SSCDD13 Company representation meeting briefing

South Staffs Water & Ofwat – Company Representation Meeting

1. Summary

We have focused only on key areas rather than considering any wider arguments, given the positive and responsive way the Ofwat team has considered and supported our plan. Our focus areas are as follows.

- We welcome the increased focus Ofwat has put on **power costs** to address the pressures facing all companies in the sector. But we are concerned that the costs assessment approach in our draft determination still underfunds us for efficient power costs.
- We fully support Ofwat's ambition to enhance performance commitments. We take pride in being an efficient, upper quartile service provider. But in preparing for the new operational delivery incentive (ODI) targets, we have identified that the proposed rates may unintentionally lead to a **negatively skewed package**.
- We appreciate Ofwat's consideration of the impacts of the **COVID-19 pandemic and associated lockdowns on per capita consumption (PCC)**. We propose an adjustment to the modelling approach for water only companies and smaller firms, which appear to be significantly disadvantaged in the current assessment. This should include an emphasis on regional differentiation.
- In our business plan, we included a **regulatory capital value (RCV) run-off rate of 4.5%**. We have provided additional evidence to support this figure and encourage the exploration of alternative mechanisms to enhance customer affordability.

2. Power

We welcome that Ofwat has put an increased focus on power costs – through the re-introduction and fundamental support for the average pumping head variable as the best cost driver for topography and the further examination of recent power price input pressure faced by all companies in the sector, by introducing an RPE mechanism.

The cost assessment approach at draft determination still underfunds us for efficient power costs. This is a combination of topography and power RPEs. Our efficient AMP8 power budget is £98.6 million. This is derived from a detailed bottom-up assessment of energy use, both electricity and gas, including various pass-through charges. In our draft determination, our base cost allowance is £24 million short of what we asked for, and this gap appears to be entirely as a result of the power issue, which we explain further in our representation. Our power costs are efficient. We operate a competitive process at contract renewal, historically hedging a portion of our costs, and we leverage our scale of energy use to broker competitive deals. On our assets, we run an extensive pump efficiency programme – and have done for many years – to ensure we keep on top of pump deterioration. In Ofwat's own modelling, we are sector leading in historic base cost efficiency.

We seek further actions by Ofwat to address this shortfall in our final determination, to ensure that power – a fundamental cost critical to our operations – is funded appropriately. Not doing so could make it harder for us to accept our final determination. This is because correctly funding power ensures we do not have to make expenditure trade-offs that dis-benefit our customers.

3. ODI – Negative Skew

Overall, we support the regulatory mechanisms of performance commitments (PCs) and outcome delivery incentives (ODIs). But we are concerned that if an ODI package is unbalanced, it creates greater risk for water companies like us and results in a short-term focus rather than long-term improvement. Ultimately, it will not deliver good outcomes for customers and other stakeholders. For our overall ODI package, Ofwat has assumed the performance commitment level (PCL) set is the P50 level for all PCs. We disagree that this is the case, as a number of PCs represent considerable stretch from current performance levels and there are many other factors which mean the median risk level is not at the PCL level.

Ofwat's Monte Carlo modelling appears to set symmetrical distributions for all PCs and does not appear to set necessary constraints – for example, on preventing negative performance scores. Ofwat has implemented a post-normalisation averaging step in the setting of ODI rates, which skews several of our ODI rates significantly upwards. This results in disproportionate ODI risk compared with other companies in several areas.

These issues result in a significant negatively skewed ODI package at draft determination. Through analysis of risk using our own Monte Carlo approach, we have identified solutions that would result in a more proportionate, balanced and less punitive package of PCs. We propose these changes are implemented in full alongside any sector-wide changes to Ofwat's overall modelling approach.

4. PCC Penalty

We welcome the sector-wide Europe Economics study and recognition of the significant impacts of the COVID-19 pandemic on household and non-household water consumption. We are in agreement with much of Europe Economics' qualitative findings and we draw out our view of these in this representation. But we are concerned that the impact on us is potentially greater than for the rest of the sector. While Europe Economics acknowledges our rationale, it is not critically examined in any way, and the adjustment that Ofwat makes does not take our unique circumstances into account.

On the quantitative findings, we find the assessment of the year 2 and year 3 impacts in our South Staffs region is not in line with the data – and dramatically understates the actual impact in these years. It appears the approach taken is not fully accommodating the regional impacts as a result of the unique nature of our South Staffs region. Europe Economics appears not to have questioned why it is that our South Staffs region, a significant outlier nationally, does not fit with its projected model outputs.

Europe Economics study says that the vast majority of PCC uplift is because of acute COVID-19 impacts, and this results in removing the bulk of the penalty for those companies that the model fits well. So, this should be the outcome for us as well. We do not think it is reasonable that we are left with a very significant residual penalty of £7.8 million (approximately equivalent to 0.93% of regulated equity each year) when many other companies have had penalty reductions almost to a zero level through the same modelling process.

5. RCV Run-off

In our business plan, we estimated a natural regulatory capital value (RCV) run-off rate of 5.1% for AMP8, compared with 6.58% in AMP7. The RCV run-off rate represents how much of previous capital investment is recovered from customers each year. In line with Ofwat's guidance on the upper limits of water companies' RCV run-off rates, we assumed a rate of 4.5% in our business plan. In our draft determination, Ofwat proposed an RCV run-off rate of 4.09%. This implies an allowed revenue reduction of £11 million or 1.3% during AMP8.

Our concern with this approach is that it will keep customers' bills artificially low in AMP8, leading to greater pressure on those bills in future AMPs. It will also have a negative impact on our financeability at a time when companies need to attract considerable amounts of debt and equity finance to deliver their ambitious investment programmes. In addition, we are also concerned that Ofwat appears to be focused on a five-year time frame, without accounting for the fact that the investment challenge faced by the sector is a long-term one. So, we are asking Ofwat to unwind its proposed RCV run-off reduction and allow a rate of 4.5%, as set out in our business plan.

6. Conclusion

We believe in these recommendations and are confident they will have a positive impact on our customers, communities and the environment. This is a sizeable investment – our largest ever – and it is not without its risks. As one of the smaller companies in the England and Wales water sector, it is important that we are supported in delivering this plan by ensuring we remain attractive to investors.

There is currently negative sentiment towards the sector within the investment and commentator community. While our ability to shift this sentiment is limited, a positive response to our representations would certainly help to improve perceptions.