

PR19 Water redeterminations

Approach to the redeterminations

Structure

1. This approaches document (the document) is structured as follows:
 - (a) We describe the purpose of this document in paragraphs 2 to 6.
 - (b) We invite submissions from Main and Third Parties to express views on the issues covered at paragraphs 7 to 15.
 - (c) We describe the background to the redeterminations, the legal framework and the statutory time limits at paragraphs 16 to 21.
 - (d) We describe how we are grouping issues into certain areas of consideration at paragraphs 22 to 29.
 - (e) We then set out the various areas we are considering in paragraphs 30 to 58.
 - (f) At paragraphs 60 to 67, we consider the possible approaches to taking account of the impact of Covid-19 on the redetermination (ie whether adjustments should be made and whether it is desirable and practical for this to be done by Ofwat or ourselves).
 - (g) We then set out areas and issues we propose to deprioritise in paragraphs 68 to 93.

Purpose of the document

2. This document sets out the issues which we are considering and our proposed approach to the four redeterminations (for the four water companies: Anglian, Bristol, Northumbrian and Yorkshire) in the light of our consideration of the submissions and evidence we have reviewed to date. It also sets out issues which we intend to consider and those areas where we are less likely to prioritise and re-consider due to the finite resources and time we have available (with the consequence we are more likely to come to

similar conclusions in our redeterminations to those of Ofwat's with respect to these issues).

3. This document is intended to provide a framework for our redeterminations, and to facilitate engagement with the Main Parties (Ofwat and the four water companies) and Third Parties. Four companies have rejected the regulator's determinations and have provided extensive and differing reasons for doing so. Given the scale of the redetermination task and the range of issues to consult on, we consider that this document will be an effective aid to both the Main Parties and Third Parties in engaging and submitting evidence and will also allow Parties to understand and provide any views on our approach.
4. In putting it together we have been mindful of the complexity and scale of the regulatory determinations involved and the time we have available in which to carry out our redeterminations.
5. The purpose of this document is to:
 - (a) explain to Main and Third Parties our proposed approach and process,
 - (b) seek views from Third Parties on the issues raised,
 - (c) notify Main and Third Parties of what we are not proposing to prioritise and to seek views on this, and
 - (d) notify Main and Third Parties of our current intentions on taking account of the impact of Covid-19 and to seek further views on this.
6. This document does not represent the Group's provisional views, findings or conclusions on any issues. The issues we have identified in this document are simply ones that, at this stage, we consider merit detailed investigation and analysis. The range of issues we identify or deprioritise may change as our investigation progresses.

Invitation to submit views

7. We are publishing this document now to assist those submitting evidence to focus on the potential issues we envisage being most relevant to the redeterminations, and also to seek comments on specific aspects of our approach.
8. The Main Parties to the redeterminations have provided their statements of case and have also had the opportunity to respond to each others' submissions. These submissions are published on the [CMA case page](#). We

have also received submissions from a variety of Third Parties, their submissions are also published on our [case page](#).

9. We continue to invite interested Third Parties to give us their views, where these have not already been provided, with reasons and evidence, on:
 - The issues set out in paragraphs 30 to 56.
 - Whether they are in agreement with Ofwat's determination in respect of any issues.
 - Where Parties are not in agreement with Ofwat's determination, whether it should be amended or replaced and with what.
 - Whether there are any other issues that the CMA should be addressing.
10. We also invite Main and Third Parties to provide views on:
 - our proposed list of issues that we do not intend to prioritise (see paragraphs 67 to 93); and
 - how, if at all, we should take into account the impact of Covid-19 in our redeterminations, supported where relevant by detailed evidence which would allow us to quantify those impacts (see paragraphs 60 to 64).
11. Our administrative timetable has been published on our [case page](#).
12. We are holding Main Party hearings in July. We shall then prepare a provisional redetermination report containing our provisional findings on the issues for the four redeterminations. We intend to publish the provisional report in September 2020. We shall consult on these provisional redeterminations before publishing our final report, which we intend to do by early December 2020. The purpose of publishing a provisional redetermination is to enable a consultation on our analysis and evaluation and this will be the primary means of consultation with all Parties.
13. Where it will be helpful to our assessment, we may choose to send working papers to the Parties (and publish these on our website) ahead of or around the hearings to provide an opportunity to consult on our approach and analysis. Working papers, where produced, precede the Group's decision making on the redeterminations. Where we decide to issue working papers, it will be for certain issues because we consider an early consultation on aspects of our approach and analysis to be useful, for example if we are considering possible novel approaches. But as has been the case in recent

CMA redeterminations, we do not intend to publish working papers on all areas of work, rather any such publication will be on an exceptional basis.

14. To submit views together with supporting evidence, please email Waterdetermination2020@cma.gov.uk. All Parties are requested to make any submissions in response to this document by Thursday 25 June 2020. In respect of submissions about the impact of Covid-19, we recognise it may take some time to better understand the implications for the water industry and on the price determinations. We request submissions on this matter are made by the end of July 2020.
15. Because of the current Covid-19 measures, we are unable to receive or accept letters and packages at our offices.

Background

16. On 15 December 2019, the Water Services Regulation Authority (Ofwat) gave notice to four Companies: Anglian Water Services Limited (Anglian), Bristol Water plc (Bristol), Northumbrian Water Limited (Northumbrian) and Yorkshire Water Services Limited (Yorkshire) of a determination under Condition B of the Appointments of the Price Controls for the period from 1 April 2020 (PR20).
17. On 19 March 2020, Ofwat informed the CMA that the four companies had not accepted the 'Disputed Determination' and had required Ofwat to refer the Disputed Determination to the Competition and Markets Authority (CMA). Ofwat, as required by section 12(3)(a) of the Water Industry Act 1991 and the Appointments, referred the Disputed Determinations to the CMA.
18. The CMA was required to report on and determine the Disputed Determinations within a period of six months from 19 March 2020. On 24 March 2020, following a request from the CMA, Ofwat decided that given the nature and scale of work involved in four water industry price control references and the possible disruption from the COVID-19 situation, that there were special reasons why the reports cannot be made within the period specified in the References, and so extended the period specified in the References by six months. The CMA therefore has a period of twelve months beginning with the date of the References to report on and determine the disputed determinations.
19. In deciding on the redetermination[s], the CMA is subject to the same duties and guidance as applies to Ofwat. In summary these include:

- (a) Section 2 of the Water Industry Act 1991 (WIA91) which requires Ofwat (in summary) to determine price controls in the manner Ofwat considers is best calculated to:
 - (i) further the consumer objective to protect the interests of (existing and future) consumers, wherever appropriate by promoting effective competition;
 - (ii) secure that water companies properly carry out their functions and functions under licence;
 - (iii) secure that the companies are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions; and
 - (iv) further the resilience objective to secure the long-term resilience of companies' systems and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services.
 - (b) Subject to those duties, Ofwat also has duties to (among other things):
 - (i) promote economy and efficiency;
 - (ii) secure no undue preference/discrimination in fixing prices and offering services;
 - (iii) contribute to the achievement of sustainable development.
 - (c) Ofwat must also determine price controls in accordance with the statement of strategic priorities and objectives for Ofwat from the UK Government (for English water companies) or the Welsh Government (for Welsh water companies) (sections 2A and 2B of the WIA91).
20. Ofwat is required to have regard to the principles of best regulatory practice. Ofwat and the water companies also have specific environmental duties in relation to the protection of areas of natural beauty, special environmental interest and historical sites (ss.3-5 WIA91).
21. We will undertake the redeterminations in accordance with these duties and guidance, but we may make different judgments from Ofwat on how they should be interpreted and balanced.

Issues and approach

22. We set out below the issues we are proposing to address and the ways in which we are grouping these into areas. We have concluded it is appropriate to group issues into separate areas along common themes, due to the fact that they may be closely related, relevant to the same areas of the determinations, they may rest on similar evidence, and to facilitate our internal analysis and resource allocation.
23. Within these broad areas of work, we will seek to address each of the issues and concerns raised by the Main Parties. We note that the companies have told us that the issues they are raising are largely distinct and should not be grouped, so as to avoid loss of the detail of each of their points of concern and so they can be properly considered and addressed in each of the redeterminations.
24. However, we consider that it is efficient and effective to recognise where issues have similarities and are closely related. This grouping also provides a means for presenting these topics in this document and therefore for any respondents to structure their responses in a way which makes them as clear and focussed as possible. Where appropriate, issues raised by the Main Parties will be considered within these areas. Where issues do not fit within these areas, they will be considered as stand-alone issues, including any issues which are company specific.
25. Whilst we are looking at groups of issues and themes, we are conscious of the interlinkages and interdependencies arising between them.
26. There is also a need when making each of our redeterminations, to consider the overall package of measures and its effectiveness in the round for each of the four water companies, not just the core components in isolation, ie we will consider whether each overall package in the round provides the best approach to fulfilling our duties in the price control.
27. Within our redeterminations, our consideration within an area of the price controls is not driven solely by the issues raised by the Main Parties (although this is an important part of the evidence we will be considering). We will also be considering issues raised and evidence provided by Third Parties.¹ In addition, our decisions on issues raised by each Main Party, unless the issue

¹ The Third Party submissions we have received so far have only addressed issues which have already been raised by the Main Parties.

is a solely company-specific matter, will be likely to have relevance for the redeterminations for the other companies.

28. The titles assigned to each grouping of issues is necessarily a shorthand descriptor. More details of what is included in each grouping is set out below.
29. We are proposing using the same regulatory building blocks as Ofwat used in its determinations. However, we do not exclude the possibility of revisions to Ofwat's approaches and methodologies, including consideration of whether approaches may be modified, simplified, or any aspects of the controls removed or supplemented.

Framework

30. We will be reviewing and applying the statutory framework, our (and Ofwat's) duties (see paragraph 19) and the Strategic Policy Statement to understand the background to and the objectives of the price controls.
31. We will consider the objectives of the price control in order to guide the decisions in our redeterminations. In order to inform this consideration, we will take account of the submissions received from Main and Third Parties on the interpretation of objectives and guidance, including whether and how there may be conflicts or a trade-off between the achievement of different objectives.
32. To assist our considerations, we will also consider how Ofwat has sought to discharge its duties and will take account of Main Party and Third Party views on that. As noted at paragraph 21, we may make different judgments from Ofwat on how duties and guidance should be interpreted and balanced.
33. As context for the redeterminations, we note the disagreement between Ofwat and the four water companies on whether Ofwat's determinations impose an excessive degree of stretch on the water companies, and on whether outcomes of previous periodic price controls have shown excessive returns and limited productivity gains. We also note various Parties have argued that there is insufficient emphasis in Ofwat's determinations on matters of long-term resilience and environmental impacts relative to levels of customer charges and affordability (although it could be argued that investment costs would likely be largely added to the Regulatory Capital Value (RCV) rather than being recovered immediately). Other stakeholders have emphasised the importance of affordability, particularly in relation to consumers in vulnerable circumstances (including those in water poverty).
34. When making our redeterminations we will consider the overall determination for each company, including the overall stretch or challenge (in regard to its

cost efficiency, productivity improvement, performance and returns) in the round in the light of our statutory duties. Therefore, we will also be considering the overall structure and strength of incentives that our redeterminations will provide for the water companies. The interpretation of certain duties will be addressed in the specific work areas discussed below.

35. As further context to our redeterminations, we will also be considering whether water company performance in previous price control periods sheds any light on how we should approach the redeterminations and particularly the matters in paragraph 33. We are not required to conclude on past company performance in determining appropriate redeterminations for the four water companies, but such evidence may be relevant in considering the appropriate redetermination on matters such as performance commitments, ODIs and rate of return.
36. We will also consider the utilisation of customer evidence and the extent to which this should be given weight in informing decisions on the redeterminations. We will for example be considering:
 - Where and to what extent can customer evidence give useful guidance on forming business plans, performance commitments and ODIs, and whether there are aspects of the regulatory process where customer evidence may be less likely to be informative.
 - Whether the evidence collected by the water companies is robust and of high quality.
 - How Ofwat has interpreted and made use of customer evidence (including comparisons between different companies' research) in assessing business plans and in forming its determinations.

Totex – overall

37. We will consider the appropriate totex allowance for each of the disputing companies. This will primarily consist of an assessment of base and enhancement expenditure as described below.
38. Ofwat's PR19 Determinations define company specific cost sharing parameters that influence the incentives for companies based on the level of outturn expenditure relative to Ofwat's totex allowance at the Determination. We will explore if the cost sharing rates set by Ofwat for each of the four companies are appropriate to protect customers, encourage efficient spend and protect companies from unforeseen circumstances. We will also consider

the incentive effects arising from other mechanisms in the determination that could interact with the totex cost sharing approach.

39. As part of the process of calculating the price control, we will consider the appropriate split between 'fast' money (recovered from customers in this period) and 'slow' money (added to the RCV) for the relevant company. This will involve setting an appropriate pay-as-you-go (PAYG) rate and RCV run-off rate for each of the disputing companies. Our starting point for this would be the consideration of the 'natural' rate, and whether any adjustments to this are necessary to reflect specific needs or circumstances

Totex – base expenditure

40. Within this area we propose to address the following:
- (a) Base models - we will evaluate the econometric models and data used by Ofwat and the submissions we have received containing alternative econometric models. We will consider whether there are improvements that can be made to the Ofwat cost modelling and whether it accounts for capital maintenance appropriately.
 - (b) Cost-service relationship- we will consider the companies' arguments that Ofwat's approach does not take proper account of the links between costs and the targeted levels of service (including leakage). We will consider whether there is a cost-service trade-off and whether taking account of service levels in the econometric modelling is the most appropriate approach, or whether there are better alternatives, for example, Ofwat's or a different cost adjustment scheme.
 - (c) Catch-up efficiency – we will consider the appropriate approach, including the level of stretch, the models employed by Ofwat, and Ofwat's decision to move away from an upper quartile approach.
 - (d) Growth – we will consider the appropriate approach to account for growth, including the relative merits of the local authority and ONS forecasts, the appropriate unit rate adjustments, integrated vs stand-alone growth models, and the need for and design of any reconciliation mechanisms.
 - (e) Frontier-shift – we will consider the appropriate approach to estimating and applying frontier shift for productivity, including the choice of comparator sectors and time period, gross output or value-added measures, the role of embodied technical change and the potential impact of the move to a totex framework. We will also consider to which areas of costs the frontier shift should be applied.

- (f) Real price effects – we will consider whether there should be any real price effect adjustments applied to any aspects of costs, including labour, energy, chemicals and material and plant equipment. As part of this we will consider the appropriate indices and the need for and design of any reconciliation mechanisms.
- (g) Treatment of ‘uncontrollable’/‘unmodelled’ costs – we will consider how additional costs (such as abstraction charges, business rates, traffic management act charges, licence fees, and certain compliance costs such as those associated with the Industrial Emissions Directive), including the level of allowance are set and the use of uncertainty mechanisms.
- (h) True-ups - Ofwat in PR19 used several true-up mechanisms, including growth expenditure, RPEs, outcome delivery incentives (ODIs), and the cost of new debt.² We will consider where and how a true-up mechanism should be applied.

Totex – enhancement expenditure

41. Within this area we propose to address the following:

- (a) The use of benchmark models – we will consider whether it is appropriate to use benchmark models to assess the efficiency of enhancement spend in certain cost categories (eg cost of phosphorous removal), how these models might be designed and used, any limitations in these models, and any alternatives which may address these limitations.
- (b) Efficiency challenges applied – we will consider if and how efficiency challenges should be applied on enhancement allowances, in particular as this applies in the benchmark models, and the potential for ‘double-counting’ frontier shift (eg in the allowances of WINEP programmes). We will consider whether the companies have provide sufficient evidence to demonstrate that business plans represent efficient costings, and Ofwat’s use of a company-specific efficiency challenge which is based on an assessment of base operating expenditure and capital maintenance (botex). The application of any efficiency challenges will then be incorporated in our final allowances.
- (c) Project-by-project assessments (‘Deep Dives’) – we will consider and assess the detailed evidence on certain specific enhancement projects / schemes for the individual companies in the context of the purpose,

² Ofwat (2020), [PR19 reconciliation models](#), downloaded on 12 May 2020.

needs, and whole life value to the customer, in particular where we have reason to believe that the benchmark models or business plans may be incorrect, or not reflect good value for customers. The outcomes of these will assist us in deciding whether a different allowance should be made (including the possibility of providing no enhancement funding for a particular project / scheme). The most material schemes which have been raised with us by each company are listed below (we note that this list is not exhaustive, and that Bristol Water did not raise any specific issues):

- (i) Anglian Water: WRMP interconnector schemes across the Anglian region; and the treatment of uncertainty associated with the Elsham transfer scheme.³
 - (ii) Northumbrian Water: a scheme for sewer flooding risk reduction in the North East; and the Abberton to Hanningfield transfer main designed to tackle potable water demand issues in Essex and Suffolk.
 - (iii) Yorkshire Water: a programme to strengthen the resilience of Hull and Haltemprice against extreme flooding events.
- (d) Overlap with base costs – we will consider the information available to assess whether requests for enhancements cover activities which have already been funded, either partially or fully, in the base cost allowances. This includes allowances of enhancement opex. This approach will protect against customers paying twice for the same work.

42. Our review of the above will cover the majority of enhancement spend. For any parts of the assessment of company-specific projects, where we have not been provided with any evidence that a further review is appropriate, we do not currently propose to conduct any further assessment.
43. We are also planning to consider the overall approach to enhancement, most notably around the assessment of any benefits (eg improved resilience), the implied incentives on companies for future price reviews, the role of customer views in setting enhancement spend allowances, and the inclusion of contingency allowances and/or claw-back mechanisms to account for any uncertainty about the delivery of relevant schemes.

³ We note that Anglian also raises other areas of enhancement where Ofwat's allowance was below Anglian's business plans, including investment at Alton water treatment works, costs of meter installation, bioresources, Any further Security and Emergency Measures Direction, and four WRMP scheme.

44. Due to the technical nature of aspects of this work, in conducting some of this assessment we may take account of the view of independent external engineering consultants.

Performance Commitments

45. In order to set appropriate performance commitments (PCs) and outcome delivery incentives (ODIs), we will consider afresh certain methodological issues that arose during Ofwat's price control process. To the extent that we reach different conclusions on one or more of these issues than Ofwat did, this will potentially affect all or many PCs and ODIs.
46. The methodological issues that we propose to address are:
- (a) the weight that should be placed on the results of customer engagement, and particularly customer views about the benefits of incremental improvements in performance;
 - (b) the weight that should be placed on other evidence in order to determine the appropriate level of stretch for a given PC;
 - (c) the approach to determining the appropriate degree of asymmetry (if any) in the rewards and penalties for a given ODI and for each company's ODI package as a whole;
 - (d) the overall ODI package and its interaction and role with other incentive mechanisms, particularly Totex cost sharing;
 - (e) the impact of these incentive mechanisms on financeability considerations; and
 - (f) the approach to designing enhanced ODIs.
47. With respect to specific PCs, types of PCs and related ODIs, we propose to address:
- (a) the design of the leakage PC and related ODIs;
 - (b) the design of the other common PCs that have financial rewards and penalties attached;
 - (c) the design of any other PCs that have financial rewards and penalties attached and where we have sufficient evidence that it is appropriate for the CMA to review the approach taken by Ofwat;
 - (d) the design of PCs relating to customer vulnerability; and

- (e) the design of PCs and related ODIs that are related to specific enhancement expenditure.

Cost of capital

- 48. In order to estimate an appropriate Weighted Average Cost of Capital (WACC), we will independently assess and estimate each element of the cost of capital. This includes analysis and estimates of:
 - (a) the risk-free rate of return;
 - (b) beta;
 - (c) total market return (and/or equity market premium);
 - (d) the cost of embedded debt;
 - (e) the cost of new debt;
 - (f) inflation;
 - (g) gearing; and
 - (h) the proportion of embedded and new debt.
- 49. We will also consider the need for and scale of any company-specific adjustments to the cost of debt and/or equity, notably to take account of Bristol Water's size.
- 50. Our estimates will be calculated using the data and methodologies we consider to be most appropriate. Our chosen approach will not be constrained to the approaches proposed by the Main Parties. Where there is uncertainty or dispute as to best practice for calculating a particular metric, we will consider a range of evidence before deciding our approach. Where there is unavoidable uncertainty, we may choose to use ranges rather than point estimates. Our estimates will use up-to-date market and other data where appropriate. We will analyse what, if any, retail margin adjustment is appropriate.
- 51. We will provide an overall redetermined estimate of WACC based on these component part calculations, weighted according to our judgement.
- 52. We will also analyse Ofwat's proposals for introduction of a Gearing Outperformance Sharing mechanism, and whether they are appropriate as part of the overall framework for determining a reasonable balance of risk and return for investors.

Financeability

53. We will assess and ensure that the decisions in our redeterminations are consistent with the financing duty.
54. As part of this assessment, we will consider whether assessing the financeability of a company with a notional capital structure is sufficient or it is reasonable for actual capital structures to be taken into account. In assessing financeability, we will consider the appropriate use and reasonable scale of any financeability 'levers', such as PAYG rates.

Other issues

Tax

55. We will consider the approach to allowances for tax. Ofwat calculated the tax allowance for each specific company based on the projected taxable profits of the appointed business and the current and enacted UK corporation tax rates and associated reliefs and allowances as at 30 September 2019. Ofwat's PR19 methodology introduced a tax reconciliation mechanism, which intends to take account of any future changes to corporation tax or capital allowance rates. These adjustments will be subject to reconciliation at the next price review in 2024. We will therefore consider whether alternative approaches may be more appropriate, such as a pass-through mechanism which is broader in scope than Ofwat's tax reconciliation mechanism.

PR14 Reconciliation – Revenue Forecasting (WRFIM)

56. At each price review there are various truing up adjustments to account for how actual performance, costs and revenues have out turned compared to the forecasts, targets or assumptions made at the previous price review. Yorkshire Water states that it made a data input error in respect of the wholesale revenue forecasting incentive mechanism during PR14 which reduced the amount of revenue it was entitled to recover from customers. Ofwat considers it to be ambiguous whether an error occurred and so chose not to make an adjustment to remedy this in its Final Determination. We will examine this again.

Potential Grants & Contributions Error

57. We intend to consider if an adjustment should be made for the potential double-counting of some specific calculations of the expected grants and contributions. This is specific to the Northumbrian Water redetermination.

Use of updated information

58. Where there is additional and updated information available, produced since Ofwat's determination, and which is relevant to the redeterminations, we will take account of this to inform our redeterminations. For example, new market evidence may be available to inform the calculation of the cost of capital, or there may be new information on for example tax rates. However, we will also consider whether information is complete and robust so that we can place reliance on it.
59. We address the question of whether there should be adjustments for the impact of Covid-19 in paragraphs 60 to 66.

Impact of Covid-19

60. Ofwat's determination, and the company business plans and other evidence on which it was based, pre-dated the current Covid-19 situation. We recognise that the Covid-19 situation (including related public health and business support measures) may currently or in the future have an impact on the totex requirements (upwards or downwards) and performance of water companies, as well as the cost of capital. The question therefore arises as to how, if at all, we should factor this situation into our redetermination.
61. The Covid-19 situation and its impact on water companies (and the economy more generally) continues to evolve. It is therefore probable that the nature of the impacts occurring, their scale and duration will still be unclear at the time of our provisional and final redeterminations. This is something we will have to take into account when deciding how to proceed, as well as the resources available for us to address these issues in the context of a redetermination.
62. It is possible that we decide not to address the impacts of Covid-19 either at all or in some areas of our redeterminations. This could be for various reasons including:
 - (a) we are satisfied that existing mechanisms within the regulatory framework (eg the potential for Interim Determinations) appropriately allocate the risks between customers and water companies;
 - (b) that Ofwat will be making appropriate adjustments for the industry as whole (including the appealing companies) in the context of its reconciliation mechanisms (or in any other way); and/or
 - (c) there is insufficient concrete evidence of actual or likely impacts to warrant any action on our part.

63. Conversely, in some or all areas of the redeterminations we may decide that there is evidence that justifies moving away from the data or assumptions underlying Ofwat's decision. For example, we would expect to take account of the most recent available market data in setting the WACC which will necessarily take account of the impact of Covid-19.
64. Should we conclude that it is not appropriate to address the impacts of Covid-19 as part of our redeterminations, we may also consider whether we should instead address how adjustments may be made in the future (eg through the inclusion of uncertainty mechanisms, true ups or triggers for reopening). We may also propose principles which we believe Ofwat should apply in implementing any mechanisms that might be adopted to deal with Covid-19.
65. In deciding how to deal with Covid-19, we may take a different approach across different areas of the redeterminations (cost of capital, totex and performance commitments) or across different issues.
66. Views are invited (supported by evidence where relevant) on whether additional mitigation of risks for Covid-19 by the CMA is justified; if so in respect of what areas of the redeterminations and the form/extent of the adjustments.

Issues we propose to deprioritise

67. We outline below a number of issues which we are considering deprioritising in the light of our initial considerations, and thus not conducting further work on them. While the CMA is able to address any aspect of the price controls in the redeterminations, we need to prioritise our work given the limited time available. We consider it important to adopt a proportionate approach and to scrutinise most closely the areas in the determination that would have the largest effect on customer prices and other outcomes, and the disputing companies.
68. We have therefore been mindful of whether in respect to specific issues:
 - any concerns have been raised by any Main or Third Party;
 - we have identified any potential concerns, eg on Ofwat's approach;
 - there is any precedent value or read across to other parts of the redeterminations; and
 - there is a significant scale of impact on current and future customer bills and other outcomes such as service quality and resilience.

69. We will be alert to any new evidence submitted that may suggest a change to these views.
70. We will also take account of any interlinkages and interdependencies from the work we will be doing that could have consequences elsewhere. For example, there may be consequences for retail allowances from any changes in wholesale allowances, so we would need to consider the consequences of changes in the underlying figures.
71. Each of these issues is set out below.

Household retail

72. Ofwat introduced separate household retail price controls in PR14 and took a comparable approach in PR19. The decisions on retail are largely distinct from the wholesale decisions described above. Ofwat presented its assessment of charges for household retail charges as being a separate price control in its PR19 decisions.
73. Consistent with the approach taken to the Bristol Water PR14 redetermination, we do not currently intend to make changes to these retail price controls (including the associated residential retail reconciliation mechanism, and experience measures (C-Mex and D-Mex)). The water companies have not disputed Ofwat's decisions in respect of the retail price controls and no stakeholders have made submissions arguing for changes to them.

Business retail

74. The four appointed water companies that have asked for a redetermination no longer carry out a non-household retail business. Therefore, this is not a relevant factor when considering these redeterminations.

Bioresources reconciliation mechanism

75. Bioresources allowances are based on an allocation from the overall wastewater allowance, which we will consider as part of the base expenditure assessment.
76. Ofwat's methodology included a step at the end of the process (conducted after the financeability modelling) to split this allowance into a fixed and variable component. The variable component will then be (ex-post, in 2024) scaled to reconcile with actual volumes of 'sludge'. This acts as a risk mitigation mechanism around the uncertainty of actual outturn volumes.

77. The effects of this reconciliation mechanism appear relatively modest. For example, if all of the appealing WASCs experienced 10% higher volumes of sludge than projected, it would result in an overall increase in allowed revenue of less than 0.3%. Any adjustment to the allocation between fixed and variable costs within this mechanism would be likely to more marginally alter the allowed revenues. We note that this is symmetric such that a lower than projected volume would result in an equivalent reduction in revenue.
78. We note that no stakeholders have raised concerns about this reconciliation mechanism, with the principle of this adjustment approach (ie splitting into fixed and variable costs) appearing to have wide support from the water companies and wider stakeholders.⁴
79. As an ex-ante control being set in PR19, we consider that this reconciliation mechanism falls within the scope of the redeterminations. However, for the reasons stated above, we are not currently planning to prioritise reviewing it.

PR14 reconciliation (other than one potential data error)

80. The PR14 reconciliation adjusts the revenue allowances calculated during PR19 for various mechanisms specified during PR14. Ofwat's PR14 process and a subsequent consultation has explained how this 'true-up' would operate. Other than one point raised by Yorkshire Water and discussed in paragraph 56, we do not propose to review the PR14 reconciliation adjustments.

Grants and contributions (other than one aspect of potential double-counting)

81. A process is in place that allows water companies to receive funding income that is different to normal customer bills, for example, developers paying for services such as laying infrastructure to serve new developments (housing estates / commercial premises). These are generally not amended by Ofwat other than the one specific issue raised by Northumbrian Water and discussed in paragraph 57. We note that this is an area where other changes in the determination (eg growth) are likely to have consequential effects on the grants and contributions. We would intend to reflect these consequential changes in the final allowances.

⁴ No responses to Ofwat's draft determination appear to disagree with the proposed approach of an adjusted average revenue control; <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Our-methodology-for-the-classification-of-bioresources-costs-and-revenues.pdf>

Switch from RPI to CPIH

82. The decision for a phased switch from RPI to CPIH for the indexation of allowed revenue and RCV is something that Ofwat announced and consulted on in 2016. It was implemented for the first time during PR19. Given the consultation by Ofwat on this change and the fact that it has not been raised by the water companies, we do not consider it necessary to prioritise this as part of the redeterminations.

Non-price control income which is deducted from allowances

83. These are technical adjustments relating to income generated by the water companies from certain charges which are excluded from the price controls. Forecasts of this income are deducted from allowed revenues, as the revenue is not recovered from charges covered by the price control but is expected to cover some of the costs included in the calculation of the price control.
84. The impact of these adjustments is small, ranging from less than 0.5% of revenue for Yorkshire Water to just over 2% of revenue for Bristol Water.⁵
85. Given the limited impact of the adjustments and the fact that, based on Ofwat's review of company forecasts of this income, there is no reason to think we would be able to obtain further information to challenge these figures, we do not currently plan to prioritise this area as part of the redeterminations.

Innovation competition funding

86. In order to promote and incentivise increased innovation within the water sector, Ofwat established a collectively-funded innovation competition for 2020-25. This funding will be collected in proportion to a company's revenue, and is ring-fenced and administered so that it will not be used for purposes other than the innovation competition.
87. Driving innovation is one aspect of the UK Government's priorities set out in its strategic priorities and objectives statement.⁶ Combined with the limited materiality of this funding adjustment (<0.5% of revenue for any of the Disputing Companies), and the fact that no stakeholders have raised any

⁵ See Table 4.1 in the Final Determination documents, for example, see <https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Anglian-Water-final-determination.pdf>

⁶ The priority was specified as: Ofwat should promote markets to drive innovation and achieve efficiencies in a way that takes account of the need to further: (i) the long-term resilience of water and wastewater systems and services; and / or (ii) the protection of vulnerable customers.

concerns about the innovation competition, we do not currently plan to prioritise this area as part of the redeterminations.

Certain other adjustments to totex

88. Ofwat makes other adjustments when calculating totex. In its PR19 decisions, it made adjustments relating to operating leases; strategic regional water resources solutions and other cash items; third party costs; and non-section 185 diversions.
89. These adjustments are relatively small, and we are not currently aware of any concerns raised by the disputing water companies or Third Parties to Ofwat's approach. We therefore propose to take a similar approach. If we vary Ofwat's calculations of totex elsewhere, we will consider whether any consequent corrections are required to these adjustments.

Pension deficit recovery costs

90. At PR19 Ofwat adopted the same approach used at PR14, progressing a policy position that arose following a consultation completed in October 2013. The policy is to allow companies to recover 50% from customers of any remaining pension deficit costs that need to be recovered into the period 2020-25. Some companies may not need any allowance for pension deficit recovery costs if they had removed any pension deficit by 2020.
91. The expectation is that shareholders / equity owners take the risk for the other 50% if there is still a pension deficit, rather than these costs be fully financed through customer bills. This policy has allowed the issue of pension costs to be financed over a longer period than just one 5-year price control. Pension deficit costs are excluded from the base efficiency modelling.
92. Given the consultation by Ofwat and its established approach, and the fact that concerns have not been raised by the water companies or Third Parties, we do not consider it necessary to prioritise this as part of the redeterminations.

Transparency around dividend / performance-related executive pay

93. Ofwat has been undertaking initiatives intended to push for better practice in corporate governance, and transparency by water companies. Ofwat's 'Trust in Water' slogan/campaign aims to make companies justify these areas and explain their approaches to customers/stakeholders. Concerns have not been raised by the companies, and we do not consider that this is a price control matter. We therefore do not propose to review Ofwat's approach.