SOUTH WEST WATER

Peninsula House, Rydon Lane, Exeter, Devon, England EX2 7HR . Tel: 01392 446688 . Fax 01392 434966 . southwestwater.co.uk

Resilience Consultation
Ofwat
City Centre Tower
7 Hill Street
Birmingham
B5 4UA

28 August 2015

Direct line: 01392 443260
Email: ivosper@southwestwater.co.uk

Dear Sir

RELIABLE SERVICES FOR CUSTOMERS – CONSULTATION ON OFWAT'S ROLE ON RESILIENCE

Attached with this letter is our response to the Ofwat consultation on resilience. We set our thoughts on how the resilience duty could be applied and provide a response to the specific consultation questions in an appendix.

If you have any questions on our response, please do not hesitate to contact me.

Yours faithfully

Iain Vosper
Regulatory Director

RELIABLE SERVICES FOR CUSTOMERS – CONSULTATION ON OFWAT'S ROLE ON RESILIENCE

We set out in our response to this consultation what we think resilience means for the water industry and areas where we feel Ofwat can support.

WHAT DO WE MEAN BY RESILIENCE?

In our view resilience for the water industry is the ability to successfully respond to events, pressures and challenges, whether these are financial, service or environmental and regardless of whether the impact is short or long term. We think this is the intention of the Ofwat definition, but we note in our response to the specific consultation question that there is an existing industry definition that we prefer.

In general we do not think that the resilience duty should on its own require any specific changes to the regulatory framework per se. Resilience for the industry means that the consumer, investor and stakeholder long term interests are being protected. In our opinion there are three key factors – the ways of working as to how decisions are reached and services delivered that form part of resilience:

- protecting customer, stakeholder and investor interests through industry standards and frameworks ("we know what's best") as either regulators or companies is not sufficient – the confidence of these parties in the industry framework at both a local and national level is part of resilience
- resilience is multi-faceted and relies on an understanding of others as well as the water industry and its regulatory framework
- dealing with uncertainty and the timeframe over which it is managed as risks and opportunities emerge is part of resilience.

One key question that we have considered is why resilience and not sustainability. When this new duty on Ofwat was being considered by Government there were many calls, particularly from those concerned with protecting the natural environment, for a sustainability duty to be introduced.

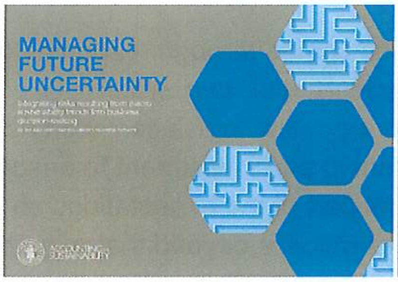
For us this reflects a matter of focus for Ofwat. It is a matter for Government policy and companies to engage with their stakeholders on the sustainability of water and sewerage services. This is largely a matter of timeframe and on many occasions no distinction should exist. However, it is possible for resilience to be achieved by the industry in a way that may not be considered, by others, to be sustainable. As an example we may as an industry at some point use chemicals that will at some point no longer be available, recognising the risk and being resilient in our planning of future replacement and maintenance of those assets.

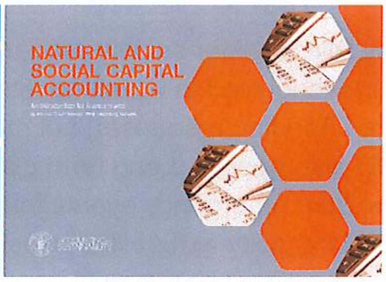
The difference for us between sustainability and resilience is that, particularly in terms of Ofwat's duties:

- resilience requires choices to be made over time, and we therefore in assessing it accept economic trade-offs between impacts on services and the environment
- resilience requires an understanding and measurement of risk, in order to make more resilient decisions

- resilience needs a specific context (water industry responsibilities, even where these are extended to sectors in other impacts), rather than reflecting wider sustainability risks.

It is important to recognise that the issues of how companies can make better longer term decisions that balance wider resilience considerations with customer and investor needs is not limited to the water industry. For instance the Prince of Wales Accounting for Sustainability CFO Leadership Network has recently published a series of guides on improving decision making for future risks which consider that many of the same issues facing the water industry are shared by other sectors. Case studies in these guides from SWW and a number of other water companies suggests that the changes associated with the PR14 regulatory framework were necessary for the long term sustainability of the industry, as foreseen in the policy framework developed after PR09. Further guidance specific to the sector may be less necessary from Ofwat than in the past, given the increasing amount of focus in the wider business community on these issues, including the supporting tools and concepts such as cost benefit analysis and natural and social capital accounting.





FEATURES OF RESILIENCE

As we identify above, we think resilience considerations have to be inherent in the industry regulatory framework. They should be inherent in company risk and opportunity management processes, and to a large extent both at a price review and in on-going industry monitoring Ofwat's focus on company Board governance and self-assurance processes is likely to provide the main way in which Ofwat can further the resilience duty.

We think in practice resilience has to be embedded in a regulatory framework, but this is generally something for companies to define. Resilience benefits from local interpretation, particularly where it is supported by strong customer engagement. We think this is a common theme of the case studies shown in the consultation – effective communication and engagement, collaboration with other stakeholders and responsible organisations and high quality business decisions.

The key generic complex challenges facing the water industry in resilience are:

- the local and geographic nature of economic, social and environmental factors, in the context of a national policy framework and wider supply chain

- exposure to long term and uncertain global sustainability factors, including climate change, water scarcity, resilience, biodiversity impacts of change in land use etc

- increasing consumer and stakeholder expectations and reduced tolerance of failure, particularly where responsibilities are not clear and easily understood.

These factors are not specific to the water industry and similar (if not harder) challenges are faced by other public services – the water industry having benefitted from the willingness of investors to finance improvements, supported by a stable and well regarded economic regulation regime and a track record of the industry in delivering outcomes in recent years.

However, the water industry has to recognise the wider public value and resilience that is delivered by its activities and the complex nature of relationships with customers and stakeholders that affect the efficiency and effectiveness of delivery. This is an area of economic and social research which is aligned with Ofwat's vision for the sector of strong relationships between companies and stakeholders, that relies on transparency of the options for delivery that are available for allocative and dynamic efficiencies to be fully understood. Outcome incentives at PR14 provide one development in the regulatory framework in this direction, with a key question as to how this now develops for future regulatory and market reforms. The water industry has a number of examples of how allocative, dynamic efficiencies and better societal outcomes can be delivered with this framework (e.g. upstream catchment management, delivering social tariffs with CABxs, recreation access, skills development etc), which can also be considered to improve water industry as well as wider societal and environmental resilience.

An example of the water company role to wider society resilience comes through response to emergency events. Some of this is recognised in water industry legislation (e.g. water infrastructure supporting major fire / flooding response), but more general legislation such as the Civil Contingencies Act and SEMD also applies. Long term planning and investment to ensure that local areas can effectively recover from emergency events forms part of the expectations on water companies (including capability and capacity across the industry which is beyond that required for normal situations) and aligns with Ofwat's resilience duty.

We think there are a number of features of resilience for the future of the industry that should be noted:

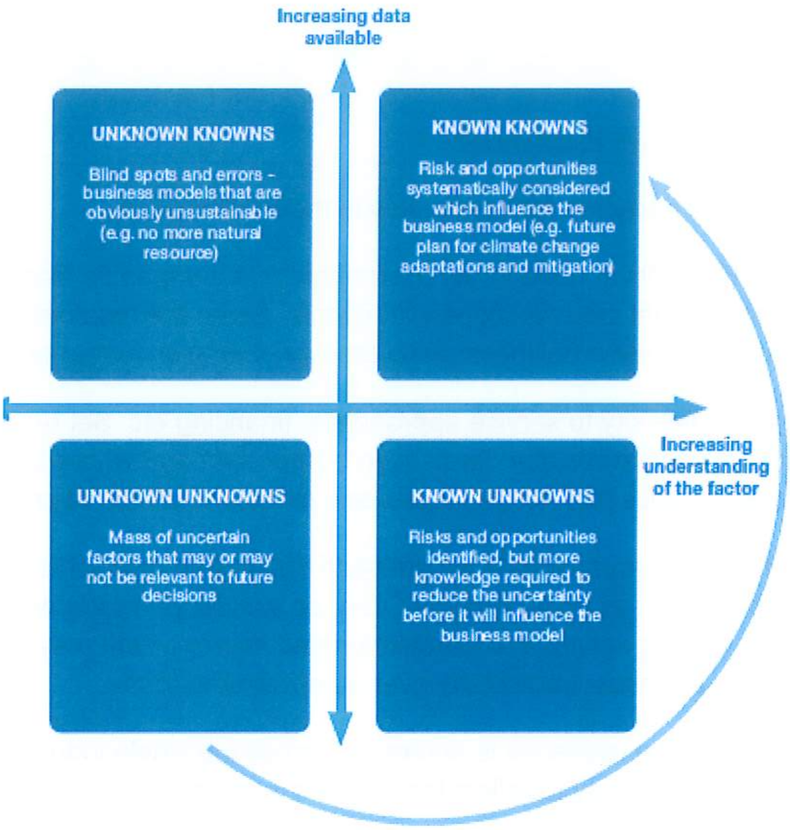
- resilience benefits from consideration of a whole business plan and not just through setting standards for individual elements. This can be seen from the suite of SWW proposals at PR14 that form part of a resilient plan (innovations such as North Plymouth WTW, upstream and downstream thinking programmes, skills development and apprentice programmes, retaining an efficient equity financed base, below RPI price promises informed by consultation on the timing of future investment, Outcome Delivery Incentives for this period and those indicated for the future and the WaterShare transparency over wider performance of the business)

- markets have a role to play in resilience. The design in itself can help to build trust and confidence in resilience even where a market could carry a risk of failure to make the socially or environmentally optimal solution. Examples include the role for social enterprises to act as a broker for supporting the allocation of resources (such as the role of rivers and wildlife trusts with upstream thinking)

- shared scenarios for the future play an important part of horizon scanning for resilience concerns. It is important that the vision for the industry has such common reference points when discussing resilient design

- trust and confidence in industry resilience ultimately requires knowledge. There is a case for pilot schemes and early investment in areas that help to convert "unknown unknown" risks to resilience into "known knowns" – understanding of the issue.

INCREASING DATA AND UNDERSTANDING OF MACRO SUSTAINABILTY TRENDS



Source: Accounting for Sustainability CFO Leadership Network (2014): Managing Future Uncertainty – Integrating risks resulting from macro sustainability trends into business decision making

In our view the best way for companies to increase their knowledge of resilience and sustainability risk is through collaborating with delivery partners, including the supply chain, in order to increase knowledge and understanding and to make better decisions.

There are a number of challenges we see to addressing resilience in the industry:

- there is a challenge as to whether a national driven framework is needed or that resilience should be considered locally

- market developments provide opportunities to further resilience (e.g. systems operator, water trading etc), but also may carry risks. The response to these challenges is to identify where barriers to resilience exist, particularly through other forms of regulation (sludge market barriers, abstraction trading, merger rules). This already forms part of Ofwat's strategy and forward programme

- where resilience requires changes that may be uncomfortable for some (e.g. mergers and changes to industry structure), it is important to communicate the benefits
- the water industry delivering wider benefits to other sectors (e.g. flood defence) has resilience benefits, but should not necessarily provider of first or last resort (e.g. WFD obligations). There is a role for Ofwat to ensure that there is balance in what the sector is expected to deliver.

What should Ofwat do on resilience?

We think Ofwat could apply the resilience duty in the following way:

- build on PR14. Ofwat need to get assurance from companies that they are managing long-term risks and that they can cope with events. Given the timeframe for the industry, company price review business plans (built on their own longer term plans) will work best.
- accept local diversity to service approaches, financing etc. Set out some high level scenarios in what areas standardisation is important and where local plans should not diverge. Recognise that not all targets and measures will be appropriate in all areas.
- be careful with comparisons – we question the degree to which some regulatory approaches (such as upper quartile ODIs, as a wider principle) will help to support resilience. Driving service standardisation and improvement may not support wider resilience in all cases, particularly over a narrow time frame.
- understand where resilience is enhanced across the whole industry from one approach against where diversity to reflect local issues is better*
- consider risk from an investor perspective – a key aspect of industry resilience is access to a diverse number of financing models
- use a consistent set of scenarios on sustainability and resilience risks to test the Water 2020 framework.
- open and transparent decision making during the price review will be essential to ensure that ownership of resilience issues remains with the water companies. Resilience issues will (depending on the delivery route) by their very nature be enhancements and are likely to be assessed on a case by case basis. Given the diversity of resilience approaches for the industry and the lack of a single set of resilience cost drivers, it is unlikely that either econometric or unit cost models will provide sufficient scrutiny, particularly as some resilience projects will span price control periods. Ofwat has a clear duty to challenge the need, economy and efficiency of such proposals, but care will need to be given within the design and methodology framework for the next price review to ensure that the ownership of resilience issues is not transferred from the companies to Ofwat during this essential challenge process. Delivery of the resilience duty and associated projects should inherently be part of the company business planning process rather than a bid by the company to secure funding for resilience which is then either rejected or approved by Ofwat.

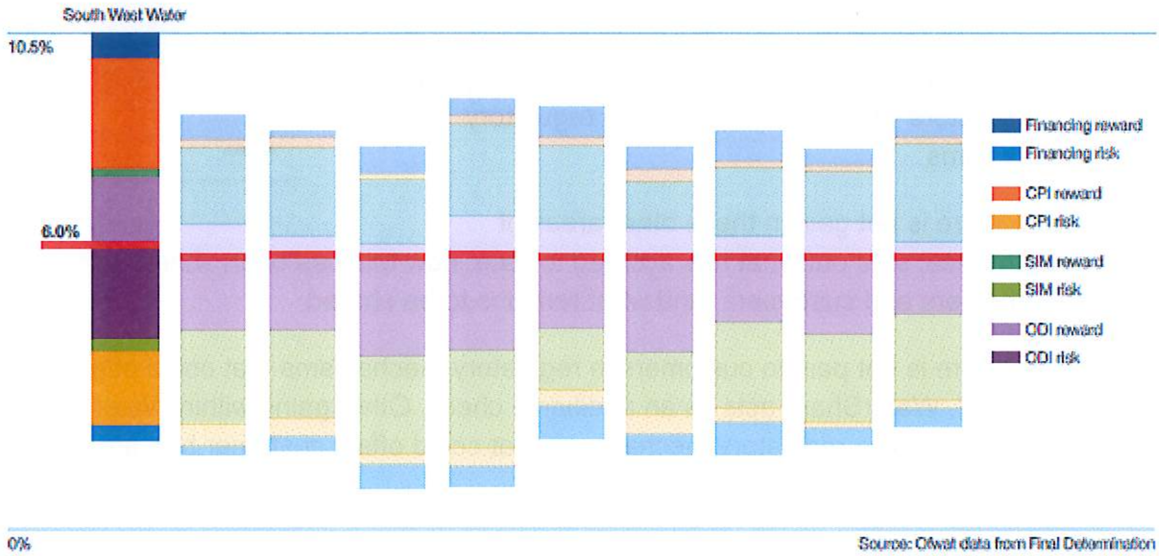
- the governance and decision making processes Ofwat and will face during any future price review should consider the transparency of the trade-offs between the new resilience duty and the other duties, these will always need to be balance carefully and will inevitably lead to difficult choices. Ofwat should consider both the framework by which these tradeoffs and balances will be considered and the extent to which any such framework is transparently communicated to stakeholders, and how the decisions applied using this framework are transparently communicated during the price review process.

* p.19 of the consultation says *"We will not be setting sector-wide targets. We will not set standards, which would turn resilience into a 'compliance' issue, and could let service providers off their responsibility to go further where that was the right thing to do".*

MONITORING RESILIENCE

We think Ofwat monitoring of resilience should consider company performance in the round – including outcomes, expenditure and ODIs within a RORE framework. We will respond to the specific proposals in other consultations, such as the proposed financial monitoring framework. It is for companies to consider how they can demonstrate that they are making long term decisions, and ODIs in areas such as serviceability and resilience flood risk can help to achieve this.

The SWW Board monitor cost and the performance incentive targets. This is considered through the return on equity, as external impacts of performance (e.g. pollution incidents) have been taken into account in the incentive framework, with the value of the incentive reflecting the social and environmental factors considered by customers in their willingness to pay surveys, and other social and environmental valuation data sources.



The impact of this approach stretches beyond the price review to delivery. Monitoring this return on equity at Board level, along with the outcomes that drives it allows for a balance with traditional Board reporting on cost performance and financing performance, as well as customer satisfaction and complaints measures that also traditionally are used in balanced reporting. There are two key differences to the past now embedded in the SWW approach:

- social and environmental factors, with targets that take into account the sustainability trends within them have enhanced status, alongside financial consequences within Board reporting
- the return on equity measure is consistent with a short term (one month or current year), medium term (2 to 3 years) or long term perspective (the five years of the price control period or 25 years of the strategic plan for the company for its stakeholders).

SWW has recognised the importance of engaging with customers and stakeholders on performance and how wider factors affecting company performance should be shared between prices, service levels (including to the environment) and investors. Through the WaterShare framework, the company has committed to transparent reporting on performance against commitments with scrutiny from an independent representative panel, and where there are gains, discussing how these should be fairly shared.

The WaterShare framework is a key part of SWW's proposals for 2015-20. We are implementing a framework that allows for sharing the benefits of excellent performance and other beneficial factors in a timely manner with customers. The proposal was inherent to the plan and works alongside the wider industry regulatory framework, with the overarching message being that **this mechanism protects customers and is one from which customers can only gain**.

Specifically the WaterShare framework:

- monitors cost and outcome incentive performance from regulatory mechanisms
- considers other performance areas of risk and opportunity ("other factors") that are not subject to regulatory mechanisms
- where there is net gain in these other areas of performance, sets out what has accrued to date, how this has been shared between shareholders and customers, and what remains to be shared
- where there is net pain to customers in regulatory mechanisms that could affect their bills "in-period", WaterShare acts as an additional check. Other gains within WaterShare are considered before regulatory mechanisms that could offset customer bills are applied
- where customers are due net gain through lower bills from regulatory mechanisms "in-period", WaterShare does not apply and customer bills will benefit.

We think this approach is a way that Ofwat can consider in how resilience (in terms of company performance) is monitored. The ongoing discussion on whether bill levels or reinvestment (and what sort of investment) is considered provides a measure of resilience – linking industry delivery to what the next priority in long term planning is as opportunities arise.

Ofwat need to consider what industry level monitoring can be put in place in order to show resilience. As well as financial monitoring, we think the following approach could be considered. This would allow companies to own the explanation of the context of their performance, which helps with resilience as this allows them to set out how they are performing against their own targets, the financial consequences of this and their resilience compared to the performance of other companies. We think this allows diversity of approach to be maintained in a way that standardising reporting so more exact comparisons can be achieved.

Rather the focus on reporting being where upper quartile outcome comparisons have been used , the move from an outputs framework to an outcomes approach provides more the opportunity for new forms of comparisons between companies than has been seen previously. For instance, whilst sewer flooding performance has been reported (e.g. in terms of the number of floodings, or properties at risk), the raw numbers themselves did not provide much information on overall progress of the industry or individual companies, as company plans had to flex to reflect local priorities and conditions. Where there is a common measure used to normalise company performance this can be highlighted (e.g. drinking water quality), but in other situations such as leakage there is no single right way to do this (per km main or per customer or % of distribution input?) – all measures have their place and the relevance depends on local circumstances.

We would suggest that the industry performance scorecard can track company performance against their own plans (which can include the upper quartile ODIs). The ODI reward and penalty value can also be also included in this framework, highlighting where companies do not have a reward or penalty. In the context of RORE we think this provides a rounded picture of resilience, together with the company explanation of how they are approaching the topic. The company comments could include links to their own case studies and information, allowing them to contribute their examples in an open way.

The framework may ultimately look like:

Sewer flooding	Company A	Company B	Company C	Company D
Performance against plan commitment	+1	0	-30	+20
Financial consequence	0	0	+£0.9m	N/A
Industry Quartile	1	4	2	3
Company comment (with link to case studies and further information)	Small weather impact in year so no financial consequence	Improved performance in line with plan (i.e. lower quartile performance in line with customer preferences in this period)	Performance reward is recovered end of period	Pilot schemes in this period to understand performance so outcome incentive can be introduced in 2020

Companies would link this framework into their annual reporting – e.g. linking in their comments to the risk management statements they include in their annual report. Generic reporting at an industry level is, unfortunately, unlikely to provide a meaningful story about the resilience of the industry.

It should be sufficient to test and engage on industry resilience as part of the price review process. We would suggest common scenarios of external resilience factors can be used to test plans. This would be an extension of the PWC financial metrics produced at PR14 to "PESTLE" external factors. This would allow an assessment of the degree of knowledge and information on future risks and uncertainties – what is known and unknown.

APPENDIX

Q1 Is our basic understanding of resilience aligned with your own – are we addressing the right things in the right way?

Yes, but the definition is mixing causes of resilience issues with the consequences. In our view a better definition is:

"Resilience is the ability of the water and sewerage system or elements of that system to withstand or to recover from uncertain and exceptional events, such as an extreme flood, such that acceptable service levels are maintained and/or restored quickly now and in the future"

The current definition:

"Resilience is the ability to cope with, and recover from, disruption, trends and variability in order to maintain services for people and protect the natural environment, now and in the future."

This has issues as issues in terms measuring success as a) it is not related to service levels b) protection of the natural environment is unbounded and c) you don't recover from trends, rather they affect the system recovery and response.

Q2 Do you agree with our view of what Ofwat should deliver, including where we might step in, and what is for others to deliver?

Yes. We think an assurance framework that is risk based and company defined provides the indication of where companies have ceased to manage resilience and Ofwat intervention may be justified.

Q3 What views do you have on how the water and wastewater sector might measure its performance in delivering resilient services – and the best way for us to demonstrate that we are carrying out our role?

We set out in our main response there are three aspects to companies demonstrating resilience that Ofwat can utilise:

- Scenarios - company identification of risks and stress test performance (through the business plan), supported by industry scenarios in developing this and translation for local engagement.
- Transparency - detailed understanding of key risks (updated for changes in direction and indicators in annual reports)
- Risk based review - of company plans where indications are that resilience is not being managed. This may be because of events, or an absence of information about the emerging risk. This will emerge out of industry scenarios, examples of company responses in reporting on their performance and transparency over the causes of good and bad performance, and most importantly how financial and service performance today links to future investment plans.

If there are step changes in investment to meet emerging resilience risks, the question Ofwat and stakeholders have to ask is that, if this is new information, why wasn't it known before. The step change may be justified because of new information (an option has been triggered by events), so transparency of this context is the key to assessing whether it is justified, or companies are potentially being too risk averse in the absence of sufficient information on the uncertainty.