

Wessex Water Services Ltd Response to Ofwat's PR19 Draft Determination – August 2019

Representation reference: Risk and Return R2

Representation title: Removal of cost sharing cash flow benefit

Summary of issue

Ofwat's methodology committed to a cash flow adjustment such that "we [Ofwat] will set our determination (for example, revenue allowances and RCV additions) to reflect the position that the company's outturn totex in PR19 is the same as its business plan totex" (p142 of Delivering Water 2020: Our final methodology)

The accompanying worked examples showed that this meant that if there was a difference between the company view and Ofwat's view of the efficient level of costs, that the company would be funded (in cash terms through the five-year period) at a level equivalent to the amount that customers would ultimately need to pay in the event that the company spent in line with its own view of efficient costs. This level was to be set based on the cost sharing split between the company and customers.

The draft determination has unexpectedly removed this mechanism and this has significantly increased the cashflow risk to the company of a continued gap in totex compared to its legitimate expectation. It is not consistent with promoting financial resilience.

Change requested

That Ofwat reinstates the cashflow mechanism contained in the final methodology.

Rationale (including any new evidence)

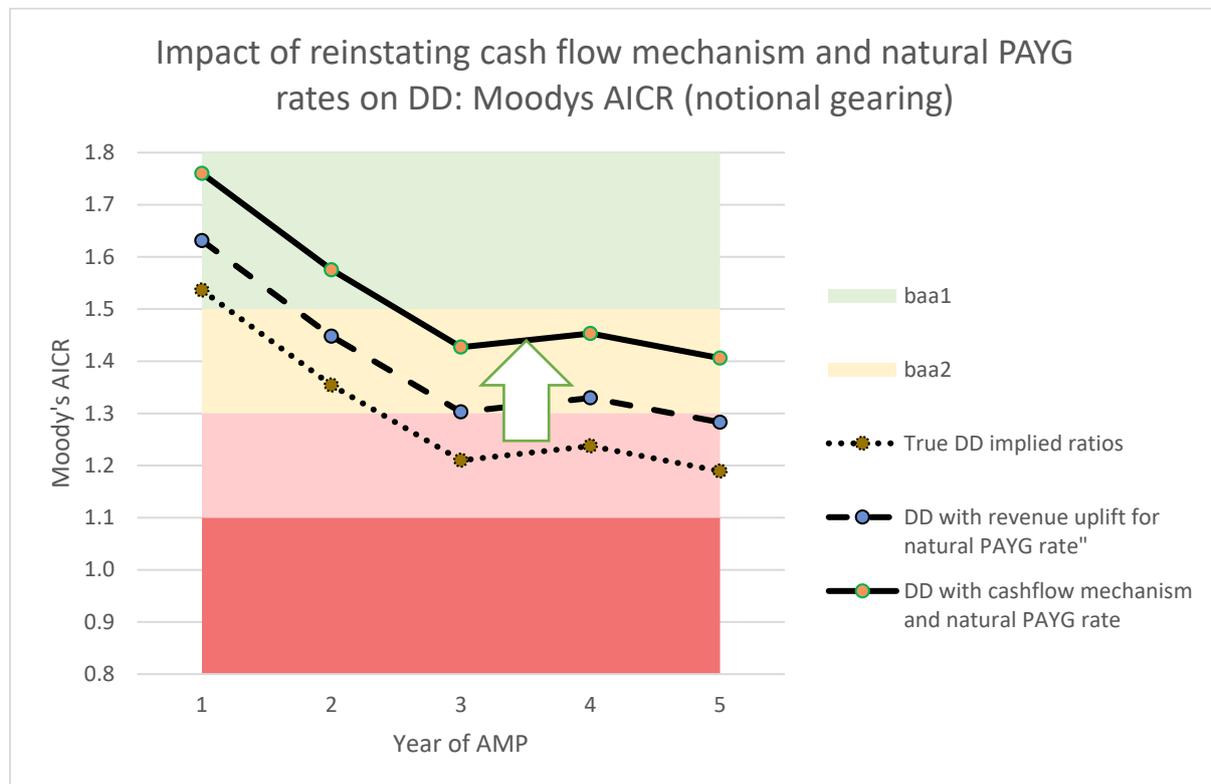
The mechanism was very clear in Ofwat's final methodology, and therefore company boards have a legitimate expectation that the methodology should be followed. They should be able to rely on the methodology being applied as they plan to achieve financial resilience over the long-term. Unexpected changes such as these are not in line with the resilience objective.

Notwithstanding this there are good reasons to continue with the mechanism and little evidence to justify its removal.

Our summary representation document describes and explains the lack of financial resilience contained overall in the draft determination. By this we mean that there are some errors made in the draft determination calculations that mean that while in our view its published financial resilience is already weak it is overstated. In addition, there are also some forecast assumptions made that ex-post could very likely turn out to be wrong. These factors mean that there is no financial headroom in the determination to deal with legitimate

cost and income shocks. In this context a mechanism that improves financial resilience in the short term is valuable to both the company and to customers who will avoid paying inflated debt costs as a consequence.

The following chart shows how the reintroduction of the mechanism could make a material impact to financial resilience:



Ofwat's justification for removing this mechanism is that "on average" companies have outperformed the allowed totex values at PR14.

Average outperformance is not as relevant as the distribution of outperformance and underperformance, and we note that according to table 1F of the regulatory accounts as reported in July 2019:

[1] Six (i.e. more than one-third of companies) have underperformed on wholesale totex between 2015 and 2019, and one of those that has outperformed is Southern Water, where given recent announcements we expect much of that outperformance to be reversed.

[2] Eleven companies have underperformed in the most reporting recent year, which is notably the first year that the full upper quartile challenge on ODIs has applied.

In this analysis we also note that the wholesale cost allowances themselves are generally higher than the Ofwat PR14 view of efficient costs because Ofwat moved c.25% of the way towards the company estimates when setting these.

Also, Ofwat has said itself that at PR19 companies will need to be delivering “a step-change in efficiency” and has strongly implied that the level of efficiency challenge is greater at PR19 than that at PR14. The introduction of a frontier shift assumption of c.CPI-1.1% from Ofwat’s view of the efficient upper quartile compared to RPI cost escalation at PR14 is prima facie evidence of that. This step-change compared to PR14 is good reason to continue to implement the mechanism that was set-out in the methodology.

The step-change in performance commitment targets to achieve forward looking upper quartiles is again a more stretching than at PR14 where targets were set in relation to current upper quartiles and is more likely to lead to cost over-runs to avoid higher penalties. Again this step-change in stretch is a good reason to implement the mechanism that was set-out in the methodology.

Why the change is in customers’ interests

We think that Ofwat needs to balance the risks to customers of setting the cost allowance too low with that of setting cost allowances to high.

The methodology’s cashflow mechanism is one way of mitigating the risks to customers of setting cost allowances too low.

Links to relevant evidence already provided or elsewhere in the representation document

See Company Annual Performance Reports, table 1F for evidence of company underperformance on totex