Wessex Water Services Ltd Response to Ofwat's PR19 Draft Determination – August 2019

Representation reference: **Markets and Innovation M1**

Representation title: **Bioresources energy adjustment**

Summary of issue

The draft determination makes a negative adjustment of £10m to our allowed price control revenues by assuming that the company can gain more income from sales of biogas to third parties.

Given the determination's approach to protecting customers through setting allowed revenues based on benchmarks of efficient bioresources costs at the upper quartile efficiency level (with no cost sharing mechanism) this is an unnecessary intervention. It unnecessarily and excessively penalises Wessex for having taken a different approach to investing in energy generation.

Wessex Water's benchmarked allowance already reflects, and is offset by, the "income treated as negative expenditure" reported for other companies across the industry. The effect of the benchmarking approach is that the allowance for one company is largely determined by the costs and income of other companies, rather than by its own costs and income. It is internally inconsistent to make a £10m downward adjustment to the benchmarked allowance for one company because it is thought that its net costs should be £10m lower.

We are also concerned that intervening in this manner would set a worrying precedent, effectively eroding unregulated reward long after the risk has been taken by the unregulated business. The draft determination's approach is not only unnecessary, it is counterproductive in that it will act to reduce incentives to innovate that ultimately benefit regulated customers.

If, despite the concerns raised in this paper, Ofwat decides to make an adjustment in relation to income from sales of biogas, this should be made to the "net cost" dependent variable for Wessex Water used for the bioresources econometric benchmarking exercise. It should not be made as a revenue adjustment outside of the benchmarking. It does not make sense to make an adjustment for a Wessex Water-specific income issue and apply that to a figure that reflects the outcome of an industry-wide benchmarking analysis of costs and income. If the adjustment is intended to put companies on a like-for-like basis, this should be done before the benchmarking exercise.

Finally, we note that the adjustment itself is not correctly calculated and does not therefore deliver Ofwat's stated intention.

Change requested

This adjustment is removed.

Rationale (including any new evidence)

The draft determination sets bioresources cost allowances on the basis of benchmarked costs. Cost (and therefore revenue) allowances are set at the industry upper quartile level and are divorced from our actual cost levels.

In this way customers of Wessex Water are protected whatever pricing arrangement exists for the sale of biogas.

Therefore intervening on top of the upper quartile cost challenge to assume that Wessex can generate greater levels of income from biogas is punitive as well as unnecessary. The punishment in this case ultimately derives from Wessex having taken an innovative approach to delivery. This is not in line with Ofwat's PR19 principles and its duties more widely.

Wessex Water's benchmarked allowance already reflects, and is offset by, the "income treated as negative expenditure" for other companies across the industry.

The effect of the benchmarking approach is that the allowance for one company is largely determined by the costs and income of other companies, rather than by its own costs and income. It is internally inconsistent and erroneous to make a £10m downward adjustment to the benchmarked allowance for one company because you think that its own net costs should be £10m lower than reported. This approach to the use of benchmarking results effectively involves double counting, to the detriment of Wessex Water in this case.

Furthermore, because there is no totex cost-sharing mechanism for bioresources, Wessex Water's customers are not exposed to any differences between benchmarked allowances and the level of costs or income of Wessex Water's appointed business. The detailed terms of trade with third parties is a matter primarily for shareholders rather than customers. Our impression was that this was an intentional part of Ofwat's price control strategy for bioresources, which was intended to provide greater scope for innovation and commercial focus. The adjustment that Ofwat now seeks to make goes against this.

If an adjustment is intended to put companies on a more like-for-like basis, this should be done before the benchmarking exercise (e.g. to dependent variable data) rather than as an adjustment to allowed revenue outside of the benchmarking. This would address the internal inconsistency highlighted above.

In any event, we consider that the draft determination's underlying rationale for an adjustment reflects an over-simplified assessment.

Although Wessex Water does not report "income treated as negative expenditure" for bioresources, the costs it incurs and reports are suppressed as a consequence of its arrangements with third parties. It is misleading to look at data on the income treated as negative expenditure in isolation and draw conclusions about the terms of trade between Wessex Water and other parties.

Furthermore, the approach adopted by Wessex Water some years ago transferred all construction risk for gas to grid away from our customers and continues to shield regulated customers from all technical, operational and legislative risk. Additionally, it ensures customers receive fair value for the gas based on the current price of electricity and gives a guaranteed buyer for all biogas produced.

The energy market is generally characterised by high up-front investment costs, low marginal costs and high levels of operating margin to recoup the investment and giving a return in the long-run. Intervening in this way to increase the price of the raw material prices to capture that profit risks being viewed as exploitative.

It also risks setting a precedent that unregulated returns can be captured retrospectively once the risks have been borne outside of the regulated business. This will act as a barrier to innovation and to the diverse approaches that would imply, which we had understood to be a key principle of PR19 and therefore is in opposition to Ofwat's own PR19 methodology.

Government direction to Ofwat is that markets in the water sector should be pursued where they can be shown to be in customers' interests. Again, given the punitive nature of Ofwat's intervention in this area we consider it to be at odds with government direction.

While we do not agree with the premise or the implication of the proposed intervention we also have serious concerns about how it has been implemented: The mechanical calculation of it is flawed in that it treats nominal figures (including our business plan view on the power RPE) as 2017-18 CPIH deflated figures. We have queried this and set out what true 2017-18 prices (with the draft determination view that there is no RPE over CPIH on power) would be.

Why the change is in customers' interests

Reversing the intervention here will continue to incentivise innovation and the development of markets, which are to the long term benefit of customers. Meanwhile Wessex Water's customers will continue to enjoy the general protections afforded to customers of all companies afforded by the upper quartile benchmarking approach.

Links to relevant evidence already provided or elsewhere in the representation document

See queries WSX-DD-CMI-001, 002 & 003

Also see Wessex query 11 to Ofwat on the Draft Determination.