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David Black
Chief Executive Officer
Ofwat
11 Westferry Circus
Canary Wharf
London E14 4HD

3rd Floor
36 Broadway
London SW1H 0BH
0207 344 1844
www.water.org.uk

Dear David,

Thank you for the opportunity to respond to Ofwat's consultation on a new 'outturn adjustment mechanism' for the 2024 price review (PR24) for water companies in England and Wales.[1] I am responding with comments that reflect the position of the whole industry in England and Wales; individual companies may also choose to make their own more specific points.

As you noted in your speech to the Moody's UK Water conference when announcing this consultation, substantial concerns have been raised by a wide range of stakeholders on Ofwat's draft determinations. As we said in our response to them, we are concerned that unless the draft determinations change, water companies will not be able to attract the levels of investment that they need.[2] We are concerned that without those levels of investment, the water sector will fail to meet the expectations of customers, deliver the largest environmental programme in the sector's history, and provide the right conditions for economic growth and water security over the long term.

Ofwat's consultation at such a late stage between draft and final determinations is unprecedented. We are not aware of any equivalent in previous price reviews. In the industry's view, Ofwat's proposal leaves two fundamental problems unresolved:

i. **First, the need for this late-stage mechanism appears to be an attempt to fix the symptoms of a much deeper problem: Ofwat's general approach to setting performance targets**. In the current period, 15 out of 17 companies are in net penalty for their performance. This means that 15 independent boards, all of them faced with expenditure allowances decided by Ofwat, and strong financial and reputational incentives to meet the targets set by Ofwat, have been unable to achieve them. This is despite performance improving in 9 out of Ofwat's 11 target measures since 2020, and many areas of company performance in England and Wales exceeding that of most other OECD countries. To be clear, this is not to suggest that company performance is where it should be. However, it seems unreasonable to suggest that the failure of nearly 90% of companies to reach the targets set by Ofwat is entirely their fault. The targets themselves are simply not in the right place.

   Ofwat's approach to obliging companies to deliver inadequately funded and unrealistic ambitions is set to continue, or for some cases worsen, in PR24, as evidenced by First Economics in an analysis of Ofwat's draft determinations.[3] For example, Southern Water's performance this year is expected to result in a £20 million penalty. The same performance next year would see a £200 million penalty under Ofwat's draft determinations. Such an outcome appears excessive and would likely result in some companies risking breaching their debt covenants. Hitting companies with ever greater penalties for failing to reach ever harder

[1] 'PR24: Consultation on outturn adjustment mechanism', Ofwat (October 2024).
[2] 'Water UK response to Ofwat's draft determinations', Water UK (August 2024).
[3] 'PR24: Performance Commitments and ODIs', First Economics (August 2024).

targets has not produced the result Ofwat expects. Yet, in its draft determinations for PR24, Ofwat does not sufficiently change its approach. It should now be clear that, unless Ofwat changes its approach, companies will not meet their targets, which will lead, year after year, to severe and increasing criticism of Ofwat and government as the guardians of a failing system (even if the financial penalties on companies are ultimately mitigated years later by the proposed outturn adjustment mechanism). The only sustainable answer to this problem is to start with stretching but achievable targets, matched by adequate levels of funding.

ii. **Second, water companies, regulators and government now face a degree of complexity that makes it very difficult to predict with certainty how Ofwat's various mechanisms will interact**. As Ofwat acknowledges, "The main drawback of [its] proposal is the potential for increased uncertainty associated with the impact on equity returns of outturn performance."[4] We agree. Furthermore, this late addition adds yet another layer of complication onto an already convoluted framework. There are now many layers of different mechanism designed to reduce the financial risk ultimately created by Ofwat's approach to setting targets and allowances – all of which interact in complex and unpredictable ways, including limited exclusions in performance commitment definitions, an array of different caps, collars and deadbands, new aggregate sharing thresholds, standard and enhanced cost sharing rates, and real price effects mechanisms.

We very much hope that the Independent Water Commission, announced by the UK and Welsh Governments will enable us to break out of this needlessly complex regulatory framework.[5]

Nonetheless, notwithstanding these problems, this late proposal from Ofwat is much better than ignoring the problem altogether. However, crucially, we suggest that Ofwat changes the mechanism to apply annually rather than at the end of the period, which would sharpen incentives, reduce uncertainty and help to overcome financeability concerns with the proposal as it currently stands. We are also proposing that the mechanism excludes enhanced payments, which are earned when a water company pushes forward the frontier of performance. This would remove disincentives for companies to collaborate and share knowledge, ensuring that the customers of all companies are able to benefit from new innovations and discoveries. **We respond to specific questions on the proposed outturn adjustment mechanism in Annex A.**

Finally, however, we also kindly urge Ofwat to reconsider wider aspects of the price review. We consider significant changes are required, not just to the outcomes framework, which is beyond the proposal in this consultation, but in other aspects of the price review. For example, the proposed mechanism only mitigates asymmetric risks that affect every water company equally. Where a subset of water companies are affected, such as by extreme weather events, then Ofwat's position to not exclude such events from its performance commitment definitions will leave entire regions of the country exposed to those risks, undermining potential investment into improving resilience to extreme weather and climate change. And more broadly, without sufficient expenditure allowances (for both base costs and enhancements), deliverable performance targets and a reasonable balance of risk and returns, the water sector will fail to deliver the expectations of customers, environmental improvements and economic growth.

Addressing these issues and ensuring the final determinations for PR24 are deliverable, financeable and investable will avoid years of delay and the lost progress that will be inevitable from potential mass appeals to the Competition and Markets Authority in 2025.

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[4] 'PR24: Consultation on outturn adjustment mechanism', Ofwat (October 2024), page 2.

[5] 'Independent commission on the water sector regulatory system: terms of reference', Defra (October 2024).

As always, we are happy to discuss any of these issues raised in our consultation response. I also reiterate my offer to you in the summer to convene companies or analysis very swiftly, if it would be helpful, on tackling any of the other issues across the price review framework.

Yours sincerely,

David Henderson
Chief Executive Officer
Water UK

Annex A

Q1: Do you, or do you not, support the principle of the introduction of an outturn adjustment mechanism that adjusts the realised equity returns for all companies based on the outcome performance of the median, measured as a proportion of regulated equity?

As a first-order priority, Ofwat should aim to set a price review package that has a balance of risk and is able to attract the level of investment the sector requires. As well as setting appropriate expenditure allowances and allowed returns, that would mean setting performance targets that, whilst ambitious, are ultimately achievable and deliverable. The outturn adjustment mechanism, layered on top of the existing risk protections – such as limited exclusions in performance commitment definitions, caps and collars and aggregate sharing thresholds – is an attempt to create balance to Ofwat's performance framework. But that framework is significantly affected by Ofwat's own decisions to reduce expenditure allowances and set undeliverable targets. Enhanced cost sharing and real price effects mechanisms are also designed to reduce the risk created by Ofwat's inadequate funding allowances, which are unlikely to be sufficient for companies to meet Ofwat's performance targets.

In addition, Ofwat's approach to performance targets and expenditure allowances is likely to create cashflow issues for companies, which creates risks for financeability and can also undermine the investability of the water sector. As Oxera's report into investor views on Ofwat's draft determinations showed, current and potential equity investors seek a steady stream of income and dividends, at the cost of equity and even as new equity is being raised.[6] By delaying any adjustments until the end of the period, the proposed mechanism potentially undermines both financeability and investability.

Therefore, on its own, the outturn adjustment mechanism is not sufficient in creating a balanced package and a 'fair bet' in order to attract the level of investment the sector needs. To achieve these aims, Ofwat needs to review its approach to expenditure allowances, performance targets and the allowed return on capital.

While it is very much second-best, and notwithstanding the need to address wider aspects of the price review, we support the principle of an outturn adjustment mechanism as a means of reducing some sources of skew within the outcomes package. However, if Ofwat is minded to adopt this mechanism, the mechanism needs to change. We set out suggestions for the changes required in our response to Q4.

Q2: Do you, or do you not, agree that this should apply to Outcome Delivery Incentives (ODIs) including Measures of Experience (MeXes)?

Yes. We suggest Ofwat considers whether wider sources of risk should also be included in the mechanism, such as returns relating to base expenditure allowances. This is similar to the approach taken by Ofgem, where its Return Adjustment Mechanisms (RAMs) relate to multiple sources of risk and return, and recognises that outcomes performance is linked to expenditure allowances.

The link between outcomes and expenditure allowances is demonstrated by performance under the PR19 settlement. Water companies are currently overspending their expenditure allowances by around 12% over the first four years of PR19, with 16 out of 17 companies exceeding their expenditure allowances. On its own, this is an average reduction to notional regulatory returns of -1.8%. Over the same period, 15 out of 17 companies are underperforming overall on outcome delivery incentives and the measures of experience. Instead of attempting to balance one element of the price review in

[6] 'Investability at PR24', Oxera (August 2024).

isolation, Ofwat should seriously consider estimating and addressing broader sources of risk – either at source, or if necessary through outturn adjustments.

Q3: Do you, or do you not, agree that this mechanism should be applied after application of the Aggregate Sharing Mechanism (ASM)?

We agree.

Q4: Are there any points that we should consider if we decide to implement such a mechanism? If so, what are they?

While we are supportive of the overall proposal, we consider there are some drawbacks that need addressing as part of the final determinations for PR24. In response to this question, we set out:

- underlying issues with the performance framework, which on its own the proposed mechanism does not sufficiently address;
- specific drawbacks with the mechanism as it stands; and
- suggested changes.

Underlying issues with the performance framework

There are underlying issues with the performance framework that the proposed mechanism does not address, that Ofwat should address first:

i. Unfunded and undeliverable targets. Ofwat's significant cuts to expenditure allowances and approach to performance targets in its wider determinations, make it highly unlikely that companies will meet the performance targets Ofwat proposes to set.

ii. Excessive exposure to sources of asymmetric risk. Ofwat's approach tends to ignore company-specific characteristics and extreme weather events that only affect a subset of water companies. For example, Ofwat does not have explicit exclusions for extreme weather in its performance commitment definitions for PR24. As proposed, the outturn adjustment mechanism would only adjust returns based on the returns of the median company. It is possible to imagine a scenario in which average underperformance for a subset of companies is much larger than average outperformance for the rest. While the aggregate sharing mechanism would reduce the size of risk for those companies (if the marginal impact exceeds the aggregate sharing thresholds) the outturn adjustment mechanism would only partially address this 'across-sector' skew in performance and returns.

iii. Reliance on absolute targets. Ofwat's outcomes framework is largely based on absolute targets, with most performance commitments having the same target levels of performance for every company – Ofwat's expenditure models are assumed to account for company-specific characteristics. The use of absolute targets puts significant reliance and pressure on the accuracy of Ofwat's estimates of future performance and its expenditure models (and the impact of risk and uncertainty). We recognise that more fundamental changes are close to untenable at this stage of the price review. But we think that alternative approaches merit further consideration for future price reviews, such as setting relative target levels for individual performance commitments.

Issues with the proposed mechanism

We also consider there are the following drawbacks with the mechanism as it stands, which could be addressed by Ofwat as part of its final determinations:

i. Even less trust in the water sector. Ofwat's proposal has the additional disadvantage of generating a further weakening of trust and confidence in the water sector. Even if the financial impact from failing to meet undeliverable performance targets is partially offset by a financial adjustment at the end of the period, the water sector would still incur the significant reputational damage of failing to deliver those unachievable performance targets. Money cannot compensate for such damage. Without changing the targets themselves to levels that are achievable, further confidence will likewise be lost in Ofwat and government more generally.

ii. Reduced incentives and increased uncertainty. The nature of an end-of-period adjustment that depends on the performance of other companies makes it more challenging for companies to respond to Ofwat's performance incentives. For example, when considering whether to proceed with individual investment projects, it will be less clear to a company what cost or benefit it will incur as a result of outcome delivery incentives. While this lack of certainty will reduce over the course of the price review, the timing of an end-of-period adjustment means that companies will not know for sure what their overall returns will be until late 2031, up to six years after companies make decisions about investing in their performance.

iii. Risks to financeability and affordability. If the median company underperforms, then all companies will be due a positive end-of-period adjustment. In the meantime, companies will have lower cashflows than they otherwise would have, potentially putting financeability at risk for some companies. For example, based on our analysis of Ofwat's draft determinations, we estimated that water companies face outcome delivery incentive penalties of between £2.5bn and £8.4bn over the next five years, based on either companies' forecast performance or an average of actual performance over 2020-24. For the majority of companies, this would represent negative returns on regulatory equity of at least -1% on average (or -2.5% under the £8.4bn scenario).[7] Even if some of this is corrected under the outturn adjustment mechanism at the end of the period, companies would still carry the cashflow impact, potentially undermining their financeability. Conversely, under a scenario where the median company outperforms, then customers would pay higher bills than they otherwise would, until the end-of-period adjustment is applied.

iv. Weaker incentives to collaborate and innovate. Because of the relative nature of the proposed mechanism, water companies' returns would be reduced if every single company outperforms. We are concerned that this would have the unintended consequence of deterring companies from working together on joint initiatives or innovations. For example, an individual company would still have higher returns for improving its own performance, but would have an incentive to not share the information that led to its achievements as it would necessarily affect the performance of the median company and, therefore, reduce its returns. While it could be argued that the outturn adjustment mechanism would reduce bills for customers in the short term, it could ultimately lead to higher bills overall if innovation is reduced or fewer good ideas are shared. Such an outcome would reduce the ability of companies to meet the expectations of customers over the long term.

[7] 'Water UK's response to Ofwat's draft determinations', Water UK (August 2024), pages 20-22.

Suggested changes

If Ofwat is minded to proceed with the outturn adjustment mechanism, we **suggest changes that Ofwat should make as part of its final determinations for PR24**. We have considered proposing wider changes, but given the late stage of the price review, we consider adapting the proposed outturn adjustment mechanism is the most viable way to address the issues we have outlined.

We suggest that Ofwat:

- **Fully funds water companies' expenditure requests and sets performance targets that are achievable and deliverable**. We set out further details in our response to Ofwat's draft determinations.

- **Adopts an annual process for the outturn adjustment mechanism**, adjusting returns through the existing in-period outcome delivery incentives process. As well as sharpening incentives and reducing uncertainty, an annual process would reduce financeability or affordability risks. To reduce uncertainty further, Ofwat should publish a reconciliation model that enables water companies, investors and wider stakeholders to predict the likely impact on returns from performance prior to the end of the reporting year. This will enable companies to better assess the likely impacts of their investment decisions.

  As Ofwat notes in its response to queries on its proposal,[8] moving to an annual approach may mean that the median company changes every year, as opposed to an end-of-period process that would be based on an actual median company over the five-year period. In practice, we consider the differences between each approach to likely be minimal and outweighed by the benefits from increased certainty under an annual process. However, if Ofwat wants the adjustment to focus on the median company over the five-year period, then it should supplement annual adjustments with a further end-of-period adjustment that applies the difference between both approaches, provided Ofwat is satisfied that such an adjustment would be proportionate.

- **Excludes enhanced rewards for outcome delivery incentives from the outturn adjustment mechanism**. While this change would add some complexity, it would better enable water companies to collaborate, share innovations and deliver higher performance across the sector.

[8] 'Q and A on Outturn Adjustment Mechanism', Ofwat (October 2024).