from Southern Water

Mr Kip Meek
Inquiry Chair
CMA

Date
15 May 2020

[redacted]

Sent by email : waterdetermination2020@cma.gov.uk

Dear Mr Meek

This letter is in response to your invitation to comment on the four references from water companies to the CMA for a redetermination following Ofwat's 2019 price review (PR19). This response is written on behalf of Southern Water Services Limited, a water and wastewater company, providing essential services to over four million customers in Kent, Sussex, Hampshire and the Isle of Wight.

As I believe it will have been for many companies, accepting Ofwat's PR19 Final Determination was a finely balanced decision for Southern Water. The decision of our Board not to seek a redetermination was based on careful analysis of Ofwat's decisions and consideration of our ability to deliver for our customers within the financial and operational parameters set by Ofwat. It also reflected our specific circumstances, being part way through a significant and necessary company-wide transformation and the benefits that will deliver for customers, and weighing this against the significant draw on management time that an appeal would have represented. Our acceptance of the determination should not therefore be interpreted as accepting that Ofwat had, in all cases, arrived at the correct balance of costs, outcomes, and financeability.

It is for this reason we have chosen to make this submission. In our business plan we sought to carefully balance the affordability of our services, with the need to tackle long-term challenges such as climate change and population growth which our customers asked for. Our plan delivered very significant improvements in service to customers and the environment, enabled additional investment to start to tackle some of the long-term challenges and delivered bill reductions of 3%. While it is right that Ofwat should challenge companies' plans on behalf of customers, Ofwat's policy choices have ultimately led to an AMP7 package that appears to be skewed towards short term bill reductions with bills across the sector falling by an average of £50, or 12%, before inflation[1]. This followed a

[1] PR19 final determinations: Overview of companies' final determinations, Ofwat, December 2019

5% reduction in bills at the previous price review (PR14)[2] and flat bills at the 2009 review[3]. The level of efficiency challenge set by Ofwat at PR19 to support such bill reductions is beyond what is reasonably achievable in the time period, with implications for our ability to invest to deliver the necessary step change in resilience in light of the challenges we face.

The CMA's judgement on these key industry issues and how to strike the right balance between customer bills and investment to deliver more resilient service will play a vital role in shaping the next price review for the period 2025-2030. Below, we expand on some of these key issues that we anticipate the CMA will wish to consider as part of its deliberations.

Resilience

In its Strategic Policy Guidance to Ofwat4, Defra set out its priorities for the sector as securing long-term resilience and protecting customers. The National Infrastructure Commission has highlighted the importance of, and the economic case for, a more resilient water sector5. In the region we serve, twenty-five years from now we will have lost a third of our water sources through climate change, seen a reduction in the amount of water we are allowed to take from rivers and underground sources, and our population will have grown by 15%. The resilience of their water supply and wastewater service is a key priority for customers. Ofwat's approach does not, in our view, give sufficient weight to the need to invest to address these challenges. In a sector with long-life assets, which can have very long delivery lead times, we risk missing a key opportunity to implement a long term strategy for the benefit of customers at a time when interest rates are at their lowest levels. Whilst Ofwat has allowed for some increases in the level of enhancement expenditure compared to previous periods, its base cost allowances are derived from backward-looking econometric models that do not adequately capture how different the future will be. For the next price review it is important that Ofwat develop tools and assessment methods that are better able to capture these forward-looking challenges, such that companies can make the investment that is needed to address them.

In considering the resilience of the sector we would also emphasise the broader ecosystem that Ofwat's Price Review process is a part of, including the Water Resource Management Plans, and in the future Drainage and Wastewater Management Plans. Whilst we welcome the establishment of the Regulators' Alliance for Progressing Infrastructure Development

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[2] Setting price controls for 2015-20 – overview, Ofwat, December 2014

[3] Future water and sewerage charges 2010-15: final determinations, Ofwat, December 2009

[4] The government's strategic priorities and objectives for Ofwat, Defra, September 2017

[5] Preparing for a drier future, NIC, April 2018

(RAPID) that includes Ofwat, the Environment Agency, and the Drinking Water Inspectorate, we keenly await the CMA's assessment of whether the "need for investment" as established by these plans has been adequately reflected in Ofwat's Price Review funding. Ofwat is uniquely placed to take a broader cross-company perspective on resilience, working within the context of regional plans, to deliver a more resilient water and wastewater sector. This will be critical for us at PR24 and beyond as we consider the supply demand challenges that lie ahead in the South East of England region. Ofwat's econometric, company-by-company approach misses this opportunity at this price review.

We would also highlight Ofwat's broad interpretation of their statutory resilience duty as it pertains to capital structures, and financeability. Over the price review Ofwat has highlighted what it perceives to be the past failings of equity investors in the sector to act in a way that is aligned to water companies' public purpose[6]. Companies have taken positive steps over the last few years to address these concerns and underline their current investors' commitment to the sector. Nonetheless there is a perception that Ofwat, at this price review, is seeking to redress the balance by significantly reducing equity returns while at the same time expecting equity to bear greater downside risk. Many of the previous investors, who Ofwat believe have not acted in the best interests of customers, are no longer in the sector and Ofwat's approach, in targeting potential returns and increasing downside risk asymmetrically, has the effect of significantly reducing base and potential cash flow within the regulatory system that could otherwise be used to absorb risk. Credit Rating Agencies' assessment of the credit quality of the sector has been steadily dropping and has reached an all-time low. It is important that in reaching its decisions on these appeals, the CMA considers the long term framework for investment that provides the correct balance of risk, return and financial resilience.

Customer voice

We put our customers at the heart of our business planning process. We engaged directly with over 42,000 customers, local and regional stakeholders and experts. We have also gained insight from broader engagement with more than one million customers and had a continuous dialogue with our Customer Challenge Group (CCG). Having undertaken this work we submitted a plan to Ofwat that was supported by over 80% of our customers, with 76% considering our proposals affordable. We were therefore surprised that this customer voice was not more evident in the final determinations, which in places appeared to substitute what customers have said they actually want, in favour of Ofwat's own view of what they should value. This is particularly evident in relation to performance commitments - where Ofwat has required significant short-term improvements based on the upper quartile in a core set of metrics which it determined itself – and bill levels and volatility –

[6] See, for example, Jonson Cox speech at Water Industry City Conference, 1 March 2018

where Ofwat has disallowed investment in order to reduce bills and over-written companies preferred bill profiles.

This type of customer engagement is both costly and time consuming, but in a sector where customers can not choose their supplier is of vital importance. It is important that it is clear how Ofwat has taken into account the customer voice and balanced between customer views and its own sectoral policy objectives. Without this clear 'line of sight', there is a risk that customers become disenfranchised from these processes, or that companies cannot in good faith submit business plans that allow for their customers' priorities to be adequately reflected.

Disconnect between cost assessment and service levels

In our draft determination response, we made representations in relation to Ofwat's assessment of the efficient costs of growth, raw water deterioration and leakage. These specific concerns each result from the lack of a clear linkage in Ofwat's modelling between service levels and costs. Ofwat have undertaken a comprehensive econometric approach to benchmarking historic costs levels. However, this is done without sufficient consideration to a company's performance, or long term asset strategy. This disconnection is most explicit in the case of leakage, where Ofwat required 15% reductions from all companies. Despite the fact that Ofwat acknowledge that the period covered by the cost models included no significant leakage reductions[7], it nonetheless made no separate allowance for the costs of reducing leakage.
If the legitimate costs of service quality improvement are not recognised in setting cost allowances, this will inevitably temper companies' ambitions at future price reviews and is one of several factors that adds to the overall asymmetric downside skew of the PR19 final determinations. It also inevitably means that companies may well focus on delivering at the lowest short-term cost to avoid regulatory penalties, rather than on delivering sustainable performance improvements in a way that contributes to a more resilient sector in the long term.

Efficiency

Ofwat's decision to not make any allowance for the costs of service improvements in its assessment of costs, compounds the overall level of efficiency challenge built into the price controls. Ofwat's approach to efficiency has been formulated in a disaggregated way without sufficient consideration of how it all interacts at an aggregate level within the Final Determination. In combination, not allowing for the cost of service improvements, upper quartile cost targets and a forward looking efficiency assumption of 1.1% (at the higher

[7] Page 54. Delivering Water 2020: Our Final Methodology for the 2019 Price Review, Ofwat, 2017

end of the plausible range) results in a level of stretch that cannot reasonably be delivered in the required timeframe without a negative impact on the resilience of the sector, particularly in respect of our ability to absorb shocks.

Capital Structure and Financeability

In aggregate we consider Ofwat's PR19 final determination has weakened the sector's financeability and financial resilience. This can be seen very clearly through the "notional" company's credit rating as assessed by Moody's, Fitch, and Standard & Poor's[8]. This is, in part, a consequence of Ofwat's mechanistic approach to assessing the cost of capital, along with the introduction of material downside ODI risks, with the aim of significantly reducing potential equity returns over the period. We believe this approach to potential returns needs to be addressed and rebalanced to ensure that adequate consideration is given to financial resilience, credit quality, and the overall balance of risk.

The need to rely on the acceleration of cashflows from future periods by switching from RPI to CPIH and using pay-as-you-go (PAYG) levers in order to meet the thresholds for Ofwat's target credit rating of BBB+ points to the need for a broader analytical perspective in setting required returns. It is worth highlighting that bringing cash forward, especially via PAYG levers is ignored by Credit Rating Agencies, hence their assessment of notional (and actual) credit quality is lower than Ofwat's assessment. It is the assessment by the former that informs the actual cost of borrowing.

We would also note Ofwat's late policy change in relation to companies' actual capital structures. It has been a cornerstone of UK regulation that capital structure is for each company to decide, and for equity investors to take the risk and reward of those decisions. More recently, Ofwat has expressed concerns about highly geared companies.. These concerns are based on the premise that these structures reduce resilience, or negatively impact performance, but that has not, we believe, been proven by Ofwat. This view, which is not supported by theoretical or empirical evidence, and in our view rests on a misapplication of finance theory, led to the late introduction of a "gearing sharing mechanism" which had not been trailed in any of Ofwat's methodology consultations.

There are some important policy decisions around the issue of capital structures, which need to be resolved in a considered way. We hope for a constructive discussion between Government, UK regulators and investors as to what their financial policy goals are, and over what period these can be achieved. These business structures did not develop overnight, it has taken over 30 years to get to this position and it is hugely expensive to

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[8] See, for example, Outlook remains negative as price review leads to unprecedented number of appeals, Moody's, April 2020

make changes, particularly when low interest rates are exacerbating mark to market values. We hope such discussion can inform a more measured approach at PR24.

Conclusion

Our response focuses, inevitably, on those areas where we disagree with Ofwat. There were of course many positive aspects to Ofwat's process, and we are supportive of their over-arching ambitions in relation to resilience, innovation, affordability and vulnerability, and service levels. It is therefore vital that we use this period, ahead of PR24, to build on these positive aspects and address the concerns the four companies and the wider industry are raising. We support Ofwat's direction of travel in relation to our broader public purpose, and social value but we must ensure that the right balance is struck between the need to deliver value for money for customers and addressing the long-term challenges of the sector.

We have highlighted above a number of areas where we believe Ofwat have not struck the right balance in its final determination decisions. Taken as a whole the final determination package does not, in our view, move us toward the more resilient sector that our customers and other stakeholders want to see.

Yours sincerely,

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Ian McAulay
Chief Executive Officer