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Dear Ofwat

Northumbrian Water's response to the 2024 Draft Determination

We welcome the opportunity to respond to Ofwat's Draft Determination (DD) for the 2024 Price Review (PR24). We set out to create a business plan driven by our customer priorities that delivered substantial benefits for all our stakeholders and we are pleased that many of these benefits have been recognized in the DD.

In our business plan we propose some of the best service levels alongside the lowest charges, with no customer spending more than 5% of their income on their water bills, but also a step change to support the environment with a ten-fold increase in investment. We were pleased to see the quality and ambition of our plan recognised and that the overall form of our plans was broadly retained. A comparative assessment across companies also shows that we have one of the smallest gaps between our plan and the DD on both the allowed costs and the service performance targets for the 2025-30 period. We will support Ofwat in its work to ensure we can close this gap with further evidence to reach a Final Determination (FD) that avoids any need for a redetermination.

We acknowledge and accept Ofwat's challenge in several areas and we additionally have taken the opportunity to increase our ambition on storm overflow spills to match the most ambitious plans in the sector. However, if the FD mirrors the DD, then it appears to us unlikely to best serve the long-term interests of current and future customers and would not represent the best approach to meeting Ofwat's statutory duties. We would not be able to support it as it would:

- **Not be financeable**- Ofwat introduces a range of 'true-up' mechanisms which would drive a downgrade to the rating of the notional company, underfund companies for their efficient costs, and increase bills sharply when the corrections are introduced in 2030. The DD also represents an unbalanced package that would drive material penalties for almost all companies in the sector; repeating an error from PR19.
- **Undermine resilience-** The DD leaves customers exposed to greater risk of service failure through extreme weather events or asset failure. Whilst Ofwat's adjustments are welcome, they are piecemeal and in some cases are likely to do more harm than good. We make some suggestions as to how they can be improved but consider that we should be properly funded for managing these risks.

To improve the outcomes for customers we ask Ofwat to look again at five areas. To ensure the FD is financeable Ofwat should:

1. **Deal with 'shocks' as they arise: Amend the true-up mechanisms to ensure the notional company is financeable and funded for the efficient costs.** The DD contains a range of 'true-up' mechanisms (e.g., for business rates, power costs and 'gated' investment).These mechanisms collectively create financeability constraints on the notional company causing it to drop a rating. We do not understand why these mechanisms are needed as the costs in their targeted areas are known with a high degree of certainty. In NWL's case the end-of period adjustments will increase bills by as much as c.10%- we do not think this is in customers' interests and it does not meet the financing duty. Our plan is affordable with the affordability score actually increasing since October, but if Ofwat is concerned about the presentational picture on bills then it could introduce a targeted reopener for these costs in-period when they arise. We further note that a reopener is likely to be needed anyway, to capture the additional investments driven by the new compliance standards established through Ofwat's enforcement notice.

2. **A fair bet: Adjust the package so that good performers have a fair chance of delivering it and earning our base return.** Setting the overall balance of the package is challenging, it must be stretching to drive improvements for customers but also deliverable or shareholders will face losses that will quickly make it less attractive for investment. This is why Ofwat's primary duties reflect the need to balance

customer protection with financeability. Looking at the last five years no company is meeting the current settlement, and this has damaged trust in the regime and undermined investor confidence. Our view is that the DD would deliver a similar or worse set of outcomes than PR19. We make some targeted suggestions in our response to remove asymmetry on both costs and incentives but what matters is that the material downside bias in the package is removed for the notional company.

3. **Match the PR19 CMA precedent: The allowed nominal equity 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) at PR19. The need to address this is reinforced by the huge new equity requirement and the clear increase in risk, which is visible in the market.

To ensure the FD supports the resilience of the sector Ofwat should:

4. **Focus on Asset Health: Revisit our asset health investment case to include appropriate funding and consider an alternative central adjustment.** We appreciate Ofwat's intervention for targeted mains renewal investments- recognising that this is a shift from its historical policy position 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. 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 that this approach is flawed and the conclusions from it incorrect. 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. The DD proposals will make the asset health problem worse because they may constrain scarce capital maintenance investment to be made into specific types of mains renewal, to satisfy a PCD, and therefore away from other asset groups that we believe are likely to be more critical. The current regulatory framework is not working well here, but there is also an information gap in terms of a consistent analytical quantification of risks across every asset cohort: We intend that the work we are doing ourselves, and with others, can provide a future blueprint, but it is important we establish momentum now on managing asset risk during PR24, hence our business plan proposals.

5. **Evidence for Climate Change: Ofwat needs to reassess our climate change resilience case and either provide adequate funding to manage future extreme weather events or establish reasonable exclusions.** We have added more information to support our case in response to the DD feedback. However, we disagree with Ofwat's central approach, which funds companies based on the volume of climate resilience requests rather than the evidence provided. We believe that Ofwat's framework and past policy will have discouraged companies from proposing resilience investments, in particular due to a fear of these being interpreted as inefficiency, and that the 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. 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 we would prefer resilience to be 'built in.'

We hope this letter is helpful and look forward to discussing these points with you on the 9th of September.

Yours sincerely,

Heidi Mottram

Heidi Mottram, CEO Northumbrian Water