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June 2021

Ofwat and future price reviews: a stake in the ground

Contact
Leon Fields
Senior Consultant

In May 2021, Ofwat, the economic regulator of the water industry in England and Wales, set out its vision for the next price review (PR24). Key themes are long-term planning, resilience, how cost assessment is undertaken, eliciting customer preferences, outcome incentives, capital structure, and financial resilience. Ofwat has put a stake in the ground. What are the key issues, and what risks do the proposals pose for the sector?

Ofwat's report (https://bit.ly/3jbcHbB) sets out its vision for the next price review (PR24) and beyond.[1] The document opens with an aspiration to address the numerous challenges that the sector faces by adapting the regulatory framework to focus on creating value for customers, communities and the environment. What are the main changes proposed by Ofwat, and how does it see these being taken forward?

Facing into the future

Two key components of Ofwat's future framework are set out in chapter 4 of its report (on increasing the focus on the long term)[2] and in chapter 5 (on how to best use incentives to complement the existing TOTEX and outcomes regime).[3] If implemented, the proposals would generate substantial changes to the business planning process and how companies approach it.

The main proposed changes to the price review (PR) framework are:

- greater upfront guidance from Ofwat on key parameters of the price control, such as the return on capital, base expenditure, performance commitments, and outcome delivery incentives (ODIs);
- streamlining of the business planning process so that it involves fewer steps;
- tweaks to how Ofwat incentivises business plan submissions—in particular, fixed cost-sharing rates independent of the quality of the business plan; retention of direct financial rewards for high-quality business plans; widening the scope of early certainty mechanisms for high-quality business plans; and the introduction of penalties for low-quality business plans;
- a requirement for companies to set out five-year business plans in the context of a longer-term strategy, accounting for government priorities and customers' wants and needs—with the potential for a collaborative approach to planning between different stakeholders in Wales;
- clarity over Ofwat's expectations for the long term, and the introduction of regulatory mechanisms that span price controls to incentivise companies to take a longer-term view;
- ongoing assessment of whether price control mechanisms sufficiently incentivise innovation.

It is difficult to unpick the net effect of these changes on company incentives—the impact will depend on which changes are ultimately implemented and in what form.

There are clear potential benefits from focusing companies on the longer-term impacts of expenditure, through incentivising performance over a longer time horizon (e.g. locking in ODI rewards/penalties over multiple price controls) and requiring companies to publish long-term plans. It is less clear how other aspects of Ofwat's framework will lead to companies taking a long-term approach. For example, Ofwat claims that it will ensure that companies are not incentivised to underinvest in asset health by setting low-cost sharing rates (i.e. requiring more outperformance to be shared with customers), without substantiating the link between sharing rates and incentives to manage assets responsibly.

The extent to which Ofwat's PR24 framework will move the sector towards taking a longer-term approach will depend on how it balances comparisons of companies' short-run business plans against strategic plans. It will be particularly important to make sure that those companies that are assessed as having high-quality five-year business plans are not achieving this through insufficiently challenging strategic plans.

As well as placing weight on the quality of companies' strategic plans, Ofwat will need to ensure that business plans are consistent with these strategic plans. For example, if improving resilience is a goal in a company's strategic plan, this might be inconsistent with a business plan that reduces the level of necessary capital maintenance expenditure. While Ofwat's approach could help to make these trade-offs more transparent than they are currently, it will be a difficult task for Ofwat to unpick the various elements when comparing plans.

A key issue with Ofwat's proposals is the potential inconsistency between a focus on the long term and moving to determine key price control parameters in advance of the price review (in particular, base costs)—and, as a consequence, basing these solely on historical data. By design, use of historical data bakes in the performance specification of the last price control, as the costs reported over this period relate to the ex ante outputs or outcomes that companies were required to target at the last price review. Consequently, such analysis could fail to pick up any need for a step change in expenditure required to improve resilience, for example.

To mitigate this concern, Ofwat's historical cost models will need to accommodate all potential drivers of increasing expenditure, including decarbonisation, public value, nature-based solutions, service quality, and operational resilience. While it sets out an ambition to control for these factors in chapter 10 ('Cost assessment'), it is likely to face the following challenges:

- developing an econometric framework that accommodates drivers of increasing expenditure, while simultaneously capturing key drivers of regional cost variation;
- the absence of historical evidence for some outputs—for example, there is no historical evidence of the cost to deliver water and wastewater services with net-zero emissions, without strong assumptions that extrapolate from the observed cost impact of the progress towards decarbonisation made so far.

The detrimental impact of a historical approach to determining key price control parameters on the incentives for, and ability of, companies to meet the long-term challenges facing the sector may be exacerbated by the introduction of business plan penalties for 'poorly performing plans'. There is a risk that companies will perceive Ofwat's published price control parameters as both an upper bound on allowed revenues (limiting their ability to deliver greater outcomes that require a step increase in costs) and a lower bound on the extent of productivity improvements that they are required to make.

The extent to which Ofwat is able to resolve this tension will determine how effective its fremework is for focusing on the long term.

Productivity: Panacea or Pangloss?

A key expectation of Ofwat's framework is that improvements in productivity across the industry will enable a large increase in required outputs (in terms of resilience, customer outcomes and decarbonisation), while minimising any increase in bills.

Ofwat cites a report for Water UK on productivity in the water sector in support of its claims that there is scope for substantial productivity improvements in the sector.[4] Ofwat interprets the report as saying that water productivity grew at a high level of c. 3% p.a. over the period 1993–2010, and fell to a lower level thereafter. However, this interpretation does not acknowledge the problems that the study had in capturing service quality improvements from 2004 onwards. The authors state that:[5]

> the more muted impact [of quality improvements on total factor productivity growth] since then [2004] is likely to be partly due to the conservative nature of the quality measures adopted.

Moreover, this somewhat contradicts Ofwat's justification for uplifting productivity growth assumptions at PR19 based on the alleged productivity improvements unlocked by its move to a TOTEX and outcomes regime at PR14 (2014)—i.e. after the point at which Ofwat claims that productivity improvements slowed down.

There is an absence of evidence for what the magnitude of future productivity improvements could be, and how this compares with the numerous drivers of increasing expenditure faced by the sector. This is concerning to the extent that it sets aside difficult questions regarding whether the current level of funding through customer bills will be sufficient in the future.

Finally, Ofwat sets out that, similar to Ofgem's (the energy regulator for Great Britain) RIIO-2 approach, it anticipates returning the cost of the £200m innovation fund that it has set up to customers through additional future uplifts to required productivity improvements. This has proved contentious at RIIO-2, with companies appealing Ofgem's decision to uplift its ongoing efficiency assumption by 0.2% p.a. for innovation funding.[6]

Having established the potential for greater productivity (and leaving to one side the credible magnitude of anticipated improvements), Ofwat sets out a number of regulatory drivers to unlock these improvements at PR24, as follows:

- the removal of regulatory barriers to the formation of competitive markets in developer services, bioresources, water resources and the provision of large infrastructure;
- setting targeted challenges (such as the largely unfunded step change in leakage at PR19) for water efficiency and wastewater discharges;
- the aforementioned £200m innovation fund;
- better use of data and digitalisation;
- specific price control mechanisms to incentivise innovation, such as setting performance commitments and ODIs over multiple price review periods.

These span approaches that take a more planned approach to innovation (e.g. regulator-operated innovation funds) to approaches that place the onus on companies by incentivising and rewarding leading performance. The latter incentives have often been removed by regulators over time.[7] A key question for stakeholders in the sector is which approaches best maximise improvements in the efficiency frontier and ultimately maximise customer benefits.

Eliciting customer preferences: a major shift

Customer research: a centralised approach

In chapter 6, Ofwat sets out its proposed strategy for customer research and how it intends to interact with the industry in the run-up to PR24.[8] In this regard, Ofwat acknowledges the culture change that has taken place in the sector over the last ten years, with increased company engagement with customers and communities to address service needs. However, while giving praise on the one hand, on the other hand Ofwat criticises the research undertaken in PR19. It makes the following complaints.

- Customers were not always well placed to provide views on technical issues.
- The results from different companies' research on willingness to pay for improvements in performance in some common areas (e.g. leakage reduction) varied significantly, for no clear reason.
- Companies spent considerable amounts on customer engagement in PR19, even though 75% of project expenditure at PR19 was non-discretionary and mandated by government and the quality regulators.

In particular, Ofwat notes that the mandatory nature of much of the expenditure limits the extent to which customers can influence decisions on it (although they may have views on *how* it is delivered). This portion of the expenditure is likely to increase at PR24.

Ofwat therefore places a stake in the ground. It seeks to develop a more targeted approach to capturing customers' views at PR24, focused on areas where they can have a meaningful influence. It aims to do this through collaborative research, which would cover areas common to all companies. The definitive list of areas is not provided by Ofwat, but it will arguably lean towards the common performance commitment (PC) areas.[9]

Ofwat intends for the collaborative research to complement companies' own local research, which should continue. However, the regulator wishes to avoid companies repeating research delivered within the collaborative approach. In addition, feedback on the industry-identified areas with scope to solicit informed opinions from customers was intrinsically limited. These areas included health and safety, calibration of ODIs, affordability (relating to specific bill profiles), and areas where customers have never suffered a service failure.[10]

In Ofwat's view, the collaborative approach would better reflect customers' preferences by:

- increasing the overall quality and consistency of customer research on customer preferences and valuations;
- providing Ofwat, companies and other stakeholders with greater certainty that the research is reliably identifying similarities and real differences between customers and communities across company, regional and national boundaries;
- providing (where appropriate) comparable results across all companies, which can help the customer challenge process;
- (potentially) increasing the efficiency of company expenditure on customer research, particularly for smaller companies.

Regarding the specific design and implementation of a collaborative approach, Ofwat will work with the sector to examine this further. Respondents to Ofwat's December 2020 discussion paper on customer preferences made a distinction between 'nationwide' research and a 'standardised' approach.[11] Nationwide research would involve customers of all companies being included in one research project. A 'standardised' approach would mean all companies agreeing a common methodology for a research project that is applied locally by each company. Ofwat will explore both approaches with the companies.

In tandem with this shift to a centralised approach, Ofwat does not plan to mandate (as it did in PR14 and PR19) that each company should have a customer challenge group (CCG). Companies may continue with that model if they wish—and many companies indicate that they plan to do so. At the same time, Ofwat will work with the Consumer Council for Water and the sector to agree minimum standards for high-quality research, challenge and assurance.

Overall, the change in approach set out by Ofwat marks a major shift—from an emphasis on local customer engagement at the company level, scrutinised by CCGs and reviewed by Ofwat, to a more centralised approach, at least for issues that are common across companies. Indeed, it builds on the shift from PR14 to PR19, which saw Ofwat increasingly applying PCs and ODIs using standard targets in preference to local research. The PR24 strategy now represents a further shift—in how the underlying research is undertaken to elicit preferences.

Companies will need to think carefully about how they strike this balance in terms of where they consider that they do and do not fit into the centralised approach—especially if they have major local company-specific issues such as leakage, where there may be genuine reasons for different willingness-to-pay valuations across companies.

Outcome incentives

In chapter 9, Ofwat also proposes a number of potential changes to the system of PCs and ODIs, including reducing the number of PCs and focusing on those that are 'of enduring interest' to customers.[12] Most of these changes would be common across companies, with far fewer bespoke PCs than in PR19. In addition, at PR24, Ofwat may streamline the business planning process by setting out its views on efficient levels of performance for common PCs ahead of business plan submission—together with the associated ODI incentive rates.

For mandatory environmental commitments, Ofwat is considering following Ofgem's approach and distinguishing these from PCs, renaming them 'Price Control Deliverables' that are linked to specific funding.

All of these changes to PCs and ODIs will affect the risk exposure of companies, and will require further scrutiny.

Finance issues: aligning the company, investors and customers

In chapter 11, Ofwat sets out its proposed strategy for assessing risk and return as it seeks 'to align the interest of companies and investors with those of customers'.[13] The chapter explains Ofwat's proposed strategy for estimating the key parameters of the allowed rate of return, assessing risk and financeability and ensuring longer-term financial resilience of the sector in PR24 (and beyond).

Allowed rate of return

On the cost of equity, Ofwat has suggested potential indexation of the allowed return on equity (in particular, the risk-free rate parameter) to protect investors and consumers from forecasting risk.

On the cost of debt, Ofwat has suggested reviewing the use of index and balance sheet data in determining the cost of debt allowance. It has also suggested adopting a single allowance covering the costs of both embedded and new debt, similar to the approach taken by Ofgem at RIIO-2.

In addition, Ofwat has raised concerns about the appropriateness of a single notional capital structure for all companies, hinting that it may consider the use of alternative notional structures to set the base allowed return to mitigate the risk stemming from risky financing strategies adopted by the companies:[14]

> Most of our previous price controls have focused on using a single notional capital structure to set the base allowed return. This approach benefits from simplicity and provides some protection to customers from bearing the risks of company choices around their capital and financing structure. However, concerns remain that this regulatory approach may not do enough to discourage some companies from adopting risky financing strategies to arbitrage gains for investors. Our concern is that the financing structures which result lack adequate levels of long-term financial resilience and are not in customers' interest.

Financeability and financial resilience

Ofwat considers financeability assessment to be a key measure of setting the PR24 price control. It plans to explore its approach to determining notional company financeability, and suggests two potential changes relative to PR19 that would, in its view, improve notional financeability assessment:

- a further reduction in the notional gearing assumption relative to PR19;
- an increase in the assumed share of the index-linked debt relative to PR19.

In addition, Ofwat emphasises the importance of actual (rather than notional) company financeability and long-term financial resilience. For the latter, Ofwat is considering increasing protection for customers via the following changes, although the proposals are yet to be developed in these areas:

- changing the approach to notional financeability;
- changing the overall approach to the price determination;
- considering mechanisms to protect consumers from the financing decisions of companies.[15]

In addition, Ofwat is considering full indexation of prices and RCV to CPIH in PR24, in line with the energy and telecoms sectors.

Risk analysis

Ofwat states that in PR19 companies adopted different measures in undertaking conduct risk analysis, which made it difficult to compare the resulting risk ranges or directly incorporate this evidence into a sector-wide assessment.

For PR24, Ofwat is therefore suggesting adopting common approaches to the presentation of return on regulated equity risk ranges that take account of historical performance data across the sector. For this, Ofwat is also considering using risk measurement tools such as Monte Carlo analysis.

While estimating common risk ranges across companies may not be an easy task, given each company's unique challenges, Ofwat states that 'planning to focus on fewer performance commitments that would be common to companies, could have the benefit of making the common distribution of risk easier to model across companies'.[16]

Next steps?

Ofwat's vision for PR24 sets out and seeks to address a number of future challenges—with regard to the long run, the environment, outcomes and affordability. Proactively setting out these challenges, proposing regulatory solutions and seeking consultation is the right thing to do, and can only strengthen legitimacy. However, given that these proposals have been published just two months after the CMA redetermination for four appealing companies of PR19, will they form the basis of a collaborative vision in the water industry, or generate new areas of potential disagreement for the next price control?

Contact

leon.fields@oxera.com

Leon Fields

joseph.duffy@oxera.com

Joseph Duffy

summayah.leghari@oxera.com

Summayah Leghari

[1] Ofwat (2021), 'PR24 and beyond: Creating tomorrow, together', May—hereafter 'Ofwat PR24 report', https://bit.ly/3wVtpzz.

[2] Ofwat PR24 report, '4. Increasing focus on the long term'.

[3] Ofwat PR24 report, '5. Getting more for customers, communities and the environment'.

[4] Frontier Economics/Water UK (2017), 'Productivity improvement in the water and sewerage industry in England since privatisation', 29 September.

[5] Ibid., p. 22.

[6] UK government and Competition and Markets Authority (2021), 'Energy Licence Modification Appeals 2021', 5 March, https://bit.ly/35OyOg0.

[7] For example, setting no ongoing efficiency target or setting only a proportion of the expected productivity achievable, Ofwat's multiplier incentive, cost allowances of greater than 100% of submitted costs for efficient companies, and additional financial rewards for enhanced status.

[8] Ofwat PR24 report, '6. Reflecting customers' preferences'.

[9] While Ofwat states that it has set out these common areas in an accompanying appendix, this list is missing and the appendix refers back to the main document. Compare '6.2.1 Potential scope of a collaborative approach to research' of the main document with '3.3 Potential scope of a collaborative research' in the appendix: Ofwat PR24 report, 'Appendix – Reflecting customers' Preferences'.

[10] See '5. How to best capture the views of customers, communities and stakeholders' in the Appendix.

[11] Ofwat (2020), 'PR24 and beyond: Reflecting customer preferences in future price reviews – a discussion paper', December.

[12] Ofwat PR24 report, '9. Outcomes'.

[13] Ofwat PR24 report, '11. Risk and Return'.

[14] Ofwat PR24 report, p. 116.

[15] Ofwat PR24 report, p. 120.

[16] Ofwat PR24 report, p. 115.