South Staffs Water
Green Lane, Walsall WS2 7PD
www.south-staffs-water.co.uk

Competition and Markets Authority,
PR19 Determinations

By email to: waterdetermination2020@cma.gov.uk

25 January 2021

Dear Sirs,

South Staffs Water response to the CMA working paper “Leakage Enhancement Totex Allowances”.

Thank you for the opportunity to feed in to this element of the redetermination process. Leakage is an important area for the long term and therefore it is important that regulatory decisions are made in a sustainable way.

We have expressed our views on some of the points raised through the CMA’s determinations on this topic, on the following pages.

Please feel free to get in contact for any clarifications or further discussions on our views.

Yours sincerely,

Caroline Cooper,
Strategy and Regulation Director,
South Staffordshire Water PLC

Why we wanted to respond to this consultation:

Leakage enhancement has been a prominent area of previous price reviews and even more so in the PR19 price review. At PR19, Ofwat's policy on leakage was a major step change from what had gone before and a material factor in our regulatory settlement for 2020-2025 both in terms of cost allowance and service level. We think the CMA's decisions in these determinations will influence future regulatory policy and we therefore want to express our views in this area.

Along with other companies, we have a significant step change to make on leakage performance and we did not receive an enhancement cost allowance for this.

Funding of leakage enhancement for companies not at upper quartile:

We agree with the CMAs provisional decision that companies who are not at upper quartile should still be funded for the efficient costs of leakage enhancement. We note that Ofwat remains strongly against this approach and we do not agree with its assertions about past performance and past cost allowances.

Our decision to accept the determination without an explicit leakage allowance was taken in the round, and leakage was one of many factors in this decision. We do not agree with Ofwat that this means non-disputing companies automatically agree with Ofwat's policy on this[1]. Our lack of an enhancement allowance for leakage will mean we have to make other expenditure trade-offs to fund leakage improvement during this period, in order to meet our 15% improvement targets. This is not a sustainable approach going forward as it risks under investing in other essential activities, such as asset health and resilience, over the long term.

We also do not agree with Ofwat that performance outside the upper quartile means that leakage has been neglected historically[2]. In expressing this view, Ofwat is ignoring its own significant regulatory role in how previous leakage targets, cost allowances and incentives were set. As the CMA has observed, in previous price reviews SELL was the main mechanism for justifying leakage targets and costs. If a company wanted to deviate from its SELL, this had to be strongly justified in its business plan and water resources plan otherwise it would not have been accepted by Ofwat and would not have formed part of the determination. For many companies not under supply stress, this naturally resulted in a least cost approach that meant a broadly stable leakage target over time. Achieving an upper quartile performance level was never a criteria within the previous regulatory approaches and was deemed not appropriate, by Ofwat, at PR14, when other service levels had been set in that way.

Ofwat makes the assertion that all companies have been implicitly funded for leakage reduction to the upper quartile level because some companies have achieved that in previous periods. However this does not take into account that other companies will have made different service or asset improvements using their cost allowances. There is a vast array of other areas of investment and service improvements that companies can make using their allowances, for example in asset health, resilience, environmental issues, or customer service. Considering leakage performance in isolation does not take this into account.

[1] As implied by paragraph 22 on page 6.
[2] As implied by paragraph 23 on page 6, and paragraph 26 on page 7.

On the basis of the above, we support enhancement cost allowances for all of the disputing companies as it is important that the misinformation about previous regulatory processes and historical performance is not allowed to undermine a sustainable future approach to leakage reduction, which we all want to see. It is vitally important for sustainable future service levels in water that all elements of service improvement are appropriately funded and where step changes in service levels are desired, that these are funded sufficiently without risking under-investment in other areas.

We however observe that Northumbrian Water appears to have undermined its own case by not including the genuine costs of leakage reduction in its original business plan nor has it taken subsequent opportunities to do so. It should be clear in CMAs decision that leakage allowances for non-upper quartile companies are correct in principle but that Northumbrian's own choices have undermined its case in this instance. We would also note that this may be a side effect of the fast tracking incentives at price reviews. These incentives are intended to encourage companies to put forward stretching and efficient plans, but they also have the potential to encourage companies to put forward unrealistic plans as well.

Cost efficiency:

We are fully supportive that funded enhancement costs should be efficient, and comparative benchmarking is an appropriate tool to assess this but relies on good quality data. The CMA may not be aware but going forward Ofwat has redefined how leakage enhancement expenditure is reported in future annual returns. It has now specified that any company who did not receive a leakage enhancement allowance at PR19 should not report any costs related to leakage reduction as enhancement, and instead include them in base costs. We are concerned about this for the following reasons:

- It will reduce the transparency of leakage reduction costs making assessment of efficient costs more difficult in future.
- In turn this could also undermine future cost modelling, making it difficult to determine what base costs are without leakage enhancement.
- It permanently embeds Ofwat's assertion that leakage reduction costs for companies not at upper quartile should be funded from base costs, something which the CMA disagrees with in its provisional findings as it has allowed enhancement funding in principle, as discussed above.

We would ask the CMA to consider advising Ofwat to reconsider its regulatory reporting definitions for leakage enhancement costs to ensure these problems do not occur in future.