

June 2020

**Reference of the PR19 final determinations:  
Cross cutting issues – response to  
companies’ 27 May submissions  
to the CMA**

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## 1. Introduction

1.1 We appreciate that the Competition and Markets Authority (CMA) has received huge volumes of documents containing great detail on many aspects of the PR19 price review. As such, at this stage of the appeals process we consider it important to clarify:

- where Ofwat can offer additional information in response to new points raised by companies in their submissions on 27 May 2020; and
- where Ofwat has been significantly mischaracterised by the disputing companies and third parties.

1.2 In their 27 May submissions, disputing companies presented many arguments which we have previously responded to throughout the PR19 price review and in our response to companies' statements of case. In the interest of brevity, we have not responded to these issues again. Our final determinations were made in-the-round, and should be reviewed by the CMA in that way. This view is also shared by third parties including other, non-disputing water companies.<sup>1</sup>

1.3 While limited, some new evidence has been submitted and some new arguments have been raised by disputing companies in their 27 May submissions, as well as the third party submissions.

1.4 **In this document, we address new arguments made by more than one of the disputing companies on cross-cutting issues.** These cross-cutting issues include:

- Our base cost models;
- The catch-up efficiency challenge;
- The application of frontier shift to the Water Industry National Environment Programme (WINEP) costs;
- The application of frontier shift to metering costs;
- Costs related to the Industrial Emissions Directive (IED);

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<sup>1</sup> For example, Severn Trent states in its CMA submission, 'We recognise that price reviews demand a substantial resource commitment...With any review of this nature, individual companies can expect to see variations in the level of stretch and challenge across their own business and in comparison with the rest of the sector. We therefore think it is important that all parties consider the package in-the-round when assessing the merits of any particular decision...Our concern is that it may be easy to identify specific elements of a price review that, in isolation, could make it look like a regulator has reached the wrong decisions on its final determination. Were we to be presented with evidence of this nature, our instinct would be to take a step back for a broader perspective before taking any decision on the next course of action'. Severn Trent, 'CMA Submission', May 2020, pp. 7-8.

- Overall level of stretch on costs and outcomes; and
- The impact of Covid-19 on our final determinations.

1.5 Our response to new issues concerning individual companies are set out in the respective company-specific 'Response to 27 May submission' documents and the accompanying 'Risk and return' document.

1.6 Overall, having considered these new arguments, we stand by our final determinations and consider that customers should not pay more to receive less.

## 2. Cost efficiency

2.1 This chapter sets out our response to new cross cutting issues raised by more than one party in relation to cost assessment and covers:

- Our base cost models;
- The catch-up efficiency challenge;
- The application of frontier shift to the Water Industry National Environment Programme (WINEP) costs;
- The application of frontier shift to metering costs; and
- Costs related to the industrial Emissions Directive (IED).

### Our base econometric models

2.2 In their 27 May submissions, Anglian Water and Yorkshire Water provided evidence of alternative econometric models, and of potential issues with our suite of models.

2.3 We consider that most of the arguments raised on 27 May are not new, and our previous responses remain valid and relevant. For some of the evidence of alternative models submitted by the companies' consultants, the data and assumptions are hard to verify.

2.4 Our previous submissions provided an extensive response to the CMA on our base econometric models. We do not comment further on these issues in this submission. Instead, we make a number of high level points:

- Our models have been subject to **extensive scrutiny**, by the sector and ourselves (and they were amended and improved in response to such scrutiny). The models submitted by the disputing companies have not. Our models were part of a process where, beyond the engineering and statistical validity of the specifications, we considered the quality of the input data and the stability of modelling results, an aspect that is missing from alternative models proposed by the disputing companies. Further, we allowed companies to submit cost adjustment claims and representations, which influenced our model specification and post-modelling adjustments throughout the process.
- At different points in time, in particular when new data is made available, a company may be able to find a model specification that is more favourable for itself. **It is important that models are not assessed in isolation.**

- Our models are **supported by a significant number of the water companies**, including recent third party submission to the CMA from Severn Trent Water and United Utilities.<sup>2,3</sup> Northumbrian Water, which supports our models, has also submitted a report which rebuts criticism made by the other disputing companies.<sup>4</sup>

## Catch up efficiency challenge

2.5 All disputing companies make further comments on our catch-up efficiency challenge in their 27 May submissions to the CMA. To assist the CMA, we respond in cases where the companies have raised new evidence.

### **Northumbrian Water argues that the majority of the arguments in our response to companies' statements of case were not raised at final determination.**<sup>5</sup>

2.6 The company's concern that the policy was not subject to scrutiny lacks merit. Nine out of the 11 points mentioned by Northumbrian Water were raised at final determination resulting from information that became available after the draft determinations.<sup>6</sup> The remaining two points made in response to specific arguments which companies raised in their statements of case.<sup>7</sup>

### **Northumbrian Water raises concerns regarding achievability.**<sup>8</sup>

2.7 We reiterate that the policy was subject to assessment and consideration of its achievability. We looked at the level of stretch across costs and outcomes in the round, calibrating it based on both historical performance and company forecasts. Our overall level of stretch is similar between PR14 and PR19 and is achievable for an efficient company.<sup>9</sup>

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<sup>2</sup> Severn Trent, '[CMA submission](#)', May 2020.

<sup>3</sup> United Utilities, '[CMA Price Determinations – Comments from United Utilities Water Limited](#)', May 2020.

<sup>4</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, Appendix 2, Chapter 3.

<sup>5</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, p. 54, paragraph 233.

<sup>6</sup> Ofwat, '[PR19 final determinations: Securing cost efficiency technical appendix](#)', pp. 31-34.

<sup>7</sup> One of the arguments Northumbrian Water refers to was inserted in error in our response to companies' statements of case and was not included in our 'Cost efficiency – common issues' document. The sentence was removed in an update issued on the 18 May 2020, to align the text of the four company-specific documents with that in the 'Cost efficiency – common issues' document.

<sup>8</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, p. 56, paragraph 244.

<sup>9</sup> Ofwat, '[Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case](#)', Chapter 4.

**Northumbrian Water claims that companies were incentivised to bid low and not reveal their true efficient costs in response to our draft determination.<sup>10</sup>**

2.8 We consider that Northumbrian Water's assertion has no merit. It was clear from both the September 2018 and April 2019 business plans that, while some companies had submitted efficient cost proposals, many companies had further work to do to ensure that they appropriately challenged themselves.<sup>11</sup> To protect consumers, we must ensure that companies are incentivised to present efficient business plans.

**Northumbrian Water presents evidence to suggest that the year 2018-19 was not out of trend with the other years in the sample.<sup>12</sup>**

2.9 The inclusion of the year 2018-19 in our models was just one of the modelling changes that led to the upper quartile catch-up challenge reducing further after the draft determination.

2.10 It was clear that the 2018-19 year was a high cost year relative to both our sample and the forecast period, as shown in Figures 2.1 and 2.2 below:

- In water, it was the highest cost year in the sample, 19% higher than the historical average and 16.2% above the sector average forecast for 2020-25.
- In wastewater, it was the second highest in the sample, 6.5% above historical average and 5.2% above the forecast for 2020-25.

2.11 In addition, our econometric data sample is unbalanced towards higher cost years of the Asset Management Plan (AMP) period. The first and last years of an AMP period are typically lower cost years, with expenditure peaking during years two to four. Our data sample does not include two full five-year cycles as it excludes the years 2010-11 (ie, first year of AMP5) and 2019-20 (ie, last year of AMP6), which are both lower cost years (2010-11 in particular), therefore being more representative of higher cost years.

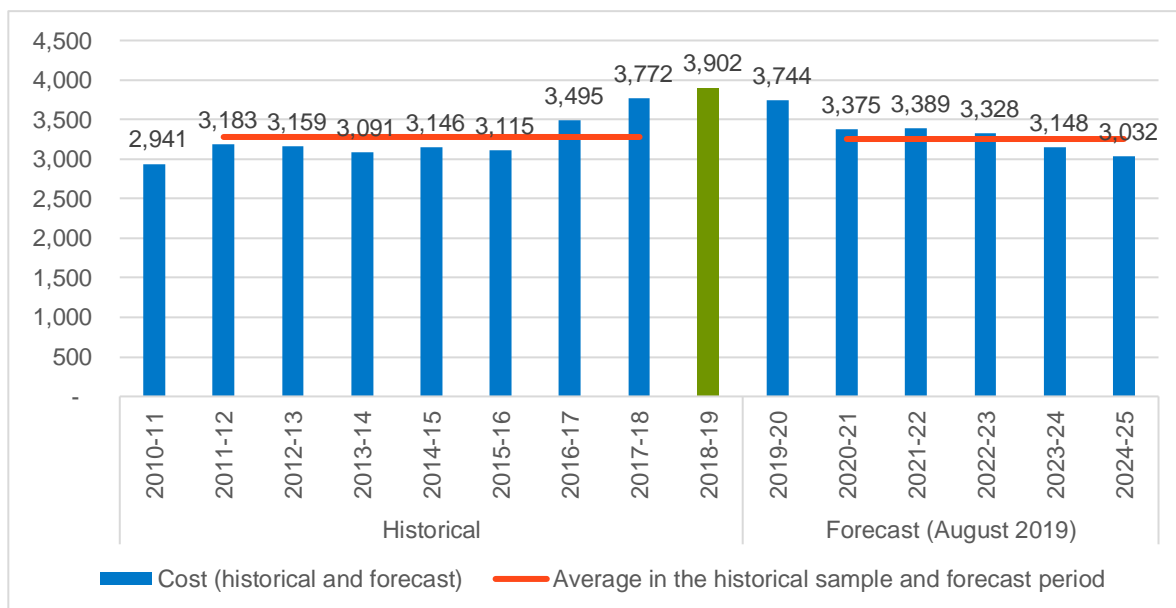
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<sup>10</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, p. 54, paragraph 235.

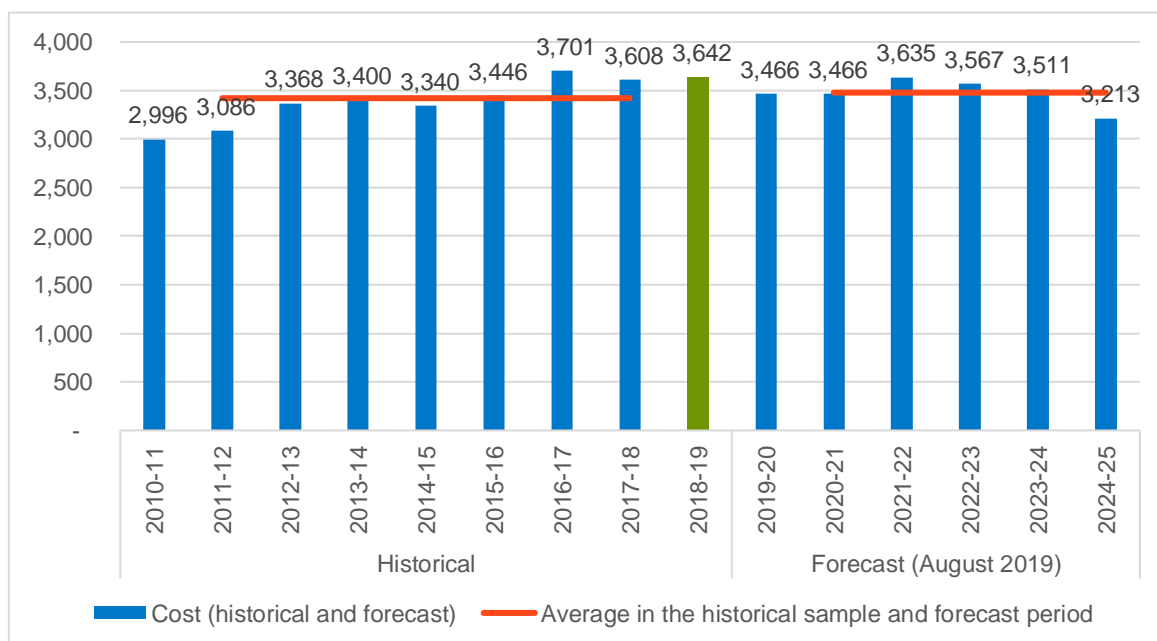
<sup>11</sup> Ofwat, '[PR19 draft determinations: Securing cost efficiency technical appendix](#)', pp. 93-94.

<sup>12</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, pp. 54-55, paragraphs 237-240.

**Figure 2.1: Industry wholesale water modelled base costs (£m)**



**Figure 2.2: Industry wholesale wastewater modelled base costs (£m)**



**Northumbrian Water states that our reference to the Northern Ireland Utility Regulator (UR) using a more demanding catch-up challenge than the upper quartile was incorrect. It references a quote from the UR: ‘The upper quartile, or the 75th percentile, is equivalent to the 3.75 placed company’.**<sup>13</sup>

<sup>13</sup> Northumbrian Water, ‘PR19 CMA Redetermination reply’, May 2020, p. 57, paragraph 245.



- 2.12 The sentence that Northumbrian Water quotes from the UR's final determination publication is the result of a typo in the UR's document. The upper quartile benchmark is equivalent to the 4.5 placed company, rather than the 3.75 placed company.<sup>14</sup> Therefore the UR's use of the 4th placed company represented a more stretching challenge than the upper quartile.
- 2.13 Furthermore, each price review is reflective of different circumstances. The overall level of efficiency challenge that each regulator sets will be specific to each price control, and the circumstances and spread of efficiency across companies at the time. As the Department for Business, Energy and Industrial Strategy's 'Principles for Economic Regulation' acknowledge, 'the framework of economic regulation needs capacity to evolve to respond to changing circumstances and continue to be relevant and effective over time'.<sup>15</sup> We provided evidence of other regulators setting the catch up challenge beyond the upper quartile to show that there can be circumstances in which going beyond the upper quartile may be appropriate.

## Application of frontier shift to enhancement costs

- 2.14 In our final determination we applied a frontier shift efficiency challenge (and real price effects (RPE) allowance) to elements of enhancement costs which are more common across companies including the wastewater elements of the Water Industry National Environment Programme (WINEP) and metering costs. This is because companies had not applied a net frontier shift challenge (frontier shift less real price effects allowance) to these costs. In addition, the potential gains from productivity improvements are likely to be more significant for large, relatively homogeneous programmes of work that are more common across companies, such as WINEP and metering costs.

## Key new points raised by disputing companies

- 2.15 Disputing companies raise some new arguments on our application of net frontier shift to WINEP costs including:

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<sup>14</sup> Out of 15 Distribution Network Operators, the median is the 8th placed company, the upper quartile is equivalent to the 4.5 placed company and the lower quartile is equivalent to the 11.5 placed company.

<sup>15</sup> Department for Business, Energy and Industrial Strategy, 'Principles for Economic Regulation', April 2011, p. 5.

- Applying frontier shift to enhancement costs such as WINEP is double-counting the efficiency gain as companies already included a frontier shift efficiency challenge in their enhancement costs.<sup>16</sup>
- Companies were asked to submit future efficient costs which by definition would include future efficiency improvements including frontier shift impacts.<sup>17</sup>
- Ofwat should have clarified that costs should be provided excluding frontier shift and real price effects.<sup>18</sup>
- Dŵr Cymru (WINEP benchmark upper quartile company) included a 1% p.a. efficiency challenge to all its schemes including WINEP.<sup>19</sup>

2.16 Anglian Water and Yorkshire Water both now clearly state their view that frontier shift should not be applied to metering costs due to double-counting of efficiency improvements.<sup>20,21</sup>

## **Our response to new points raised by disputing companies**

### **Applying a net frontier shift challenge**

2.17 Companies state that where they have applied a frontier shift challenge which is the same magnitude as a real price effects allowance, they should be exempt from any further frontier shift challenge.<sup>22</sup> This is fundamentally misconceived. In applying our frontier shift to company costs, the frontier shift is netted of any real price effects allowance to determine the net frontier shift challenge imposed on company costs. It is therefore important to identify whether the companies have applied a frontier shift adjustment net of any real price adjustment that is relevant.

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<sup>16</sup> Anglian Water, REP08 Part G, paragraph 219; Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, section 4.7.2.2, paragraphs 311-316; Yorkshire Water, Annex 19 – YWS – WINEP case study, p. 11; and Yorkshire Water, '[Response to Ofwat Reply](#)', May 2020, paragraph 3.46.2, p. 87.

<sup>17</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, paragraph 311, p. 67.

<sup>18</sup> Anglian Water, REP08 Part G, p. 60, paragraph 221; Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, paragraph 311, p. 67. Yorkshire Water, '[Response to Ofwat Reply](#)', May 2020, paragraph 3.47.1, p. 87.

<sup>19</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, paragraph 316, p. 67.

<sup>20</sup> Anglian Water, REP08 Part G, pp. 60-61, paragraph 223.

<sup>21</sup> Yorkshire Water, '[Response to Ofwat Reply](#)', May 2020, paragraph 3.48.1, p. 87.

<sup>22</sup> For example, see Anglian Water, REP08 – Part G: Reply to Ofwat's Response on Cost issues, May 2020, p. 42, paragraph 152; Anglian Water, REP02 – Part A: Review of Cost arguments', May 2020, pp. 58-59, 7.1 Frontier Shift; and Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, p. 68, paragraph 314.

2.18 In our final determination, we set a frontier shift of 1.1% per year and allowed for real price effects of 0.4% to 0.5% per year. Therefore, the net frontier shift challenge we imposed in our final determination is approximately 0.6% to 0.7% per year.

2.19 **In general companies did not make a net frontier shift adjustment to enhancement costs.** We therefore considered it reasonable to apply our frontier shift adjustment to selected enhancement costs.

2.20 We reviewed company business plan assumptions regarding application of a net frontier shift challenge to enhancement costs. Table 2.1 below summarises the most recent frontier shift and real price effects assumptions outlined by the disputing companies in their PR19 business plans. This table shows that none of the disputing companies imposed a net frontier shift challenge on their enhancement costs, with Anglian Water applying a net increase. We acknowledge the specific way in which companies have applied these assumptions to their costs can be somewhat unclear due to variances in App24a reporting and data table commentaries as outline above. In particular, Yorkshire Water reports efficiency gains in App24a but does not specify whether any of those reflect a frontier shift assumption.

**Table 2.1: Company net frontier shift challenge assumptions for enhancement costs**

Company	Frontier shift challenge (1)	Real Price Effects allowance (2)	Net Frontier Shift challenge (3)= (1)+(2)
Anglian Water	-1.0% <sup>23</sup>	1.2-1.4% <sup>24</sup>	+0.2% - +0.4%
Northumbrian Water	-1.0% <sup>25</sup>	1.0% <sup>26</sup>	0.0%

<sup>23</sup> Anglian Water, [Draft Determination Business Plan Data Table \(SOC176\)](#), August 2019, 'App24a' tab – rows 29, 30, 34, 35, 39, 40, Blocks H, I and J.

<sup>24</sup> Anglian Water, [Draft Determination Business Plan Data Table \(SOC176\)](#), August 2019, 'App24a' tab – rows 5, 6, 10, 11, 15, 16; Blocks B, C and D.

<sup>25</sup> Northumbrian Water, [NES.CA.A6 – Appendix 4.3 – Data Table Submission Commentary](#), March 2019, p. 63.

<sup>26</sup> Northumbrian Water, [Business Plan Data Tables](#), March 2019, 'App24a' tab – rows 5, 6, 10, 11, 15, 16; Blocks B, C and D.

Company	Frontier shift challenge (1)	Real Price Effects allowance (2)	Net Frontier Shift challenge (3)= (1)+(2)
Yorkshire Water	Unclear possibly 0% <sup>27</sup>	0.6% - 0.9% <sup>28</sup>	Unclear possibly +0.6% - +0.9%
Bristol Water	-0.9% <sup>29</sup>	0.9% <sup>30</sup>	0.0%

## Application of a net frontier shift challenge to WINEP enhancement costs does not double-count efficiency gains

2.21 We accept that enhancement costs are based on company estimates of future costs. Therefore to the extent that enhancement costs include future efficiency improvements due to frontier shift then there could be scope for double counting. However, we disagree with Northumbrian Water that future efficient costs 'by definition' would include frontier shift impacts. In general company enhancement expenditure forecasts are based on historical unit costs. Given that we are applying a net frontier shift challenge of -0.6% to -0.7% per year, it is only if companies have allowed for a net frontier shift challenge or made a specific adjustment for future technological change that there would be double counting.

2.22 Table 2.1 above shows that none of the disputing companies has applied a net frontier shift challenge to its enhancement costs, including WINEP. We also find no evidence that a net frontier shift challenge has been applied by the four companies that are cost efficient on WINEP.<sup>31</sup> Northumbrian Water states that Dŵr Cymru (the WINEP upper quartile benchmark company) applied a 1% frontier efficiency challenge to its forward looking WINEP costs. As outlined in our response to companies' statements of case, we did not find any evidence in Dŵr Cymru's September 2018, April 2019 or August 2019 business plan

<sup>27</sup> Yorkshire Water, [Business Plan Data Tables](#), October 2018, 'App24a' tab. The April 2019 data tables were the latest version received by Ofwat but it is not publicly available. We have hyperlinked the October 2018 version, as it shows the same results. Efficiency figures applied range from 0% to 40%.

<sup>28</sup> Yorkshire Water, [Business Plan Data Tables](#), October 2018, 'App24a' tab – rows 5, 6, 10, 11, 15, 16; Blocks B, C and D. The April 2019 data tables were the latest version received by Ofwat but it is not publicly available. We have hyperlinked the October 2018 version, as it shows the same results.

<sup>29</sup> Bristol Water, [Draft Determination Business Plan Data Tables](#), August 2019, 'App24a' tab; and Bristol Water, [Data Tables Commentary](#), August 2019.

<sup>30</sup> Bristol Water, [Draft Determination Business Plan Data Tables](#), August 2019, 'App24a' tab; and Bristol Water, [Data Tables Commentary](#), August 2019.

<sup>31</sup> See paragraphs 7.64 – 7.72, pp. 101-104 of our [Cost efficiency – response to common issues in companies' statements of case](#) document, submitted to the CMA on 4 May 2020.

submissions that it applied a frontier shift challenge to its enhancement costs.<sup>32</sup> Northumbrian Water has provided no reference or evidence to support its statement.

2.23 Therefore there is **no evidence to suggest our application of a net frontier shift challenge to WINEP costs double counts efficiency gains.**

### **Disputing wastewater companies have significantly underspent their PR14 National Environment Programme (NEP) allowances**

2.24 More than half of the PR19 enhancement programme is accounted for by WINEP. This followed the National Environment Programme (NEP) in PR14. All proposed wastewater WINEP enhancement expenditure is covered by statutory quality requirements which are subject to enforcement action from the Environment Agency if not delivered.

2.25 As it is difficult to benchmark enhancement expenditure, it can be more difficult to judge the appropriate level of efficient enhancement expenditure. As we set out in our response to Yorkshire Water's statement of case, we often see evidence of significant cost savings achieved through delivering an alternative solution to that first proposed.<sup>33,34</sup> These alternative solutions are difficult for us to discover when companies put forward their business plans.

2.26 For the three water and wastewater disputing companies, we have compared our cumulative total 2015-20 NEP capital cost allowances with their requests in their 2014 business plans and outturn (four years of actual data and one year of forecast data).<sup>35,36</sup> We find each of the disputing wastewater companies has spent considerably less than it forecast in its business plans, and the data shows that this underspend started early in the period. Of the £606 million (2012-13 prices) enhancement capex which the three companies requested in their PR14 business plans to deliver their NEPs, they expect actual expenditure to outturn at £347 million (2012-13 prices), **spending only 57% of what they**

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<sup>32</sup> See paragraph 7.70, p. 103 of our [Cost efficiency – response to common issues in companies' statements of case](#) document, submitted to the CMA on 4 May 2020.

<sup>33</sup> As stated in Ofwat, [Response to Yorkshire Water's statement of case](#), May 2020, p. 55, paragraph 3.110.

<sup>34</sup> For example a recent [Anglian Water project](#) where the built solution was less than 50% of the cost of the solution previously considered.

<sup>35</sup> As NEP is focused on wastewater we have not examined figures for Bristol Water as it is a water only company.

<sup>36</sup> Note that the final determination allowances are similar to the totex requested by companies in their business plans, which can be found at Ofwat, '[Final determinations wholesale cost assessment summary for water and wastewater](#)', 3 June 2015.

**requested.** For these three companies, the NEP underspend accounts for around half of the totex underspend against their business plans over the PR14 period. While we acknowledge that there could be changes in the NEP during the price control period, these changes need to be agreed with the Environment Agency. This typically involved one named scheme being swapped with another named scheme of a similar size. Due to the six yearly nature of the environmental regulatory cycle, the NEP was one year further on in its development at the time of the final determinations for PR14 compared to the WINEP for PR19 and so the NEP was more certain.

2.27 In PR19, to protect customers from the uncertainty around requirements unconfirmed at the time of our final determination (amber schemes), we included an uncertainty mechanism. This mechanism adjusts revenues at the end of the period for differences in the volume of work which had been undertaken compared with that which had been allowed for in the final determination.<sup>37</sup> This uncertainty mechanism does not apply to confirmed (green) schemes determinations.

2.28 Our PR19 final determination allowed the three disputing wastewater companies 83.3% of the amount they requested in their April 2019 business plans for wastewater WINEP. They requested a total of £1.86 billion and we allowed £1.55 billion.

2.29 Given the significant historical underspending on NEP, the CMA may wish to consider replacing the 0.7% per year net frontier shift challenge on WINEP in its redetermination. A suitable replacement **may be a greater efficiency challenge that reflects the scale of this historical efficiency improvement** and takes full account of the potential for increased efficiency from the use of the totex and outcomes framework, in particular moving from capex to opex based solutions.

## **Application of a net frontier shift challenge to metering enhancement costs does not double-count efficiency gains**

2.30 For the reasons explained above, there is no evidence that the disputing companies and WINEP upper quartile companies have applied a net frontier shift challenge to their forward looking costs. In addition there is no evidence

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<sup>37</sup> Ofwat, [PR19 final determinations: Securing cost efficiency technical appendix](#), December 2019, pp. 161-162.

that disputing companies have applied a net frontier shift challenge to their metering enhancement costs. Both Anglian Water and Yorkshire Water challenge our application of net frontier shift to metering enhancement costs, while Northumbrian Water states it is not challenging this.<sup>38,39,40</sup>

2.31 As shown in Table 2.1 above, we find no evidence that disputing companies have applied a net frontier shift challenge to their enhancement costs (including metering).

2.32 In our final determination we applied a net frontier shift to modelled metering costs only. However for both Yorkshire Water and Bristol Water, our modelled allowances were above their proposed allowances, so they were allowed what they sought (to which we did not make a frontier shift adjustment). It is therefore unclear why Yorkshire Water is objecting to our application of frontier shift to modelled metering enhancement costs, as it does not apply to the company. Northumbrian Water was also allowed its requested allowance in full (and a net frontier shift adjustment was not applied).

2.33 **Anglian Water was the only disputing company with some of its metering enhancement allowance subject to our 0.7% per year net frontier shift challenge.** As shown in the wholesale water metering enhancement model, only £17 million of Anglian Water's £126.3 million allowance for metering was subject to a frontier shift.<sup>41</sup> We found no evidence that Anglian Water had applied a net frontier shift challenge to its metering costs, and if it has applied its standard enhancement net frontier shift (ie, an increase in costs allowance due to real price effects) as shown in Table 2.1, then this should be removed by the CMA (which would have the effect of reducing its metering enhancement cost allowance).

## Industrial Emissions Directive (IED) costs

2.34 In its statement of case Northumbrian Water claimed that it required £99 million capital expenditure plus ongoing costs of £0.9 million per year associated with potential Industrial Emissions Directive (IED) obligations at sewage sludge biological treatment plants. We were not aware of this claim before our final determination. In our response we stated that Northumbrian Water's cost

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<sup>38</sup> Anglian Water, REP08 Part G, pp. 60-61, paragraph 223.

<sup>39</sup> Yorkshire Water, 'Response to Ofwat Reply', May 2020, p. 87, paragraph 3.48.1.

<sup>40</sup> Northumbrian Water, 'PR19 CMA Redetermination reply', May 2020, p. 74, paragraph 362.

<sup>41</sup> See "Deep dive\_ANH" tab, [Wholesale Water Enhancement feeder model: Metering](#).



estimates were likely to be significantly overstated and we provided correspondence from the Environment Agency in support of our view.<sup>42 43</sup>

2.35 In its 27 May response, Northumbrian Water now requests a £20 million cost allowance for two of its sludge treatment sites.<sup>44</sup> Yorkshire Water states that it expects to incur costs of £150 million over AMP7 to deliver compliance at 11 of its sludge treatment facilities.<sup>45</sup> Both companies have asked for an uncertainty mechanism for IED compliance costs.<sup>46,47</sup>

2.36 **These costs seem high**, and the Environment Agency has indicated it now considers costs for Northumbrian Water might be between £12 million and £20 million. We note that costs could be lower than this as it is unclear the degree to which existing facilities already meet requirements. The Environment Agency acknowledges the uncertainty about the precise requirements at each of the sites which can only be resolved at the permit review stage.<sup>48,49</sup> While we do not have sufficient detail to provide a view on the companies' cost proposals, we consider that it is important that companies have an incentive to incur costs efficiently and choose the best value solution. Given water companies' ability to control the scale of this expenditure and the lack of clarity of what, if any, additional efficient costs might be required, if the CMA were to consider an uncertainty mechanism appropriate then there is a case for not allowing the full extent of all the currently quoted costs to be passed directly on to customers. This could be done by allowing a zero or very conservative allowance for costs, with a reasonably high sharing factor with customers. In PR19 we have limited uncertainty mechanisms, for example passing through 75% of costs of business rate changes, to provide an incentive for companies to control costs.<sup>50</sup>

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<sup>42</sup> Ofwat, '[Response to Northumbrian Water's statement of case](#)', May 2020, paragraphs 3.156-3.162.

<sup>43</sup> Ofwat, Environment Agency email regarding Industrial Emissions Directive, 29 April 2020 (submitted as N006 with our response to the company's statement of case)

<sup>44</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, p. 129, Table 36.

<sup>45</sup> Yorkshire Water, '[Response to Ofwat Reply](#)', May 2020, p. 261, paragraph 12.1.27.

<sup>46</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, p. 129, Table 36.

<sup>47</sup> Yorkshire Water, '[Response to Ofwat Reply](#)', May 2020, p. 261, paragraph 12.1.27.

<sup>48</sup> X003, email from Environment Agency to Ofwat, 27 May.

<sup>49</sup> The permit review stage is likely to be between January 2021 and April 2022. See X002 – Environment Agency, 'Implications of Covid-19 for work areas and timescales for the water industry,' May 2020

<sup>50</sup> Water companies can impact business rates through engagement with the valuation office during the revaluation process.



### 3. Overall level of stretch

3.1 A number of the disputing companies raise issues on the overall level of stretch. Our response to these issues is set out in our response to the disputing companies' statement of case.<sup>51</sup> We have provided additional explanation on our approach in our cost of the base level of service note.<sup>52</sup> We provide a brief further explanation of two cross cutting issues where companies have raised new arguments:

- The stretch on outcomes compared to PR14; and
- The impact of marginal costs.

#### Outcomes stretch at PR19 compared to PR14

3.2 We set out in our response to the statements of case that overall stretch in PR19 outcomes is similar to that achieved in the PR14 period.<sup>53</sup> Yorkshire Water, Northumbrian Water and Anglian Water each argue that particular aspects of their outcomes package are more stretching than at PR14, though do not present any new evidence or dispute our overall data on outcomes stretch.<sup>54,55,56</sup>

3.3 The stretch on some performance commitments may be greater for some companies than for others, but it also may be lower. In general, the stretch on outcomes for the disputing companies is lower than the stretch for many companies that accepted the final determinations. Accordingly, it would be wrong to assume that the disputing companies have been particularly challenged on overall stretch. As we noted in our response to the statements of

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<sup>51</sup> Ofwat, '[Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case](#)', May 2020, p. 53, Table 4.4.

<sup>52</sup> Ofwat, 'The cost of the base level of service', June 2020.

<sup>53</sup> Ofwat, '[Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case](#)', May 2020, p. 53, Table 4.4.

<sup>54</sup> Yorkshire Water, '[Response to Ofwat Reply](#)', May 2020, p. 164, paragraphs 5.2.2 – 5.2.4.

<sup>55</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, p. 107, paragraph 504.

<sup>56</sup> Anglian Water, 'Anglian Water PR19, Part D: Review of ODIs arguments', May 2020, p. 5.

case, Anglian Water and Northumbrian Water are already outperforming on some performance commitments.<sup>57</sup>

- 3.4 Yorkshire Water presents data showing that the PR19 performance commitment levels are (in absolute terms) more challenging than PR14. This misses the point that it is the amount of improvement that is important, not the absolute performance level. Overall we are asking companies to improve by a similar amount to their improvements during PR14.

## Marginal costs

- 3.5 Three of the disputing companies argue that we have not accounted for the increasing marginal costs of improving performance.<sup>58,59,60</sup>
- 3.6 We agree that, in some circumstances, the marginal costs of improving performance will increase at higher levels of performance. However, we took this into account when setting our final determinations and found that companies are unlikely to be at the point of diminishing marginal returns.<sup>61,62</sup> Furthermore, we have avoided improvements where marginal costs might increase rapidly.
- 3.7 In addition we note that some companies which perform well on costs also typically performed well in relation to outcomes. As we stated in our response to companies' statements of case, some cost efficient companies are already meeting the 2025-25 performance commitment levels, and tend to perform better than other companies on service quality.<sup>63</sup> Consequently if there are higher marginal costs of meeting these higher improvements, then these will already be taken into account in our cost benchmarks which are based on historical costs. In other words, to the extent which cost efficient companies are

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<sup>57</sup> Ofwat, '[Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case](#)', May 2020, pp. 66-67, paragraph 5.33 and Tables 5.4 and 5.5.

<sup>58</sup> Bristol Water, '[Reply to Ofwat response](#)', May 2020, p. 66, paragraph 314.

<sup>59</sup> Northumbrian Water, '[PR19 CMA Redetermination reply](#)', May 2020, p. 107, paragraph 504.

<sup>60</sup> Anglian Water, 'Anglian Water PR19, Part B: Review of Cost Service Disconnect arguments', May 2020, p. 2.

<sup>61</sup> Ofwat, '[PR19 final determinations: Delivering outcomes for customers policy appendix](#)', December 2019, pp. 98-99.

<sup>62</sup> Ofwat, '[Reference of the PR19 final determinations: Outcomes – response to common issues in companies' statements of case](#)', May 2020, p. 45, paragraphs 10.3-10.10.

<sup>63</sup> Ofwat, '[Reference of the PR19 final determinations: Introduction and overall stretch on costs and outcomes – response to cross-cutting issues in companies' statements of case](#)', May 2020, pp. 84-85, paragraph 7.5.

already meeting or close to meeting their 2024-25 targets then the base cost allowances already include any increase in marginal costs. In addition we note that some disputing are already meeting the 2024-25 performance commitments levels in some areas. Further detail on how we have taken account of the historical cost of improving service is set out in our note.<sup>64</sup>

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<sup>64</sup> Ofwat, 'The cost of the base level of service', June 2020.

## 4. Covid-19

- 4.1 In our 19 March letter to all companies regarding Covid-19, we signalled clearly that '[i]n this situation and for the avoidance of doubt, incentives and penalties in our regulatory regime should not get in the way of effective prioritisation in the interests of customers. .... Please be assured that we will consider the need for any ex post adjustments to our regulatory system following an in-the-round assessment as part of our normal reconciliation process.'<sup>65</sup>
- 4.2 Our and companies' understanding of the potential impacts of Covid-19 have evolved since the statements of case in early April, though we are still some distance away from being able to test and evaluate these impacts in their totality. We consider that it may be useful for the CMA to understand how some of the potential impacts identified by companies in their 27 May 2020 submissions might be covered by the wide variety of existing uncertainty and reconciliation mechanisms available to water companies. We have also established a joint working group with the sector, via Water UK, to understand Covid-19 impacts on companies and will be gathering data from companies on impacts. If it would assist the CMA, we can provide an update on our work in the summer.
- 4.3 We note that each disputing company proposes a different approach to dealing with the impacts and uncertainty of Covid-19, and some invite the CMA to undertake this assessment as part of the redetermination process. We consider that it is important to have reasonable certainty around the impacts of Covid-19 before making any associated adjustments as part of the redetermination process.<sup>66</sup> **We consider that these impacts are best addressed when we can identify impacts across the sector as a whole and are able to benchmark company performance and apply a rounded judgement across all 17 companies.**
- 4.4 The main topics raised by the companies are changes in demand/revenue, changes in bad debt, social assistance programmes, unbilled charges, financing costs, performance commitment achievability, new connections, and input cost changes. In summary, the vast majority of these are addressed through existing PR19 mechanisms. We discuss each area in turn below.

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<sup>65</sup> Ofwat, [Letter to all CEOs from Rachel Fletcher on Covid-19](#), 19 March 2020.

<sup>66</sup> If appropriate, they may also be considered under the existing interim determination and substantial effect provisions in water company licences.

## Impacts on demand and revenue

4.5 Several companies state they expect household consumption to rise in the short-term and business demand to decrease. This has a corresponding impact on revenue. As the companies themselves note, the Revenue Forecasting Incentive Mechanism (RFIM) covering the water resources, water network plus and the wastewater network plus revenue controls allows any under or over-recovery of revenue in 2020-21 to be recovered with a two-year lag in 2022-23.<sup>67</sup> The bioresources revenue control which is covered by a different reconciliation mechanism in PR19 is also reconciled in-period. This limits the short-term cash-flow impact on companies within the price control period. Any outstanding imbalance that is not recovered in the 2020-25 period is recovered in the subsequent price control period. In relation to the residential retail revenue control, companies are able to recover any imbalance incurred during the 2020-25 period in the subsequent price control period. The revenue changes not covered in this way are bad debt (see paragraphs 4.6 to 4.9), social tariffs which provide additional discounts to customers (see paragraph 4.10), and unbilled charges (see paragraph 4.11).

## Impacts on retail

4.6 **Business retail:** Several companies note an increased bad debt risk from business retailers as a result of Covid-19. We have taken action to help business retailers mitigate the impact of Covid-19 on cash flow – it is principally business retailers who bear the risk of business bad debt. For wholesalers, including the four disputing companies, there are two residual risks from business retailers:

- Cash flow delays, due to business retailers delaying payment to wholesalers. Where business retailers do delay payment, wholesalers are entitled to charge interest (up to 5.98% nominal), and so wholesalers are no worse off over the duration of PR19.
- Potential bad debt costs from the failure of a business retailer. Wholesalers have some protection from business retailer bad debts through the credit arrangements in the market codes. Any additional bad debt costs would be shared with customers through the totex sharing mechanism. We note that most of the customers of the disputing companies are covered by associated retailers of the wholesaler (Wave (jointly owned by Anglian Water and Northumbrian Water) for Anglian Water and Northumbrian

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<sup>67</sup> Consistent with [Rachel Fletcher's letter to CEOs](#) on 19 March 2020, we will consider whether any ex post adjustments, including exceptions to RFIM penalties, are appropriate in light of the impact of Covid-19 within our normal reconciliation processes.

Water, Water2business for Bristol Water (jointly owned by Bristol and Wessex Water)). Yorkshire Water sold its business retail operation to Business Stream (owned by Scottish Water, the public water utility in Scotland), which now provides business retail services to the majority of its customers.

- 4.7 As part of our Covid-19 response, we have capped the increased exposure from the liquidity arrangements we have put in place in the business retail market to the average monthly charge for the failed retailer.<sup>68</sup> Until the cap is reached any increased bad debt costs, not covered by the credit arrangements in the business retail market, will be shared with customers through the totex sharing mechanism. Once the cap is reached all bad debt costs from the failed retailer resulting from the increased exposure are borne by customers.
- 4.8 Some companies note that their exposure to business retail bad debt is exacerbated by the cost-sharing rates we apply to totex overspend. This is not a Covid-19 specific issue. The cost-sharing rates are a result of our approach to incentivising companies, which has been discussed in detail by ourselves and the companies in previous submissions to the CMA. We responded to this issue in relation to Covid-19 in our recent decision on business retail market interventions in light of Covid-19,<sup>69</sup> and in our note to Water UK,<sup>70</sup> and therefore, in the interests of brevity, we do not repeat them here.
- 4.9 **Household retail:** Several companies note an increased bad debt risk from households resulting from the immediate impact of Covid-19 and the expected economic downturn. The extent of the downturn is highly uncertain, as the companies acknowledge, and so we intend to consider this as part of the broader in the round assessment, once the actual impact is known. Incentives to minimise bad debt are an important part of the price review process, and it would be inappropriate to distort these incentives. No company has asked the CMA to reopen the household retail price control, and so the implications of Covid-19 for household bad debt are less relevant for this redetermination process. We also note that we are providing three of the four disputing companies with more revenue at PR19 than they requested for the retail price control.<sup>71</sup>

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<sup>68</sup> Our interventions regarding business retail and coronavirus are set out in our webpage on '[Information on the water industry and Coronavirus](#)', and in our '[Questions raised in response to Ofwat's final decision published 30 April 2020](#)', which includes a worked example of the cap.

<sup>69</sup> '[Covid-19 and the business retail market: Proposals to address liquidity challenges and increases in bad debt – decision document](#)', 30 April 2020, p. 36.

<sup>70</sup> Questions raised in response to Ofwat's final decision published 30 April 2020, p. 6.

<sup>71</sup> Anglian Water, Bristol Water and Yorkshire Water.

## Social assistance programmes

4.10 Companies provide social tariffs, reducing bills for particularly vulnerable customers. Several companies suggest that these schemes may need to be extended to more customers. Apart from a few specific circumstances, these are a cross-subsidy between customer groups, with all other customers' bills being slightly higher.<sup>72</sup> Therefore the social assistance programme operates on a cost-neutral basis to the company. Similarly, payment holidays (excluding bad debt impacts) impact cash flow timing, rather than total revenue that companies can recover during the 2020-25 period. We are working with Water UK and the companies to gather more data on this issue.

## Unbilled charges

4.11 Anglian Water states that where a service has been provided but not yet invoiced prior to retailer failure, the revenue is treated as being earned and therefore reported.<sup>73</sup> As there is no fall in revenue, it argues the RFIM mechanism does not apply, resulting in further exposure. Anglian Water argues that this requires an amendment to the PR19 reconciliation rulebook. In response to this point, we set out in our response to Water UK that we would expect companies to provide commentary on any un-invoiced amounts due to retailer failure as part of their regulatory accounts.<sup>74</sup> We would then allow companies to make an adjustment relating to this amount within the RFI model as part of the reconciliation process. This would require an amendment to the Reconciliation Rule Book on which we would need to consult.

## Financing costs

4.12 Anglian Water and Northumbrian Water both note that the cost of debt could change as a result of Covid-19, though in opposing directions. Anglian Water states that 'market rates [are] at historic lows', whereas Northumbrian Water states 'finance costs are likely to remain higher for at least 2 years'. However, both companies note that the cost of debt indexation mechanism means that the benefits or costs of changes to market debt costs pass through to customers. We discuss this in more detail in our previous submission on risk

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<sup>72</sup> There are a small number of exceptions to this cross-subsidy approach in specific circumstances. Both Dwr Cymru and United Utilities make a voluntary direct financial contribution.

<sup>73</sup> Anglian Water, 'Initial submission to CMA on Covid-19 impacts', May 2020, paragraph 4.31.

<sup>74</sup> 'Questions raised in response to Ofwat's final decision published 30 April 2020', p. 12.

and return<sup>75</sup> and in the 'Risk and return' document forming part of this submission.<sup>76</sup>

### **Performance commitment achievability**

4.13 Several companies highlight the risks to achieving performance commitment levels. For example, per capita consumption reductions may be more difficult to achieve due to both delays in rolling out metering and short-term changes to consumption profiles. Companies have also suggested that capital projects may also be delayed, potentially leading to worse performance on asset health measures and leakage.

4.14 We stand by the commitments made in our 19 March 2020 letter to companies regarding performance incentives. Our reconciliation process has the clear benefit of occurring once the impacts of Covid-19 are better known, and enables companies to submit detailed evidence.<sup>77</sup> This is clearly preferable to rapidly changing (for example softening, or even removing) performance commitments at a time when circumstances are evolving quickly, risking unnecessarily distorting or removing incentives which benefit customers.

### **New connections/growth**

4.15 Several companies have indicated a reduction in new connections in 2020-21, and possibly 2021-22. We agree that there is likely to be at least a short-term reduction in demand for new connections. Customers are protected through the developer services reconciliation adjustment if outturn new connections end up being lower than forecast.<sup>78</sup> We discuss our overall approach to growth in our response to Anglian Water's 27 May submission to the CMA.<sup>79</sup>

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<sup>75</sup> Ofwat, '[Reference to the PR19 final determinations: Risk and return – response to common issues in companies' statements of case](#)', May 2020, pp. 45-46, paragraphs 3.5-3.9.

<sup>76</sup> Ofwat, '[Reference to the PR19 final determinations: Risk and return – response to common issues in companies' submissions on 27 May 2020](#)', June 2020, Chapter 5.

<sup>77</sup> Companies will submit information about 2020-21 performance in the Annual Performance Reports (APRs) by 15 July 2021. We reach a view on any required adjustments to price controls (and any potential adjustments for Covid-19 impacts) by 15 November 2021. Any adjustments are reflected in bills from April 2022.

<sup>78</sup> Ofwat, '[PR19 final determinations: Securing cost efficiency technical appendix](#)', December 2019, p. 27; Ofwat, '[PR19 final determinations: Our approach to regulating developer services](#)', December 2019, Chapter 2.

<sup>79</sup> Ofwat, '[Response to Anglian Water's 27 May submission to CMA](#)', June 2020.



## Costs

- 4.16 Some companies have stated that construction activity may be delayed as a result of Covid-19, and that this will have knock on impacts for realising cost efficiencies. Anglian Water and Northumbrian Water also highlight a potential cost increase, due to increased supply chain risk (eg, access to PPE). We intend to consider these impacts as part of the totex reconciliation. We also note that capital expenditure schemes are often delayed, even absent the current exceptional circumstances, being 'pushed back' to later years of a price control period.<sup>80</sup>
- 4.17 There are also potential real price effects for labour and energy costs. We discuss these separately in the accompanying Northumbrian Water document and in our 4 May 'Cost efficiency' document.<sup>81,82</sup>

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<sup>80</sup> See for example the profile of totex outperformance in 2015-19 in the [service delivery report 2018-19](#).

<sup>81</sup> Ofwat, 'Response to Northumbrian Water's 27 May submission to CMA', June 2020, Chapter 2.

<sup>82</sup> Ofwat, '[Reference of the PR19 final determinations: Cost efficiency – response to common issues in companies' statements of case](#)', 4 May 2020, Chapter 8.

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Ofwat  
Centre City Tower  
7 Hill Street  
Birmingham B5 4UA

Phone: 0121 644 7500  
Fax: 0121 644 7533  
Website: [www.ofwat.gov.uk](http://www.ofwat.gov.uk)  
Email: [mailbox@ofwat.gov.uk](mailto:mailbox@ofwat.gov.uk)

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