Our response to Ofwat's Draft Determination:
A summary

NORTHUMBRIAN WATER *living water* | ESSEX&SUFFOLK WATER *living water*

Our response to Ofwat's Draft Determination

We prepared a Business Plan that was both high quality and ambitious

1. In October 2023 we published our proposed Business Plan for 2025-30. Our plan was developed through extensive engagement with our customers and stakeholders. Working in partnership with all of those important voices, we sought to recognise and respond to greater environmental concerns and standards, set stretching targets for service and efficiency, ensure that the plan is resilient, deliverable and financeable and importantly to make sure it is affordable for all.

74% Across our affordability and acceptability testing, 74% of our customers considered that the plan was **acceptable.**

2. We want to be ambitious for customers and the environment in line with our vision of being the 'national leader' in the water sector in the UK. Our plan offered, for example:

A package of changes to address the environmental challenges including:

- c.£1.7bn of investment (ten times the current approved level) to improve the environment.
- Eliminating serious pollution events and delivering a c.30% reduction in all pollutions.
- Reducing wastewater spills by about a fifth - focusing on most vulnerable locations.
- Using innovation and creating catchment based communities to deliver nature-based solutions that reduce nutrients, maximising wider benefits to the environment.

Improved resilience and services to customers:

- Maintaining our position as number one in the industry for customer service.
- Reducing leakage by c.8% in Essex and Suffolk where we are already among the best in the sector and by c.10% in the North East.
- Improving our performance in relation to drinking water quality through our ongoing transformation plan.
- Making sure water supplies are resilient to 1 in 500 year drought by investing and introducing compulsory metering in Essex and Suffolk, a serious water stressed area.
- Investing c.£400m to adapt to climate change and ensure healthy asset base, reducing the risk of service disruption for customers from extreme weather.

Delivering fair investment

- Investing over £6bn of private capital – more than double the current capital programme.
- For every £1 customers pay in their bills, we proposed to spend £1.66 in the North East and £1.29 in Essex & Suffolk.
- c.£400m of this investment would come from new equity injections.
- We proposed to accelerate c.£100m of investment into 2023-25 to deliver benefits to customers and the environment sooner and are transforming our business to enable us to deliver such a large programme and remain the top water company in England and Wales to work with according to the supply chain.

Supporting customers and addressing affordability

- Our plan was to eradicate water poverty – making sure nobody spends more than 5% of their disposable income on water bills.
- Expanding our support for all customers with affordability challenges from c.£40m in the current period to c.£170m – a more than four-fold increase in support and doubling the number of households we are supporting with social tariffs to 300,000.
- Introducing a new c.£20m shareholder-funded hardship scheme to help those that need it most.

3. To deliver improvements to customers, based on that plan, bills would need to rise by between 12-20% before inflation. In Essex and Suffolk water bills will need to rise by around 9-10 pence per day and in the North East combined bills will need to rise by between 19-21 pence per day. This was substantially mitigated by the 18% bill reduction we delivered in 2020, which was the largest reduction in the sector at that time.

We are pleased the Draft Determination (DD) recognised the quality and ambition in our plan

4. We could not see other water companies' plans when we submitted our own, but we now know that in comparison our plan was:

   - **High quality** – we passed the stringent tests that Ofwat applied to company business plans to assess whether they were 'high quality'.
   - **Efficient** - our modelled base costs were within 3.3% of Ofwat's allowances for the DD[1]. We offered the biggest efficiency improvement among all the Water and Sewerage Companies, thanks to our leading position in innovation[2]. Our modelled enhancement costs were within 0.1% of Ofwat's cost allowance and our cost estimates for our allowances are largely[3] consistent with Ofwat's models.
   - **Offered stretching levels of service improvement to customers and the environment** – where Ofwat rightly assessed our ambition as 'high' and we have seen only minor adjustments to the service levels that we offered.

1 See section 7.1 of our detailed response
2 'Frontier shift' is the amount of efficiency or productivity improvement that companies can make from ongoing improvement and technological innovation, it is distinct from improvements that some companies can make from 'catching-up' with better performers.
3 See section 7.2 of our detailed response

5. Overall, our plan represented over £6bn of investment, more than 93% of which has been funded by Ofwat in the DD. While it would deliver some of the best levels of service it would also result in one of the lowest overall increases in bills across the sector[4] and the lowest combined bill in England and Wales.

6. Our affordability package for our customers was also supported and recognised by CCW in its review of business plans[5] which was also complimentary about how we engaged with our customers to understand their views and preferences in shaping our plan. We agree with members of our Water Forum that customer evidence does not feature as strongly as it should in the Ofwat DD.

The Draft Determination supports much of our original plan

7. We welcome many elements of Ofwat's DD, and we have accepted many of Ofwat's challenges in our response. In particular:
   - Ofwat has supported most of the cost allowances and service level targets that we included in our Business Plan with only a few minor amendments and has recognised our ambition.
   - Ofwat has recognised that the overall balance of risk had a much higher potential for negative outcomes than for positive results or gains when it last set prices, preventing even the best companies from achieving the service level targets and spending within their allowed costs[6]. In response, Ofwat has introduced a range of additional risk protection mechanisms, particularly focused on costs such as energy expenses. This addresses the issue where fluctuating power prices have previously been absorbed by the shareholders of water companies. Many of these mechanisms closely resemble those that we included in our Business Plan too.
   - Ofwat has raised the allowed return from its initial estimate by adjusting for changes in market data and choosing a higher point within its stated cost of equity range. This allowed return is critically important when we need such large injections of new equity finance. Investors have choices about where they invest their money and we need to ensure that the water sector is as attractive as alternatives.

4 Ofwat DD key facts
5 CCW assessment of Business Plans

6 See Ofwat's own 2022-23 Water Company Performance Report and First Economics FAQs

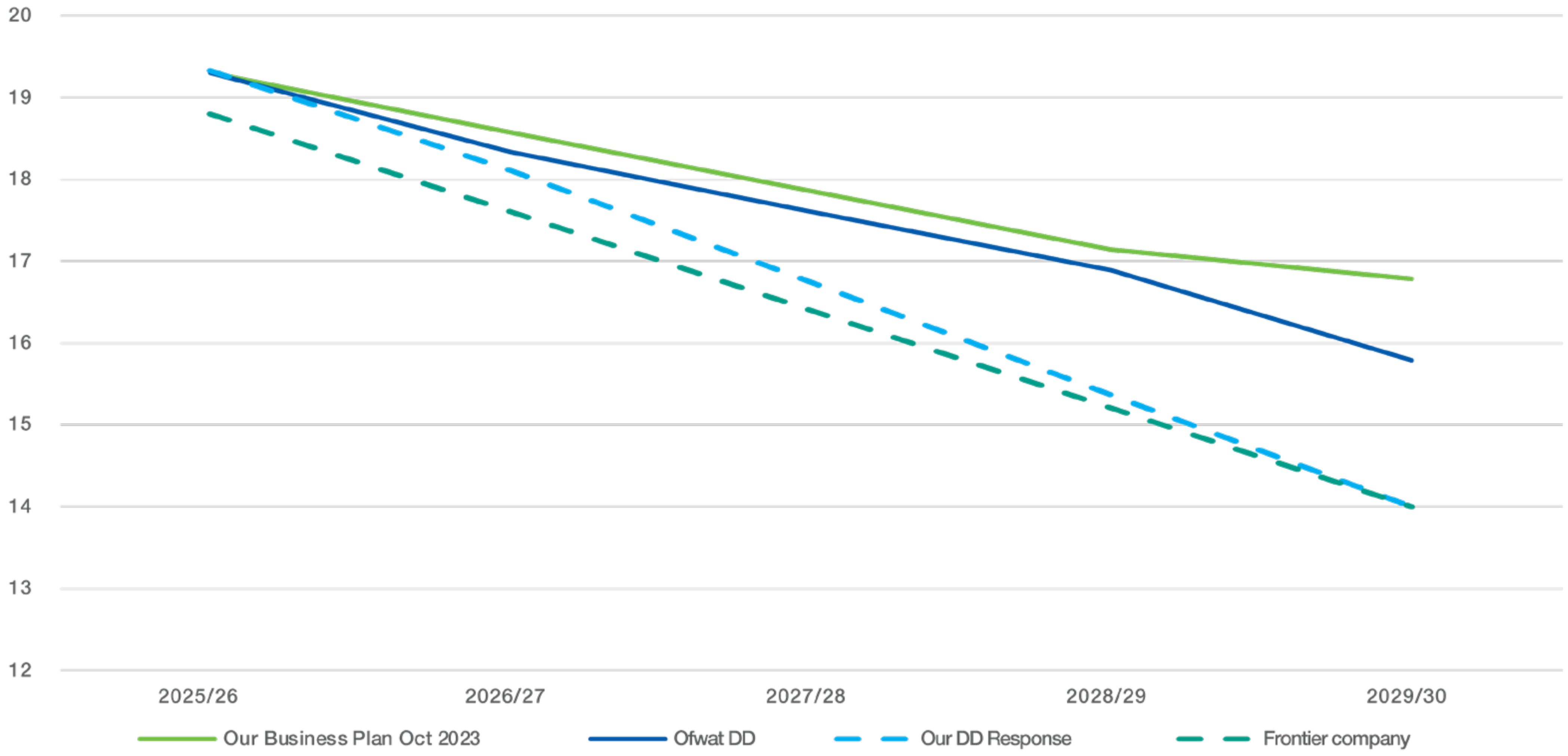
8. Ofwat has challenged our Business Plan in several areas, including using benchmarks from other companies plans that was not available to us at the time of our submission. Based on this new information, we acknowledge and accept the DD challenge in several areas.

We accept:
- The modelled base cost allowances for PR24 as set in the DD, and we make no significant representations on the models used, the individual cost drivers or how Ofwat has set these allowances.
- Ofwat's minor adjustments to most of the Performance Commitment targets and profiles that we included in our plan, including PCs for wastewater (internal and external flooding, serious pollutions, river water quality, sewer collapses, Discharge Permit Compliance, and greenhouse gas emissions) and water (Compliance Risk Index, water quality contacts, interruptions to supply, leakage, mains repairs and greenhouse gas emissions).
- Some of the challenges to our enhancement programme costs based on Ofwat's benchmarking, including adjustments to our allowances for wastewater monitoring programmes and our sludge barn investments.

9. We always wanted to be ambitious in relation to spills from storm overflows, which is a key public concern. We could not see other companies' plans when we submitted our own but, with this new information now clear, we have strengthened our PC targets for reducing spills to the most ambitious in the sector by the end of the period. We have achieved this by discovering new ways to reduce spills within our existing funding package, along with additional investments outlined in our new plan.

31% In our affordability and acceptability testing on the DD response 31% of customers highlighted that reducing spills from storm overflows was the **most important part of our plan** for them, versus 22% in response to our October Business Plan research

Figure 1: We have strengthened our commitments to reducing spills from storm overflows to match the best in the sector by 2029/30



Ofwat should make five key changes in its Final Determination in December.

10. Although we welcome many elements of the DD, if the Final Determination (FD) were unchanged from the DD then we could not accept it. This is because, as it stands, Ofwat's proposals are not likely to serve the long-term interests of current and future customers, for two reasons.

- Firstly, Ofwat has removed the funding needed to make the necessary investments that we described in our Business Plan to make sure our asset base is healthy and able to operate effectively, and to mitigate the risks from climate change and extreme weather events. These investments are necessary to ensure a reliable and consistent water supply that can meet the needs of growing populations. .
- Secondly, the package, as it stands, is not financeable. Without amendments, we would be unable to attract the necessary equity financing. Without this funding the plan can not be delivered and ultimately, the environment and our customers will end up paying the price. This is for three key reasons:
  - Ofwat has introduced a range of mechanisms that depress revenues throughout the period, leaving the sector underfunded for several efficient cost areas. This underfunding threatens the financial resilience of the business. These mechanisms need to be either removed or significantly reformed.
  - While there is a welcome increase in the proposed return it is still not sufficient to attract the investment needed, given the risk that equity shareholders would need to take. Investors will earn less by investing in UK water infrastructure than in other utilities or countries.
  - The overall balance of risk in the package is still heavily skewed to the downside unless it is amended it will be too stretching driving material penalties for all companies, repeating a mistake from the previous price review.

11. To improve outcomes for customers, we ask Ofwat to look again at five areas and we provide more detail on how it could amend the package in our main response.

Supporting resilience in the Final Determination:

In our Business Plan we included two key investment proposals to support and enhance the long-term resilience of our business:

- Investment to support a healthy asset base, where we proposed additional investment to replace some of our older civil structures on our treatment works and also increase the level of water mains renewal that we currently undertake.
- Investment to address climate change resilience, where we examined the nature and likelihood of future extreme weather events and sought additional investment to ensure that we are able to continue to provide services to customers throughout those events.

In the DD Ofwat largely rejected both cases and provided limited additional funding with none provided in some areas. This was despite the significant evidence we provided including from our customers and Water Forum members[7] which shows that they support taking action on these issues now rather than delaying investment.

7 See NES47 Water Forum Report and PR24 Research and Engagement Activities (nwg.co.uk)

Supporting a healthy and resilient asset base

We appreciate Ofwat's intervention for targeted mains renewal investments across the sector, which provided some partial funding compared to what we requested in our case. We recognise that this is a shift from Ofwat's historical policy position that all capital maintenance activity can be funded from base allowances and is greater recognition of a major sector-wide problem. However, we are disappointed that Ofwat has, without any engagement with us, excluded our proposals for investing in civil structures on our treatment works. We disagree with Ofwat's DD assessment, which largely relies on a simple approach of making comparisons to past investment for all above ground wastewater assets. We have shown in our detailed response that this approach is flawed and the conclusions from it incorrect[8].

We ask that Ofwat reconsiders our case rather than assuming somehow that the mains renewal allowance alone is sufficient. We have also worked with Water UK and Reckon to suggest an alternative 'central adjustment' mechanism, building on the work we have led with others across the sector[9].

8 See section 5 of our main response to the Draft Determinations
9 See: water.org.uk/investing-future/infrastructure-health

Ensuring essential services are resilient to climate change and extreme weather events

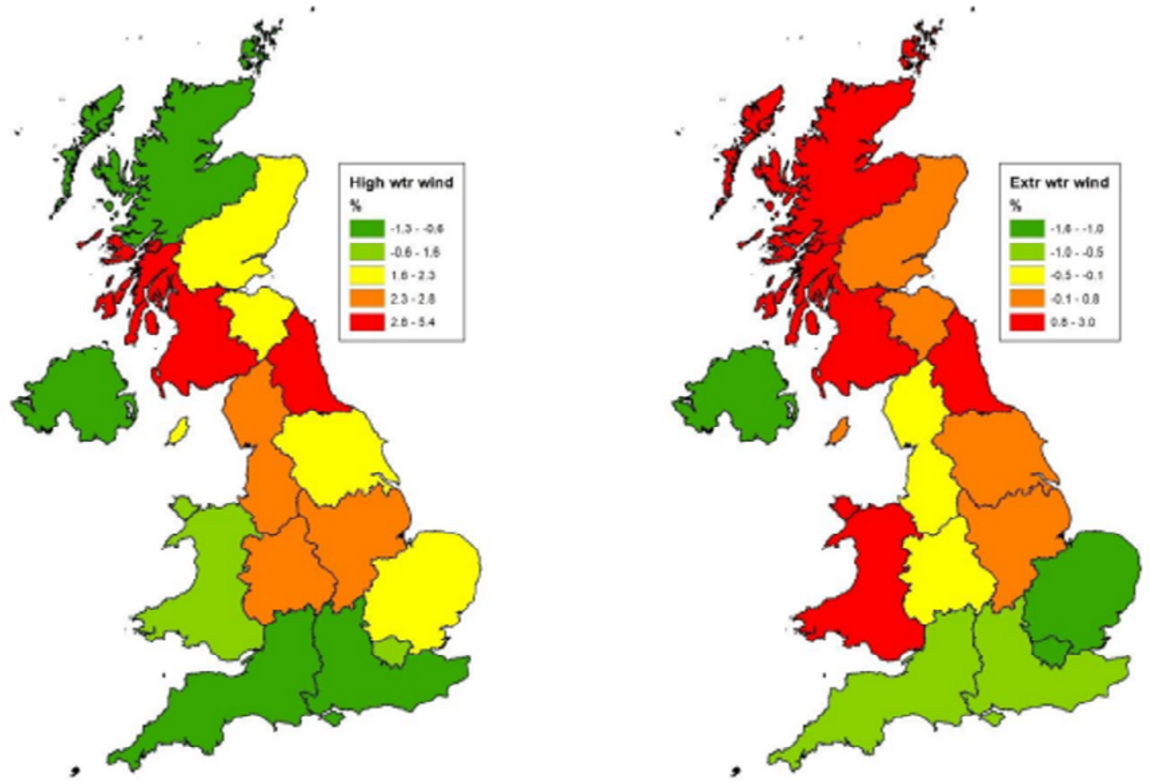
We ask that Ofwat reassesses our climate change resilience case, including the updates we have provided in the DD response, and either provides adequate funding to manage future extreme weather events or establishes reasonable exclusions for these events from its incentive package.

We disagree with the central approach Ofwat takes in the DD, which funds companies based on the volume of climate resilience requests rather than the evidence provided. Ofwat's framework and past policy has discouraged companies from proposing resilience investments, in particular due to a fear of these being interpreted as inefficiency. Drivers of extreme weather and cascading risk will be different for each region. We suggest two options: either re-evaluate our case and provide appropriate funding for climate resilience or adjust the Performance Commitment definitions to allow for sensible exclusions due to severe weather as almost every other regulator does[10].

Reallocating the risk of the severe weather to customers may be in their best interests, as it avoids over-investment and aligns with practices of other regulators. However, in line with the recommendations of our customers and their representatives on the Water Forum we would prefer resilience to be 'built in.'

10 See: ofwat.gov.uk/wp-content/uploads/2022/10/Extreme_weather_event_risk_report.pdf

Figure 2: The risks from extreme weather events are regionally different and so not well suited to a central adjustment for all companies that is the same[11]



Source: Mott MacDonald analysis of UKCP18 projections

11 See our climate change resilience case

Ensuring that the FD is financeable and can attract the necessary investment:

In its DD Ofwat includes three separate elements that combine to create an overall investment package that is not financeable and would likely fail to attract the necessary funding for the sector to deliver improvements for customers and the environment. We propose that in the FD Ofwat makes amendments in each area to address these issues.

1. Ofwat needs to amend the mechanisms that restrict companies' revenues over the period to ensure the FD is financeable and companies are funded for the efficient costs they will incur. The DD contains a range of 'true-up' mechanisms financial adjustments made to correct or reconcile differences between projected or estimated costs/revenues and the actual costs/revenues that occur over time, for example, business rates and power costs. These mechanisms collectively create financeability constraints by restricting the revenues that companies can collect over the period and reducing their credit metrics to such an extent that their credit quality would deteriorate, leading to a downgrade by the independent rating agencies.

   We do not understand why these mechanisms are needed as the costs in each of these areas are known with a high degree of certainty. In our case the inclusion of these additional revenues at the end of the period in 2030 will increase bills by as much as c.10% at that point, which is not in customers' interests. Customers consistently tell us that they want to see stable bills with managed changes rather than price spikes. Our plan is affordable with the affordability score increasing since October in our most recent affordability and acceptability testing[12].

2. Ofwat needs to adjust the package so that good performers have a fair chance of delivering it. Setting the overall balance of the price and service package is challenging. It must be stretching to drive improvements for customers and the environment but also deliverable or companies will face industry-wide losses that will quickly make it less attractive for future investment.

12 Based on our A&A testing, 50% of customers stated that it would be 'difficult' to afford the bill rises described in our October 2023 business plan. This compares to 34% in relation to our DD response.

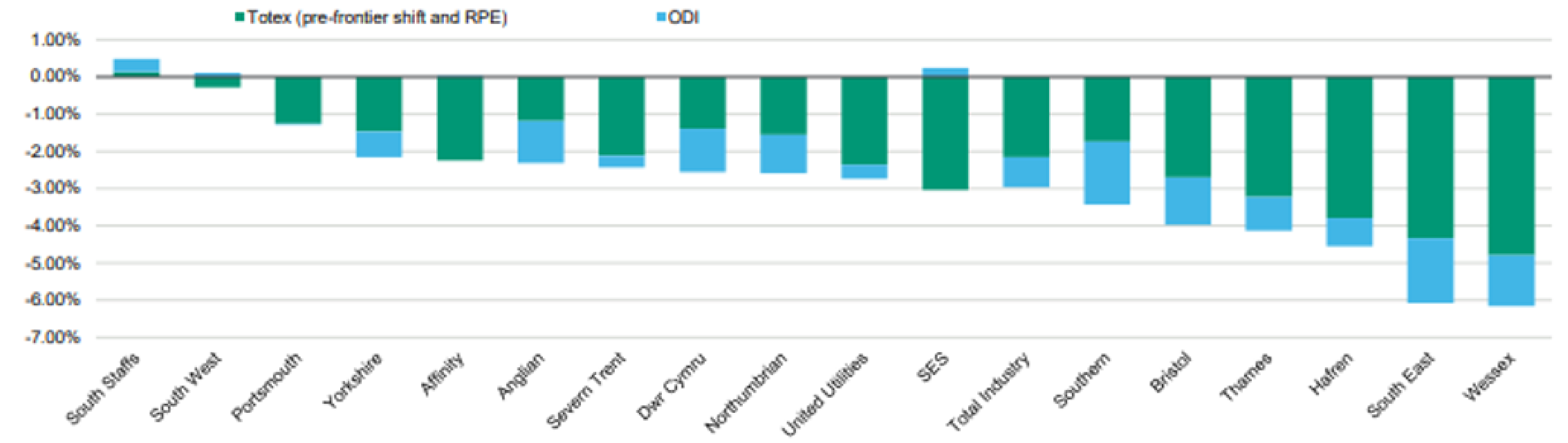
This is why Ofwat's primary legal duties reflect the need to balance customer protection with allowing investors to earn a fair return on the capital they invest.

Looking at the current settlement period from 2020-25 no company is meeting the settlement, and this has damaged trust in the regime and undermined investor confidence. Ofwat appears to have recognised this error in its DD but our view, which is echoed by a number of independent commentators[13], is that it would deliver a similar or worse set of outcomes than PR19. Moody's estimates that the package would result in c.£2bn of penalties across the sector and First Economics finds that:

13 See for example Moody's, 2024, Regulated Water Utilities – UK Ofwat's draft determination increases sector risk or First Economics, 2024, PR24: Performance Commitments and ODIs

> "As a consequence, we are not seeing how Ofwat could have satisfied itself that it has devised a package that 3/4/5/6 companies, including good representation from the water and sewerage companies, are going to look at and think "yes, Ofwat is right, this gives us an opportunity to earn a net ODI reward on the back of high levels of service to customers". We instead see a regulatory framework that says that only a few of the very strongest performers can expect, at best, to just about break even, while anyone that sits further down the industry league table is likely to suffer a loss."
>
> **First Economics**

Figure 3: Independent analysis from Moody's suggests that only one company in the sector could expect upside on operational performance to deliver the very stretching settlement that Ofwat has proposed [14]

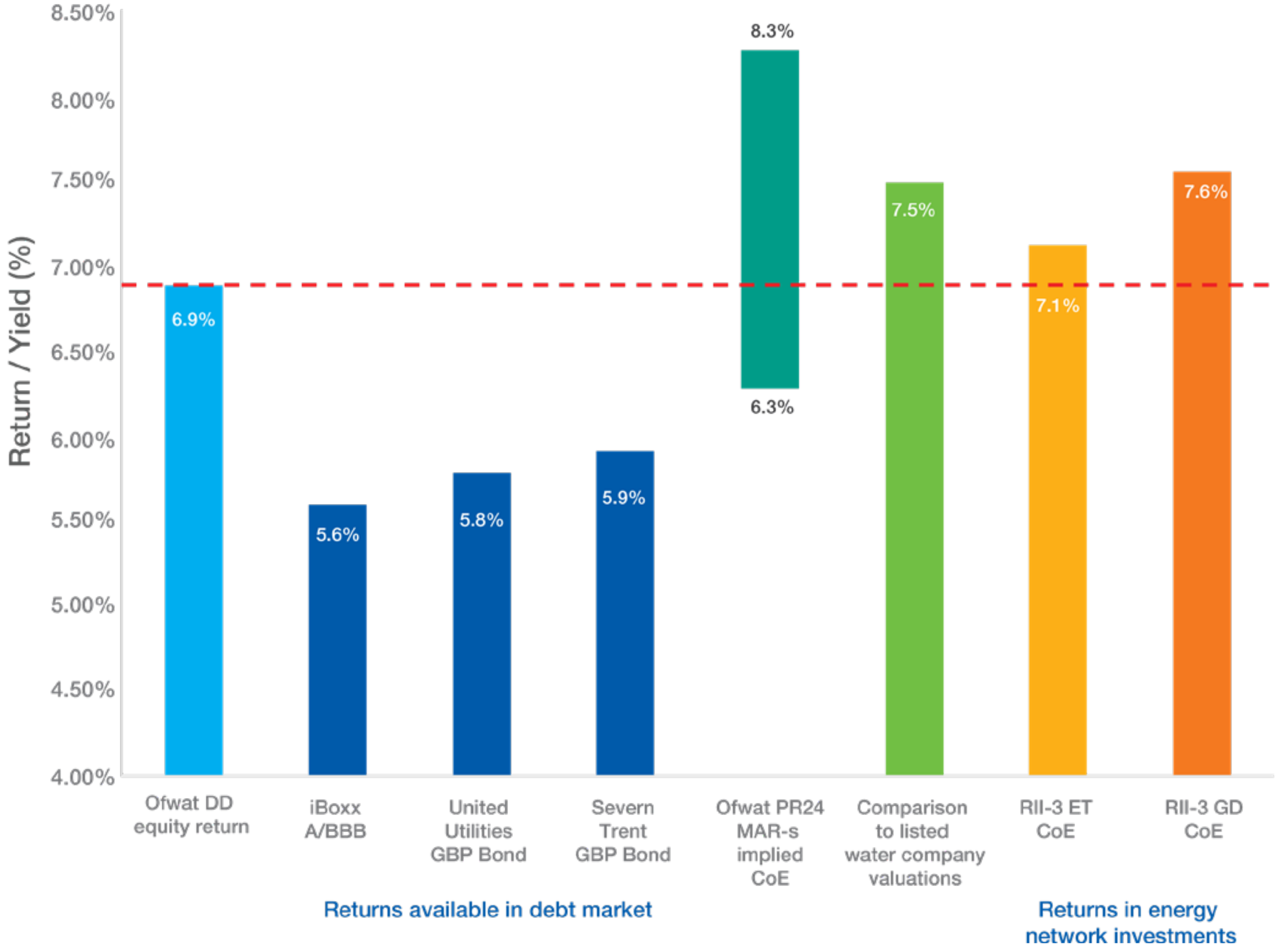


Considers operational performance only. ODI impact reflects common ODIs only (excluding service measures and also external sewer flooding for Thames Water, which has some inconsistencies). Total expenditure impact is calculated by applying 10% exposure in relation to the business rates cost gap and base cost sharing rates to the remaining base totex gap as well as 40% exposure to enhancement overspend. All totex gaps are calculated pre-frontier shift and RPE adjustments. Aggregate sharing mechanisms are reflected for any totex impact in excess of +/-2 percentage points of RORE.
Source: Ofwat draft determinations, companies' business plans and Moody's Ratings

3. The allowed return needs to be increased to match the PR19 redeterminations. The increase in the allowed equity return in the DD is a step in the right direction, but it is still too low in comparison to several alternative benchmarks on what equity investors could earn elsewhere, and reasonable cross-checks. It is well below what would be provided based on the methods used by the Competition and Markets Authority (CMA) in the redeterminations it undertook at the last price reset, well below the returns on offer in the energy sector at the lower end of the valuations of listed companies in the sector and only marginally above the returns investors could get by investing in corporate bonds (debt).

14 Taken from Moody's, 2024, Regulated Water Utilities – UK Ofwat's draft determination increases sector risk Exhibit 12

Figure 4: Ofwat's allowed return remains uncompetitive with relevant benchmarks – not sufficiently higher than debt returns and lower than equity returns elsewhere



12. If Ofwat were to address these concerns in the FD then this would provide a much better package for customers and the environment. In particular:

- Companies would still be required to deliver substantial improvements in service and for the environment that broadly reflect customer preferences.
- Bills would increase by slightly more than the DD (in our case the 11% rise in the DD would increase to 18.5% versus 16.5% that we included in our Business Plan) but would remain affordable with an increased affordability score from our testing with customers (34% of customers consider that the DD response would be 'difficult' to afford versus 50% for the original Business Plan). We would continue to offer a large affordability package to help those customers struggling to pay their bills with four times as much support as they have currently and a hardship fund of £20m paid for by our shareholders. Bills would not need to increase further in 2030 by more than 10% and customers would enjoy more stable and predictable increases.
- Services would be more resilient and we would be better able to respond to severe weather events and maintain service as well as beginning a process of renewing and upgrading our ageing asset base to ensure it can continue to provide resilience essential services into the future.
- Plans would be financeable and the sector will be more confident in being able to attract the capital that it needs to deliver the improvements, rather than struggling to get that investment or limiting the scale of it which could delay or reduce the improvements that we all want to see.

Updates to our Business Plan

13. We raised some areas of uncertainty in our Business Plan in October 2023, where various statutory requirements had not yet been finalised. We provided an estimate of costs for possible alternative programmes. We updated Ofwat on this in January 2024 (where we also confirmed the outcome of new guidance for the septic tanks programme) and then again in May[15] and June 2024. We described the key areas where there was remaining uncertainty in an update to customers and stakeholders in July on our website

14. These have now all been resolved and we seek to reflect these updates, most of which were not in Ofwat's DD, in our response to the DD. We explain these changes in section 10 of our main response including our proposed changes to our monitoring and nitrogen removal programme. We also plan to bring some further investment forward from future periods, including £130m of additional storm overflows investment and additional asset health investments in service reservoirs and wastewater treatment works.

15 Letter from Andrew Beaver to James Veaney, 24 May

15. Our customers preferred to go further on storm overflows, if possible, but were constrained by overall affordability. The Water Forum challenged us to do more without increasing bills. In this response, we propose additional investments that mean we would be going significantly further than the statutory requirements before 2030. This would increase the number of storm overflows improved by 2030 from 159 (15.6% of all overflows that need to be improved) to 239 (23.4% of all overflows that need to be improved).

16. Our customers also preferred to invest in water and wastewater rather than reduce bills, and our Long-term Strategy shows that we expect investment to remain high beyond 2030. We asked our customers how they would like us to respond to the DD on asset health and climate change adaptation, as well as their views on these additional investments and our response seeks to reflect those views[16].

16 The full report can be found in NES8

17. Overall, our response to the DD would see bills increase by around 18.5% for customers, compared to around 16.5% in our original Business Plan [17]. This is driven partly by the investment changes set out in our main response, most of which are entirely independent from the DD process and partly by changes in interest rates and market data influencing our view of the appropriate allowed return.

18. In figure 5 we compare the bill increases for the 2029-30 year at the end of the next price control period including our original Business Plan figure, Ofwat's DD and our DD response to the original business plans and the bill proposals from other companies business plans and DD's[18]. This shows that our combined overall bills and increases are still very likely to be the lowest amongst all the Water and Sewerage Companies.

17 Including our 'alternative return' proposal
18 We cannot yet see other companies' equivalent responses to the Ofwat Draft Determination

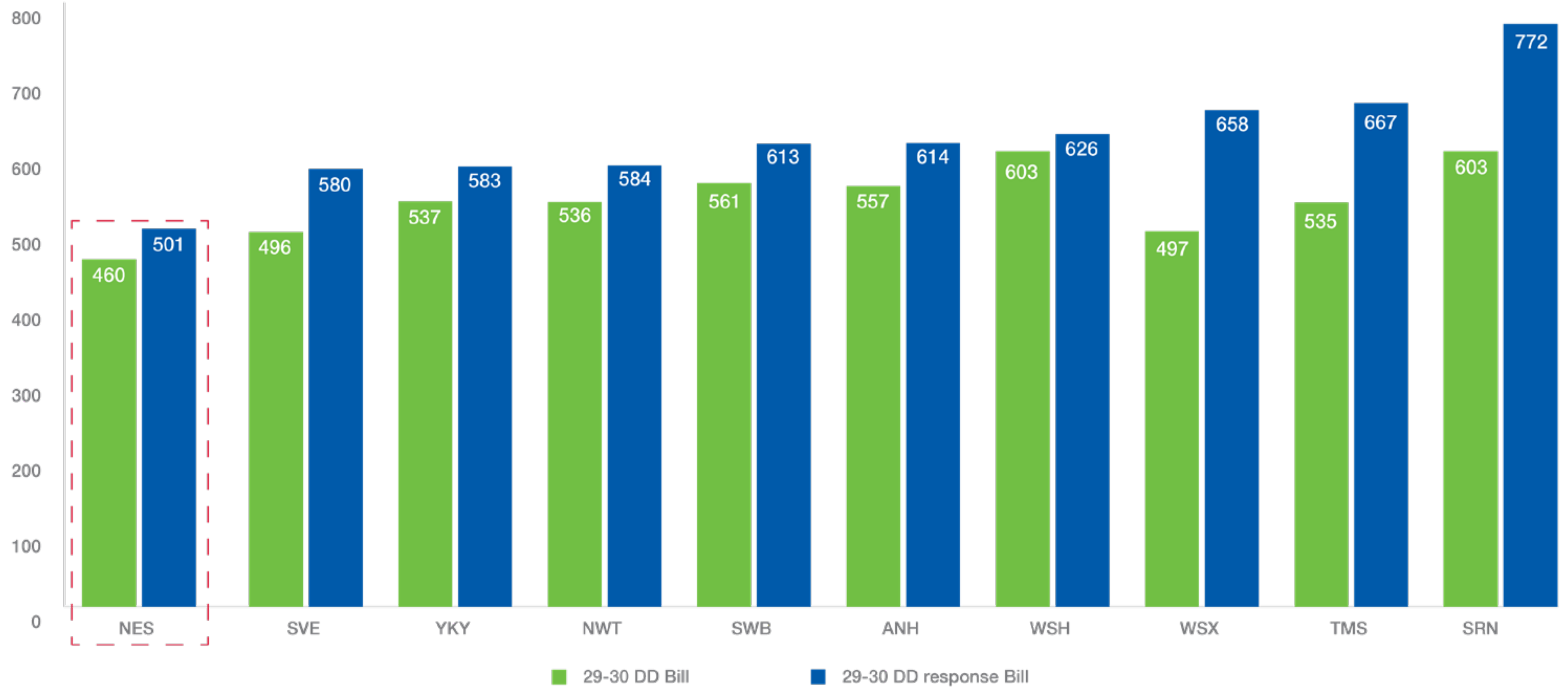
19. We also repeated some of the affordability and acceptability testing[19], to compare how customers feel now compared to in summer 2023. Customers are more likely to say that they could afford their water bills now than in 2023 despite the small increase since the original Business Plan – but acceptability has dropped a little, and 18% of our customers say that our plan is not acceptable, often linking this to trust in water companies[20].

66% of our household customers in testing say the plan is **acceptable,** saying that they still support what we are trying to do in the long-term; and that our plans still focus on the right services.

19 NES83
20 Our affordability and acceptability (A&A) research was carried out in the brief seven week window of the Ofwat DD response period. In the fourth week of that period Ofwat issued a draft enforcement notice for NWL which may have influenced the results of the A&A research.

20. We hope that Ofwat will consider the evidence we have provided and make suitable changes in its Final Determination this winter. In the meantime we are already seeking to move forward with this programme of investment, accelerating more than £100m of this investment from 2025 into the current year and building our delivery capability with our supply chain partners to ensure we can deliver such an ambitious programme of work.

Figure 5: Projected 2029/30 household bills (company Business Plans and Ofwat's DD) compared to our DD response (excluding inflation)



Notes: Northumbrian Water ('NES') figures are shown for the original Business Plan submission (in green using our 'alternative return') compared to the Ofwat DD (in blue) and our DD response (in grey). These figures are compared to other Water and Sewerage Companies business plan and DD responses.
Source: NWL analysis of company business plans and Ofwat's DD

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Cover image: Tollesbury salt marshes, Essex

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