

1. PURPOSE OF PAPER

The purpose of this paper is to provide an overview of the main components of our business plan and to set out the possible impact on household bills and levels of service.

2. BACKGROUND

In its final methodology published in December 2017, Ofwat clearly set out its expectations for PR19. Customers expect great service and companies to be resilient to both short-term shocks and long-term challenges such as climate change and population growth. They also expect those services to be affordable, including for those struggling to pay. The only way companies will achieve all this is to find new ways of working. Hence Ofwat's key themes for PR19; great customer service, affordable bills, resilience in the round and innovation.

In-line with Ofwat's key themes we set out the main factors that will drive bills from 2020-2025.

3. FACTORS DRIVING BILLS FROM 2020 TO 2025

In its final methodology, Ofwat estimated that the WACC will be 3.4% on a real CPIH basis, or 2.4% in RPI terms which is 1.3% lower than PR14. We are using this figure to develop our submission, but must bear in mind that it can be amended to reflect changing market conditions at both the draft and final determination stages.

Ofwat has estimated that the reduced WACC could result in savings of £15 to £25 per year from 2020.

In PR14, as part of the revenue control, there was an allowance made by Ofwat for reconciling 2010-15 performance. For NWL, this included a Revenue Correction Mechanism (RCM) adjustment to recover income losses made over 2010-15. There was a further revenue allowance for the water service to correct an error made in assessing the Dagenham supply pipes scheme. These revenue adjustments end in 2019/20 and will not repeat in 2020-25.

Finally we are achieving totex outperformance in AMP6 and a proportion of these gains must be shared with customers which will add further to downward pressure on bills.

Taking into account all these factors and any other minor adjustments we estimate that bills could reduce by at least 10%. This would result in an average household combined water and waste water bill reducing in 2019-20 from £390 to £351 in 2020-21. We used this figure in customer research when asking customers if they would like to re-invest some of the potential saving on schemes that could deliver additional resilience. Even if customers chose to invest the full amount, bills would be no higher than in 2019-20 and there would be a significant commitment to reduce risk to levels of service.

4. SETTING CHALLENGING PERFORMANCE COMMITMENTS (PC)

We must set stretching PCs with financial Outcome Delivery Incentives (ODIs) for the five years from 2020-21 to 2024-25 and to support these with long-term projections for at least another ten years. Unlike PR14, ODIs this time will be in-period and impact companies' revenue meaning that any bill adjustments resulting from ODIs will first occur in AMP7 year 3, 2022-23.

PCs with financial ODIs can be divided into three categories; common, bespoke, scheme specific.

Common PCs

There are 14 common PCs which rely on good-quality, consistent definitions. Companies are expected to implement the common definitions to enable them to be used in final determinations and Ofwat will take into account progress towards implementing common definitions in the initial assessment of business plans.

Common PCs apply to the following areas:

- Customer service: C-MeX and D-MeX.
- Water service: water quality compliance, water supply interruptions, leakage, per capita water consumption.
- Waste water service: internal sewer flooding, pollution incidents.
- Resilience: risk of severe restrictions in a drought, risk of sewer flooding in a storm.
- Asset health: mains bursts, unplanned water supply outages, sewer collapses, waste water treatment works compliance.

Common PCs will be expected to be set at the most stretching level meaning at least upper quartile (UQ) or possibly better where UQ could represent a deterioration in service.

Bespoke PCs

Using information gained from customer research, industry practice (for example, Discover Water) and where there are clear pointers in the methodology we are developing a range of bespoke PCs. While these measures are not explicitly subject to common definitions, accepted industry definitions might already exist, for example bathing water quality or external sewer flooding.

Again PCs must be stretching and we will be challenged where they are not set at UQ where available, or better. While there may be scope to set some PCs at levels worse than UQ, it will be difficult to justify rewards being earned for performance less than UQ.

Scheme specific PCs

Our totex plan will consist of base and enhancements. Ofwat will use econometric benchmarking models to assess companies' base totex allowances. This will cover all expenditure we require to meet our PCs with any incentive outperformance or under-performance being rewarded or penalised through ODIs.

We also expect to have significant expenditure on enhancements; investment that materially improves our levels of service. The main areas of enhancement expenditure are to deliver the Water Industry National Environment Programme (WINEP) and to deliver enhanced resilience where supported by customers.

This investment is likely to be subject to scheme specific outputs. We had two examples of this form of PC and financial ODI during AMP6; Whitburn CSOs and the new customer contact and billing system. Most of these ODIs will be penalty only.

PCs 'in the round'

Common PCs will be set at least at UQ level. In some cases where we are performing very well we may have to go beyond UQ. Not to do so would be deemed to be insufficiently stretching. In setting PCs we will also review measures individually as well as collectively to make sure we have considered Ofwat's 'in the round' test.

Earning any rewards is extremely challenging. Companies will only earn outperformance payments for delivering beyond stretching service levels. A company whose future performance remains at the current average will incur underperformance penalties. On balance, a company that delivers levels of performance consistent with Ofwat's benchmarks (mostly set at UQ) would be net zero in terms of ODI rewards and penalties.

Enhancements

Enhancement schemes are those linked to an external driver to deliver enhanced levels of service such as new legislation, new obligations, increased demand or enhanced resilience. The main drivers for enhancements at PR19 are:

- WINEP.
- Supply/demand schemes (growth, new development, metering).
- Enhanced resilience.
- Security and emergency measures direction.

Even if we receive customer support to invest in all the current potential enhancement schemes this would only add around 4-5% to bills which is likely to be less than half the reduction we expect will apply from the beginning of AMP7. In other words bills would still fall albeit, by a lower amount.

5. AREAS OF DISTINCTION

In addition to areas of ambition we will ensure that our business plan includes areas of significant distinction. These will be presented in line with the long-term strategy document 'Shaping our Future' under the six themes of:

- Unrivalled customer experience.
- Affordable and inclusive services.
- Leading in innovation.
- Reliable and resilient services.
- Working with others to improve the environment.
- Building successful economies in our regions.

Under each theme we will highlight a single, sector-leading ambition. For example, the goal under 'Affordable and inclusive services', is our aspiration to reach zero water poverty by 2030. These areas of distinction need to be agreed with customers.

6. PRICE AND SERVICE PACKAGE

Ofwat has set out very challenging criteria in its PR19 methodology which will result in significantly reduced bills, possibly by 10% or more if enhancements remain the same as in AMP6. Even if investment in schemes to deliver enhancements increases significantly, bills will still reduce at the beginning of AMP7 compared to AMP6.

In addition we will be committing to significantly higher levels of performance. The default position for PCs in AMP7 will be at the UQ and any attempt to set PCs at worse than this level will be overwritten or result in significant challenge from Ofwat.

Finally, our price and service package will contain ambitious areas of distinction such as our commitment to eliminate water poverty. Hence we envisage a plan that achieves ambitious performance commitments, demonstrates continuing efficiency, innovation and leadership with higher environmental investment and significant enhancement of service resilience whilst still achieving a reduction in bills.

We believe this will be a very attractive package for customers which will receive good support through acceptability research to endorse our final plan.

7. RECOMMENDATION

The Water Forum is asked to note and comment on the shape of our proposed price and service package as described in our business plan.

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