

26 October 2020

[www.water.org.uk](http://www.water.org.uk)

## Summary

Water UK is the representative body and policy organisation for water and wastewater service providers across the UK; individual companies may have different perspectives.

We welcome the opportunity to comment on the provisional findings. In doing so, we are conscious that these findings have significance not only to the four price determinations which have been referred to the CMA, but also to future price determinations for all water and wastewater service providers in England and Wales, to their customers, and to the environment.

We value the important role that the CMA plays in the sector in providing an expert and independent review of the merits of determinations and the arguments of the main parties and others, and we appreciate the thorough approach the CMA has taken to fulfilling this role, particularly given the difficult circumstances of Covid-19.

Overall, we view the provisional findings as going some way towards achieving the long-term orientation that we and many others see as crucial for the sector. However, there are areas where the CMA could go further, in particular ensuring that customers' views are central to the regulation of the sector and recognising the cost of improving service and resilience.

We also agree that, as well as maintaining incentives for companies to continue to improve efficiency and performance, in view of the long-term challenges facing the water sector it is in the interests of current and future customers for continued investment to be encouraged and the sector's longer-term attractiveness to investors maintained. We welcome the direction of travel in this regard of the CMA's provisional findings. We note, however, that given the scale of long-term investment needs, even in light of the changes the CMA has proposed thus far the investability of the sector should not be taken for granted.

Below, we expand on some of the aspects of the provisional findings most pertinent to the future regulation of the sector.

### **Customer engagement**

We note the observations made in the provisional findings about the role of customer engagement and the weight evidence thus derived should be given when considering all evidence in the round.

While we recognise that determinations necessarily involve the assessment of inputs from a range of sources, as a point of principle our view is that the legitimacy of the sector is enhanced by customer views being reflected in outcomes from the regulatory process – including redeterminations by the CMA – to the greatest extent possible, including reflecting regional customer preferences where these can be robustly demonstrated.

As we look towards PR24 and subsequent price reviews, greater clarity on the role of customer evidence will be important. We suggest that if there are to be circumstances when well-evidenced customer views do not flow through to outcomes, there should be a robust and explicit rationale for this.

### **Resilience**

While it is for the companies concerned to comment on details of the provisional findings in relation to specific schemes, given that customers consistently place a high priority on ensuring that their services remain resilient to the challenges of climate change and demand growth and can be relied upon now and in the future, it is naturally welcome that some additional investment has been included to address challenges to resilience against both drought and floods.

We would though note that there remains a considerable gap in the views of required investment, and given that resilience is likely to become an even more important driver of investment in future reviews, we suggest that a clearer framework to assess and reach agreement on resilience needs would be beneficial.

More broadly, we support and endorse the importance placed by the provisional findings on encouraging long-term investment in resilient services and ensuring a continued willingness of investors to commit capital to the sector.

A key aspect of maintaining resilient services is ensuring that there is sufficient expenditure on capital maintenance in each period, to avoid compromising services to future generations. We note that this issue, as well as expenditure to achieve net zero carbon emissions, has been central to the parallel regulatory process in Scotland<sup>1</sup>.

In this context, we welcome the recognition that current approaches to cost assessment are backward looking, and that potential issues with capital maintenance may be forward looking. We agree that the current approach should be enhanced with a forward-looking element, and look forward to working with Ofwat and other stakeholders on this important issue. More immediately, to reduce the degree to which cost assessment is backward looking, we suggest that the CMA should incorporate 2019-20 data into its analysis for its final decisions, consistent with the approach that is signalled in the provisional findings.

### **Disconnect between cost assessment and service levels**

We welcome the recognition that, in relation to leakage, a step change in performance will result in additional costs, and that these additional costs should be reflected in determinations. The industry remains committed to ambitious long-term targets to reduce leakage; in this context, we note with interest the observation that, given that leakage improvements will impose costs on customers, there

---

<sup>1</sup> [https://www.watercommission.co.uk/UserFiles/Documents/Strategic%20Review%20of%20Charges%202021-27%20Draft%20Determination\\_1.pdf](https://www.watercommission.co.uk/UserFiles/Documents/Strategic%20Review%20of%20Charges%202021-27%20Draft%20Determination_1.pdf)

will be a level of leakage below which the costs of further reduction will outweigh the benefits, including wider social and environmental costs and benefits. Ultimately Government policy will rightly influence this judgement, but it is important that companies are sufficiently funded to meet the outcome of this policy decision, rather than being faced with asymmetric outcome incentives.

We also note that a similar logic applies to other areas of company performance, for example sewer flooding or interruptions to supply, but has not been addressed in the provisional findings.

While we acknowledge that higher service performance does not automatically result in increased expenditure, neither is it the case the higher service performance can automatically be achieved without increased expenditure. We suggest that it is important to robustly assess the potential for service improvements to result in higher costs on a case-by-case basis, and also to consider the level at which further improvements would impose costs on customers that outweigh the benefits. Considering the most recent industry cost and service data, from 2019-20, is likely to be informative for the CMA, enabling an assessment to be made over the full period of AMP6.

### **Efficiency assumptions**

Companies recognise that the regulatory regime should spur greater efficiencies and incentivise innovation to deliver those efficiencies, while noting that overly aggressive assumptions on the scale of the achievable sector-wide frontier shift and efficiency gains result simply in the erosion of resilience in the sector to manage shocks such as the current COVID-19 pandemic. In this context, we welcome the degree of moderation in the provisional findings to some of the more aggressive assumptions, while noting that the required stretch remains challenging.

### **Financing the sector**

As in our earlier submission, we will not enter the debate on specific parameters for the capital asset pricing model, which continues to be well covered by others. We do though reiterate our support for the recognition in the provisional findings of the importance of ensuring that the sector is seen as an investable proposition, with a reasonable prospect of an appropriate balance of risk and returns - particularly in light of the substantial investment that will be needed in subsequent regulatory periods to meet the challenges of climate change and growth. The provisional findings will help in this regard, although given the scale of future investment needs, even in light of the changes the CMA has proposed thus far the investability of the sector should not be taken for granted.

We welcome the CMA's recognition that there is a clear and direct link between the level of risk in a price control and the level of return that is needed. If a price review leads, as is the case for PR19, to asymmetric downside risk, then the level of the WACC and other parameters should reflect this. We also welcome where the CMA has identified that regulatory consistency is important to investors, such as maintaining the principle from previous CMA cases that smaller companies can be expected to have a higher cost of financing.

Regarding financeability, we agree that the WACC is an important driver in ensuring that an efficient firm can finance its functions, and that as a matter of principle, if the WACC is set at a reasonable level, both debt and equity investors should earn sufficient returns to cover the costs of financing. We also note the clarity which the provisional findings bring to the merits of the gearing outperformance sharing mechanism.