisions by the Water Industry Commission for Scotland⁸.

¹ <https://www.water.org.uk/policy-topics/improving-services-for-customers/marketplace-for-ideas/>

² <https://www.gov.uk/government/publications/strategic-policy-statement-to-ofwat-incorporating-social-and-environmental-guidance>

³ <https://www.assembly.wales/laid%20documents/gen-ld11283/gen-ld11283-e.pdf>

⁴ <https://www.nic.org.uk/assessment/national-infrastructure-assessment/reducing-the-risks-of-drought-and-flooding/>

⁵ <https://www.nao.org.uk/report/water-supply-and-demand-management/>

⁶ <https://www.parliament.uk/business/committees/committees-a-z/commons-select/environmental-audit-committee/news-parliament-2017/chair-writes-to-defra-chairs-comments-19-21/>

⁷ <https://www.ofwat.gov.uk/wp-content/uploads/2019/10/Time-to-act-together-Ofwats-strategy-1.pdf>

⁸ https://www.watercommission.co.uk/view_Press_Releases_2020.aspx?ArticleId=259

In Scotland, the water sector has faced essentially the same challenge as elsewhere in the UK of balancing the need to invest in order to deliver long-term priorities with an understandable desire to minimise the impact on customers in the short term. It is notable that there, the approach⁹ has been to recognise that to meet long-term priorities, charges will need to increase by at least 1% and, potentially, up to 2% above the rate of Consumer Price Inflation (CPI), with a key driver being the need over time to reach a sustainable level of asset replacement¹⁰.

The key in future will be for aligned long-term strategic intentions to flow through clearly and consistently into implementation and decisions in all parts of the UK, ensuring future price reviews are not missed opportunities. Below, we expand on some of the key issues that we believe the CMA should consider as part of its deliberations in order to help ensure that this is the case. We may wish to follow up with further observations after consideration of the most recent submissions by Ofwat and others.

Resilience

PR19 was the first price review to be fully carried out within the context of the sector, and specifically its economic regulator, having a statutory primary duty to secure long-term resilience¹¹. Stakeholders have been clear that the case for improving long-term resilience to drought and floods is compelling. This is both to improve the resilience of service to customers and to avoid customers facing higher bills in the future from deferring resilience investment to future periods (see for example the National Infrastructure Commission¹²).

The sector is facing significant challenges arising from climate change, population growth and other matters. The impacts of these challenges on water companies are dynamic and varied – and by definition, the past is unlikely to be a good guide to the future.

In this context, it would be beneficial for there to be a greater distinction in practice, as well as in theory, between the respective roles of Price Reviews and the Water Resource Management Process (WRMP). In the future, this distinction will also be important in relation to the new, broadly corresponding, process for the long-term planning of wastewater services, Drainage and Wastewater Management Plans.

Our understanding is that the policy expectation, as set out for example by the UK Government, is that WRMPs determine the ‘need’ for investment, while price reviews determine the best value way to meet that defined need over the long term:

‘We expect Ofwat to recognise the need for investment in solutions to balance supply and demand and achieve the level of service that is set out in final water resources management plans. We also expect Ofwat to continue to challenge companies to meet that need in a way that represents the best value for money over the long term, including through the price review. Ofwat should work closely with the Environment Agency and use its role as a statutory consultee

⁹ <https://www.watercommission.co.uk/UserFiles/Documents/2021-27%20FDP%20Prospects%20for%20Prices.pdf>

¹⁰ https://www.watercommission.co.uk/UserFiles/Documents/2019%20Asset%20Replacement_Final.pdf

¹¹ <http://www.legislation.gov.uk/ukpga/2014/21/section/22/enacted>

¹² <https://www.nic.org.uk/wp-content/uploads/NIC-Preparing-for-a-Drier-Future-26-April-2018.pdf>

on water resources management plans to enable it to recognise future investment needs, in line with its statutory duties'¹³

We suggest that the CMA should consider carefully the extent to which this policy expectation has always been met in practice. In particular, when determining the appeals for the referred price determinations, the CMA should ensure that the investment needs set out in the companies' respective Water Resource Management Plans are fully included in the redeterminations.

Customer engagement

As the challenges faced by companies, and customer views, are not homogenous across England and Wales, regional customer insight into these challenges and how to respond to them is crucial to informing decisions at price reviews. Companies carried out extensive customer engagement activity related to PR19 – including consulting with more than 1.5 million customers¹⁴, with oversight and scrutiny from Customer Challenge Groups (CCGs). This represents a significant step up from the equivalent activities in PR14 (when Ofwat described companies' engagement with more than 250,000 customers as the biggest-ever customer conversation in the utilities sector¹⁵).

The role of customer engagement in determining outcomes – and the role played by CCGs – was independently reviewed¹⁶ in 2015 following the last price review, PR14. This aim of this was to help to create conditions in which customer engagement and customer preferences would more clearly and decisively shape future price controls to the benefit of all parties in the process.

Three possible models for PR19 were set out, ranging from CCGs being consultees but decisions being firmly for regulators, to CCGs having a progressively greater role with greater benefits for customers.

It seems to many companies that despite the significant step up noted above, customer engagement, and the views of CCGs, have again been shown to have played a limited role in final decisions at PR19, with other sources of evidence such as the regulator's comparative assessments given more weight.

Risks for future price reviews include that if different regional customer preferences with respect to service and investment to address long term challenges are disregarded, and if members of CCGs are unclear on whether their inputs into the process will have a meaningful impact on outcomes, then both customers and CCGs can be expected to be less willing to participate in future price reviews – compromising what we believe to have been a key and positive development in the last decade of water sector regulation. When determining the appeals for the referred price determinations, the CMA should place the greatest proportion of weight on the companies' customer engagement and the views of the CCGs.

Disconnect between cost assessment and service levels

¹³ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661803/sps-ofwat-2017.pdf, paragraph 13

¹⁴ <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Overview-of-final-determinations.pdf>

¹⁵ https://www.ofwat.gov.uk/wp-content/uploads/2015/10/det_pr20141212final.pdf

¹⁶ <https://ukwir.org/new-report-on-the-future-role-of-customer-and-stakeholder-engagement-in-the-water-industry>

In competitive markets, there is a relationship between cost to serve and the level of service provided to consumers, with markets typically segmenting between low cost 'no frills' offerings and higher cost fuller service offerings.

In contrast, Ofwat's approach to PR19 assesses costs with no consideration of service levels – and assesses service levels with no consideration of cost implications. The result of these separate assessments is an assertion that the cost of achieving step changes in performance rarely if ever seen in the sector, for example on leakage, can be met from allowed base costs and further assumed efficiency gains. This creates a significant downward skew to the risks facing all companies, which is particularly stark where steep glidepaths are required to meet new performance levels.

If the additional costs of achieving a step change in performance levels were not explicitly recognised, an alternative would be to explicitly recognise the additional efficiency challenge required to absorb the additional costs required to deliver improvements in performance levels.

Risks for future price reviews include the effective further erosion of resilience in the sector to shocks such as those it is seeking to cope with now. Furthermore, it would be a fundamental change to the incentive properties of the regulatory regime if it continues to be asserted (without robust economic assessment) that step changes in performance can be delivered without additional cost. When determining the appeals for the referred price determinations, the CMA should ensure it includes the additional costs required to deliver improvements in service.

Efficiency assumptions

Companies recognise that the regulatory regime should spur greater efficiencies and incentivise innovation to deliver those efficiencies, However, overly aggressive assumptions on the scale of the achievable sector-wide frontier shift and efficiency gains, for example from treating econometric models as being deterministic rather than a guide to decision-making, result simply in the erosion of resilience in the sector to manage shocks.

Financing the sector

In this submission, we will not enter the debate on specific parameters for the capital asset pricing model, which is well covered by others. We would however make the following observation: the degree of stretch being placed on the financeability of the sector is demonstrated by the near uniformity of company responses to the Draft Determinations that without change those Determinations would be unfinanceable (while recognising there was some movement in the Final Determinations), and by the extensive use of 'pay as you go' levers that are disregarded by credit ratings agencies.

This stretch is driven by the combination of simultaneous pressure on costs, outcomes, risks and returns. It risks eroding the long term investability of the sector as one with a reasonable prospect of an appropriate balance of risk and returns, potentially resulting in shorter-term perspectives from investors.

Avoiding this outcome is all the more important given the scale of investment that will be needed over the coming decades to address the challenges from climate change and growth that are recognised in the various strategies mentioned above, and which is expected to be privately funded. A further risk is the erosion of the headroom needed for the sector to be resilient to shocks, such as the significant effects of the current COVID-19 pandemic on the sector.