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Decision time

Price review 2019 (PR19): Ofwat's final determinations

December 2019

Just over two years since Ofwat published their final methodology for the price review 2019 (PR19), the PR19 final determinations documents have now been published. This is the culmination of a process which began in 2015 with Ofwat setting the direction as part of its Water 2020 programme.

It is now time for companies to decide whether or not to accept Ofwat's final determinations and they have two months to do so. As our 'Next steps' set out below, where companies accept the final determinations, these will take effect for a five-year period starting on 1 April 2020. In the event that companies reject Ofwat's proposals, this will lead to a referral to the Competition and Markets Authority (CMA).

But what, if anything, has changed over the last five months since Ofwat's draft determinations were released?

Average bills

Ofwat's final determinations for PR19 imply a reduction of average water bills by 12% in real terms (i.e. before inflation) over the period 2020 to 2025. This is on top of the 5% real decrease in average bills over the current price control period (2015 to 2020). The impact of the final proposals differs by company, as shown in Table 1.

Table 1: Comparison of average bills—business plans, draft determination and final determination

Average bills (2017-18 prices)			Business Plans April 19 (Apr19 BP)		Ofwat Draft Determination (DD)		Ofwat Final Determination (FD)		Comparison	
	Company name	2019-20	2024-25	% change from 2019-20	2024-25	% change from 2019-20	2024-25	% change from 2019-20	Apr19 BP vs FD	FD vs DD
WASCs	Anglian Water	£422	£416	-1%	£370	-12%	£378	-10%	-9%	2%
	Northumbrian Water	£429	£337	-21%	£319	-26%	£319	-26%	-4%	0%
	United Utilities	£429	£382	-11%	£378	-12%	£370	-14%	-3%	-2%
	Southern Water	£420	£392	-7%	£362	-14%	£343	-18%	2%	-5%
	Hafren Dyfrdwy	£300	£297	-1%	£286	-5%	£292	-3%	-2%	2%
	Severn Trent	£343	£325	-5%	£327	-5%	£313	-9%	-3%	-4%
	South West Water	£527	£454	-14%	£450	-15%	£422	-20%	-6%	-5%
	Thames Water	£389	£373	-4%	£344	-12%	£361	-7%	-3%	4%
	Dŵr Cymru	£441	£417	-5%	£378	-14%	£399	-10%	-4%	5%
	Wessex Water	£457	£430	-6%	£390	-15%	£398	-13%	-7%	2%
	Yorkshire Water	£383	£379	-1%	£342	-11%	£349	-9%	-8%	2%
WOCs	Affinity Water	£172	£170	-1%	£151	-12%	£162	-6%	-5%	6%
	Bristol Water	£182	£172	-5%	£155	-15%	£155	-15%	-9%	0%
	Portsmouth Water	£101	£97	-4%	£90	-11%	£96	-5%	-1%	6%
	SES Water	£194	£180	-7%	£161	-17%	£164	-15%	-8%	2%
	South East Water	£205	£240	17%	£185	-10%	£190	-7%	4%	2%
	South Staffs Water	£140	£128	-9%	£116	-17%	£126	-10%	-1%	7%

Source: Ofwat publications (draft and final determinations); company business plan submissions to Ofwat.
Note: WASCs denotes Water and Sewerage Companies, WOCs denotes Water only Companies; rows highlighted denote fast-tracked companies.

[1] Consumer Prices Index including owner occupiers' housing costs

Although the average bills in the final determinations are lower than business plan submissions for all companies, there is significant variation within the group. Some reductions are well above the average (20% or more reduction in average bills), while a handful of companies will see bills reduced by 6% or less. This reflects specific customer priorities, investments to be made, and the relative cost efficiency of each company.

There have also been some updates made by Ofwat between the draft and final determinations, with 11 companies having a lower reduction in average bills to 2024-25 (see the final column of Table 1). This reflects additional representations made by companies to Ofwat at the end of August 2019, and changes made by Ofwat since the publication of the draft determinations.

The three fast tracked companies (Severn Trent, South West Water and United Utilities) have seen their average bills further reduced between the draft and final determinations. This is driven by a number of factors, including the reduction in the cost of capital that Ofwat has implemented in the final determinations relative to the draft, re-profiling of bills to allow for a faster transition to CPIH[1] or to reduce bill volatility, and changes to the pay-as-you-go (PAYG) ratios. Southern Water is the other company that has seen its average bill further reduced between the draft and final determinations. This reflects a number of changes made since the draft determinations including changes to PAYG ratios and the financial penalty applied by Ofwat following an investigation into misreporting of operational performance information.

The final determinations also include a 'glide path' in revenues for most companies, which then feed through in to average bills over the 2020-25 period. This marks a change from the draft determinations published by Ofwat where the full price reductions took place immediately in 2020-21 (with the exception of South Staffordshire Water). In part, this change has been driven by financeability considerations and the need to balance financial ratios with the benefits to customers of earlier price reductions. Ofwat has also brought forward over £650million of revenue from future customers to support the financeability of companies over the next five years.

This is undoubtedly a tough control for water companies which is driven by a combination of factors including:

- The lowest cost of capital to date for a regulated network business in the UK;
- A comprehensive cost assessment with companies benchmarked to achieve efficiency at the level of the top 4 (wholesale water) or top 3 (wholesale wastewater) company;
- Tougher penalties for underperformance; and
- Significant delivery targets, including an average reduction in leakage of 16% across the sector.

Allowed returns

"The lowest allowed return on capital since privatisation 30 years ago", is how Ofwat has described the allowed return of capital for 2020-25. The figure of 1.92% - wholesale weighted average cost of capital (WACC, RPI terms) - is 16bps lower than the same figure at draft determination stage. With the change since draft determination mostly driven by falling gilt yields.

The reduction in wholesale WACC from 3.6% (RPI terms) at PR14 has been driven by both the allowed return on equity and the cost of debt. The PR19 allowed return of equity figure of 3.18% (RPI terms) is significantly lower than the PR14 equivalent of 5.65%, and an even greater distance from the PR09 equivalent of 7.1%.

Despite the magnitude of these reductions, Ofwat remains of the view that the allowed return for 2020-25, in the round, is consistent with market expectations.

Transitioning away from RPI

2020-25 marks the beginning of the sector's transition away from RPI. With half the RCV, and all future RCV additions, now indexed to CPIH. Going forward, the proportion of RCV indexed to CPIH will attract a CPIH terms wholesale WACC (2.92%), while the remainder of the RCV will continue to attract a RPI terms wholesale WACC (1.92%).[2]

The switchover to CPIH will help soften the landing from the large reduction in allowed returns – retaining the full RCV on RPI terms would have led, all else being equal, to greater pressure on revenue. Nevertheless, a number of concerns regarding company financeability has still led to future revenue being advanced to this control period.

In practice, this advance has been achieved through a combination of PAYG ratio increases and RCV run-off increases. Ofwat's final determination shows more than 1% of cumulative sector 2020-25 revenues has been advanced from future periods to this control period. While this relieves short-term pressure on credit ratios, these measures are not without cost. Over the long-term, this combination of higher PAYG ratios and higher RCV run-off – alongside CPIH indexation - will depress sector RCV growth.

Return on Regulatory Equity (RoRE)

The return on regulatory equity that companies are able to achieve will depend on their performance against final determination targets. The biggest opportunities and risks are present by totex and Outcome Delivery Incentive (ODI) performance. Ofwat's analysis at final determination confirms the possibility that poor performing companies could make negative returns on regulatory equity – implying the company would not be in a position to pay debt interest costs. However, Ofwat cautions that they consider this scenario unlikely to occur - as it would require downside performance against a range of risks simultaneously.

Small company adjustments

Four companies applied for 'company-specific adjustments' to allowed returns. While the applications of Portsmouth Water and South Staffs Water were successful, those of Bristol Water and SES Water were not. Where applications were not successful, it was because Ofwat did not find sufficient evidence for customer benefits, and/or customer support for the adjustment proposed. The two companies that were successful are allowed to earn an additional 33bps on the overall cost of debt (approximately +20bps on the WACC).

2 Ofwat estimates a long-run wedge of 1.0% between inflation as measured by RPI (3%) and inflation as measured by CPIH (2%).

Totex expenditure

Ofwat has set an ambitious efficiency challenge for water companies, expecting a 'step-change' from companies. For this, it has considered cost performance within the water sector, as well as wider factors such as efficiency improvements in the wider economy, to come to a view of efficient costs. Across the industry, in its PR19 final determinations, Ofwat has set a £6 billion efficiency challenge for the coming five years.

At draft determinations, Ofwat had set even more ambitious targets. But after taking into account representations from the industry, it has now softened its overall position slightly. The main changes to Ofwat's approach to setting total cost allowances from draft determinations are set out below. These include some stronger challenges on efficiency, but also revised positions based on further evidence from companies:

Data for modelled base costs: outturn figures from 2018-19 Annual Performance Reports (APR) are now included into the cost models

Modelling scope: Ofwat made adjustments to the representation of costs within or outside of certain modelling categories

Forecasts: adopting company forecasts for water complexity, and revising the approach to population growth forecasts has resulted in changes to companies' allowances

Efficiency challenge: base cost efficiency challenges have strengthened as Ofwat has chosen to move from the upper quartile challenge to setting the benchmark based on the 4th ranked wholesale water, and 3rd ranked in wholesale wastewater costs. The 'frontier shift' challenge dropped to 1.1% per year, but now extends to all wholesale base costs

Real price effects: taking into account additional company data, Ofwat increased the proportion of costs accounted for by labour costs from 35% to 39%

Enhancement funding for leakage: For final determinations Ofwat considers the weighted performance on leakage per property and leakage per mains length as the criteria for leakage enhancement funding

Drainage and Wastewater Management Plans (DWMPs): Ofwat has granted partial allowances to develop DWMPs to ensure a more consistent basis for long-term planning of drainage and wastewater services as recognised by Water UK, Defra and the EA

Residential retail: Ofwat has increased the emphasis on its total costs models relative to the 'bottom up' models

These changes to Ofwat's approach have resulted in slightly milder final determinations compared to draft, with an overall increase in allowances across the industry of 2%, or less than £1bn. Most companies have therefore seen an increase in allowed costs since the draft determinations, with the exception of Portsmouth Water, Severn Trent and United Utilities. The companies facing the largest efficiency challenge from the final determination compared to their original business plans are as follows.

Table 2: Companies facing the largest efficiency challenge based on PR19 final determinations

		Company name	Efficiency
WASCs	1	Anglian Water	-21%
	2	Thames Water	-16%
	3	Yorkshire Water	-15%
WOCs	1	South East Water	-10%
	2	Bristol Water	-10%
	3	SES Water	-9%

Source: Ofwat PR19 final determinations

Table 3: Total costs (wholesale water, wholesale wastewater, residential retail) (£m)

	Company name	Historical (£m)	Busines plans (£m)	DD view	DD vs. BP	FD view	FD vs. BP	FD vs. DD	Commentary
WASCs	Anglian Water	4,633	6,692	5,318	-26%	5,553	-21%	4%	Additional allowances for wholesale base and enhancement spend, partly due to stronger population growth forecasts
	Northumbrian Water	2,720	3,211	2,916	-10%	2,933	-9%	1%	Additional allowances for enhancement spend including the 'Suffolk investment', but reduced allowances across wholesale base and retail expenditure to reflect low growth forecasts
	United Utilities	7,243	6,102	5,837	-5%	5,814	-5%	0%	Reductions in the allowances for wholesale base expenditure, with additional allowances for enhancements, mainly due to changes in the modelling approach
	Southern Water	3,184	3,725	3,435	-8%	3,501	-6%	2%	Additional allowances across all totex components, with the majority of the increase from wholesale base spend, still reflecting a challenge to the company re-submission particularly for enhancement
	Severn Trent / Hafren Dyfrdwy	6,345	6,753	6,638	-2%	6,629	-2%	0%	-
	Severn Trent	-	6,594	6,475	-2%	6,463	-2%	0%	Additional allowances due to a reduction in the allowed returns, with increases particularly for enhancements
	Hafren Dyfrdwy	-	159	164	3%	166	4%	1%	Minor adjustments only
	South West Water	2,031	2,049	1,944	-5%	1,994	-3%	3%	Additional allowances for wholesale base and enhancement spend, particularly for enhancement costs for the Isles of Scilly and additional costs for Knapp Mill and Alderney water treatment works
	Thames Water	9,710	10,993	9,263	-19%	9,440	-16%	2%	Additional allowances for wholesale, particularly for base expenditure. Two conditional allowances amounting to £480m relate to improving water supply infrastructure
	Dŵr Cymru	3,248	3,514	2,943	-19%	3,077	-14%	4%	Additional allowances for wholesale, particularly for enhancement expenditure on proposed resilience schemes
	Wessex Water	1,936	2,365	2,128	-11%	2,198	-8%	3%	Additional allowances for wholesale, making positive growth adjustments to base expenditure, as well additional enhancement expenditure
	Yorkshire Water	3,825	5,124	4,323	-19%	4,442	-15%	3%	Additional allowances for wholesale, with the majority of the increase from enhancement spend including on resilience and WINEP schemes, but reduced base expenditure due to lower growth forecasts
WOCs	Affinity Water	1,400	1,582	1,450	-9%	1,500	-5%	3%	Additional allowances across all totex components, with the majority of the increase from wholesale base spend, including an adjustment due to increased population growth forecasts
	Bristol Water	555	509	439	-16%	462	-10%	5%	Additional allowances across all totex components, with the majority of the increase from wholesale base spend, including an adjustment due to increased population growth forecasts
	Portsmouth Water	169	189	211	10%	204	7%	-3%	Reductions in the allowances for wholesale base expenditure and retail, with additional allowances for enhancements
	SES Water	272	296	242	-22%	271	-9%	11%	Additional allowances across all totex components, with the majority of the increase from wholesale expenditures. This includes additional allowances for enhancement resilience and adjustments for higher population growth
	South East Water	943	1,087	954	-14%	987	-10%	3%	Reductions in the allowances for wholesale enhancements and retail, despite an increased allowance for leakage enhancements, with additional allowances in wholesale base spend
	South Staffs Water	531	657	588	-12%	616	-7%	4%	Additional allowances for wholesale expenditure, with small reductions in retail
	Industry	**48,745**	**61,599**	**55,268**	**-11%**	**56,250**	**-10%**	**2%**	

Source: Ofwat publications (draft and final determinations); company business plan submissions to Ofwat.

Outcome Delivery Incentives (ODIs) and impact on the return on regulatory equity (RoRE)

At PR19, Ofwat challenged companies to set stretching targets in relation to their performance commitments for the 2020-25 period, and sought to strengthen the financial incentives associated with these commitments. To drive improvement in the sector, Ofwat was prescriptive in a number of cases as to measures and associated levels that companies should achieve:

- **Leakage**: companies should achieve at least a 15% reduction in leakage over the 2020-25 period;
- **Water Supply interruptions, internal sewer flooding and pollution incidents**: companies should set their commitment levels to at least the forecast upper quartile level;
- **Asset Health**: companies should have four common Performance Commitments (PCs) on asset health: mains bursts, unplanned outages, sewer collapses and treatment works compliance; and
- **Bespoke PCs**: companies should select bespoke PCs that provide coverage across the different price controls and address customer vulnerability, the environment, resilience and abstraction.

To maximise the incentives to achieve these levels, Ofwat set out that companies should attach financial Outcome Delivery Incentive rates to these metrics as a default, and presented an indicative range of +/-1% to +/-3% RoRE for the total financial value of companies' ODI packages.

Draft determinations

At PR19 draft determinations, Ofwat made adjustments to the majority of fast track, slow track and significant scrutiny companies. This includes interventions on individual performance commitments so that companies are targeting stretching service levels and appropriately calibrating financial outcome delivery incentives. Amongst the key outputs were:

- **Leakage**: reduction on average by 17% over the 2020-25 period
- **Water supply interruptions**: 64% reduction across the sector
- **Pollution incidents**: 34% reduction
- **Vulnerability**: support for an additional 1.5 million customers in paying their water bills

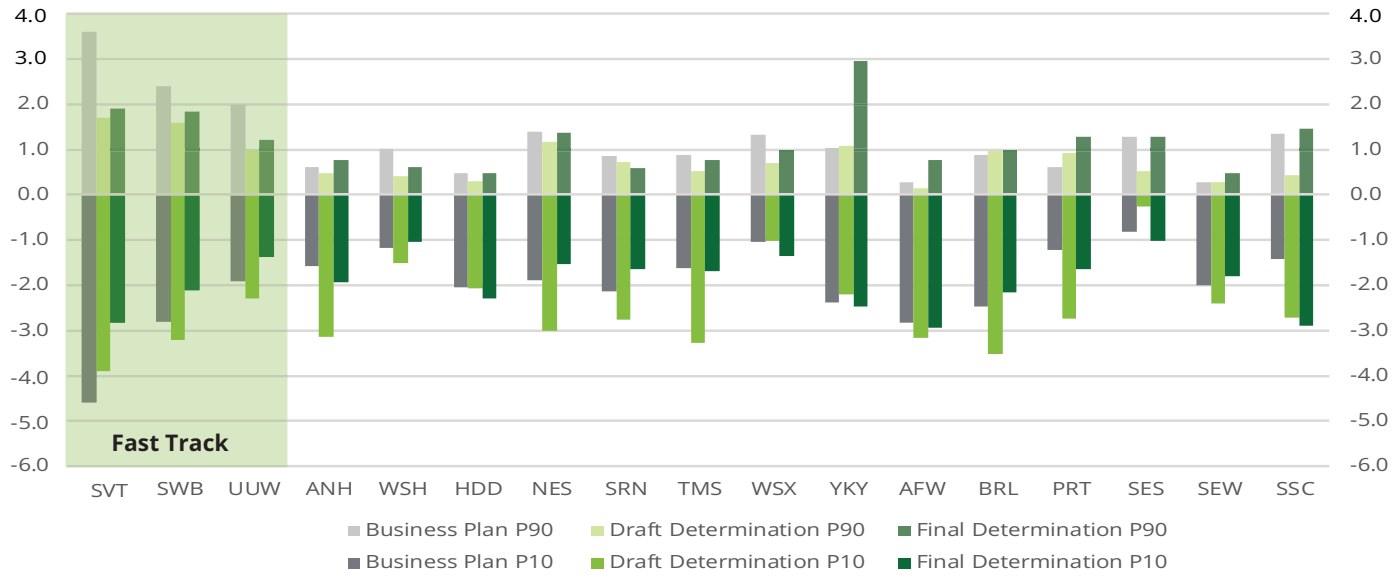
At an overall package level, Ofwat also made further interventions to protect customers against the risk of companies focusing on a small number of financially material performance commitments (through the introduction of caps on outcome delivery incentives) and in case their ODI payments turn out to be much higher than expected (through a sharing mechanism above 3% RoRE in any year).

At PR19 draft determinations, the average ODI RoRE risk range is from -2.6% to +0.6% for slow and significant scrutiny companies, with a wider range for the fast tracked companies. This aims to add further incentives for the delivery of performance commitments compared to the incentives set in the current price control review (2015-20) where companies have delivered ODI performance that averages +0.1% in 2015-18, within a range of –0.5% to +1.5%.

Final determinations

For the PR19 final determinations Ofwat has made some adjustments to ODIs, in particular including some caps/collars on a number of incentives for outputs that are more difficult to predict. As shown in Figure 1, the ODI ranges as a percentage of five year regulatory equity have moved upwards slightly for most companies, with the lower end (P10) being above what was set in the draft determinations, and most cases the P90 being slightly above the draft determinations. Despite this change, the overall balance of the ODIs has remained asymmetric, with greater potential downside for most companies than upside.

Figure 1: ODI value as a percentage of 5 year regulatory equity



Source: Ofwat publications (draft and final determinations); company business plan submissions to Ofwat.

Next steps—decision time

Companies now have two months (to mid-February 2020) to decide on whether to accept or reject Ofwat's proposals. Where companies accept the final determinations, these will take effect for a five-year period starting on 1 April 2020. All domestic consumers can expect to see a reduction in their water and sewerage bills in real terms from this date.

In the event that companies reject Ofwat's proposals, they can ask Ofwat to refer the whole determination to the Competition and Markets Authority (CMA). Appeals against price determinations under the Water Industry Act 1991 (WIA 1991) are a re-determination (a fresh appraisal) by the CMA. Only the regulated water company subject to a price determination by Ofwat may appeal against that decision and must start the process by requiring Ofwat to refer the final price control decision to the CMA.

The CMA is required to make its re-determination in the overall public interest. As the water company - and Ofwat - cannot choose or limit what is re-examined, it is possible for the CMA to take a different or unexpected angle, and may also look to develop its own methodology. Any decision by the CMA will not impact companies that have already accepted Ofwat's PR19 final determinations.

The CMA must make its decision within the time limits Ofwat specifies when it refers the matter. That period may be up to a maximum of six-months, extendable by a further maximum six-month period. The CMA inquiry group will reach its own conclusion, on the basis of its investigation, as to what price control decision Ofwat should have reached in light of the statutory duties imposed on it. The CMA may reach a decision that is either better or worse for the water company than Ofwat's initial determination, or it may confirm Ofwat's decision. Ofwat is then required to implement that decision.

Companies that are considering a potential CMA referral will need to:

- Identify the key areas of disagreement between their own plans and what Ofwat is proposing, and take a view on how the CMA is likely toconsider the issue;
- Assess the extent to which Ofwat has changed their view between the draft and final determinations, in particular if there is new evidence that can support the company's view;
- Weigh up the costs and benefits of a potential referral, including uncertainty and opportunity costs of time spent focusing on the CMA referral;
- Have a clear plan for responding to the CMA's queries, including having all the necessary information, evidence and supporting documents easily accessible and ready to be submitted to meet tight deadlines;
- Identify a core team and potential external support required for the duration of the referral process, including assessing the potential knock on effect on the business delivering business plan for the first year of the new price control period in line with the final determinations during the CMA referral period; and
- Make sure the required approvals and governance for the CMA process are in place.

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