ISSUES WITH OFWAT'S APPROACH ON "CUSTOMERS NOT PAYING TWICE"

A report for Southern Water

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In the PR24 Draft Determinations (DDs), Ofwat has indicated that one of its key considerations in setting expenditure allowances is to "*prevent customers from paying twice*".[1] On this basis, it has made significant reductions to companies' proposed enhancement expenditure. This note sets out our assessment of Ofwat's approach. In summary, there are material issues with Ofwat's approach to making adjustments to companies' proposed expenditure on this basis because: (i) Ofwat is not assessing the proposed expenditure against the correct counterfactual since it does not consider the impact that delivering the enhancement scheme would have had on the other expenditure choices the company made; (ii) Ofwat's approach does not allow it to identify efficient costs because its evidence on the scale of the adjustment is not robust; and (iii) Ofwat's position is inconsistent with the wider evidence that there has been historical underinvestment in the sector. We would encourage Ofwat to reconsider its approach.

1 Context

In its DDs, Ofwat has indicated that it intends to set expenditure allowances to achieve two key considerations, in the following order:

(i) "*customers to get value for money, by not paying for inefficiency and <u>not paying twice for investment</u>*" [emphasis added]; and

(ii) "*companies to have sufficient funding to maintain asset health, provide a good level of service and deliver improvements to customers and the environment*".[2]

To achieve (i), Ofwat has: (a) "*removed expenditure requested by companies that is <u>already covered in base expenditure allowances</u>*" (which, as per Ofwat's analysis, equates to around 20 to 30% of its enhancement cost challenge); and (b) "*removed expenditure*

1 *'PR24 draft determinations: Expenditure allowances.' Ofwat (July 2024); page 7.*
2 *'PR24 draft determinations: Expenditure allowances.' Ofwat (July 2024); page 2.*

which has previously been funded" (which equates to 10 to 20% of its enhancement cost challenge).[3]

In light of this, Southern Water (Southern) has asked us to consider whether Ofwat's approach of reducing companies' enhancement cost allowances to "*prevent customers from paying twice*" is appropriate from an economics perspective.

This note sets out our assessment as follows:

- in section 2, we detail the conceptual issues with Ofwat's approach of reducing allowances on the basis that investment has been funded before;
- in section 3, we set out the issues with Ofwat's approach to identifying the scale of the adjustment at a high-level; and
- in section 4, we discuss the wider implications of Ofwat's approach of reducing companies' allowances in this manner.

2 Ofwat's approach is inconsistent with the incentive regime in the sector

We agree with Ofwat's guiding principle that, consistent with its consumer duty, it must ensure that companies are funded for the efficient costs of delivering high-quality and resilient water and wastewater services to consumers. However, Ofwat's approach of assessing the extent to which each enhancement scheme has been previously funded in isolation is at odds with the incentive regime in the water sector. We explain this below.

Since PR14, the regulatory regime in the water sector functions as follows:

- Ofwat sets expected service levels (e.g. through performance commitment levels) and total expenditure (totex) allowances on the basis of companies' business plans (and, through discussion with other stakeholders).
- Companies respond to the incentives set by Ofwat in their Final Determinations (FDs) by making decisions regarding how best to deliver expected service levels using their totex allowances. The salient point here is that, while they operate within the bounds of the expected service levels and totex allowances in their FDs, companies are not expected to deliver these service levels through specific outputs. Ofwat also highlighted this in its PR14 Review: "*the totex framework gave companies more flexibility to choose the best way to provide outcomes for consumers*" [emphasis added][4] and that "*this contrasted with the outputs-based approach at previous price reviews, in which companies committed to delivering specific schemes*" [emphasis added].[5]
- In doing so, companies need to make careful decisions regarding how to balance their efforts (and, funds) across the range of expected service levels. For instance,

[3] *'PR24 draft determinations: Expenditure allowances.' Ofwat (July 2024); page 7.*
[4] *'PR14 Review.' Ofwat (January 2022); page 6.*
[5] *'PR14 Review.' Ofwat (January 2022); page 19.*

if company A expects to outperform Ofwat's expected service level on (say) resilience, it is incentivised to redirect its funds towards achieving Ofwat's expected service level on (say) customer experience, on which the company risks underperforming. Likewise, if company B is concerned about possible underperformance on (say) BR-MeX, it may redirect its highest performing team away from dealing with household customers to business customers, even if it risks a small penalty on C-MeX. Put simply, companies face trade-offs across the range of service levels they are expected to deliver as well as their totex allowances, which they need to carefully balance.

- Ofwat does not regulate the specific decisions each company makes because, under its framework, companies are inherently incentivised to deliver these expected service levels in the most efficient manner possible since their returns are linked to their operational performance. For instance, if Company A can deliver expected service levels for cheaper than its totex allowance, it is allowed to reap the benefit by earning higher (than allowed) return. Likewise, if company B fails to deliver its expected service levels despite using its totex allowance, it will be subject to penalties through the Outcome Delivery Incentives (ODIs) and, therefore, earn lower (than allowed) return. This is consistent with firms' incentives in competitive markets.

Given the framework that companies were operating under in previous price controls, Ofwat's consideration of each individual enhancement area in isolation is flawed, for two key reasons:

- **Firstly, Ofwat has retrospectively changed the trade-offs that companies considered at the time of making their expenditure decisions.** This is because, had companies known that Ofwat might penalise them for reprioritising away from an enhancement scheme at the next price control (and, therefore, that they face a harsher trade-off on that enhancement scheme), companies may have made a different decision in previous price controls.

- **Secondly, Ofwat has not considered the correct counterfactual, because it does not recognise that delivering one enhancement scheme would imply that the company would not have been able to deliver another.** As noted above, companies are inherently incentivised to deliver the expected service levels in the most efficient manner possible. This implies that the expenditure decisions companies made at previous price controls, including not delivering the individual enhancement scheme under consideration, would have been the most efficient choice for the company (given the incentives Ofwat set at previous price controls). However, in assessing each enhancement area in isolation, Ofwat asserts that the company could / should have delivered it previously, but ignores: (a) that doing so would have meant that the company would have failed to deliver something else; and (b) that doing so would have been less efficient for the company and, therefore, would have lead to worse outcomes for customers overall.

The only scenario under which companies could have delivered the individual enhancement scheme under consideration, *without* any implications on the other expenditure choices they made, is if companies were earning excess profits (i.e. systematically and persistently earning economic profits).

However, this is unlikely to have been the case because it would imply that Ofwat had been too generous to companies in previous price controls, and therefore, the regulator would have tightened the next price control. Put simply, it is unlikely that the regulator would have allowed companies to systematically and persistently earn excess profits at previous price controls.

Consistent with this, evidence from the water industry shows that companies are not making excess profits.

- As we discussed in our report on the "Financeability of the notionally efficient firm" at PR19, there is no evidence of substantial, systematic and persistent historical outperformance by the industry on its WACC.[6]

- In fact, the recent evidence from AMP7 indicates that equity returns in the industry have been below the allowed returns set by Ofwat and the CMA. Table 1 shows the return on regulatory equity (RoRE) earned by companies in AMP7 (both under a notional and their actual capital structures) relative to the base (allowed) return on regulatory equity.

Table 1: Average industry RoRE performance in AMP7

Return on Regulatory Equity	2020/21	2021/22	2022/23	2023/24	AMP7 to-date
Base RoRE	4.05%	4.08%	4.10%	4.13%	4.09%
RoRE (actual return - notional regulatory equity)	2.25%	3.91%	3.62%	1.75%	2.74%
RoRE (actual return - actual regulatory equity)	2.46%	4.25%	3.62%	1.26%	2.32%

Notes: The industry average is based on a simple average of RoRE across all companies.
Source: Economic Insight analysis of data reported by companies in APR Table 1F.

3 Ofwat's approach does not allow it to identify efficient costs

Ofwat's approach is unlikely to be able to identify efficient costs for the relevant enhancement areas for the following reasons:

- **Firstly, Ofwat appears to "assume away" the delivery of ever-stretching levels of service within base costs allowances.** As Ofwat itself acknowledged in its PR14 methodology, "*the cost-service relationship is a challenging and complex area*",[7] i.e. it is challenging to conclusively determine the scope of activity that companies can efficiently deliver using base costs.

6 *'Financeability of the notionally efficient firm: Top-down analysis.' Economic Insight (August 2019).*
7 *'PR24 draft determinations: Expenditure allowances.' Ofwat (July 2024); page 60.*

It is inappropriate in this context for Ofwat to make material cuts to companies' proposed enhancement expenditure in a broad-brush assessment on the basis that the activity *should* be covered within base costs. This approach effectively assumes away activities that companies consider to be additional (relative to the activities they were previously funded to deliver) without any robust evidence. This further exaggerates the wider issue with Ofwat's cost assessment approach which, as we explain in our report on "Issues with Ofwat's approach to base costs assessment",[8] does not engage with the operational realties that companies face in delivering outcomes for customers by expecting companies to deliver an ever-stretching level of performance.

As an example, in considering Southern's enhancement request on Resilience - Heatstress, Ofwat states that "*The company does not provide sufficient and convincing evidence that there is an increasing risk from hazards outside of its control. If required, the company should therefore be undertaking the investment within base expenditure allowances*." [emphasis added][9] The evidence on the basis of which Ofwat has made this assessment is not clear.

- **Secondly, the scale of the adjustment is not based on robust evidence and does not follow the principles of better regulation.** From our reading of Ofwat's DD documents, the only place where Ofwat has transparently identified cuts on the basis of "base overlap" or "previous enhancement overlap" is under the "Need" criterion for deep dive enhancement areas. Specifically, it suggests that it has applied "*bespoke adjustment based on sufficiency of evidence and degree of investment overlap*", where the scale of the adjustment ranges from 10%-100%.[10]

  However, the scale of the adjustment appears to be arbitrary and unsubstantiated with any evidence. For instance, in considering Southern's enhancement request on Reservoir safety programme, Ofwat makes a 10% adjustment downward on the basis that "*the company has not provided sufficient and convincing evidence that all the investment is enhancement rather than base maintenance*."[11]

  Ofwat appears to justify this on the basis that "*The company is better placed to know what the best option and efficient cost is, but may not be incentivised to reveal this information to Ofwat. We therefore challenge companies to provide sufficient and convincing evidence to justify their proposals*."[12] However, it is unclear: (a) why companies are expected to know the extent of base overlap if, as Ofwat itself accepted, it is incredibly complex; (b) (to the extent this is knowable) why it has not been possible to get input from engineering consultants to inform this; and (c) (if it is unknowable) how it has reached conclusions on the scale of the challenge (i.e. picking a point in the 10%-100% range).

8 *'Issues with Ofwat's approach to base costs assessment.' Economic Insight (August 2024).*
9 *Please see 'PR24-DD-WW-Resilience-2' model available here: https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/draft-determinations-models/.*
10 *'PR24 draft determinations: Expenditure allowances.' Ofwat (July 2024); Table 10.*
11 *Please see 'PR24-DD-W-Reservoir-safety' model available here: https://www.ofwat.gov.uk/regulated-companies/price-review/2024-price-review/draft-determinations-models/.*
12 *'PR24 draft determinations: Expenditure allowances.' Ofwat (July 2024); page 60.*

4 Ofwat's approach can have severe implications for the water sector

We would encourage Ofwat to reconsider its position because, taking a step back, Ofwat's assertion that companies have been previously funded to undertake investment is inconsistent with the wider evidence that recent investment in the water sector has not kept pace with the needs of current and future customers. For instance:

- In its review, the House of Lords found that "*Pressures on the sewage network have increased substantially over time due to a combination of population growth, property development and climate change. Levels of investment have not risen to match these demands. The result is a network unable to cope, and which relies on releasing polluted water into the environment. Nor has investment kept pace with the demands of future water supply needs, leaving us lacking appropriate plans and infrastructure to deal with future demand, and the loss of billions of litres of water to leakage every day*." [emphasis added][13]

- Likewise, in its latest National Infrastructure Assessment, the National Infrastructure Commission (NIC) noted that in the water sector "*Assets often are not resilient to current climate risks. This is partly due to a historic failure to anticipate risks and understand the underlying health of assets*."[14]

While there are multiple confounding reasons for the historical underinvestment, this outcome is inconsistent with Ofwat's primary duty to "*further the resilience objective to secure the long-term resilience of water companies' water supply and wastewater systems; and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services*."[15]

As a result, we have serious concerns with Ofwat's approach to consideration of enhancement cases (and its approach to costs assessment more broadly)[16] because:

(i) It risks exaggerating the cycle of underfunding resulting in underinvestment that the water industry urgently needs to break out of in order to drive productivity improvements.

(ii) It undermines investors' expectations of a "stable and predictable regulatory regime" and, therefore, has implications for investors' risk perceptions (and, therefore, required returns).

(iii) The latter also implies that it might become harder for companies to attract committed long-term investors who are seeking stable (i.e. low risk) long-term returns.

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13 *'The affluent and the effluent: cleaning up failures in water and sewage regulation.' House of Lords (March 2023); page 3.*

14 *'The Second National Infrastructure Assessment.' National Infrastructure Commission (October 2023); page 110.*

15 *Please see: https://www.ofwat.gov.uk/about-us/our-duties/.*

16 *'Issues with Ofwat's approach to base costs assessment.' Economic Insight (August 2024).*