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Competition and Markets Authority

The Cabot

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Dear Jessica

A response to the CMA's approach and prioritization document

I would like to thank you for the opportunity to comment on the CMA's draft approach and prioritization document. The thoughts that I set out below are based on my time as the Water Industry Commissioner for Scotland and the Chief Executive of the Water Industry Commission for Scotland. I served in these roles for nearly 25 years until the end of 2023.

What follows are my personal views, based on many years of observing, and seeking to measure, the performance of water companies.

<u>The Policy Question</u>

I can understand the reluctance of the CMA to get into the business of designing a future framework for the medium and longer term funding of asset maintenance and replacement. This appears to me to be a not unreasonable position.

As you know, I submitted a paper to the CMA on Scotland's experience in considering asset replacement. As the economic regulator, we worked closely with the regulated company, the quality regulators (SEPA and DWQR) and customer representatives to understand the potential need to invest in asset replacement. We concluded that we had underfunded the regulated company and were storing up problems for the future. I recognize that the CMA has limited time available to it and it would not be possible for it to replicate fully the work that was completed in Scotland.

That said, I note that the National Infrastructure Commission, the National Audit Office and the interim thoughts of the Cunliffe Review all agree that we have invested insufficiently in asset replacement. It was also interesting that, consistent with our approach in Scotland, Cunliffe highlighted the difference in asset age that can exist. I agree that there is not a 'one size fits all' approach that can be applied. Companies have very different asset challenges. These can relate to asset age, construction materials, soil types and many other factors. The asset maintenance and replacement challenges faced by companies over the current regulatory control period may be quite different to those faced by peers.

Ofwat also appears to recognize that there has been insufficient investment in the replacement of assets: it increased funding to allow for a higher proportion of water mains to be replaced (not pre-judging in any way the decisions the CMA may reach as to what the extra funding should buy) and it decided to make a special allowance to Thames Water to replace water mains. It also commented on the unsustainably low level of asset replacement in its April 2025 document: 'Expenditure allowances – addressing asset health'.

I agree that the CMA should principally focus on ensuring that the decisions made for this regulatory control period are as robust as possible. As I seek to explain below, this will inevitably involve a review of how Ofwat has set allowances for asset maintenance and replacement. The future resilience and sustainability of the UK water industry require the asset replacement challenge to be addressed. The CMA did set out some higher level obligations when considering referrals from the PR19 Price Review – it could perhaps further develop its thinking during its current redeterminations of charges. The CMA's review can offer an important insight into the magnitude and urgency of this challenge.

It is in the interests of all stakeholders that this asset replacement challenge start to be quantified, and the CMA, as the expert body charged with redeterminations, is well placed to offer its assessment. Such an assessment need not impact on policy considerations such as when customers should pay.

<u>Price Setting</u>

An economic regulator is always keen to follow as straightforward and linear approach as is possible. It starts by assessing the current situation (what was learnt from the previous price setting, how has performance changed). There is typically then decisions about the priority areas for the next price review. A methodology and information request follow. In setting prices, the regulator is combining the approach that it has set out with the information that it receives from the companies. Final decisions therefore balance:

- the performance levels that the regulator wants to see delivered
- Ofwat's assessment of the costs and performance information received from companies; and
- Ofwat's approach to its analysis.

It is, unfortunately, not possible fully to disentangle the second two elements. There can also be a valid question whether the way in which elements two and three have been completed is consistent with performance levels sought.

Achieving performance targets may require a higher level of expenditure or may simply require an improvement in a company's efficiency. The assessment of base expenditure is critical to both these situations. Properly defining base expenditure should allow performance levels which are simply about doing things better to be achieved. But properly assessed base expenditure represents the baseline for the determination of the incremental expenditure required to achieve an enhanced level of performance.

Expenditure on maintenance and asset replacement represent a substantial proportion of base expenditure. As such, I do not think that the CMA can simply set aside the concerns of the appellant companies on the level of funding that has been made available to companies to maintain and replace their assets. If Ofwat's approach systematically underestimates the requirement for expenditure in this area, or its assessment of the need advanced by regulated companies was incorrect, the resulting base expenditure will be wrong. And if base expenditure has been underestimated, the performance targets that the regulator expects to be achieved will not have been adequately funded.

The entire framework for risk and reward and the measurement of performance makes the necessary assumption that the costs allowed for are consistent with the outcomes expected.

The CMA has rightly identified the importance and complexity of the risk and reward framework. I agree. However, in order to assess the appropriateness of this framework and the performance targets and commitments included in the company determinations, the CMA will need to assure itself that the level of funding provided for asset maintenance and replacement has been assessed correctly. The CMA should, in my view, ask itself the following question:

Are the allowances made for asset replacement and other elements of base expenditure consistent with the performance expectations that are integral to the risk and reward framework?

When the CMA considers the various projects that appellant companies have suggested are underfunded, it will inevitably have to consider issues of asset maintenance and replacement. Any issues identified in such a review may well apply more broadly across the allowances for costs and it would be very helpful for these to be drawn out clearly. They should underpin the necessary future work on the asset replacement liability facing the UK water industry.

<u>A potential way forward</u>

As noted above, I agree that the CMA should not seek to establish a definitive approach to setting allowances for asset maintenance and replacement going forward. It will, however, have to assure itself that the current approach has adequately funded companies to achieve the performance levels required. Reassessing individual projects requires looking at both the base expenditure component and the incremental expenditure required (where relevant).

One way forward may be to consider three different ways of setting allowances for asset maintenance and replacement. These could include:

- What level of expenditure is required to ensure that the average age of the assets of the appellant company (across different categories) is not increasing? In making such an assessment, it could be useful to pay particular attention to performance critical assets such as MEICA and where there could be high impact consequences of failure. If such an approach requires a large adjustment, the CMA could consider a transition to this level of expenditure over, for example, a couple of regulatory control periods.
- What level of expenditure is implied by the companies' asset management systems? The performance and risk levels of these models could be compared across the appellant companies and with those adopted by Ofwat.
- What level of expenditure on asset maintenance and replacement would be required in the coming regulatory control period, if the proportion of maintenance and replacement expenditure for the coming period relative to the company's RCV were to be broadly similar to that which has applied at previous regulatory control periods.

Doubtless there are other approaches that could also be considered, and may be more effective. My aim in suggesting different approaches is to avoid the CMA from being perceived to make decisions about which approach to setting asset maintenance and replacement allowances may be the best long term approach (ie a question of government and regulatory policy).

<u>Conclusion</u>

I wish the CMA well as it embarks on the considerable challenge of reviewing the considerable body of work that Ofwat completed in making its decisions. I would be happy to talk further with you if that would be helpful.

With all best wishes,

Yours sincerely

Alan D A Sutherland