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WONDERFUL ON TAP

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Dear David,

Hafren Dyfrdwy draft determination: company response

We are pleased that the draft determination (DD) recognises our positive engagement, and that you feel there are no significant material issues remaining. We recognise that the timing of licence change has created extra complexity and we appreciate Ofwat's constructive and detailed feedback. We want to continue this positive engagement and in this spirit we have confined our representations to a small number of critical issues on the basis that they are:

- material to the financeability / financial resilience of the company; and
- needed to correct outliers, ensure fairness and retain a fair balance of risk across a package of stretching service improvements.

We have also raised a few minor technical points for completeness and to ensure smooth and transparent reporting throughout AMP7.

The slow track DDs provide an update on key industry wide issues, notably on the WACC and updates to cost assessment. In a number of areas we believe the slow track determinations represent excellent progress including a pragmatic approach to developer services cost assessment. Ofwat's latest position on the WACC, however, represents a significant negative shift in the overall package that companies are expected to absorb. And if Ofwat were to pursue the 37bps reduction signalled in the DD documents, for Hafren Dyfrdwy this would manifest itself in a very significant way at the price control level where Moody's AICR for the water resources and water network controls would be one notch above sub investment grade. At the wholesale level, we would be sub investment grade on the Moody's AICR.

To support your teams' assessments of our response we have structured our representations according to the test assessment areas used in the initial assessment of plans (IAP). The remainder of this letter sets out the key representations across four test areas:

1. Aligning risk and return - relating to the cost of capital and implications for financeability across price controls.
2. Securing confidence and assurance - relating to the actions raised on our dividend policy and executive bonuses.

3. Delivering outcomes for customers – relating to new interventions that take our overall incentive package outside Ofwat's recommended range. We have focused on a few material performance commitments and incentives where the intervention is disproportionate compared to other companies. This chapter also includes additional information requested on shadow measures.
4. Cost efficiency – relating to the new intervention on nonhousehold costs and developer services. This chapter also includes responses to the data table updates and action on metaldehyde.

1. Aligning risk and return – package in the round

As we developed our business plan, we carefully considered the balance of risk and return – the service improvements we could deliver for our customers, the efficiency improvements we could make and how we could ensure a sustainable basis for future financing. Our discussions were based on Ofwat's early view of the WACC, but with the expectation that updates would reasonably need to be made to reflect any changes in market conditions. And at the IAP stage, we went further by accepting Ofwat's challenge to make the service improvements we would deliver even more stretching and the downside incentives stronger.

The draft determination marks another significant ramp up in the level of challenge and therefore risk in our plan. As we explain in more detail in the following section, the DD has introduced a further c.50 interventions in relation to outcomes, our RORE range at -6.57% to 0.15% is significantly biased towards the downside and is outside Ofwat's reasonable range, and we continue to commit to deliver sector leading efficiency. And it's in this context that the 21bps reduction proposed in the DD – which (considering the treatment of beta and the risk free-rate) would result in the allowed cost of equity being lower than at any other time in UK regulatory history – becomes even more concerning.

It was a relative strength of Ofwat's approach to estimating **beta** over a two-year period for early view that the outcome was in line with the longer term daily 5-year view (a longer term view being an approach that has been favoured by the CMA and UKRN at recent reviews). This is no longer the case given that the revised estimate of 0.29 (from 0.32) now significantly diverges from the longer term daily 5-year unlevered beta estimate (0.33) and draws into question the appropriateness of this approach.

In the latest view, RPI, which has been widely discredited – including by Ofwat for other building blocks in the price review – has been given a much more prominent weighting in the calculation of the **risk free rate**. The 100% weighting given to RPI linked gilts in this latest iteration is in stark contrast to the 100% previously given to nominal gilts in the early view and lacks coherence with other decisions made in the PR19 process.

Ofwat's proposals involve the **cost of new debt** being funded in line with the average of A/BBB non-financials, with a deduction to reflect a 'halo effect' that water companies have historically benefitted from when raising debt (when they achieved higher credit ratings). Ofwat's proposed increase in this halo effect for its latest view of the WACC appears to run contrary to the fact that the notional company would not be able to achieve the credit rating assumed by the proposed iBoxx-based benchmark.

Overall, we believe that the summation of the changes above go much further than a simple exercise to update the early view that plans relied on, and instead mark a more fundamental change in the methodology used – one that introduces significant additional stretch, and draws into question the fairness of the overall balance now proposed.

Financeability

When we developed our business plan we wanted to create a stable and resilient basis for future investment to benefit our customers. We have tested financeability on the basis of the draft determination (including the 21bps reduction in the WACC). At an appointee level, we are financeable under the notional and actual structure, with financial metrics sufficient to support an investment grade credit rating over AMP7. The Board is satisfied that the draft determination would be financeable at the appointee level for both the notional and actual financing company and has made a Board statement included as part of this submission.

We have, however, also reviewed whether the draft determination is financeable at an individual price control level. As highlighted in the draft determination, the financial ratios for the wastewater network and bio resources controls remain weak and not financeable in their own right. While the ratios for the water resources and water network controls are financeable, Moody's AICR and gearing (for water network) fall to a level one notch below our target rating of Baa1.

2. Securing confidence and assurance

In our Business Plan and subsequent response to the IAP and associated queries we confirmed that we are committed to adopting the expectations on dividends for 2020-25 as set out in "Putting the Sector in balance". We recognise it is critical to have a dividend policy that transparently demonstrates:

- how the dividends we pay to our shareholders take account of our obligations to our customers and wider stakeholders;
- how dividends relate to our overall performance; and
- how our dividend policy allows us to maintain financial resilience in the long term.

We also confirmed our Board's commitment to publish our dividend policy in our Annual Performance Report through 2020-25, including how our policy will take account of obligations and commitments to customers, and to explain transparently any change to that policy and the judgements the Board has made in making that change.

The draft determination set out further expectations that we should ensure that our 2020-25 dividend policy transparently takes account of obligations and commitments to customers and demonstrates that in paying or declaring dividends it has taken account of the factors set out in the 'Putting the sector in balance' position statement.

We are fully supportive of the back in balance position statement and in our representations we have updated our policy and have provided additional clarity on the factors that we will consider in paying or declaring dividends.

We have also provided the additional detail required about the application of our policy on executive remuneration.

3. Outcomes for customers

There are many important service areas where we are providing sector leading service, such as internal sewer flooding and water quality compliance but there are also areas where we have already recognised that we need to improve and we have embraced the challenges from both Ofwat and our CCG. In response we have committed to step change improvements (around 75% improvement in supply interruptions, nearly 40% improvement in pollution performance and a 35% improvement in drinking water quality complaints). All of this is being delivered in the context of a bill that is over £100 / year cheaper than the industry average and based on Ofwat's assessment of sector leading efficiency. However, we are concerned that DD has introduced nearly 50 more interventions, half of which were not raised at IAP stage which now takes us to a package of material downside risk on targets which put at risk successful delivery within our stretching efficiency challenge. We believe this position lacks fairness and proportionality and we discuss why below.

Fairness

- The cumulative impact of the interventions on the full package of outcomes is significantly tougher than for any other company and results in a RORE range of -6.57 to +0.15%, which is far outside Ofwat's expected reasonable range. The representations we are making would give a revised aggregate RoRE range of -2.35% to +0.35%, back within the acceptable range.
- The Ofwat methodology for setting collars is based on balancing upside and downside risk, but the application of the framework significantly penalises companies with predominantly penalty only incentives. The impact of this is that collars have been removed and we are exposed to significant downside risk.
- Several DD interventions on our bespoke PCs are based on comparative performance, but only a selection of companies have been used in this analysis, which is distorting our relative performance.

Proportionality

- The scale of HD means that in many areas we are operating at the level of single digit incidents (particularly in the waste service), so overall penalty or reward is likely to hang off one or two incidents that are disproportionality difficult to prevent and also costly to solve.
- The normalisation methods Ofwat have used have a disproportionate impact on us. The implied incentive rates for HD are now significantly larger than other companies. This is a function of our size and the effects of normalisation. In several cases the DD put us as a significant outlier when you consider the financial implications of a change in one unit of performance for individual households.

In light of these issues we have a small number of specific representations against individual PC and ODI interventions. However we also recognise that because of the size of HD and its infancy there is a need for a different approach, one which utilises the thinking from PR14 in terms of an aggregate cap and collar. We discuss this aggregate protection first before addressing the specific interventions.

3.1 HD Aggregate Cap and Collar

The c~50 interventions applied against our outcomes package create a very significant risk by making the P10 extremely exposed to the downside (more than double Ofwat's indicative bottom range of -3%).

In our response we address the most material issues, for example supply interruptions. However there will inevitably remain challenges with the PC and ODI package for HD given its infancy and very small size which means many of the tests used (e.g. normalised ODI rates and use of collars) do not appear to work in the manner intended or expected – leading to a -6% P10 RoRE range.

Having considered the problem confronting both ourselves and Ofwat's in its assessment of the HD plan, we think there is a compelling case to apply an aggregate cap and collar for HD. This would be consistent with the position from PR14 that argued an aggregate cap and collar was required to address two issues:

> *1. there was therefore a degree of uncertainty in companies' P10 and P90 estimates of outcome delivery rewards and penalties; and*
> *2. provide a further safeguard to customers and companies, and reduce the need to intervene more systematically to reduce the risks associated with individual new incentives.*
> **Ofwat, Final price control determination notice: policy chapter A2 – outcomes**

The issues described by Ofwat above at PR14 remain just as relevant for HD today due to our infancy and unique size. We discuss this below.

Uncertainty in companies' P10 and P90 estimates

One of the key drivers for an aggregate cap and collar at PR14 was the uncertainty about estimates of company performance. At PR19 these concerns for most companies have largely gone away due to the availability of four years of historical data for nearly every measure. Where companies have new measures then these typically have P10 and P90 caps and collars to provide additional customer protection.

Our position is very different to every other company. When the licence was varied in 2018 to ensure both SVE and HDD reflected national boundaries, the Welsh licence changed significantly. This involved the removal of customers in Chester, a predominantly urban area, and the addition of customers in Powys, a highly rural area.

The transfer of customers has meant that performance under the HDD licence is significantly different to performance under the old Dee Valley licence (as it relates to different customers and different asset systems). This means there is no historical data set that can be reliably drawn upon to estimate P10 and P90 performance. Instead, with only nine months of historic data we have had to make assumptions to derive P10 and P90 estimates.

This means there will inevitably be a higher degree of uncertainty about our P10 and P90 estimates relative to every other company. What this suggests is there is merit in exploring a more bespoke and pragmatic solution.

Reduce the need for more systematic interventions

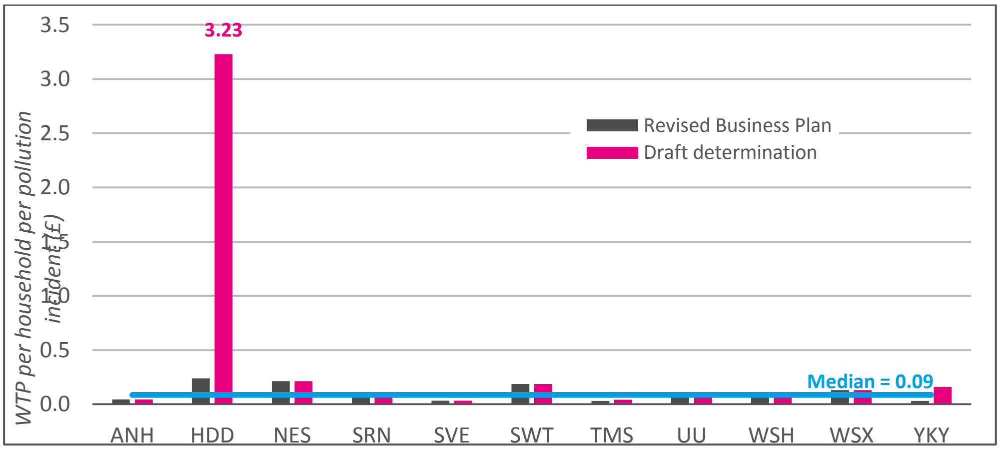
The other key driver for an aggregate cap and collar at PR14 was that it reduced the need for Ofwat to review and intervene on many more measures – ie, it reflected a proportionate approach to safeguarding customers and companies.

For HD there are two particular issues that make the use of an aggregate collar (and cap) compelling:

- the approach used for normalisation of incentives doesn't work in a way that is suitable for very small companies like HD; and
- the P10 estimate is extremely negative and rather than setting many individual collars, a more pragmatic approach would be to set an aggregate collar.

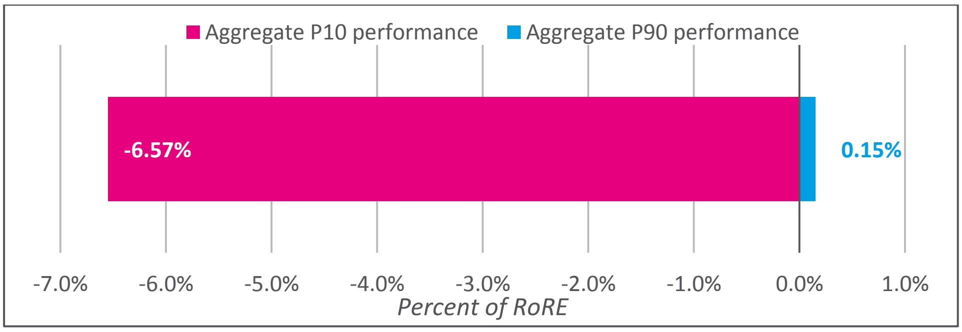
We have reviewed the DD interventions and whilst we support the principle of normalisation, the way it has been applied has a disproportionate impact on us and our customers. This is because the implied incentive rates for HD are now significantly larger than any other company. In several cases the DD put us as a significant outlier when you consider the financial implications of a change in one unit of performance for individual households – the chart below shows pollution incidents as an example.

Implied WTPs per household per pollution incident



The cumulative impact of the intervention on incentive rates; and the removal of nearly every penalty is that our RoRE range is significantly tougher in the round than any other company. As illustrated below it now results in a RORE range of -6.57 to +0.15% of RORE.

RoRE risk significantly exceeds Ofwat's reasonable range and has very limited upside potential



One solution to this problem would be to assess our incentive rates in isolation from every other company (and identify a more suitable basis for normalisation). However with only a very short window to assess DD representations and issue Final Determinations, we don't think this would be feasible. Instead we think a more appealing and pragmatic solution would be to:

- Introduce an aggregate penalty collar that protects us against this extreme downside. In designing the collar we think the most logical solution would involve setting this at the industry average of -2.6%. Although our P90 is very small, for completeness we think this should be set at a symmetrical level of +2.6%.
- Limit our representations on other measures to the most material items, as we discuss below.

3.2 Specific outcome interventions

We have reviewed the interventions made across our outcomes package. We want to stretch ourselves and have started work to refine our AMP7 plans to enable us to deliver most of them. However, there are 11 material interventions Ofwat have made that we are making representations on - five on targets; four on ODI rates; and two on protection collars. We set out a summary of the issues below and provide full evidence in chapter 3.

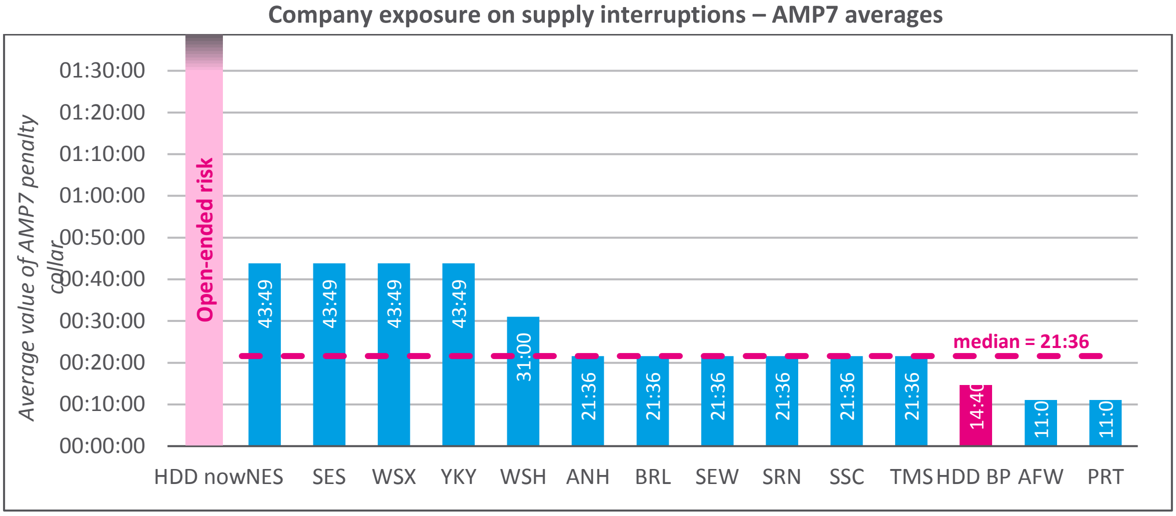
Supply interruptions

Our representations are three-fold; (1) on the sector target; (2) ODI rate; and (3) on the removal of the penalty collar.

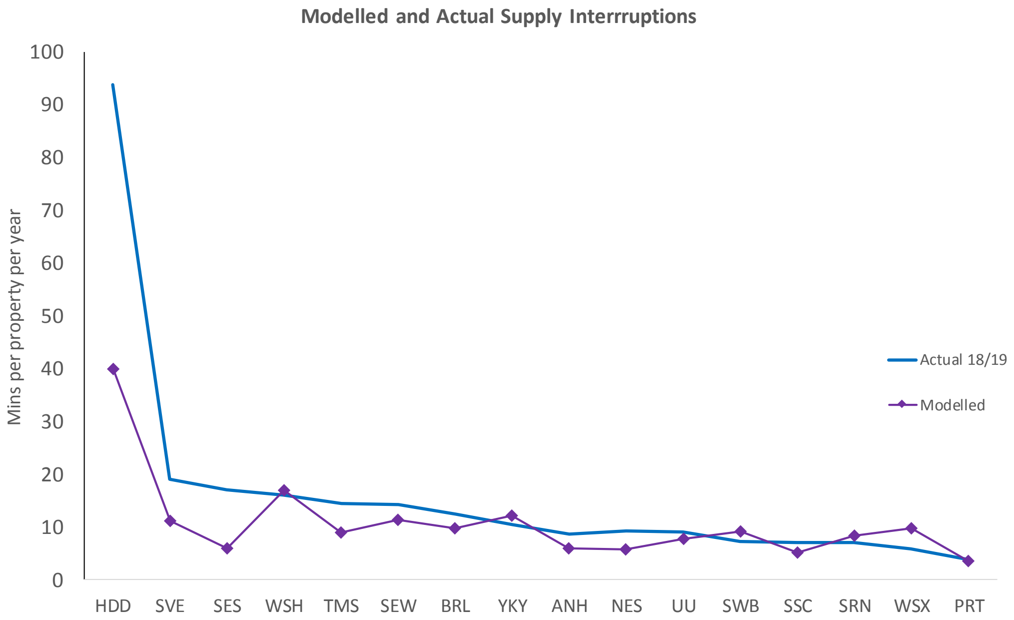
We have reviewed the robustness of the estimates made for the 18/19 performance compared to the business plan forecasts, which demonstrates the optimism bias present. We propose an adjustment to the forecast UQ target to account for this.

We have set out our continuous improvement process and how this is driven by robust and detailed root cause analysis. We believe this will provide you with sufficient confidence to remove the multiplier that was applied to the penalty rate on the grounds that we haven't provided sufficient evidence that we can deliver the sector wide expected improvement.

We show that the consequence of removing the penalty collar is that we now face extremely significant risks on this measure. For example, just two complex incidents could have an impact greater than 10% of RoRE under the current proposal. This extreme level of open-ended risk is even more pronounced when compared with the sector – following the DDs, all slow track and significant scrutiny company have downside protection in place on this measure – as the chart overleaf illustrates.



Our updated econometric analysis sets out the evidence to demonstrate the statistical relationship between network characteristics and supply interruptions performance. The graph below shows that the target is significantly more challenging for us than any other company. This emphasises the need for the penalty collar to be reintroduced.



Low pressure

The DD introduced new interventions on this measure, to both increase the target and the penalty rate. We demonstrate that the increase in our target from 28% to 44% is inconsistent with:

- customer views – both in terms of the engagement we did on the measure and target as part of our plan development, which shows around 75% of customers support our planned improvement, but also in relation to the very low number of customer complaints (13 complaints in 18/19);
- comparative data and the underlying limitations in data accuracy; and
- what is actually deliverable given the characteristics of our region.

The increase in the ODI rate is also not in line with our customer views, where 52% of customers think this measure should be reputational only. The DD intervention to make this penalty only, using the median range takes this even further away from our original proposal. Our response sets out the basis for returning the penalty rate to the lower bound of the acceptable range.

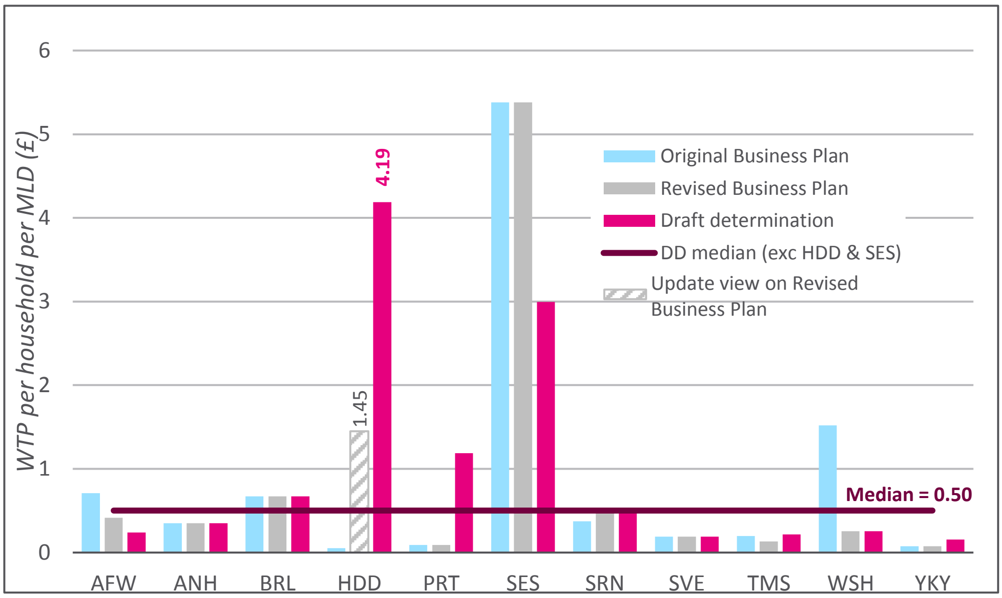
Leakage

The DD intervention increased the penalty rate for leakage by more than 4000%. The impact of this large valuation results in a downside exposure of -0.54% of RoRE that – because we're the only company in the sector to have this as a penalty-only measure - has no counterbalancing potential to earn rewards from outperformance.

The ODI rate proposed by the DD is underpinned by an implied per-customer valuation that is by far the highest in the sector and far higher (8.4 times) than the sector median, as shown in the chart below. These values also imply small companies are exponentially less efficient than large companies, which is counter to Ofwat's assessments which concludes the two smallest companies are the most efficient.

Applying the Ofwat methodology and using our customer research we think the ODI rate should be set at £69,931 per MLD. This is in line with our view on the reasonable range upper-bound of £1.15 per-household per-MLD. This would, nevertheless, still mean we have the sector's second highest incentive rate per-household per-MLD.

The proposed leakage ODI rate is a marked outlier



Note – analysis is focused on those companies that have consistently reported their ODI rates on the correct basis

Affordability commitments

We proposed an innovative affordability measure to complement the more traditional measure which effectively counts the number of people receiving support.

The interventions made in the DD do not seem to work coherently:

- We have to almost double the number of customers we help through schemes defined in the PC definition (by including the 'just about managing' (JAM) customer segment), of which the majority will be through the social tariff (there are other defined schemes such as payment holidays which is important to some customers such as farming communities).

- The social tariff contributions are defined (based on customers' WTP to contribute) and therefore to double the number of customers we help we would need to reduce the quantum of support per recipient, making it less meaningful and more likely to reduce the effectiveness of our support.
- This in turn puts at risk the PC relation to 50% of customers not falling back into debt.

These interventions are not only disproportionate but also dis-incentivise companies from innovating at future price reviews.

We think a more appropriate intervention is to triangulate the existing source data sources and add the latest research, which includes our updated affordability research and the independent CCW research published in July 2019 (which resulted in 12% of customers found the HD bill unaffordable). This would increase the estimate of the proportion of our customers struggling to pay from 11% to 13%. This triangulated approach is more reliable given the very small sample size of JAM customers which was the basis of the increase to 18%.

There is limited data from which to estimate a target for the innovative measure on the effectiveness of the support, but we understand and accept Ofwat's desire for us to be ambitious. But that needs to be done in a fair and consistent way across the industry and in recognition of the limited extent to which customers' longer term financial circumstances are within our control. Based on the limited data available, we are making representations that a 10% improvement by 2025 is more appropriate.

Reduction in the number of voids

We accept the interventions made on the definition (subject to a minor clarification), target and ODI type and rate. However, as a result of these interventions we think that a collar is needed to protect us from disproportionate downside risk, especially given that we are likely to have a higher proportion of genuinely void properties. If we miss our target by one percentage-point it equates to a penalty of £0.146m. To illustrate the materiality this would equate to 0.5% of the entire appointed business's RoRE from one retail measure.

Pollutions

The DD has intervened to raise our incentive rate from £149 per incident per 10,000km to £2,000 – over a 13-fold increase. In considering the revised ODI rate, we have reviewed the underlying value it implies our customers place on an actual pollution incident. Our expectation is that the value customers place on an actual pollution incident should not differ greatly across the sector simply because of variations in the size of company that provides waste services.

When we convert the proposed penalty rates into a per-incident per-customer WTP value it gives a value of £3.23, which is both the highest in the sector and 36 times larger than the sector median

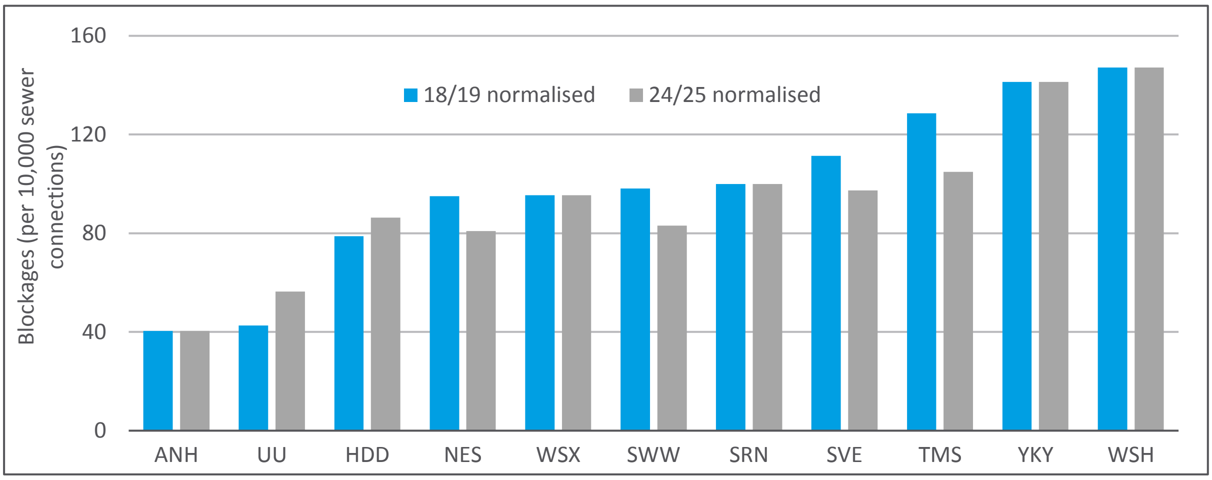
The FD should retain the ODI value of £149 per incident per 10,000km of sewer. With its underlying per household valuation of £0.24 per incident it remains the highest valuation in the sector.

Blockages

The DD increased our target by 17%, the maximum improvement being offered by any company, on the basis that HD are relatively poor performers. We do not believe this intervention is justified on the basis of:

- the incomplete data set being used to inform the comparative analysis, which if expanded shows our performance isn't poor lower quartile as suggested in the DD;
- comparative assessments are strongly influenced by our short sewer length, which makes comparison based on normalisation more sensitive to assumptions such as the length of sewer adopted (this point was recognised by Ofwat in relation to pollution incidents). The chosen denominator is also a significant factor

and given a high proportion of our blockages are caused by sewer misuse, the number of connections is an equally valid denominator. If this is used it shows we are the third best performer as shown below; and



- our customer views - 88% found stable performance an acceptable target, which suggests that even more customers would have found our planned 6% improvement acceptable. In addition, customers felt that the size and impact of a blockage should be taken into account in the target. Customer impact appears not to have been taken into account when setting the DD as only 3% of our blockages convert into either a pollution or internal sewer flooding incident.

4. Securing cost efficiency

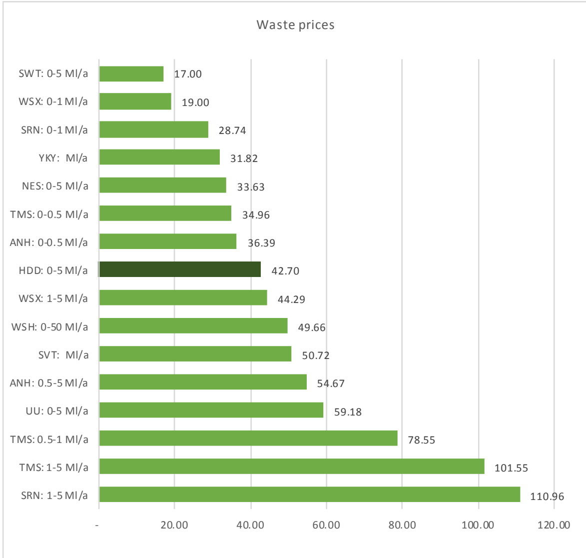
We are making two representations relating to cost efficiency covering nonhousehold retail costs and developer services.

Nonhousehold retail price control

The DD includes an intervention on NHH costs because our costs for small businesses appear high and we provided insufficient evidence to justify the differences. We have reviewed our costs, alongside Ofwat's retail modelling approach and we disagree that the household costs are a reasonable proxy to warrant a 40% challenge. This is a significant reduction and inconsistent with the household (HH) assessment in which Ofwat assessed our retail costs as being relatively efficient.

Our costs can be justified in two ways removing the need for an Ofwat intervention:

- first, the additional costs seen in the NHH price control that are not seen in the HH control (and therefore why the HH costs cannot be used as a proxy), these are predominately associated with the costs of bad and doubtful debt, the omission of trade effluent and the costs relating to additional services required in Wales (such as Welsh language services); and
- second, comparative data from PR16 shows our costs are average when compared to non-household retail costs in the rest of the industry at that time.



We have also reviewed the performance of the NHH retail team to understand if they are delivering for customers. Both our sixth-monthly tracker and CCW independent research shows extremely high levels of satisfaction with our customer service.

Developer services

The updated approach to developer services cost assessment is a welcome development. The move from a separate enhancement model used at the IAP, to inclusion in an expanded set of botex econometric models (termed botex+) is a pragmatic and effective solution to the known data problems in this area.

We believe, as Ofwat has done, that it is reasonable to assume that new development will affect all companies and that on-site activity at a high level is scalable. We're also pleased that the incorporation of developer services does not appear to have affected the predictive power of the botex models more broadly.

We understand that Ofwat is continuing to explore whether a separate model that improves on the earlier version used at the IAP could be developed in time for the final determination. We agree with the need to develop such models, however, we believe that this would be better done at PR24.

For PR19 we don't think it will be possible to address the data quality issues, particularly given that companies have had only six working days to respond to the last developer services data request. This is because we do not believe that companies can yet produce the granularity and quality of data that would be required to generate an accurate result from such a precise model. It seems unnecessary to introduce such uncertainty and risk for error at this late stage when the current pragmatic solution works sufficiently well.

5. Concluding remarks

Overall the 2019 Price Review has been a very comprehensive and thorough process that should help deliver the best outcome for customers. However as we have noted there remains two meaningful issues – WACC and the magnitude of interventions on our PCs and ODIs – which we believe need to be addressed to ensure a balanced package that is also fair in the round.

We have worked hard with Ofwat to ensure that this review is undertaken on a constructive manner. We have set out a number of key points that ensure that the determination for HD is robust and fair, and want to ensure that discussions about the WACC does not unduly overshadow the many successes that have been secured for customers. We look forward to continuing our discussions with you and the opportunity to present our evidence in person in September.

Yours sincerely

Liv Garfield
Chief Executive Officer