NORTHUMBRIAN WATER

DRAFT DETERMINATION COMPANY REPRESENTATION

1. EXECUTIVE SUMMARY

We remain firmly committed to the fundamentals of our original submitted plan, which was widely supported by both our customers (91% support) and our CCG. In limited areas we have made some further adjustments to our plan.

We are deeply concerned that the very substantial work we have undertaken to understand and reflect our customers' preferences has in many instances been effectively overwritten by Ofwat's top-down benchmarking on costs and service, particularly in relation to resilience enhancements. It is unclear what engagement Ofwat has done with customers to justify overwriting our plan.

Notwithstanding the above, we have made a determined effort to fully consider Ofwat's latest round of feedback, particularly where this provides new information. As a result of this further detailed review, we have incorporated a £92m reduction to our planned totex, which reduces the gap between our and Ofwat's view of efficient costs from £296m at Draft Determination to £204m.

The remaining £204m gap relates to areas where we consider our totex proposals to be very well evidenced and thus remain beyond the scope of any further reduction.

The balance of the Draft Determination as a package is not acceptable.

Northumbrian Water is proud to be recognised as a high performing company within the water sector. Indeed, Ofwat's assessments show us to be operating at or beyond the upper quartile level of efficiency on costs across the sector in AMP7, with generally improving and above average levels of service and some service levels at the industry frontier. We set ourselves highly ambitious targets to deliver for our customers, and this ambition was reflected both in our original business plan submission, and our response to the IAP, where for example we adopted several of Ofwat's more stretching PC levels once new information about our comparative position was revealed.

In its Draft Determination, Ofwat has proposed further changes to the service package, made further changes to the allowed costs across the sector, and has also made a substantial reduction to the allowed cost of capital, which was already at a historic low based on its 'early view'. We are very concerned that these changes have been made on an unconnected, top-down basis without adequate 'in the round' assessment.

We note in the PR14 Bristol Water re-determination by the Competition and Markets Authority (CMA), the CMA stated '*for Ofwat to consider that upper quartile performance (historical or otherwise) would match economic levels appeared unlikely to us in general'*.[1] Ofwat appears to have ignored this judgement and exacerbated the error it made at PR14 by applying this upper quartile benchmarking approach not only to costs but to a much wider range of service levels. Indeed, we are not aware of any companies, currently or historically, that have simultaneously achieved an UQ level of efficiency alongside UQ service levels across all the common performance measures Ofwat is now imposing.

This conclusion is supported by the attached independent expert review from Economic Insight and results in an overall package that in our view, and when taken in aggregate, is not financeable for the notionally efficient company[2] raising significant questions as to whether Ofwat is meeting its statutory financeability duty.

Our financeability concerns are further exacerbated by a late change to Ofwat's methodology, which was not consulted on, to set totex allowances entirely on the baseline rather than combining this with the reconciliation of cost out or underperformance based on business plan costs. This increases the financeability consequences of totex overspends.

[1] CMA (2015) 'Bristol Water plc: A reference under section 12(3) (a) of the Water Industry Act 1991', p283.

[2] See Economic Insight report

We do not believe that Ofwat's approach is in the best interests of customers or the sector as a whole. Even for a high-performing company like Northumbrian Water the package is now undeliverable and we are concerned this could result in some less well positioned companies facing financial default, potentially leading to permanent loss of trust in the sector.

Ahead of the Final Determinations we would encourage Ofwat to take a broader in-the round assessment of these determinations, and in particular to review whether they represent a robust but fair level of challenge whilst still ensuring that the notional company is financeable.

Our Board is unable to provide assurance that our Draft Determination is financeable.

The Board has formed this opinion based on un-deliverability of the package as described above and the resulting deterioration in our key credit rating metrics. Specifically, we are concerned that the Draft Determination would result in a deterioration in some of our interest cover ratio and FFO/debt metrics which would result in a credit downgrade.

We believe that maintaining our current BBB+/Baa1 ratings is appropriate and in the interests of customers in order to provide the required credit headroom, particularly in light of the challenges and risks of AMP7. It is consistent with Ofwat's view that companies should maintain "sufficient headroom" above minimum investment grade with a "higher evidential bar" applying to companies arguing that BBB is an appropriate rating to target, and also consistent with Ofwat's approach to choice of IBoxx spot rates in relation to calculating debt allowances. The level of challenge Ofwat is applying elsewhere in the Draft Determination with limited justification only serves to increase the importance of maintaining adequate headroom. As does the proposal to amend company Licences to strengthen the credit rating requirement. Given all of the above it seems inconsistent for Ofwat to be proposing Draft Determinations that would result in companies facing at least a one notch downgrade across the sector.

Although we welcome the additional clarity in the Draft Determination regarding Ofwat's expectations for enhancement investment cases that relate to resilience and the protection of future services, we remain concerned that Ofwat is not fully meeting its new statutory duty with regard to resilience.

We raised concerns in our response to the IAP in relation to Ofwat's approach to resilience and whether it was meeting its new statutory duty. We also sought further clarity on Ofwat's expectations for those cases.

We were pleased to see that Ofwat accepted some of our enhancement investments in the Draft Determination and also provided more detailed feedback on individual cases. In light of this we have made some changes to our enhancement package and this has further reduced the cost gap with the Draft Determination.

However, our plan included significant investments to support resilience on which we have strong customer support and which Ofwat has still not accepted[3]. We believe it is essential that these projects are funded in the Final Determination as they are key aspects of our plans to secure the long-term resilience of our supply and sewerage systems including the management of risks to service in the interests of our current and future customers

Significantly reducing our proposed enhancement investment is contrary to customer views on the balance of bill reductions and costs in our original plan and risks unfairly shifting the burden of associated risks and costs on to future generations.

This is reinforced in our CCG's response to the Draft Determination:

> *"During NWL's research customers were clear – they wanted to see some of the cost savings reinvested in enhancement projects that will improve resilience, rather than in a bill reduction beyond*

[3] We recognise that Ofwat has not accounted for all the evidence we submitted after the IAP in the Draft Determination and that some of that evidence will need to be considered at the Final Determination

> *that which they gave support for. We heard this many times at the engagement events we attended and are concerned that short term bill reductions could lead to long term bill increases……and bring increased risk to NWL customers and the communities and environment they live in."*

We acknowledge that Ofwat has accepted a number of the challenges we made in our response to the IAP.

In our response to the IAP we set out a number of concerns around Ofwat's assessment and we acknowledge that some of these were accepted at the Draft Determination:

- Ofwat has addressed a range of issues that we raised in relation to its assessment of efficient costs. It has corrected the error it made in failing to reflect our full abstraction licence costs, it has used a more appropriate forecast for STW load and it has also used our updated data for the novel SPS variable in its base cost modelling.
- Ofwat has also accepted some of our enhancement investment cases, amended its approach to operating expenditure in enhancement, and provided some additional clarity on its expectations for resilience investment cases.
- Finally, Ofwat has also revisited its approach to enhanced incentives in relation to ODIs and taken some limited steps to recognise the difficulty in delivering some of the PC levels. For example through the provision of slightly wider dead-bands on CRI and glide-paths for the supply interruptions target.

In our view, all of these changes were necessary and appropriate.

However, there remain significant specific issues to resolve ahead of the Final Determinations in December.

In particular, the risk return balance of the package as a whole - including costs, service levels and the allowed return - needs to be revisited for the Final Determination. We do not believe that the current package is financeable for the notionally efficient company and some adjustment to the package is therefore required:

- We accepted Ofwat's initial assessment of the WACC. In the context of the package as a whole we do not accept the further WACC reduction which Ofwat has applied at Draft Determination, nor could we accept any additional reduction at Final Determination.
- We believe the allowed PAYG rates need to be consistent with the composition of the allowed costs. In the Draft Determination this was not the case. Ofwat used the PAYG rate we submitted but made significant adjustments to our submitted costs which should have resulted in a change to the PAYG ratio to maintain the 'natural rate'. Failure to do this results in a departure from the natural rate so that costs are not apportioned fairly between current and future customers.
- We have set out the PAYG rate we believe to be appropriate for our resubmitted costs. Should Ofwat's view of efficient costs in the Final Determination differ then the PAYG rate must be adjusted to reflect the extent to which the adjustment to costs arises in opex or capex. For Northumbrian Water this is relatively easy to calculate as all of the enhancement costs in our amended plan are capex.
- We further note that, as Ofwat's Draft Determination pushes companies beyond the financeability threshold, inconsistencies in Ofwat's approach, for example differing treatment of Infrastructure Renewal Expenditure (IRE) in relation to calculation of PAYG ratios, are likely to be exposed.
- We set out our views on these first points in more detail in **Section 2 – The Balance of Risk and Return, WACC and PAYG.**
- Despite the complexity and short timescales, we have made determined efforts to understand the rationale underpinning Ofwat's view of efficient costs. As a result we have closed the cost gap significantly from £296m to £204m. The remaining gap relates primarily to enhancement investments which we remain strongly committed to. We have submitted further revisions to our enhancement cases and recognise that some of the updated evidence we submitted previously has not been accounted for in the Draft Determinations. This area is likely to be a focus for us in future discussions with you. We remain concerned with the low weight which appears to have been attached to customer views in this regard, believing our

customer engagement on this topic to have been meaningful, innovative and robust. Our views are set out in more detail in **Section 3 – Cost Assessment.**

- Whilst there is much closer alignment between our plan and Ofwat on PCs and ODIs (and we acknowledge that Ofwat has made some changes to ensure that they are more deliverable, for example widening some dead-bands and applying glide-paths) we still have some concerns and believe that Ofwat needs to go further. In the IAP response we highlighted that benchmarks needed to be robust and credible. We were therefore surprised and disappointed to see that Ofwat is seeking to make unplanned outage a financial PC/ODI and is proposing more stretching targets there. In our view this measure is far too novel to apply these benchmarks. Indeed Ofwat's own targeted review of this PC in 2018 clearly shows this to be the case. At the same time, whilst it was good to see Ofwat recognising that more stretching enhanced incentives are justified for truly frontier shifting performance, we are concerned that Ofwat is setting thresholds so demanding as to make these incentives unlikely to be achieved in practice. Our views are set out in more detail in **Section 4 – Performance Commitments and Outcome Delivery Incentives**.

Our response also includes **Section 5 – Further Points** and **Section 6 – Draft Determination Actions**, which contains our response to the further actions which Ofwat has raised at Draft Determination including our response to Ofwat's request to provide board assurance that the Draft Determination is financeable. A number of supporting papers and appendices provide further evidence in support of our position throughout.

Finally, we have found it extremely challenging to respond to the Draft Determination in the timescales available due to the sheer complexity of the framework. In the July Draft Determinations Ofwat published over 200 documents and over 300 models. This volume of materials has been extremely difficult to reasonably review, understand and digest in the six week period Ofwat has allowed. Indeed, we note that Ofwat itself has struggled to fully explain its Draft Determination decisions with clarifications, webinars and amendments to documents being published throughout the Draft Determination response period. This unreasonably constrains the ability of companies to respond, particularly as adequate time still needs to be devoted to matters such as board and external assurance. In the interests of best regulatory practice and ensuring the right outcome for customers, Ofwat should have allowed companies more time to respond to the Draft Determination. This time constraint was exacerbated by Ofwat making significant changes to its final methodology.

Given the time constraints we have not focused in detail on aspects of Ofwat's approach where the outcome of the Draft Determination is broadly consistent with our plan. Accordingly, the absence of detailed challenge in this representation should not be taken as acceptance of Ofwat's overall approach.

Our Board is able to confirm that, should Ofwat address the points set out in this representation, and assuming no further tightening in other areas, then our plan once again becomes financeable.

Addressing these points would also maintain the fundamentals of our plan which was widely supported by customers as reflecting an appropriate balance between prices, service levels and future resilience.

We look forward to working through these issues with Ofwat in an open and constructive manner ahead of the Final Determinations.

2. THE BALANCE OF RISK AND RETURN, WACC AND PAYG

We do not accept the Draft Determination package as a whole, and in the context of this package we do not accept the WACC reduction which Ofwat has applied at Draft Determination. It logically follows that we could not accept any further reduction at Final Determination. We consider Ofwat's 'early view' of the WACC, as set out in the IAP, appropriate.

In the Draft Determination, Ofwat sets a real wholesale WACC (RPI stripped) of 2.08%. This is 22 basis points lower than the 2.30% in the early view WACC that we used in our Business Plan. This is important, as when our Board stated that our Business Plan was financeable, it was on the basis of the 2.30% WACC.

We note also the Ofwat reference to data changes from 28 February 2019 to 28 June 2019 suggesting a possible further 37 basis points reduction in the WACC.

The Draft Determination cost of capital is set on the basis of average industry performance data during 2015-20. This is then applied to a new regulatory period in which Ofwat has specifically ensured that the balance of risk and return is to be skewed significantly to the downside.

Along with a number of other companies, we have commissioned a report by Economic Insight (EI) into **"Financeability of the Notionally Efficient Firm"** (See **Appendix: Other Documents; Economic Insight - "Financeability of the Notionally Efficient Firm"**). The introduction to this report states:

> *"Ofwat's assessment of financeability is undertaken with respect to the notionally efficient firm. As such, the question of whether Ofwat is fulfilling its financeability (and consumer) duty is intrinsically connected to whether the regulator has set an achievable efficiency challenge for the notional firm.*
>
> *This issue is critical at PR19, because Ofwat has intentionally set a 'step change' in the scale of challenge to the industry. Whilst identifying the cost efficiencies and outcomes an efficient firm can achieve is complex, a 'top down' approach provides a practical way of considering the question. In particular, for such a 'step change' to be appropriate, one would need to: (i) find evidence of substantial, systematic and persistent historical outperformance; and (ii) ensure that the increase in the PR19 challenge is proportionate to this.*
>
> *The analysis contained in this report shows that neither is true – the implication being that Ofwat is at risk of failing to fulfil its primary duties and so needs to recalibrate its cost and outcomes incentives packages, in order to ensure the notional firm is financeable and protect the interests of consumers. These findings are unsurprising and are consistent with prior academic studies and the logical presumptions that follow from Ofwat's methodology."*

In summary, we believe that the cost of capital proposed in the Draft Determination does not reflect the asymmetric balance of risk and reward in the Determination, resulting in a package in-the-round which is neither sound nor financeable on a notional or actual basis.

Our board is thus unable to provide assurance that the NWL is financeable on the basis of the Draft Determination.

In subsection 2.1 we draw Ofwat's attention to a number of important points in EI's report.

In subsection 2.2 we refer to a further report published by Anglian Water: "PR19 – Notional Company Financeability" which arrives at the same conclusions.
https://www.anglianwater.co.uk/siteassets/household/about-us/notional-company-financeability.pdf

Subsection 2.3 highlights a number of specific concerns regarding the calculation of the WACC.

In subsection 2.4 we describe what we believe is a significant and material error in relation to Ofwat's approach to calculating PAYG rates.

Finally, subsection 2.5 makes a further observation in relation to Ofwat's approach to assessing financeability, and 2.6 highlights an important inconsistency between companies in relation to PAYG.

2.1. "Financeability of the Notionally Efficient Firm"

We draw Ofwat's attention to the following statements by Economic Insight and comment briefly on them in this response. The full EI report attached to this representation sets out the evidence behind them.

Ofwat's Draft Determination implies a downside asymmetric level of risk for the notional efficient company.

> *"Contrary to Ofwat's suggested intentions, expected returns for the more efficient and/or fast track companies are just as skewed on the downside as the less efficient firms (page 42)"*

In the PR19 methodology (Dec 2017), Ofwat considered the RPI stripped Wholesale WACC to be 2.30%. At Draft Determination this is now set at 2.08%.

The PR19 methodology in Dec 2017 had symmetrical indicative RORE ranges for both Fast and Slow Track companies. This balanced assumption has now become a material downside risk, with an industry average RORE range of +2.7% to -4.9%. This downside asymmetry applies even for the fast track companies.

Ofwat has clearly not recalibrated the WACC against the risks of the incentive package in the determination. The balance of risks has moved substantially to the downside, whilst the WACC has also been reduced, without consideration of the interaction of the two.

Ofwat's justifications for its step change approach are incorrect and the level of challenge is not justified.

Ofwat's approach to PR19 has been underpinned by the principle that it expects to see "*a step change in efficiency for the sector"*. This has translated into a Draft Determination that applies a materially greater efficiency challenge, relative to previous price determinations. EI has set out significant concerns, however, that the premise is "*problematic as a matter of economic theory and logic"* and is not supported by any robust evidence.

The water industry was privatised 30 years ago. The Frontier Economics analysis referred to within EI's report confirms that water industry productivity has during that time converged on general UK productivity. The inference Ofwat appears to draw is that because productivity improvements have slowed since 2011 "*there appears to be scope for water companies to improve on-going efficiency*" and "*now is the time for an efficiency step change"*.

As the EI Financeability Report clearly sets out, this is an evidence free assertion – Ofwat is suggesting that the fact that it wishes something to happen is the evidence to justify its assumptions.

On the contrary, EI states that: *"There is no logical basis to suppose that the water industry can materially outperform the UK total factor productivity indefinitely" (page 13)*

EI also states that: *"There is no evidence of substantial, systematic and persistent historical outperformance by the industry" (page 17)*

The EI Financeability Report shows instead that when looking at historical outperformance there have been roughly equal numbers of winners and losers:

- For 2015-18, eight companies have underperformed on RORE, with nine outperforming: "there is an 'even balance' of companies out and under-performing on overall RORE." (page 26)
- Over a time period longer than the last three years, average industry ROCE was only 0.1% higher than WACC: there is "on a ROCE basis, there is no evidence to suggest that the industry (or individual companies) are substantially, systematically and persistently outperforming Ofwat's allowed returns." (page 22)
- On a ROCE versus WACC basis "there is no evidence of any significant 'pent up historical catch up inefficiency that objectively merits a 'step change' in efficiency challenge at PR19" (page 22)

This suggests that the PR14 approach has successfully balanced the 'winners' and 'losers' rather than allowing substantial industry outperformance.

As such, there appears to be no evidence to underpin Ofwat's assertion that PR19 is the appropriate point in time to introduce such an efficiency step change or to justify Ofwat's multiple PR19 asymmetric changes to the balance of the risk reward package. Consequently, there is no evidential basis whatsoever for assuming that the notionally efficient firm can deliver materially larger efficiency gains and outcomes improvements than in the past.

As noted above, it is not just the timing of the efficiency challenge that is questionable, but also its scale:

> *"we find the increase in regulatory challenge at PR19, relative to the past, to be unprecedented and well in excess of even the most 'aggressive' view of historical outperformance" (page 56)*

The EI Financeability Report indicates that the PR19 regulatory challenge to company business plans has increased by 60% relative to the past. For NWL, like five other companies, the increase in challenge is over 100% (168.2% for NWL). This is despite companies using the Ofwat guidance WACC in their plans for the first time in PR19.

As EI concludes, this is deeply concerning, particularly when the average 60% challenge is set against the industry average outperformance of 3.8% in the long run:

"Under any logical view, the 'efficiency challenge' proposed by Ofwat at the Draft Determinations must be beyond the performance level a notionally efficient firm can deliver. Moreover, the extent of the mismatch between historical performance and the increase in challenge is so large, that it likely renders the notional firm unfinanceable." (page 35)

Not only is such an approach inconsistent with Ofwat's financeability duty, but it also is clearly contrary to Ofwat's duty to protect the interests of consumers.

2.2. Anglian Water – Notional Company Financeability

A recent publication by Anglian Water arrives at similar conclusions.

Anglian Water's recent paper "**PR19 – Notional Company Financeability**" reinforces many of the points that we make in this response. In particular we agree with the conclusions that:

Since September 2018, the overall risks facing companies have increased significantly due to:

- *Regulatory challenges on Totex plans, embedded cost of debt, assumption of the 'halo' effect on the cost of new debt*
- *Upper-quartile performance targets and downside-skewed ODIs: an average company will face penalties*
- *Unprecedented loss of confidence in the sector from credit rating agencies*
- *Significant macroeconomic risks including Brexit*

Assessing this 'in the round' we do not believe the Draft Determination, and the level of WACC proposed, is financeable for the notional company. Based on our analysis and the balance of evidence available, the minimum WACC for a notionally geared company should be somewhere around 2.5% RPI stripped (based on *the component parts discussed earlier). This will ensure a notional company could remain financially resilient over a longer term and achieve Baa1 level rating.*

A lower WACC of 2.4%, considered in our previous paper, could be feasible, but only if the balance of risk in the Draft Determination can be revisited for the Final Determination.

2.3 – WACC – Technical Points

We have not carried out a line by line analysis of the data underlying the WACC components. We understand this is being carried out by some other companies using credible and well respected consultants and we may comment further on their reports when published.

We do note that the Draft Determination cost of capital technical appendix that sets out the WACC calculations makes no reference to financeability or impacts on credit rating.

In our view, the cost of capital should be considered with financeability in mind. Should the cost of capital be set at a level that causes financeability issues for the notional efficient firm, then it should be reconsidered.

We do note the following areas of the WACC calculations that Ofwat should consider in particular:

2.3.1 – Interpretation of Short Term Share Price Movements

We urge Ofwat to take a longer term view in its assessments.

Extract from the Moody’s report: Ofwat tightens the screws further: 26 July 2019
Most of the 22 bps cut in the wholesale return came from a fall in Ofwat's estimate of the equity beta, a measure of the undiversifiable risk of investing in a water company. This change was not a result of lower observed equity betas for listed UK infrastructure companies, which have actually risen slightly since the early view, but an increase in the debt/capitalisation ratio because their share prices have fallen sharply.
Ofwat and its economic advisers believe that because share prices fell without a corresponding movement in the market, equity investors must believe there is less systematic risk associated with investing in water companies and that they therefore require a lower return.

In our view, interpretation of short term share price movements to calculate beta at a time of Brexit uncertainty and during regulatory announcements that themselves affect share prices should be made carefully, not mechanistically. Longer time periods should be used for such calculations, rather than volatile short term spot rates.

2.3.2 – Market to Asset Ratios (MAR)

Ofwat should use the full MAR data range in its assessment of WACC.

We note that market to asset ratios have declined by 10% from 1.2 to 1.1 since Ofwat published the early view of the Total Market Return. Despite this, Ofwat has continued to use the estimates from the original early view analysis when considering the TMR range.

We note Ofwat suggests that the impact of the Labour Party’s nationalisation Manifesto may have affected the post 2017 market data. In our view, Ofwat should either use the whole MAR data range from 2016-2019 or not use MAR at all. The dataset is either reliable or it is not.

2.3.3 – Ratio of New to Embedded Debt

Ofwat should reconsider its current use of 20% new debt in the ratio.

Ofwat propose a ratio of 80% existing debt to 20% new debt when calculating the average cost of debt. An average of 20% new debt implies that, by 2025, 40% of total debt will have been raised over 2020-25. This implies an industry average debt tenor of 12.5 years, which seems inconsistent with the debt tenors reported in company APRs.

Ofwat's Draft Determination cost assessment challenge, reducing totex by 11%, will reduce the projected levels of new debt compared to the levels proposed in the company business plans on which the 20% was based. We further note that the Europe Economics (EE) calculation of weighted average new debt of 22% appears to be at the end of 2022/23, rather than mid-year, which would be a more accurate average for 2020-25.

We note that Ofwat has chosen 20% as nearer the weighted average rather than the company average (unweighted). This is not quite the same approach as taken by Ofwat for embedded debt (Table 4.6 of Draft Determination appendix), which uses the average of median and weighted average. The median mix per the EE CoC Report is 15.5%. Taking all of the above into account, we believe an 85%/15% mix is the most appropriate approach.

2.3.4 Cost of New Debt

Ofwat should correct a fundamental inconsistency in its assumptions. Ofwat should also remove the halo effect from its calculations.

We note that the cost of new debt estimate is based on the IBoxx A/BBB (average) spot figure plus a market projected rate rise less an outperformance wedge.

We believe that there is a fundamental inconsistency in Ofwat assuming that new debt can be raised at financing cost consistent with a BBB+/Baa1 rating when the Draft Determination as a package results in financial ratios with a lower BBB/Baa2 rating.

Given that company credit ratings for the majority of the industry are currently on negative outlook, we believe that the asymmetric outlook for future credit ratings should be taken into account in this calculation. The outperformance 'halo' wedge in particular is a projection of past credit rating circumstances that should not be assumed to continue (see Anglian Water paper 2.3-2.4). Halo effects are not permanent - they are driven by market conditions that can change rapidly. In circumstances where the industry as a whole faces significant downside ratings risk, it is clearly not appropriate to forecast an increase in the halo effect.

2.4 – Calculation of PAYG rates

We consider that Ofwat's approach to calculating PAYG rates is incorrect, and represents a departure from the natural rate.

In the Draft Determination, Ofwat has applied the £268m wholesale totex cost challenge (the difference between Business Plan and Draft Determination costs) to the Business Plan opex and capex pro rata using the company PAYG rates for all totex.

This approach does not take into account the specific opex/capex mix of the totex challenged. It results in understated revenue and overstated RCV, giving a PAYG rate that does not represent the true natural rate. It does not match what was stated in the associated Draft Determination reports, which has since been confirmed in an Ofwat query response.

The result is a Draft Determination that subsidises current customers (revenue) by overcharging future ones (RCV). It does not reflect the intergenerational equity that our customers support and which our plan reflected. Nor is it consistent with Ofwat's duty to protect the interests of both existing and future customers. In a query to Ofwat (NES-DD-001), we set out the corrected balance of opex and capex in the following table:

Draft Determination Wholesale £m	2020-21	2021-22	2022-23	2023-24	2024-25	Total
All capex	237	279	293	325	259	1,393
All opex	267	264	262	259	258	1,310
Wholesale totex	504	543	555	585	516	2,702
Corrected for PAYG Draft Determination £m Wholesale						
All capex	222	261	274	305	242	1,304
All opex	285	282	279	277	275	1,398
Wholesale totex	507	543	554	581	517	2,702

A full breakdown by service is set out in **Appendices - Tables and Commentaries; Table and model commentaries.** See also **Appendices - Tables and Commentaries; NES Corrected DD opex- capex split and PAYG of August 2019 DD response**.

In practice, the £268m Draft Determination wholesale totex challenge was split by Ofwat as £43m base totex, £225m enhancement totex. Our resubmitted enhancement totex (tables WS2/WWS2) is entirely capex related. Whilst we anticipate any totex gap between our revised tables and the Final Determination baseline to be minimal, we make the following suggestions on how Ofwat could apply a cost challenge in the Final Determination.

- The full enhancement totex cost challenge should be applied to capex only.
- Any base totex cost challenge could be applied using the company PAYG rates.

Ofwat should appreciate the importance of making this correction - it is extremely important for financeability. For the Draft Determination we calculate the bill impact to be around 2%.

It is important to note that this would still result in bill reductions in excess of those in our business plan which already had strong support from customers.

We calculate that if our Draft Determination was uncorrected for this issue then we will have a FFO/Net Debt ratio reduction of 0.7% compared to the Draft Determination as presented by Ofwat. The ACIC ratio would be 0.2x lower. This would have severe effects on financeability.

2.5 – Ofwat’s Approach to Assessing Financeability

There is a mismatch between the Ofwat Financial Model and the approach taken by the rating agencies.

As has been noted by Anglian Water, ratings agencies will often remove any adjustments to PAYG that Ofwat has made for financeability. For example, Moody’s ‘look through’ any PAYG adjustment for AICR. The CMA has previously acknowledged that “*in assessing financeability, it is good regulatory practice to consider the views of the credit rating agencies, and by implication, the financial ratios they partially base their views on.”*

For NWL, one of the key financial ratios to ensure retention of a BBB+ rating with S&P is the FFO/Net Debt.

We therefore make the following observations:

- The FFO/Net Debt ratios shown in Ofwat’s risk & return appendix are not the ones used by S&P, who deduct the indexation from index linked debt loans before calculating the ratios. This reduces the NWL ratio by almost 1% from 9.96% to 9.01%. Ofwat should use the same ratios as S&P.
- Both the FFO/Net Debt and AICR ratios are calculated including the revenue from the pension deficit recovery charges (PDRC), per Ofwat IN13/17. They do not include this value as a cost, giving an artificial uplift to these ratios. We understand Moody’s would deduct the PDRC revenue from the FFO for these

calculations. We do not expect Ofwat to deduct the full company forecast PDRC values, but the costs that Ofwat does recognize in IN13/17 should be deducted.

2.6 - PAYG – Treatment of Infrastructure Renewals Expenditure (IRE)

We observe inconsistent treatment of IRE in PAYG across the industry.

We have a further concern over the consistency of what is meant by the ‘natural rate’ for PAYG. In the risk & return appendix, figure 5.2 shows the varying PAYG rates for companies. Ofwat states that:

> *“We do not set out a definition of natural rates as each company’s choice of PAYG and RCV run-off rates should reflect their own expenditure and investment plans within each control”.*

Of the 17 companies shown in Ofwat’s comparison of average PAYG rates across the sector, four have fully expensed IRE as part of their opex and thus include it in PAYG. A further seven include IRE capex in their PAYG rates. That leaves a minority of six companies (including NWL) that have not included IRE capex in the PAYG rate and thus it is in the RCV.

If Ofwat fails to address this inconsistency at Final Determination, it will result in companies’ financeability being assessed on different bases.

3. COST ASSESSMENT

Despite the complexity of Ofwat's methodology and the short timescales available to companies to respond, we have made determined efforts to understand and fully consider Ofwat's latest round of feedback, particularly where this provides new information. As a result of this further detailed review, we have incorporated an additional £92m reduction to our planned totex, which reduces the gap between our and Ofwat's view of efficient costs from £296m at Draft Determination to £204m.

The remaining £204m gap, however, relates primarily to enhancements where we consider our proposals to be very well evidenced in relation to need, solution and cost efficiency and thus remain beyond the scope of any further reduction.

Section 3 firstly responds at a high level to Ofwat's approach to setting totex and base cost allowances in sub sections 3.1 and 3.2, and then focuses in detail on enhancements in 3.3.

3.1 – Totex Allowances

We note that Ofwat has changed its PR19 methodology so that it sets totex allowances entirely on the baseline rather than combining this with the reconciliation of cost out or underperformance based on business plan costs. This change in policy, which was implemented as part of the Draft Determination, was not consulted on but simply signaled in the Draft Determination Cost Efficiency Appendix. It increases the financeability consequences of totex overspends, which will now be borne 100% by the company until a reconciliation in PR24.

We believe this increases totex financial risk for 2020-25 compared to PR14 and is part of the general trend for PR19 of increased risk with lower returns. The total business plan to Draft Determination totex gap for the industry is over £6bn, and, with no consultation, Ofwat has effectively deferred £2-3bn of this from being spread over 2020-25 to a 2025/26 true up (year 1 of PR24). This may also have an adverse effect on bill volatility, as well as unfairly loading costs onto future generations.

3.2 – Base Costs

On the basis that overall we are close to the upper quartile baseline, and given the limited time available to respond to the Draft Determination, we have not focused in detail on Ofwat's approach to base costs. Accordingly, the absence of detailed challenge in this representation should not be taken as an acceptance of Ofwat's overall approach.

For base costs the Draft Determination places us below the upper quartile baseline for water service, above it for wastewater and above for retail, resulting in a 2.7% gap above overall.

For wastewater, we believe the majority of the gap is due to the inclusion of certain costs in the base models which we believe should be more properly treated as enhancement expenditure such as flood risk reduction.

Whilst we agree that growth costs, particularly new development, can reasonably be included in the base cost models, we do not agree that totex relating to reducing flooding risk can be included in this transfer without an associated cost driver. We address this in subsection 3.3.1.

For retail, we disagree with Ofwat's approach of ignoring input price pressure in the retail models. In PR14, Ofwat did make an allowance for input price increases for efficient companies (upper quartile). We also believe that, as for wholesale, Ofwat should base the efficiency challenge entirely on historical cost performance.

Our base costs are largely unchanged from our April business plan, apart from updating 2018/19 figures to actuals.

We agree that Ofwat should update the base costs models with 2018/19 actual data, including cost driver data from most recent APRs. We believe this is important from an individual company perspective, even if, in the round, the industry position is not materially different.

Finally, we note Ofwat's suggestion that it may use separate catch-up efficiency challenges for each of the wastewater controls or use a bioresources model alone to set the bioresources price controls. We disagree with these proposals.

The IAP costs appendix suggests that models are subject to statistical error and so Ofwat manages this risk by triangulating across a suite of models. This benefit would be lost by applying models to smaller individual controls, especially as the controls and supporting data are still relatively new – which is precisely why Ofwat triangulate.

Further, Ofwat's March 2018 Consultation states "*The aggregate models will allow a comparison of costs that internalise inherent choices and trade-offs across the value chain, and is less susceptible to misallocations of costs across services.*"

If Ofwat does apply a bioresources model only for the bioresources control, it should also recalibrate the network plus models (which allow less than average costs at present before UQ challenge) at the same time, to ensure a consistent approach of either separation or aggregation for both controls.

3.3 – Enhancements

As indicated earlier in this section the remaining cost gap of £204m relates primarily to enhancements which we remain strongly committed to and which we consider to be well evidenced.

These comprise resilience and flood risk enhancements which have been disallowed in full (or in the case of the latter assumed to be allowed for in base costs, which is effectively the same). Subsections 3.3.1 - 3.3.5 provide further evidence in support of our proposals.

We are concerned that Ofwat's decision to disallow these investments is inconsistent with its statutory resilience duty, and we remain disappointed with the low weight which appears to have been given to the strength of customer support for these schemes in Ofwat's decision making.

We also draw Ofwat's attention to our recently submitted resilience action plan, which addresses Ofwat's more generic feedback in relation to identification and management of resilience risks.

The remaining cost gap also comprises enhancements which have been allowed in principle, but where significant and in some cases arbitrary efficiencies have been applied. In subsections 3.3.6 to 3.3.8 we provide further evidence in support of our original costs.

We are concerned that the application of these efficiencies is not consistent with the evidence we have provided. Combined with Ofwat's wider approach to cost assessment which already locks in efficiencies delivered in AMP6, it further undermines the soundness of the Draft Determination in-the-round, and exacerbates the inappropriate balance of risk and reward set out in section 2.

In many areas we have attached updated business cases to support our position, and recognise that some of the updated evidence we have submitted previously has not been accounted for in the Draft Determination.

We also note that Ofwat is continuing to apply a rule of using the lower of business plan costs and modelled costs in a number of its enhancement models, albeit that the WINEP assessment is now done on an aggregated basis. We reinforce the point made in our response to Ofwat's IAP that this is asymmetric and undermines the incentive for companies to submit efficient costs for enhancements. For consistency Ofwat should apply the approach taken for base costs, which applies the modelled costs regardless of the business plan costs.

In other cases we broadly agree with the position set out in the Draft Determination and are only challenging a limited number of aspects, or are proposing an alternative means of recovering costs. These are set out in subsections 3.3.9 – 3.3.11.

We also welcome Ofwat's recent suggestion to include an allowance for funding in relation to strategic regional water resources – subsection 3.12

Finally subsection 3.13 briefly summarises those areas where we accept Ofwat's view of costs in the Draft Determination in light of the further clarity on its approach and supporting evidence that Ofwat has provided.

3.3.1 – Reducing Property Flooding Risk

We do not accept Ofwat's position that this activity is accounted for in base costs, and restate in full our claim for £86m of enhancement funding.

It is noted that the additional evidence we submitted in July 2019 in support of £86m enhancement funding has not yet been fully considered by Ofwat, but we understand it will be for the Final Determination.

Our latest business case is also attached to this representation – see **Appendix; Supporting Documents - 3.3.1 Reducing Property Flooding Risk**.

In summary:

We set out a chain of independent, peer reviewed evidence which demonstrates that trends in climate change and urban creep will significantly increase the risk of flooding to properties in our region over the next investment period.

This increasing risk warrants **additional** intervention over and above that which has been undertaken historically and hence that which we would normally carry out.

Our proposed intervention is both proportionate to the increasing risk while being sufficiently conservative to account for any uncertainty in the associated trends and models.

The associated costs are not reflected in Ofwat's base cost models as, by definition, they are not included in historic costs. Neither do the simplistic cost drivers of population growth and company size, which Ofwat's models are based on, account for the climate and urban creep trends we have evidenced.

We have referenced within the business case the strong alignment to important and leading third party publications and strategies, including the EA's FCERM strategy, Defra's published documentation on adapting to climate change and the outputs from UK Climate Change Projections 2009 (UKCP09).

The need for addressing this risk is further emphasised by The Committee on Climate change which has stated that current plans to protect the UK from the impacts of climate change are inadequate.

The Adaptation Sub-Committee of the Committee on Climate Change reports to Parliament every two years on the Government's progress in preparing the UK for the impacts of climate change, by delivering the National Adaptation Programme (NAP). A key finding of their report stated that flooding remains one of the most serious current and future risks to the UK from climate change. Investment in flood and coastal defence assets has increased over the NAP period. However, more needs to be done to address the risks from surface water flooding, especially to deal with increasingly heavy rainfall.

The National Infrastructure Commission has also expressed a strong opinion on building resilience in the face of the effects of climate change. As part of the National Infrastructure Assessment it states *"Climate change will continue to make extreme weather events such as floods and drought more likely in future years, and cities, towns and villages must be resilient. Decisive policy action is needed to mitigate these risks".* They go on further to state that "*Protection from floods in the UK over the past years* ***has too often been reactive rather than proactive."***

We note also Ofwat's comment that: **"*we expect companies to identify and act on the risks of flooding, including additional challenges created by climate change, and ensure that these are reflected in the investment and delivery plans".***

Our proposal is strongly supported by customers, our CCG, and the Environment Agency. A letter of support can be found in **Appendix; Supporting Documents - 3.3.1 Environment Agency Letter**. It is likely that the Chair of Northumbria Regional Flood and Coastal Committee will provide further comments in support of our proposal, which we will forward upon receipt.

We have included in our plan a bespoke flood risk PC to protect customers in the event that this enhancement investment is delivered late or not at all. If the enhancement funding continues to be disallowed we request that the corresponding PC is also removed, otherwise we face the risk of having to return funding to customers which has not been allowed in the first place – further contributing to our concerns of risk/reward asymmetry as set out earlier in this representation. However, our strong preference is for Ofwat to reconsider the evidence we have set out and allow this enhancement funding in full at Final Determination.

We are very concerned that Ofwat's current stance of insisting that this activity is allowed for in base funding is both:

- **akin to denying that the climate change trends we have set out in our business case are occurring,**
- **inconsistent with Ofwat's statutory resilience duty.**

3.3.2 – Essex Resilience - Abberton to Hanningfield Transfer Main

We do not accept Ofwat's decision to disallow funding for this enhancement, and restate in full our claim for £20.3m of enhancement funding.

We note Ofwat's statement that evidence submitted after mid-June may not have been taken into account in the draft determination.

We also recognise that it would be helpful to specifically address the question of why both this investment and the investment in enhanced treatment at Layer WTW (see subsection 3.3.7) is needed. The needs cases for these two schemes are related but separate and we strongly contend that both interventions are needed.

Our latest business case is also attached to this representation. See **Appendix; Supporting Documents – 3.3.2 Essex Resilience – Abberton to Hanningfield Transfer Main**.

In summary:

Our proposed scheme for Layer WTW simply mitigates the risk of deployable output being reduced as a result of raw water deterioration

However, raw water deterioration in Abberton reservoir is only one of the factors behind Hanningfield reservoir being drawn down to dangerously low levels in recent years. The wider context is that we have seen periods of drought together with periods of high demand in Essex which can only be expected to become more frequent as the effects of climate change continue to develop, highlighting the need for action within the next AMP.

This is supported by our revised business case which describes two recent periods when Hanningfield reservoir has been drawn down to historic lows, including a period in 2018 which was unrelated to problems with raw water quality at Abberton.

Our investment in the expansion of Abberton reservoir in AMP5 increased the overall level of supply capacity in the Essex water resource zone but we were clear that there would be further investment required in future to make full use of that resource. The most pressing need is for greater capacity for raw water transfer to strengthen resilience in the face of climate change. This will be a cost effective means of securing supplies across the zone and also defer the need for investment in increased treatment capacity to cope with increasing demand in future.

Specifically, we want to avoid a drought situation where one part of the Essex water resource zone is experiencing supply restrictions while a neighbouring part holds ample supplies which cannot be used.

Conversely, delivering the Abberton to Hanningfield pipeline without also ensuring Layer WTW's full treatment capability during periods of raw water deterioration would lead to over-reliance on Hanningfield WTW.

We would draw Ofwat's attention to the fact that the Abberton to Hanningfield scheme has been included, at Defra's request, in the final version of our WRMP. We note that Ofwat was provided with a copy of Defra's letter and has subsequently made no further comment.

Finally, we note that our approach to improving resilience within our region appears identical to that which Ofwat is endorsing, on an inter-company basis, in the form of Strategic Regional Water Resource Solutions, as set out in its Draft Determination Strategic Solutions Appendix:

"*Meeting the water resource supply-demand balance to ensure resilient supplies during droughts is becoming ever more challenging with increasing pressures from climate change, population growth, societal expectations and increasing environmental aspirations. In response to this challenge we identify the potential for companies to jointly deliver strategic regional water resources solutions to* ***secure long-term resilience*** *on behalf of customers while protecting the environment and benefiting wider society. This requires the development of new infrastructure, such as storage reservoirs and* ***strategic transfers****, to manage water supplies at a regional and national level. This* ***facilitates the movement of supplies from areas of water surplus to areas of water stress during drought*** *providing* ***benefits both now and for future generations***."

3.3.3 - Suffolk Resilience

We do not accept Ofwat's decision to disallow funding for this enhancement, and restate in full our claim for £14.2m of enhancement funding.

We maintain that our proposed combination of schemes is needed, acknowledging that our business plan submission could have provided a more detailed explanation of the needs case. We addressed this through the provision of further evidence on 1 July 2019 in the form of an expanded response to query NES-DD-CE-007. We note Ofwat's statement that evidence submitted after mid-June may not have been taken into account in the Draft Determination, but will be for the Final Determination.

Our latest business case is also attached to this representation. See **Appendix; Supporting Documents – 3.3.3 Suffolk Resilience**.

In summary:

Our proposal mitigates against the risk of partial loss of water production at Barsham or Ormesby WTW. It is important to specify that the failure modes of particular concern do not relate to asset condition, but to wider factors beyond management control.

The potential impact on customers of such a failure would also be significant, and beyond our capability to mitigate via emergency response.

As such our proposals are consistent with Ofwat's definition of resilience investment in relation to addressing low likelihood / high consequence risks.

There are 36,614 properties which currently depend on Barsham WTW with extremely limited access to treated water storage to protect them in the event of a loss of supply. Barsham also lacks any form of raw water storage to mitigate any temporary deterioration in raw water quality. For example, we have historically experienced temporary loss of abstraction on two occasions due to water pollution events from upstream oil and a chemical spill in the River Waveney.

The wider context in north Suffolk is that the security of supplies is expected to be increasingly challenged by the effects of climate change, particularly at Ormesby's intakes. On 1 April 2017 a cessation clause in the Ormesby Broad abstraction licence came into effect. This means that we could be required to cease abstraction from the Broad during periods of low rainfall and depend solely on the River Bure abstraction. However, the River Bure abstraction licence has a "Hands Off Flow" condition which means that the normal daily licensed quantity reduces once river flow falls below a threshold. There are 43,570 properties in the towns of Great Yarmouth and Gorleston which rely on this works as a sole source of supply.

Following the completion of a connecting mains scheme from Lound to Gorleston in 2020, alternative supplies will be available from Lound WTW. However, this will have a knock on impact on the Barsham supply area and Barsham works will then be needed to provide for the increased demand that we are expecting from the Lound to Gorleston link. Given the above, during periods of drought the number of our customers that will be supplied from Barsham WTW will increase and so it is also important that its resilience (ability to meet demand during pollution events) is also increased. The lack of strategic storage means the system lacks flexibility and the ability to respond quickly in an emergency situation, as there is no supply of treated water readily available to make significant transfers if they were needed. There are also limits placed on transfer capability by hydraulic restrictions in the network.

Having reviewed all potential options, this resilience scheme is the most appropriate solution to enhance the capability of the Suffolk area in response to issues at Ormesby, Lound or Barsham irrespective of the unplanned event trigger.

3.3.4 - Howdon STW Resilience Enhancement

We do not accept Ofwat's position that these costs are accounted for within the base allowance (based on the primary driver being growth). We maintain our view that the driver for this proposal is to improve resilience, and restate in full our claim for £14.7m of enhancement funding.

We believe our proposal is consistent with Ofwat's definition of resilience investment in that it provides mitigation against high consequence risks which could result in significant loss of service to customers and to the environment should failure occur.

Additionally, these risks are beyond our management control as they relate to single points of failure within Howdon STW for which no other mitigation is possible.

As such, this proposal goes beyond (and is separate from) the scope of expenditure for normal course of business in preparing for growth.

In summary:

Our proposal relates to the following facilities at Howdon STW, which have been identified as Too Critical to Fail':

- Howdon South Bank Pumping Station
- Primary Effluent Pumping Station (PEPS)

- The Return Activated Sludge (RAS) and Surplus Activated Sludge (SAS)

Were these assets to be out of service there are no facilities for the storage of flows. Failure would quickly result in a loss of service (within hours) leading to a significant environmental impact.

Our proposals include the addition of a second rising main and pumping station at these locations which would ensure environmental compliance. The second pumping station will work in parallel with the existing, providing the necessary resilience in the event of a pumping station or rising main failure.

This proposal is consistent with current EA guidance and policy, which seeks to minimise the potential for environmental impact, ensuring more robust permit compliance and reducing the risk of prosecution. See **Appendix; Supporting Documents – 3.3.4 Howdon STW Resilience Enhancement**.

3.3.5 - Drainage and Wastewater Management Plans (DWMPs)

We do not accept Ofwat's position that DWMPs are accounted for in base costs, and restate in full our claim for £9.2m of enhancement funding.

We believe that the development of DWMPs is a new requirement not reflected in either historic costs or the cost drivers which Ofwat's base cost models utilise and, therefore, should be funded as enhancement.

The government has confirmed that it intends to proceed with the proposal to place DWMPs on a statutory footing, produced on a five-year cycle. This is likely to be in place for the next price control cycle (2025/29) and it is therefore important that we continue to develop our approach in accordance with the framework documents during the next investment period. There is also an expectation from the National Infrastructure Commission that they require the information from the first round of DWMPs to help inform their next state of the nation report.

The government's response to consultation responses on "Improving our management of water in the environment", July 2019, states that it is aware that statutory plans may add additional costs to current non-statutory planning processes.

This is indeed the case with the DWMP framework representing a notable increase in expectations for the delivery of long term drainage planning, with the results of our assessment being viewed publically through a "national picture".

The prescriptive nature of the framework documents require a significant number of modelling and non-modelling scenarios to be undertaken, across a number of future planning horizons, climate change and urban creep projections. DWMPs will also require significant external stakeholder engagement.

These requirements significantly exceed our normal wastewater planning activities and hence are above and beyond existing base levels of investment.

(Following a meeting with Ofwat on the 7 August 2019, we have moved our proposed DWMP enhancement investment from line 27, Resilience, to line 30, reduce flooding risk for properties. We believe that this is now in line with the rest of the industry.)

3.3.6 Wastewater WINEP

We are pleased that Ofwat accepts the need for this investment, but we do not accept Ofwat's efficiency challenge which reduces our allowed costs to £144.7m. We restate in full our claim for £173.9m of enhancement funding.

Specifically, we challenge Ofwat's approach to determining allowed costs for phosphorous (P) removal schemes and wastewater investigations.

We also challenge Ofwat's approach to determining efficient, upper quartile costs at programme level.

We would also like to highlight that we have already set ourselves an annual efficiency target for all enhancement costs of 1% p.a, compounded over the period. This should be taken into consideration when assessing whether or not to add an additional efficiency challenge.

Phosphorous Removal Costs

We have reviewed Ofwat's approach to modelling these costs. We note that that South West Water is a significant outlier in the P models, with the difference between plan and allowed totex > 100%. We would suggest that Ofwat's approach would be strengthened if South West Water was assessed separately.

In support of the case of our submitted costs for P removal schemes, we would like to make the following points:

The water industry is required to meet much tighter Phosphorus standards in AMP7. This is a new challenge for the industry as a whole. As a result there are limited genuine benchmarking comparisons which can be made. We have good experience of the actual cost for P removal schemes to meet current requirements (relating to concentrations of typically 1 or 2mg/l), via chemical dosing and have based our technology selection for AMP7 on the outputs from the national P removal trials undertaken as part of the Chemicals Investigation trials (which we participated in).

We consider that our AMP7 P removal costs benchmark closely with P removal schemes delivered within AMP6. As the standards for AMP7 are significantly tighter, this already implies a significant efficiency.

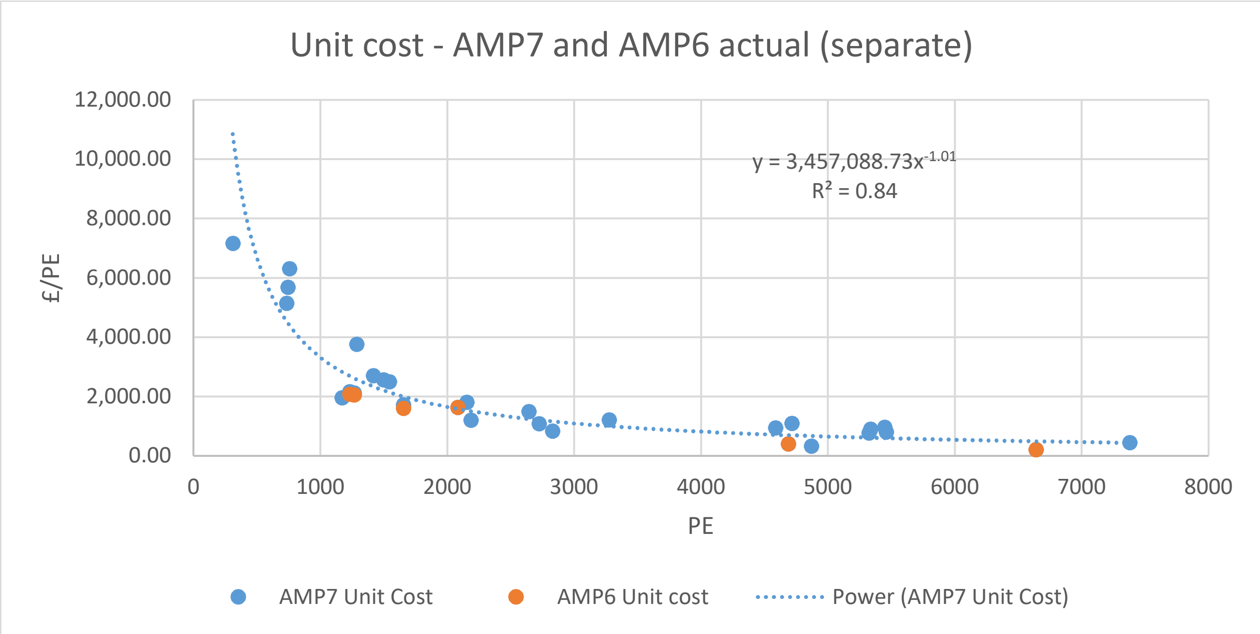
A further key factor not reflected in Ofwat's cost models is how efficiently sites are currently designed in relation to complying with current permits – with leaner sites requiring a greater uplift to meet tighter future permits. In particular, when considering solutions for additional nutrient removal, it became apparent that many of the settlement process units at our sites, whilst performing well under their current permit, could not accommodate either chemical treatment or co-settlement of solids from the tertiary treatment processes. The existing settlement units could not cope with the chemical sludge and could not be effectively de-sludged as frequently as these new processes require. We therefore costed to replace all horizontal flow or pyramidal settlement tanks with radial flow units where they are integral to the nutrient removal process, this could be primary, secondary, or in some cases both. When we have checked with other companies applying similar processes, they either have radial flow units already in place or are installing them similar to how we have costed. This has been confirmed by our consultants Stantec who have been working with other water companies.

While the model Ofwat has applied does take some account of both the size of the works and where the permit standards are more onerous (less than 0.5 mg/l), we would question how well this approach takes account of the very low end of the population equivalent (pe) range (i.e. very small sites).

The majority of the works we are targeting in AMP7 are **less** than 5,000 pe. We note that there are significantly increased knock on costs associated with smaller, rural works due to the need for:

- improved access for chemical deliveries, and sludge transport; and
- increased pressure on existing assets

The following chart indicates our costs for both AMP6 and AMP7 expressed as £/pe. This indicates how costs rise significantly at the lower end of the scale.



We have updated our business case for wastewater WINEP (see **Appendix; Supporting Documents – 3.3.6 Wastewater WINEP**) to include additional information on the options appraisal adopted by NWL. This indicates our overall optioneering approach and site specific consideration of where the need for additional assets has been identified specifically as a result of the introduction of new and very tight standards.

Wastewater Investigations

We challenge Ofwat's decision to apply a 20% efficiency challenge based on insufficient information and detail on the optioneering undertaken.

The options appraisals and cost estimates for these investigations have been established based on information from the EA in support of each corresponding WINEP entry. All investigations have required the development of a 'Measures Specification' in agreement with the EA, however these have only been developed post business plan submission, constrained by the EA's timeline for river basin management plans.

We propose that Ofwat should assess costs for each element (driver) separately.

We provide additional information relating to the two drivers of material value in supporting paper [reference]. Other areas are of low materiality, and have been costed based on previous similar investigations.

Finally, the Draft Determination states that we haven't included for the cost of the late entry Bathing Water (BWINV4) investigations. These were a late entry from the EA to raise ambition and undertake catchment wide investigations. We confirm the cost for these was included in our April 2019 business plan.

Determining Efficient, Upper Quartile Costs at Programme Level

We note that Ofwat's approach includes costs for Hafren Dyfrdwy, who are noted to be an extreme outlier. The WINEP submission from Hafren Dyfrdwy appears to be extremely untypical – based on a very small programme, dominated by three P removal schemes none of which are required to meet very tight P standards.

In our view Hafren Dyfrdwy should be excluded from the benchmarking.

3.3.7 Raw Water Deterioration Enhancements - Layer and Mosswood WTWs

We are pleased that Ofwat accepts the need for these investments, but we do not accept Ofwat's efficiency challenge which reduces our allowed costs to £26.4m. We restate in full our claim for £34.8m of enhancement funding.

Specifically, we understand this cost challenge relates to Ofwat's view of our approach to optioneering, along with the fact that final letters indicating DWI support for these schemes were not provided. Both of these points are dealt with below.

We would also like to highlight that we have already set ourselves an annual efficiency target for all enhancement costs of 1% p.a, compounded over the period. This should be taken into consideration when assessing whether or not to add an additional efficiency challenge.

DWI Support

We can now provide Final Decision Letters in support for these schemes from the DWI (see **Appendices; Supporting Documents – 3.3.7 Layer Final Decision Letter and 3.3.7 Mosswood Final Decision Letter**) which were not available at the time of our April business plan submission.

As is standard practice, we have now also received follow on notices from the DWI confirming that delivery of these schemes will be formalised into legal undertakings with specified milestones for delivery [see **Appendices Supporting Documents – 3.3.7 Layer Reg 28 Notice a; 3.3.7 Layer Reg 28 Notice b; 3.3.7 Mosswood Reg 28 Notice a and 3.3.7 Mosswood Reg 28 Notice b**). This will afford customers protection against non-delivery of these schemes.

Optioneering

We demonstrate our robust approach to optioneering in the revised business cases for these schemes as set out in supporting paper [see **Appendices; Supporting Documents – 3.3.7 Layer Business Case and 3.3.7 Mosswood Business Case**).

We would also like to clarify Ofwat's understanding in relation to a specific comment it has made regarding our Mosswood UV raw water deterioration scheme:

"Although Option 4 includes single duty only UV reactors on each outlet main it appears that, as there are multiple outlet mains, failure of a single unit would not lead to total loss of works output"

It is important to note that the two outlet mains supply entirely separate areas, so failure of a sole UV unit on one of the works outlet mains will result in an instantaneous shortfall to the distinct area supplied by that main. A duty/standby arrangement is required. As such, Ofwat's conclusion that failure of a single unit would not lead to a total loss of works output is incorrect. This is explained in more detail in the business case.

3.3.8 - STW and SPS Flood Risk Enhancement

We are pleased that Ofwat accepts the need for this investment, but we do not accept Ofwat's efficiency challenge which reduces our allowed costs to £33.3m. We restate in full our claim for £36.6m of enhancement funding.

Specifically, we understand this cost challenge relates to Ofwat's view of our approach to optioneering.

We demonstrate our robust approach to optioneering in the business cases for these schemes as set out in Section 8.3 of Appendix 3.2 Enhancement Business Cases from our April Business Plan submission.

We would also like to highlight that we have already set ourselves an annual efficiency target for all enhancement costs of 1% p.a, compounded over the period. This should be taken into consideration when assessing whether or not to add an additional efficiency challenge.

3.3.9 – Wearside Resilience

We accept the Draft Determination allowance of £30.8m with one exception. We do not accept Ofwat's 20% efficiency challenge in relation to our proposal for Springwell service reservoir, and restate in full our claim for enhancement funding for this aspect, resulting in a total claim of £34.1m.

We note Ofwat's challenge related to detail in our original business case which suggested that a reservoir capacity of 42.75Ml was sufficient to account for peak demand conditions, vs the costed capacity of 62Ml. We acknowledge the justification for the size of the reservoir was not as clear as it could be and therefore provide a supporting paper (see **Appendix; Supporting Documents – 3.3.9 Wearside Resilience**) setting out why our preferred option is the best one for customers. We believe this addresses the 20% optioneering challenge that Ofwat makes in the Draft Determination.

3.3.10 - Traffic Management Act (TMA)

We accept the Draft Determination allowance of £6m in relation to enhancement funding, however request an alternative means of recovering Lane Rental costs, should they arise.

We accept Ofwat's position that the Lane Rental element of our TMA proposals should not be funded as enhancement due to uncertainty as to whether Lane Rental will be introduced and hence whether the associated costs will arise.

However, we request that this element becomes a notified item to take account of the cost risk and that in addition a cost uncertainty adjustment mechanism will apply which will enable us to retrospectively recover efficiently incurred costs, should they arise, in an NPV neutral manner at PR24.

This is in customers' interests as it avoids any necessity for upfront funding, with customers only being asked to pay should the costs materialise.

For clarity, data tables WS2 lines 24 and 63, and WWS2 line 33 have been amended to show £0.000m. The TMA part of our totex has been removed from WS2/WWS2 as it is instead included in base costs as unmodelled costs, as per the Draft Determination model.

3.3.11 - SEMD & Security

We accept the Draft Determination on the basis that our proposals went beyond the regulatory requirements, with one exception. We maintain our request for £2.15m enhancement funding in relation to improving our emergency response.

We maintain our request for £2.15m funding to improve our response and recovery capability in relation to significant water supply interruption events. Our wider resilience planning was on the basis that we would invest in this improvement which ensures that supply risks relating to smaller population centres are mitigated in a cost effective way and complements our more substantial water resilience investment cases. This demonstrates that we have taken a balanced and cost effective approach to improving resilience.

3.3.12 Strategic Regional Water Resource Solutions

We thank Ofwat for highlighting the opportunity to claim funding in relation to strategic water resources solutions. We are hence submitting a claim of £0.425m.

This claim related to activities undertaken in conjunction with two regional water resource groups, Water Resources North and Water Resources East, in order to improve regional planning and resilience.

Supporting paper **Appendix; Supporting Documents – 3.3.12 Strategic Regional Water Resource Solutions** sets out the basis of our claim in more detail.

We understand a similar allowance has been made on a similar basis for other companies.

3.3.13 Aspects Where we Accept Ofwat's View

We confirm that we accept the position set out in the Draft Determination with regards to the following proposals:

- Resilience enhancements for Lartington WTW and Tees supply system

- Wastewater network resilience enhancements (with the exception of funding for DWMP)
- Wastewater resilience enhancements for:
- STWs at risk from extreme temperature
- SPSs deemed too critical to fail (in relation to fire and pump replacement lead time)

4. PERFORMANCE COMMITMENTS AND OUTCOME DELIVERY INCENTIVES

We are pleased that there is now much closer alignment between our plan and Ofwat's views on PCs and ODIs, although it should be noted that our decision in response to the IAP to align more closely with Ofwat's view was based in part on the wider aspects of the package as set out at the time which have now changed materially in the Draft Determination.

We still have some concerns and believe that Ofwat needs to go further.

In particular, Ofwat has applied some further tightening at Draft Determination which further shifts the balance of ODI risk and reward to the downside. This contributes to our concern that the overall package set out in the Draft Determination, in-the-round, is neither sound nor financeable.

Subsections 4.1 to 4.7 set out in more detail our areas of concern. The remaining subsection, 4.8, relates to areas where we accept the Draft Determination in broad terms, but wish to clarify some points of detail.

Finally, we note Ofwat's feedback in relation to some aspects of our customer engagement on PCs and ODIs, which we responded to comprehensively after IAP.

4.1 – Unplanned Outage PC

We do not accept the further interventions that Ofwat has applied to this PC.

Further to the intervention which Ofwat made at IAP to remove our proposed underperformance dead-band, we note that Ofwat has made further interventions to:

- Significantly tighten the PC level at 2024/25 from 6.67% to 2.34%.
- Remove our proposed underperformance collar.

This significantly increases the downside ODI risk to a level which is highly inappropriate for a PC which is so new, with the definition only being finalised on 4 April 2019, and hence which contains an inherent level of uncertainty. This view is supported by Ofwat's own targeted review of this PC in 2018.

We have further concerns that Ofwat has not applied its position consistently to all companies. Other companies have retained an underperformance collar and, despite Ofwat's indication at IAP to the contrary, there remains significant variation in underperformance rates.

We would also point out that any customer impact relating to underperformance against this PC will manifest against PCs for interruptions and water quality, which already have underperformance payments attached.

A supporting paper (see **Appendix; Supporting Documents – 4.1 Unplanned Outage PC**) sets out our arguments in more detail.

4.2 – Thresholds for Enhanced Outperformance Payments

We are pleased that Ofwat has listened to our response to the IAP and accepted higher enhanced reward rates, but we do not accept Ofwat's decision to further tighten the thresholds at which they apply.

We believe the thresholds contained in our April business plan were consistent with:

- Ofwat's guidance indicating that the enhanced outperformance threshold should be set at least at 2017/18 frontier performance.
- The thresholds set in Draft Determinations for fast track companies.

We note that Ofwat has now further tightened the thresholds based on its view of the forecast frontier level in 2020/21, which may be partially a result of more recent improvements in performance.

We consider that continued ratcheting of thresholds and targets below what was reasonable at the time of business plan submission is not appropriate. It risks incentivising companies to game the regulatory settlement by throttling back on improvements at the end of the current period so they can be delivered in the next period. This is not in customers interests.

It also weakens the effectiveness of the incentive as it is now much less likely to apply in practice, in turn reducing the chances of future improvements in industry frontier and upper quartile performance levels.

4.3 - Internal Sewer Flooding PC – Penalty Collar

We do not accept Ofwat's decision to remove the underperformance collar for this PC.

This is a common PC, and as such we would expect a consistent approach to be taken for all companies. We note that we are now the only company without such a collar.

We do not accept Ofwat's argument that these penalties are not material - our penalty rates are now consistent with the industry range, and an extreme weather event could expose us to a very high level of underperformance.

A supporting paper (See **Appendix; Supporting Documents – 4.3 Internal Sewer Flooding Penalty Collar**) sets out more detail in support of our proposed underperformance collar set at 3.35 incidents per 10,000 connections, and a corresponding outperformance cap.

4.4 – Bespoke Flood Risk PC

This is covered in more detail in subsection 3.1. In summary, if Ofwat continues to disallow the associated enhancement, then we request that this PC is removed.

4.5 – C-MEX

We are supportive of the C-Mex approach, but think that Ofwat has set an unreasonably high bar for standard and enhanced rewards.

Specifically, we do not agree with the upper quartile performance against the UKCSI being used as a gateway for enhanced rewards. While this wider benchmark is helpful it needs to be taken in the context of the mix of sectors included in the index, namely retail and leisure sectors which offer 'desirable' goods and services as opposed to the 'necessities' offered by utilities.

We also note the lack of a clear, published methodology for the UKCSI which, along with variations in sample sizes across different sectors and the scope for customer bias, could undermine the robustness of the results.

Given the above considerations, we consider that UKCSI mean, as opposed to upper quartile, performance would be a more appropriate gateway.

We also disagree with the way the complaints gateway is set out, based on the levels of improvement in complaints. This favours companies who have improved from a poor base, as opposed to companies who already perform well. Basing the gateway on absolute levels of performance would be more appropriate.

Finally there are also flaws in using the C-Mex standard deviation to calibrate both rewards. It could result in a single significant underperformer, currently Thames, increasing the standard deviation and hence reducing the rewards paid to strongly performing companies - which seems perverse. Given the complexity, further consultation with the industry on this aspect might be beneficial.

Setting the bar for incentives at too high a level results in significantly less likelihood that they will be achieved in practice, reducing the effectiveness of the incentive in driving performance improvements for customers.

4.6 - Leakage

We are pleased that Ofwat accepts our proposed % reductions, but do not accept Ofwat's decision to adjust the way in which the baseline is calculated.

Ofwat has changed the baseline from which AMP7 PC levels are calculated from our end of AMP6 PC level, as proposed in our plan and unchallenged at IAP, to end of AMP6 actual performance.

In our view this is not appropriate as it directly penalises companies who, through good management, attempt to make an early start on progressing towards very stretching AMP7 PC levels.

Instead, Ofwat should revert to using our end of AMP6 PC level as the baseline.

4.7 - Customer Protection PCs - Smart Metering & Lead Enhancement Programmes

We do not accept the changes that Ofwat has applied to these PCs.

Our April business plan contained PCs relating to these two enhancement programmes in order to return funding to customers should volumes delivered be lower than forecast.

Ofwat has intervened to update the definition of these PCs so that they track percentage completion of our smart water metering and lead enhancement programmes with annual performance targets, in period penalties, and a more complex end of period penalty mechanism. In combination this would potentially mean returning a sum greater than allowed costs. These interventions are also complex, which in our view reduces transparency.

While we support companies being strongly incentivised to deliver commitments set out in business plans, in this instance we would like to remind Ofwat that **demand for each of these programmes of work is primarily customer led.**

While customers in the round are supportive of these proposals, the extent of take up from individual customers remains uncertain. This is, and will remain, outside of our control. Under these circumstances we are more than happy to return unused funding at the end of period, if volumes are lower than estimated. We do not, however, accept the further interventions that Ofwat has made.

4.8 – Detailed Points on PCs and ODIs

4.8.1 Customer Protection PC - Cyber Resilience Enhancement Programme

We are pleased that Ofwat has funded this enhancement and accept the corresponding PC, however we wish to clarify a point of detail.

Two of the activities included within the second milestone of the PC relate to implementation of:

- Microsoft E5 licences which provide enhanced security functionality.
- MS operations manager's suite.

These activities are aligned with Microsoft's current offering in relation to security controls. However, technological development moves at a rapid pace and Microsoft change their offering and licensing every few years. At the time of implementation these products may have changed, in terms of name and specification. To ensure our commitments are robust for the future we would like to add a caveat to both entries, stating "or equivalent security controls in the event of product or licensing evolution".

4.8.2 - ODI Outperformance – Customer Protection (50 / 50 sharing)

We are pleased that Ofwat has accepted this aspect of our plan, however we wish to clarify one point of detail.

At IAP Ofwat indicated that we should apply additional customer protection, should outperformance payments be higher than expected, through an appropriate outperformance payment sharing mechanism.

In our April submission we agreed a number of caps on measures to protect customers, whilst we also proposed that any outperformance rewards greater than 2.04% of RoRE will be shared 50:50 with customers.

We clarify that 50:50 sharing with customers will occur when net outperformance payments exceed 2.04%.

We maintain that this mechanism is highly unlikely to apply in practice, due to the downside skew in the performance framework.

4.8.3 - Carbon Emissions PC

We remain committed to our PC, but wish to re-baseline our PC levels in response to a significant change expected to the Carbon Accounting Workbook.

A supporting paper (see **Appendix; Supporting Documents – 4.8.3 Carbon Emissions PC**) sets out more detail along with some further points.

4.8.4 – WINEP Delivery PC

We simply request that the proposed delivery profile is updated, if required, in line with any changes agreed through the EA's change control protocol.

5. FURTHER POINTS

5.1 - Water Trading Export Incentive

We do not agree with Ofwat's decision to disallow our water trading import incentive claim for our trade with Thames Water.

Contrary to Ofwat's assertion, our arrangement with Thames Water is consistent with the criteria in our Trading and Procurement Code for a qualifying trade: "A *qualifying trade will be a new agreement with another water company for Northumbrian Water to import from or export to that company's water supply network".*

Our trade with Thames Water is a new agreement, in that it has a separate legal basis, such as price and time period, compared to the existing pre-privatisation perpetuity agreement. To ensure efficiency of administrative and legal costs, it makes use of the non-price terms of the existing agreement.

Ofwat should consider that, in interpreting the new agreement in a narrow legalistic way, it is effectively saying that the incentive would have been considered if NWL and Thames had copied and pasted the non-price terms of the original agreement into an entirely separate contract.

Further, if NWL had laid a parallel main sending water back to Thames rather than using an existing one, this would have been seen as in line with the policy intent. This seems to us to be a penalty for the parties for carrying out a transaction in an efficient way rather than a desire to ensure only 'real trades' qualify.

In our view, the Ofwat decision misses the key 'substance over legal form' tests – that the trade was new, discretionary, on commercial terms, benefitted both Thames and Essex & Suffolk customers and was done with the minimum of transaction costs.

5.2 – Past Delivery: Service Incentive Mechanism

We were surprised to see Yorkshire Water classed with a higher SIM score than NWL in Table 3.1 of the past delivery appendix. Unless there has been a restatement of their Table R10, we calculate Yorkshire's four year average score to be nearer 83.6. Please can Ofwat review its calculations in this regard.

5.3 – Bill Reductions

If Ofwat accept our representations, we calculate that the average bill reduction would revert from a 25.7% reduction quoted in the Draft Determination to a reduction consistent with our business plan of 21%, if we use the average combined bill as generated by the financial model.

Reductions quoted on this basis are not a reliable indicator of the actual bill reductions that customers could expect in practice, however, and may falsely set customer expectations. For example, our bill reductions for wastewater are larger than for water. By analysing a single combined bill taken from the financial model, Ofwat is exaggerating the level of bill reductions that can be expected by our Essex & Suffolk customers who receive a single water service bill from NWL. The published combined bill reduction is misleading particularly for our water service only customers and we would welcome the opportunity to discuss with Ofwat a more helpful way to present the data for the Final Determination. Splitting the average bill profile between Northern combined service customers and Essex & Suffolk water only customers would be the obvious solution and we would be happy to provide a simple model that takes the financial model results and makes this important presentational change. This would not change the revenue control in any way but would provide a more meaningful breakdown for our customers.

6. DRAFT DETERMINATION ACTIONS

This section sets out our responses in relation to the further actions raised by Ofwat in the Draft Determination

6.1 NES.OC.A24 – Delivering Outcomes for Customers, Risk of Severe Restriction in a Drought PC

Action: *Risk of severe restriction in a drought PC: This is a sector wide action. The company should provide a full set of intermediate calculations at a zonal level, underlying the risk calculation (for both baseline levels and performance commitment). The company should confirm that its performance commitment levels are reflective of its water resources management plan position. This should include the potential that it will have access to drought orders and permits. The company should confirm which programmes of work will impact its forecasts. The company should confirm which schemes will impact its forecasts.*

Company response

We have provided a full set of intermediate calculations at a zonal level, underlying the risk calculation (for both baseline levels and performance commitment) [reference]. We confirm that our performance commitment levels (i.e. 0% of population at risk of severe restriction in a drought) is reflective of our water resources management plan position (i.e. we have a resource surplus in all of our Northumbrian and Essex & Suffolk Water Resources Zones).

Our Essex & Suffolk Water Industry National Environment Programme (WINEP) could impact on our supply demand forecasts. It requires us to investigate the sustainability of our groundwater abstractions in AMP7. These investigations could conclude that one or more of our abstractions is unsustainable. This could result in sustainability reductions which could impact on our Water Available for Use (WAFU) forecast. Sensitivity scenario supply demand balance graphs have been presented in our Essex & Suffolk Water final Water Resources Management Plan which show WAFU capped at recent actual abstraction utilisation.

6.2 NES.OC.A25 – Delivering Outcomes for Customers, Risk of Sewer Flooding in a Storm PC

Action: *Risk of sewer flooding in a storm PC: The company should confirm that it is: using the updated parameters in the catchment vulnerability assessment; reporting the extent they use 2d or simpler modelling; and adopting FEH13 rainfall as standard and if not when expect to do so.*

Company response

We can confirm that for our catchment vulnerability assessment we have used the updated parameters as stated in reporting guidance – Risk of sewer flooding in a storm, April 4 2019. We have developed a methodology document describing our approach to this as part of our DWMPs, and will be happy to share this if requested.

In calculating our risk of flooding in a storm percentage, we have adopted the 1D flood volume buffering approach, as described in the Developing and trailing wastewater resilience metrics (Atkins) methodology document.

We undertake 2D modelling on discreet catchments as a standard procedure when investigating flooding causes and for developing options during feasibility stages of projects. Given the catchment wide assessment required for this PC, we did not believe that a high level approach to 2d modelling would provide any better information than the approach we adopted.

In calculating our risk of flooding in a storm, we have completed the analysis using our existing modelling library, with all models set up to run FEH99. For DWMPs (BRAVA stage), our approach is to use FEH13, and therefore we will complete all future reporting using FEH13 results. The BRAVA stage of DWMPs will be completed by December 2020.

6.3 NES.OC.A66 – Delivering outcomes for customers, Wastewater Resilience Programme PC

Action: *The company should provide latest information on the timing of the schemes including any further milestone deliverables that could be assessed as discrete elements in its representations to the draft determination.*

Company response

This action only relates to one item under line 27, Wastewater Resilience in Table WWS2: Too critical to fail: STW and SPS identified at risk of flooding, £36.6m.

Based on our historical performance for the delivery of similar programmes of work, and in discussion with key stakeholders and supply chain partners, we have assumed a straight delivery curve for years 2, 3, 4 and 5. In year 1, we have assumed that feasibility and design work will be undertaken.

Our anticipated delivery programme is therefore (141 sites):

	Year 1	Year 2	Year 3	Year 4	Year 5
No of schemes completed	0	35	35	35	36

It should be noted that we have identified 141 sites. In the Draft Determination, Ofwat incorrectly referenced only 41 sites in its deep dive audit and within the calculation of our underperformance payment. We have referenced this change in our response to the Draft Determination.

As the definition of the PC is to increase the wastewater network resilience through the reduction of flooding risk to 141 sewage treatment works, not 41, we are reducing the penalty rate associated with a unit of underperformance.

Our Draft Determination valued the underperformance penalty at £0.410 million per site. Using the same methodology applied by Ofwat we have reduced the penalty to £0.1191 million per site.

6.4 NES.LR.C1 – Securing Long Term Resilience, Board Assurance of Financeability

Action: *We expect companies to provide further Board assurance, in their responses to the Draft Determination, that they will remain financeable on a notional and actual basis, and that they can maintain the financial resilience of their actual structure, taking account of the reasonably foreseeable range of plausible outcomes of their Final Determination, including evidence of further downward pressure on the cost of capital in very recent market data as we discuss in the 'Cost of capital technical appendix'.*

Company response - Board Statement on Financeability of the Draft Determination
We confirmed in April 2019 that our Business Plan was financeable on both a notional and actual basis. The changes that Ofwat has made to our plan in the Draft Determination mean that we cannot provide that assurance on the basis of the Draft Determination as set out.

Given this position, it follows that we are also unable to confirm our financeability under the scenario of a further downward reduction in the cost of capital as described by Ofwat in the Draft Determination Cost of capital technical appendix.

Our representation sets out a series of challenges to the Draft Determination. These cover the balance of the risk and reward package, the cost of capital, the PAYG ratio, the totex allowance and the outcome delivery incentives. Were these issues to be addressed as we propose in our representation, we would be in a position to confirm the Determination was financeable against maintaining our current credit ratings.

6.5 NES.CE.A1 – Securing Cost Efficiency

Action: *We provide our view of efficient costs for the company along with our reasoning. We expect the company to continue to address areas of inefficiency and lack of evidence.*

Company response
This is covered extensively in **Section 3** of this representation.

6.6 NES.CE.A3 – Securing Cost Efficiency, Metaldehyde

Action: *Company to provide evidence to confirm DWI agreement with its submitted plans/revised undertakings and that no metaldehyde specific treatment or product substitution costs are included in the requested allowance.*

Company response
At Draft Determination Ofwat recognised the company has revised its submission in relation to metaldehyde treatment and £1m was removed over 2020-25 for product substitution costs to farmers. The WINEP Drinking Water Protection Area submission for catchment management activity amounting to £2.97m was allowed.

Our September 2018 business plan submission included Paid for Product Substitution (PfPS) to manage metaldehyde risks as part of the wider WINEP DWPA scheme. This was in accordance with EA and DWI advice. In December 2018 Defra banned metaldehyde for outdoor use, effective from June 2020. In response to this and in line with EA guidance, our revised April 2019 submission did not include PfPS. The DWI response to the change in March 2019 was:

> "*Regarding your programme for metaldehyde in AMP7 and 'paid for product substitution' schemes whereby farmers in target catchments, are paid the difference between the cost of metaldehyde and a comparable ferric phosphate product, is a decision for the company, taking into account the specific local challenges to drinking water quality that need to be managed to deliver and maintain compliance up to and beyond the date of withdrawal of metaldehyde from the market. The Inspectorate would expect the company to use all available means at its disposal to maintain compliance, appropriate to local circumstances. We support the continuation of all catchment management initiatives throughout catchments to reduce risks to drinking water from all emerging risks.*"

The ban on metaldehyde has been subject to a legal challenge, and as a result it was overturned on 30 July 2019. Sales of metaldehyde can resume and there is now no legally binding restriction on its use after 30 June 2020. Defra's formal statement was:

> *"The government has decided to withdraw and review the decision made in December 2018 to restrict the sale and use of metaldehyde products, following concerns raised about the decision-making process. We will retake the decision as swiftly as possible, taking account of the procedural points raised."*

This does not provide any certainty regarding timescales for when a future ban may become effective.

There is no further guidance from the Environment Agency at this time. Information received on 13 August 2019 indicated that they are also awaiting further guidance from Defra regarding their timescales for a potential future ban. For the time being, the EA has indicated that:

> *"Nothing changes in our assumptions for metaldehyde substitution schemes in PR19 up until 30 June 2020 and they must be included in [WINEP] Measure Specification Forms. After 30 June 2020, metaldehyde substitution schemes MAY need to continue if a new ban is not put in place. We do not know this for sure at this point and will issue further guidance as soon as Defra's position becomes clear."*

In response to this and considering DWI expectations and our responsibility to manage metaldehyde risk, we are reinstating the PfPS element of our WINEP DWPA scheme. The impact of this change is the expenditure request increases from £2.97m to £4.29m. This is detailed on Line 17 of data table WS2. The WINEP cost adjustment mechanism applies and offers customer protection, specifically if the legal challenge is successfully overturned. Additionally the catchment management schemes will be formalised into legal instruments with DWI in due course. This forms an additional protection for customers.

6.7 NES.RR.C3 – Aligning Risk and Return, RoRE Range Update

Action: *We expect companies to update their overall RoRE risk range analysis in updated App26 submissions as part of their response to the Draft Determination.*

Company response
We have updated App26 accordingly.

6.8 NES.PD.A1 – Accounting for Past Delivery, App5 Update

Action: *In its representations on the Draft Determinations the company should ensure that tables App5 (PR14 reconciliation – performance commitments) and App27 (PR14 reconciliation – ODI summary) reconcile, and both tables contain values that have not been adjusted for tax.*

Company response
Tables App5 (PR14 reconciliation – performance commitments) and App27 (PR14 reconciliation – ODI summary) have been updated to reflect values that have not been adjusted for tax.

6.9 NES.CA.A4 – Securing Confidence and Assurance, Dividend Policy

Action: *We expect Northumbrian Water to be transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers and to demonstrate that in paying or declaring dividends it has taken account of the factors we set out in our position statement. We expect the company to respond to this issue in its response to our Draft Determination.*

We expect the company to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the Final Determination. In doing so, the company should refer to the examples of best practice we have identified among companies.

We also expect the company to clarify its proposed base dividend yield for the period 2020-25.

Company response
We set out our dividend policy each year in our Annual Performance Report (APR). In our APR for 2018/19 we also included a section headed 'Application of Dividend Policy' explaining how the NWL Board determines dividend payments each year.
The Board makes all decisions 'in the round' and, when declaring dividends, takes a holistic view of business performance, the prospects of the Company and the principal risks facing the business, as well as having regard to levels of operational performance, investment requirements, customer service and our employee pension obligations.

In deciding upon the level of dividends to pay in any year, the Directors consider the future investment and financing needs of the Company as set out in our detailed five year plan. The five year plan reflects all our expenditure plans to deliver excellent levels of service to our customers and our commitments to customers, regulators and other stakeholders, as well as investment to maintain the health and long term resilience of our assets.

Our assessment of long term financial resilience in our business plan was based on a nominal notional base dividend yield of 4.52%. However, as explained above, the Board makes decisions on dividend payments 'in the round' and not by reference to a base or target dividend yield.

Our APR will continue to give transparency as to the level of dividend, and how it relates to assumptions in the Final Determination.

6.10 NES.CA.A5 – Securing Confidence and Assurance, Executive Pay

Action: *There remain some details to be finalised, for example evidence of how the targets in the long term bonus will be stretching and further evidence to demonstrate alignment of incentives to substantial delivery for customers. Once finalised, we expect Northumbrian Water to provide an update in its response to the Draft Determination to demonstrate that it is committed to meet the expectations we have set out in 'Putting the sector in balance' position statement.*

We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the Final Determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25.

We expect the company to report transparently, in its annual performance report, about further updates to the development of its policy that will apply in 2020-25.

Company response

In our response to Ofwat query NES-DD-RR-002, we set out at some length the approach taken by our Remuneration Committee to executive pay and the changes we have made to our executive pay policy for 2020-2025. We confirmed these changes in our Annual Report and Financial Statements for the year ended 31 March 2019.

Putting the sector in balance:

As we stated in our query response, we believe the information contained in the response and the revised policy provides evidence of our Board's commitment to aligning to the principles in 'Putting the sector in balance' on performance related executive pay.

Substantial link to performance delivery for customers:

Our revised policy increases the proportion of our short-term incentive plan (STIP) related to customer-focused measures to 50%, across ten measures linked to performance delivery for customers.

The revised policy has amended our long-term incentive plan (LTIP) to include 50% based on Return on Regulated Equity, which is aligned with driving excellent performance to our customers and developers, through C-Mex and D-Mex, industry-leading ODI performance and efficient levels of totex.

We believe that both our STIP and LTIP demonstrate a substantial link to performance delivery for customers through 2020-25.

Stretching targets assessed continually:

As we set out in our query response, our philosophy for setting stretching targets on our balanced scorecard measures used in our STIP is to reference performance levels which are industry-leading, or leading outside of the sector, rather than be constrained by our Business Plan performance commitments. Our Remuneration Committee reviews these targets each year in the light of industry performance to ensure that they continue to be aligned to achieving industry-leading levels. We will continue with this approach throughout 2020-25.

Transparent reporting of policy changes:
We have reported transparently on executive remuneration in our Annual Report and Financial Statements for a number of years and will continue to do so. This is cross-referenced in our Annual Performance Report to avoid duplication. We will continue to include updates on executive remuneration policy as and when changes are made.