

1. REGULATORY UPDATE

The purpose of this paper is to update the Water Forum on the latest regulatory developments in terms of messages from Ofwat and legislation relating to drinking water quality and environmental management and associated guidance. This summary highlights guidance from Ofwat and signposts the level of engagement that NWG achieves with the Drinking Water Inspectorate (DWI) and the Environment Agency (EA) as part of our regulatory approach. It provides insight into areas that need to be addressed within our Business Plan for PR19.

2. OFWAT

2.1 November 2017: Ofwat Company Monitoring Framework: Assessment of Northumbrian Water as Self Assured

In November, Ofwat set out their 2017 assessment of water companies assurance processes. Northumbrian Water was placed in the top category of 'Self Assured'. This represents an improvement from the 2016 'targeted' rating and puts NWL alongside South East Water and United Utilities as the only Self Assured companies.

This is a significant part of NWL's aim to be a leading company and places it well in advance of the Business Plan submission.

A further accolade was received in the same week when Northumbrian Water won the Utility Week 'Utility of the Year Award'. These awards are the highest profile and most competitive across the utilities, so winning was a major achievement.

The Company impressed the judges with its "all round, consistent out-performance". It was described as a "recognised leader in its sector, a champion for its community and an outstanding example of a utility operating at the top of its game."

2.2 12 December 2017: Ofwat's Final PR19 Methodology Changes since the draft methodology in July

Overall

The movement from draft to final guidance is broadly neutral. A lower cost of capital than expected is off-set by greater clarity of, and some increase in, available incentives. It remains a tough settlement for investors with a lot of good news for customers.

Finance

Ofwat have proposed a 2.4% cost of capital in RPI terms – down from 3.7% at PR14 and a record low for a regulated utility. Ofwat said this equates to an average saving per customer of £15-£25 a year from 2020. The transition to CPIH indexation from 2020 was confirmed.

The cost of capital (specifically the cost of equity) was lower than consensus expectations. The 2.4% figure may be adjusted by Ofwat for the Final Determination, but it is the value to be used for the 2018 Business Plans.

Business plan assessment

Ofwat have proposed a larger potential reward of up to 35 basis points (bp, 0.35%) (from 20bp in July) on Return on Regulatory Equity (RORE) for top level 'exceptional' plans. There will be a new reward of 10bp on RORE for 'fast track' plans.

Both of these changes were proposed by NWL and are welcomed.

Outcomes

Ofwat have proposed some relaxation on their upper quartile (UQ) challenge - companies will be challenged to achieve forecast UQ performance each year rather than the 2024/25 UQ forecast from year one.

The 14 common Performance Commitments have been confirmed. Number 14 was amended from “Asset health: waste water asset failure causing pollution” to “Asset health: treatment works compliance”. The definitions of three others have been adjusted.

The move to a yearly comparison was proposed by NWL in a recent meeting we had with them. This change should allow companies to propose ambitious targets up to 2024/25 without being expected to meet them immediately in the first year.

Cost efficiency

Ofwat have set out stronger cost sharing incentives - companies with efficient plans are to be allowed to keep a greater share of cost outperformance while inefficient plans will retain a lower proportion of outperformance than presented in July.

This is a welcome change as it improves the incentives for efficient companies, whilst ensuring inefficient companies do not gain from submitting unrealistic plans.

Price controls

The household retail price control timeframe was extended from three to five years.

Customer engagement

Ofwat clarified that companies should engage with business retailers as part of their customer engagement work.

Clarification was provided on how environmental concerns should be included in the customer engagement model.

2.3 11 December 2017: Ofwat announces new Chief Executive

Ofwat has announced the appointment of Rachel Fletcher as its new Chief Executive.

Rachel joins from Ofgem where she is Senior Partner for Consumers and Competition and sits on the Ofgem Board.

She joined Ofgem in 2005 and during her time there was also Partner for Distribution, leading the Electricity Price Control Review and introduced the Low Carbon Network Fund. Before joining Ofgem, Rachel worked as a consultant advising public and private sector organisations around the world on energy strategy and policy.

Rachel's appointment follows the departure of Cathryn Ross, who is leaving to take up an executive position at BT. Rachel will join Ofwat on 8 January.

3. DRINKING WATER INSPECTORATE

In December 2017, we submitted water quality proposals to DWI for schemes requiring their support as part of the PR19 process. The proposals were completed in line with the guidance note issued by the Inspectorate in September 2017 on ‘Long Term Planning for the Quality of Drinking Water Supplies’.

Our submission included the following items:

- A continuation of NWG's lead strategy. This focused on public health and full lead service pipe replacements for vulnerable customers, plus the withdrawal of phosphate dosing in rural communities on sustainability grounds after removal of all lead service pipes in these supply areas.
- Extensive installation of flow meters and in line valves within the strategic water distribution network to manage discolouration risk through cost-beneficial pipeline management techniques.
- Laying a new 37km large diameter main from Lartington water treatment works in Teesdale through to Longnewton service reservoir in Teesside to replace existing assets whilst minimising discolouration risk and building a more resilient service for customers.

- Managing resilience, compliance and drinking water events in our Central (Wear) area of supply with the construction of a new service reservoir near Washington.
- A statement on our catchment management plans for AMP7 and intended activities around pesticide compliance and our wider catchment-based approach.

The DWI has issued the outcome from its consultation on the revised drinking water regulations. Although the aim is to move towards a risk based monitoring regime at customer taps, the initial changes will see all companies increase sampling frequencies for a number of named parameters. This new drinking water directive is due to come into force part way through 2018, and is expected to have an upward pressure on laboratory activities and resources.

4. ENVIRONMENT AGENCY

The current charging structure for surface water and groundwater discharge activities, the Charging for Discharges (CfD) scheme, annually recovers costs totalling approximately £55m for the EA, and has been supplemented in recent years by some grant aid funding. The EA is currently consulting on a revised charging mechanism for both permitting and subsistence charges which will run until the end of January 2018. The proposed changes aim to better reflect the effort EA use to permit and regulate different discharge types and remove the cross-subsidy between subsistence and permitting incomes. The plan is to recover full costs from the various sectors to which CfD applies.

As part of the consultation, each water and sewerage company was provided with an assessment of the effect on their annual charges based on an acceptance of the EA's proposals. For Northumbrian Water, the costs will indicatively increase by around £1.35m per annum, a rise of around 50% of the current activity charge. Sector increases range between 21 – 47% therefore the impact on NW as a company is significant. The major factors influencing the increase are our very large coastal discharges and the fact that the EA is removing a receiving water factor – all waters are to be given the same sensitivity weighting so high dilution through sea outfalls no longer applies. NW also has a high number of combined sewer overflows with sewer level monitor capability. Whilst this is a positive situation in terms of intermittent discharge management and spill frequency, the information is being used by EA as part of operational performance assessments and is therefore reflected in the charges.

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