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10th February 2016

Dear Cathryn,

Thank you for the opportunity to respond to your consultation on Water 2020.

We welcome the early insights on Ofwat's intentions for the PR19 price control and the range and depth of issues raised.

The Water Act 2014 creates new opportunities for upstream competition. Within that policy context, we agree with the main proposal that a separate price control is the best means of identifying the relevant costs and benefits that can be realised for customers. We look forward to working with you and the sector to develop the most appropriate mechanisms to ensure upstream markets function effectively and efficiently and that customers as well as entrant and existing companies are treated fairly in the access pricing regime that will need to be established.

In other respects, we appreciate the guidance on the suggested role of customer engagement and customer challenge groups, and we will work to ensure that the relevant processes are implemented effectively to support the development of PR19 business plans. We agree that our day to day engagement with customers provides a great amount of information that we can take forwards into our business plans, and you will note that we are looking to use a range of options to take a more sophisticated account of customer preferences going forward.

We note concerns raised elsewhere in the industry and investment communities on the movement from RPI to CPI. We agree with your assessment that, particularly in relation to revenues and bills, RPI has lost some legitimacy with customers due to the government's usage of CPI as its primary indicator, and the findings of the ONS on the ongoing validity of RPI. We will support Ofwat in its intention to provide a smooth transition to CPI, whilst recognising the potential issues that may arise until a CPI-linked debt market is in active operation.

We set out our views on the specific consultation questions below.

I look forward to meeting with you soon to discuss our views on the consultation in further detail.

Yours Sincerely,

Luis García
Chief Executive

Sludge Market

Q1-Q6

At present Bristol Water has no plans to enter the sludge market and therefore we have not responded to these questions.

Water Resources Market

Q7 Do you agree with our proposal to have a separate binding price control for water resources?

With the scope for upstream competition enabled by the Water Act 2014, we consider that a separate price control is an appropriate way forwards and it is a logical step towards market transition. We consider that effective implementation will provide real benefits to retail customers in the long-term.

We support Ofwat in its introduction of the separated price control. The design of the price control may need to be adjusted for the outcome of abstraction reform and work with Open Water, the Government and the Environment Agency (EA) to ensure that market arrangements are effective both economically and environmentally. In particular we look forward to contributing to discussions how Ofwat intends to set a water resources price cap for the period up to market opening, similar to the approach taken for the non-household retail market.

In the longer term, additional price controls may no longer be required as effectively competitive markets emerge. In order to achieve the full benefits of competition, including dynamic efficiencies brought about by innovation, it will be important for Ofwat to facilitate commercial initiatives while avoiding over-prescriptive ex-ante regulation. For example, a positive step would be to establish objective and tangible criteria when Ofwat would remove price controls due to effective competition being in place. This could operate in a similar manner to the Energy Distribution Network Operator regime for connections, where the obligation is on companies to demonstrate that regulations are no longer required.

Within the context of achieving market-based outcomes, we would expect an sufficiently flexible approach to price controls that will take into account the critical issues associated with the management and operational requirements associated with a water resources business. While detailed criteria are beyond the scope of this initial response, the factors we would expect Ofwat to take into account would include:

- Changing legal monitoring and maintenance requirements
- The impact of abstraction reform and third party operational charges
- Changing sustainability and environmental issues, including necessary compliance with EU and UK water quality regulations.

- Due consideration of the mix of the types of resources and asset lives
- Margins sufficient to attract investment and offset risks

Bristol Water would be delighted to discuss these issues with Ofwat in greater detail as part of the development of proposals for the separated Water Resources price control.

Q8 Do you agree with our proposal to implement an offset mechanism to ensure that entrants can recover the cost of new resources appropriately, while also ensuring that prices reflect average costs?

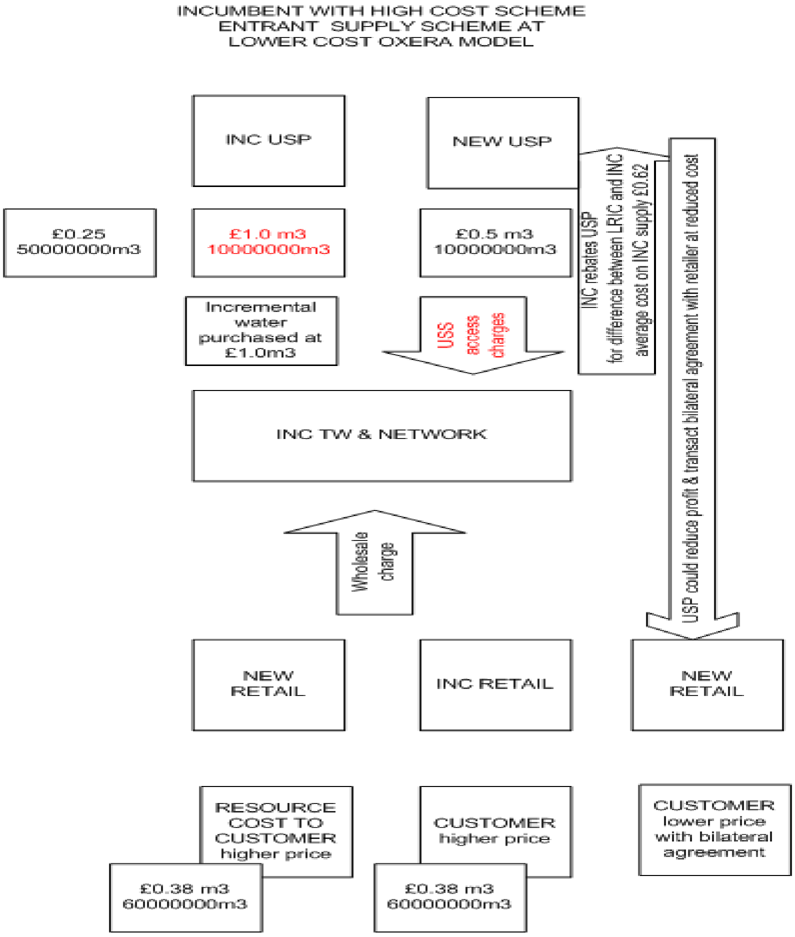
We believe competitive market reforms should from the outset demonstrate retail customer benefits otherwise the process will lose credibility. Relevant benefits to customers to be considered could include short-term benefits such as lower bills and longer-term benefits such as improved resilience and security of supply.

We support the concept of an offset mechanism, but we consider that significant further work is required to establish the detail of how it will operate. We would be happy to contribute to further industry thinking and working groups in this respect.

We recognise that the price paid by customers for implementing new resources should reflect the average costs associated with supply of those water resources. It is important to ensure that that the offsetting mechanism is not simply a mechanism to facilitate retail customers subsidizing new entrants. On that basis wee consider that it would be optimum for new entrants to have bid to supply at a level that provides an economic return without the need for further incentive. The design of the mechanism should also take into account inter-generational aspect of subsidies, as any short-term approach may need to be wound out in the longer-term as one moves into a period of cost-reflective prices.

There is no evidence that additional incentives to stimulate the market are needed. If an evidentially-based case for further incentives were made as means of stimulating new entry, we consider that it would need demonstrate an immediate benefit to retail customers, rather than delaying these benefits to the AMP period following the introduction of a new resource. The offsetting mechanism may be acceptable to charge payers if at least half of the incentive proposed for new entrants remained with customers. The intended period that customers would be liable for offsetting payments is not clear from the consultation.

Our understanding of the offset mechanism is set out below for the case where a new upstream entrant bids a scheme that has a lower LRIC than the incumbent. In this model a new upstream provider will supply water at a notional cost of our next resource (even though their cost may be substantially lower). In the regulatory regime, they would pay the general access charge but receive a rebate on the access charge equivalent to the difference between the old average cost and the new LRIC.



The proposed offset mechanism to stimulate new entry is likely to generate an inbuilt bias towards smaller resource development or short-life resources. The lower cost schemes will tend to displace larger schemes that could potentially be more beneficial in the long term (from economies of scale). This is likely to create an incentive to favour opex schemes over longer term capex investments. It is therefore likely that a patchwork of less reliable and less resilient smaller sources would be generated over time. This could adversely impact the security of supply to customers, so it is important to consider the true economic cost and customer benefits inherent in the proposed solution.

While there is an increasing use of long run incremental cost models in setting interconnection prices in regulated industries there a number of ways in which it can be achieved and it is important that the appropriate cost model is identified for water sector. The LRIC has not been defined by Ofwat at the present time and the AIC is proposed as a temporary measure. We consider that two important aspects need to be consider in this respect. First in terms of ensuring the nature of financing within the water sector and the second is in relation how to take into account environmental and social impacts. With regard to financing Ofwat will recognise that the primary reason for the implementation of price regulation based on the use of LRIC is to foster efficient entry, adequate investments and innovation. In practice within the water sector, companies will in reality in better position to compete who can source efficient financing based on how they are rated in terms of their risk profile. This profile is likely to be different therefore say to a entrant in the telecoms sector and therefore any cost model would have to take that into account.

In this regard, we suggest that Ofwat should give further consideration to the use of capacity markets. For example in the energy there is the electricity Capacity Market mechanism. Under Project Discovery, Ofgem identified an emerging security of supply issue brought about by the increasing deployment of renewable generation technology, the output of which is unpredictable. As a consequence, there was a need to build flexible plant to provide power when required. Investors need confidence that the plant would be adequately remunerated on the few occasions when the plant was required. Ofgem discovered that investors were unwilling to finance plant on this basis as the returns were too difficult to predict. The capacity market was established to address this problem.

If the issues around the mechanism can be ironed out, it could provide guaranteed additional revenue for the provision of generation capability to produce power (capacity), rather than per unit of output. This guaranteed revenue is intended to remunerate risk-averse investors.

Bristol Water consider the parallels with water resources market reform are clear. With the risk that Ofwat's proposals bring forward myriad, unpredictable small sources of water, would investors have confidence that an investment in a large asset, with a long life would be "in the money"? Would they require some form of guaranteed income to make the asset financeable.

In relation to environmental and social impacts, we do not consider that the the AIC fully takes these into account when considering new sources of supply. We consider that issues such as the environmental impact and sustainability of the new source, security of supply and issues of water scarcity cannot be discounted or ignored.

New water resources are usually evaluated on the basis of full cost and benefits to society of the AISC methodology. An entrant may have a different view on the environmental and social environmental costs, which may or may not reflect the preferences of their customers, for example, which in the first instance is likely to include one or more large non-household customers, whose valuation of security of supply and environmental impacts may differ from that of domestic customers. In order to be consistent and fair, we consider that new entrants should be required to submit their bids on the same basis and using the same information.to allow scheme evaluation to properly take into account all externalities associated with provision of new resources.

Q9 Do you agree with our proposals to create a market information database and bid assessment framework to allow for the ‘bidding in’ of third party resource options on an ongoing basis – as set out in the Deloitte report?

We agree that a market information database would facilitate the ‘bidding in’ process for new water resources. However, it is unclear as to the type of data that will be held and how bids would be assessed (other than basic, but undefined LRIC data). We would expect to see additional supporting controls and information to take account of the multiple benefits of water resources management to society, such as:

- Definition of supply security and yield profile
- Drinking Water Quality
- Environmental cost benefit
- Regulatory, resilience and sustainability risks
- Guarantees of confidentiality

There should be clearly defined requirements for relevant information, identical for both incumbents and new entrants.

Consideration should also be given to how entrants will assess location and network logistics issues. Companies would need to show that they are not leveraging dominance if they ask for network reinforcement or object to specific water resources schemes on the grounds of logistical constraints.

Q10 Do you agree that a third party organisation may be best placed to manage the information database?

Yes. To engender confidence in a competitive market, the information database should be managed by a third party organisation. This entity must be perceived as independent of both water company and regulatory influences.

The third party organization should also be technically capable of assessing the quality of new entrant resource bids and ensuring they meet the usual regulatory requirements of current water resource planning guidelines.

Q11 a) Do you agree that measures should be introduced to increase transparency and certainty around security of supply for water trading?
Yes

b) How can this objective best be achieved?

Some of these issues could be addressed by guidelines to address the following:

- Delivery guarantees and penalty terms (taking into account potential drought and abstraction restriction scenarios)
- Defined yield assessment methodology
- Resilience assessment methodology
- Strategic environmental assessment and sustainability assessments
- Entrants to publish resources based WRMP and demonstrate compatibility with relevant drought contingency plan
- Strategic risk assessment methodology

RCV Allocation

Q12 Do you agree with our rationale for allocating the RCV?

We agree that RCV should be allocated to provide transparency and consistency. We agree that an unfocussed approach is preferable for water resources. We have concerns as to the implications when the market is fully operational that there could be 'stranded assets', as an element of the protected RCV will be in water resources. As Ofwat will be aware infrastructure investments made in our sector are extremely long-term typically covering periods of 25-30years. Within the context of market reform there is scope for more efficient entry using innovative techniques which could lead to the stranding of assets built under entirely different assumptions.

Q13 Do you agree with our proposed approach for allocating the RCV for sludge?

Bristol does not currently have views on the issue consistent with our reply to Q1-6 above.

Q14 Do you agree with our proposed approach for allocating the RCV for water resources?

Using the unfocused approach enables a reasonable allocation to be made using published data. It reflects the company's investment in different parts of the value chain. Being a company with a high percentage of MEAV in water resources in comparison to other companies, the full consequence of this allocation needs to be clear to be able to comment fully. It is important that the appropriate level of detail is established in order to ensure the right outcome is achieved for customers.

RCV Protection

Q15 Do you agree with our proposal to address stranded asset risks by extending our commitment to protect efficient investment included in the RCV to 31 March 2020?

We agree with this proposal as it aligns with the assumptions under which investment was envisaged to be treated in PR14 and will have therefore been made by companies during this period. Given that the risk of stranded assets is likely to be a key concern for investors, we believe it would be helpful for the assumptions supporting this approach to be set out.

Q16 Do you agree with our assessment that there is no prospect for stranded assets due to the proposed form of control for sludge and water resources for the 2020-25 period?

We welcome Ofwat's intention to avoid the risk of stranded assets, but it is unclear from the detail provided so far how this can be confirmed. Our initial assessment is that there could be stranded assets, but this will be a risk that the company will be aware of before making the investment. The company should decide whether it is an acceptable risk to proceed with the scheme or not. It may have no alternative, and have to take the risk regardless of it being acceptable.

Q17 a) Do you agree with our proposed approach of an income guarantee recovered through the network plus control for protection against the risk of stranding, if a mechanism is required?

b) How do you consider that such a mechanism could be designed to provide a simple, transparent, largely ex ante mechanism that preserves incentives for efficiency?

This would be an acceptable mechanism, although it does produce an unfair weighting on the network plus element of the value chain in the next AMP, and present potential inter-generational issues. An alternative would be for the guarantee to be added to the return on the protected RCV in the water resource control while it exists, thereby recompensing the investment. This would also provide a clear signal for the intention towards other investments.

It would be helpful to fully establish the definition of asset stranding to be applied, to avoid the risk of misinterpretation, and ensure incentives are correctly aligned.

Access Pricing

Q18 In relation to water resources, do you agree with our proposals to implement an approach based on the average cost of providing 'network plus' activities?

In relation to access pricing we consider that an approach that reflects the financing of both existing providers and entrants a like need to be taken into account and that environmental and social obligations into be taken into account also. Therefore an average cost of network plus activities would be consistent with such an approach.

Q19 a) In relation to access prices for water resources, do you agree with our proposal that companies should be responsible for calculating and publishing these?

We agree companies should be responsible for calculating and publishing these, as they hold the necessary data.

b) Do you agree they should be published by water resource zone, with network distribution and treatment costs separately identified?

We agree distribution and treatment costs should be separately identified, and water resource zones where applicable. This would produce access prices which are more representative of the underlying costs. However, we have one water resource zone, as water is transferable across the company's area, but the relevant costs of treatment and distribution vary significantly due to the nature of the different resources and geographical characteristics of the supply area. It may be more cost reflective if these differences within water resources zones could be reflected within calculations of access prices.

Q20 In relation to water resources, do you agree with our proposals to implement a mechanism that offsets the difference between the LRIC (or potentially the AIC in the absence of LRIC data) of new resource and the prevailing average cost of resource?

The offsetting mechanism or compensation payment does provide an incentive for entry. (We have commented on this more fully in our response to question 8.) We reiterate that the mechanism will require careful definition. We agree that in the absence of LRIC data then AIC would be the most appropriate cost to offset against.

It is not clear how long this payment would continue, and that would be a critical factor for the entrant in evaluating the arrangement. Would it be for the life of the new supply? What happens when there is a change in the LRIC, does the price paid to the new entrant mirror the change, or is it fixed at the time of entry. Likewise when there is a change in the average cost, does the compensation payment change? How aligned are these to AMP periods. The value of the LRIC will be very sensitive to the method of calculation of the LRIC and the period it covers, neither of which are defined.

Q21 Do you further agree that it is the incumbent's, rather than the entrant's LRIC, that should form the basis of the payment, to provide a stronger incentive for entry?

We agree that it should be on the basis of an incumbent's rather than an entrant's LRIC.

As indicated in our response to Q8. above, of pricing based on the use of LRIC is designed to foster efficient entry, adequate investments and innovation. In practice within the water sector, companies will in reality in better position to compete who can source efficient financing based on how they are rated in the context of the appetite for risk from water investors and therefore any cost model would have to take that into account which would depend on the type of entrant in the sector. This profile is likely to be different then say to companies competing in the telecoms sector.

Q22 In relation to sludge, do you agree that price and non-price terms should be the outcome of commercial negotiation, supported by the cost or price and capacity information previously set out?

Bristol Water does not currently have views on this issue consistent with our reply to Q1-6 above.

Q23 Do you support our proposals to develop high-level guidelines as to how rival offers in relation to sludge treatment, transport and disposal should be evaluated?

Bristol Water does not currently have any views on this issue consistent with our reply to Q1-6 above.

Direct Procurement

Q24 Do you agree with our proposals relating to the use of direct procurement on behalf of customers?

While direct procurement could have a number of benefits for customers, it is important to learn the lessons from other sectors. In particular Bristol Water would caution against any scheme that effectively place Ofwat as the procuring organisation, as opposed to a mechanism employed by the water companies themselves. In energy, the Offshore Transmission (OFTO) regime has been running for a number of years. Ofgem found this could only be made effective by providing offshore transmission operators with a guaranteed revenue for twenty years (with a single outcome incentive focused on maintaining the availability of the assets).

Although the OFTO regime has been applauded, aspects of the arrangements were criticised by the NAO in a report[1]. Some of the concerns were similar to the issues that arose from the PFI experience, including:

- the length of the procurement process with some projects taking three years to go through the procurement process; and
- the level of transaction costs, which the NAO estimated were between £7m and £8m for each transaction (ignoring Ofgem's own costs).

Moreover, Ofgem required a considerable department to run the Offshore regime with 30 and 40 people in this department.

Learning from the experience, Ofgem has been considering the scope to introduce competition for onshore transmission assets and are proposing that three criteria should apply to the selection of projects that will be tendered:

- the projects should relate to a new asset (a new line, a new cable or a new substation), or a complete replacement of existing assets; and
- it should be possible to clearly delineate the boundaries of the asset(s) in question; and
- the expected value of the project should exceed £100m or more.

In addition careful consideration should be given by any regulator including Ofwat to ensure that any process does not delay a critical investment

Q25 Do you have any views on our specific proposal to set a £100 million threshold above which point we would expect companies to procure at market on a standalone basis?

In addition to our concerns in reply to Q24 above, we are also unsure about the use of a monetary threshold related to the size of the project. We think that it may be desirable to have a degree of flexibility and to treat individual projects on their own merits. In particular, we are concerned that a firm threshold may create incentives for a company to invest in a series of small projects to avoid creating a large project that would be required to go to tender. If a threshold is to be applied, it may be preferable to base it on the bill impact rather than project cost, or to consider the type of scheme rather than the financial impact.

We believe that the incumbent should also be allowed to partake in the process, as there may be situations in which the incumbent is best placed to deliver part, or even all, of a project. We believe that the threshold should not be applied if the incumbent is able to show that they are better placed to deliver the project.

We believe that the process should be managed by a third party and think that Ofwat should consider taking this role as Ofgem have.

Form of controls

Q26 Do you agree that our proposal for four binding wholesale price controls should apply to

[1] https://www.nao.org.uk/wp-content/uploads/2012/06/121322.pdf

companies whose area is wholly or mainly in Wales, as well as to companies whose area is wholly or mainly in England?

We make no comment, as this question does not directly apply to Bristol Water.

Q27 Do you agree with our initial view that the network plus controls for water and wastewater and the water resources controls should be total revenue controls?

We agree that the water network plus and water resources controls should be total revenue controls. This is consistent with the approach applied to the wholesale control at PR14, and provides certainty of revenue to support investment decision making. We agree that retaining this approach for the water resources control is appropriate.

Q28 Do you agree that future investment in relation to sludge treatment, transport and disposal should be exposed to volume risk and, accordingly, what are your views regarding the appropriate form of control in this area?

We make no comment as this question does not currently apply to Bristol Water as a water-only company.

Q29 In your view, how should new investments be remunerated in the sludge and water resources controls from 2020?

We suggest remuneration should be compatible with the requirements of financial markets, to allow efficient financing by either incumbents or entrants.

Q30 How can we best ensure that long-term contracting arrangements are not dis-incentivised – and that any continued application of a return on RCV approach for incumbents is on a level playing field with third party providers?

We suggest that the approach should focus on reimbursement of costs and avoiding asset stranding.

Risk-based Review

Q31 Do you agree with our proposal to retain our RBR approach for PR19?

We agree that the Risk-Based Review provided a useful stage in the assessment of PR14 business plans, and that such an assessment should be retained for PR19.

We support the points noted in the consultation document regarding clarity of assessment criteria and weighting of different elements being set out in advance of the submission of business plans.

To the extent that wholesale costs form part of the RBR assessment, we believe it is important that the position in relation to the cost baseline fully reflects any special cost factors which may cause companies to be above or below the baseline. This will require companies to have greater visibility around the specification of the cost assessment models, in order to identify variables which may not be fully taken into account. We consider the establishment of the cost assessment working group to be a positive step in this regard, and look forward to further engagement in the development of wholesale cost models.

Q32 Do you agree with our proposal to reflect current performance in our RBR assessment (and for CCGs to consider this as part of their report?)

We agree that this should form part of the assessment, but would be concerned if it carried undue weight in comparison to the strengths and weaknesses of companies' plans. This is because performance against outcome performance commitments during AMP6 is already subject to financial and reputational incentives as set out in the PR14 determination. If performance against these measures also then impacts the award of "enhanced" status at PR19, this may create additional financial and reputational incentives that were not envisaged in the PR14 determination, altering the intended balance of risk and reward.

Q33 Do you agree that the RBR assessment should consider the extent to which the business plans are part of a longer term plan?

We agree that this is an appropriate assessment criterion. We would support the adoption of a longer-term perspective in the review of investment proposals and associated incentives and financing policies.

Assessing Cost Efficiency

Q34 Do you agree that the consideration of disaggregated cost models is appropriate given the price control structure proposed?

We welcome Ofwat's proposal to review the form of the benchmarking models and agree that it is appropriate to consider disaggregated cost models.

We support the use of alternative methodologies to act as a cross-check and believe there may also be a role for using these to help inform special factors. This could be considered as part of the regulatory toolkit, for example as employed by Ofgem, where a variety of bottom-up, top-down and benchmark approaches are incorporated into the cost assessment method.

It is important that any methodologies are presented in a timely manner to allow companies sufficient time to evidence their case for any appropriate special factors.

Q35 Do you agree that the development of detailed cost allocation guidelines is appropriate?

We agree that it is appropriate to develop detailed cost allocation guidelines and do not believe that disaggregated cost models can work without this. It is important that these are developed and consulted on early to ensure sufficient time for companies to allocate their costs and go through a suitable audit process.

Price Control Periods and timing

Q36 Do you agree with our proposal to retain the current timings of our price controls – that is, a) **not** change the duration of wholesale price controls,

Whilst we have no objection to retention of five year control periods, our response to the earlier consultation set out our view that extending the duration of controls to six years may have some advantages.

In particular, this would allow an extra year of certainty in investment decision making, to help reduce the cyclicality of investment created by five-year reviews. It would also allow for alignment with the River Basin Management Planning timetable.

We also note that a move to a six-year period would also de-couple water price reviews from the electoral cycles, whereby the Fixed Term Parliaments Act means that general elections will be held the month after the first customer bills resulting from price reviews come into effect. A move away from this cycle would help to maintain the political independence of the regulatory process.

b) **not** to stagger wholesale water and wastewater price controls

As a water-only company, we are not directly impacted by combined wholesale price controls, but note that the process creates a particular pressure on Ofwat and companies that may be alleviated by staggering water and wastewater controls. Consideration should be given as to whether the synergies for companies and Ofwat of a combined control, such as in customer engagement, assessment of cost of capital and financeability decisions, outweigh the increased work load created by submission and review of larger plans.

c) **not** seek to further align the timing of controls with other planning processes?

We support Ofwat's intention to work closely with Defra and the Environment Agency to explore how the price review cycle and be best co-ordinated with other processes. In particular, we would support greater integration between price reviews and the Water Resources Management Plan processes, to ensure alignment between proposed solutions and allowed costs.

Q37 Are there any other measures, not considered above that could help to encourage a longer-term approach?

We believe that the requirement for companies to publish 25 year 'Strategic Direction Statements', introduced as part of the PR09 process, was a useful tool to encourage long-term thinking. We produced an update to our SDS in 2012 as part of our PR14 plan development, and consider that a five-yearly update to this plan remains appropriate to encourage a longer-term planning and investment horizon.

In period adjustments

Q38 Do you agree that we should amend the licence to allow for in period adjustments for some or all of the following: outcome delivery incentives, revenues and cost sharing?

We agree that facilitating in period adjustments would require licence change, and that Ofwat should make the necessary amendments to enable companies to introduce adjustments if they wish.

In period adjustments avoid inter-generational issues and provide a closer link between performance and revenue, but there is a trade off with the certainty provided by the price control. Research has shown customers have a preference for stable bill levels, which may be impacted by the application of annual adjustments. We therefore consider that it should be for companies to discuss with their customers whether and how in-period adjustments should be applied.

Inflation and Indexation

Q39 Do you agree with our proposal to move to CPI (subject to the UKSA's final recommendations)?

We recognise Ofwat's desire to make this change, given the concerns on legitimacy of RPI following the Johnson report and discontinuation of RPI as a national statistic by the ONS.

We have no objection in principle to this proposed change, although given the level of change to the price control mechanism to be introduced through separation of upstream resources, sludge and possibly household retail competition, we suggest further consideration is given as to the urgency for change of index at PR19, rather than delaying to a future review. We also appreciate that other companies have a different legacy position to Bristol Water. In this response we have considered the impact on Bristol Water and, in particular, our customers.

Assuming that the proposal does go ahead, we look forward to further discussion and consultation to ensure that the aims and goals are met both for PR19 and future regulatory periods. We note a report produced by Nera and commissioned by Water UK that highlights some points that could help develop the proposals further.

Q40 Do you agree with our proposal to implement a CPI based approach, for both revenues (prices) and the RCV, subject to a transition process?

We recognise that using CPI for revenues could provide greater legitimacy for customers, in that it would align more closely to the headline inflation figure used by government and the media. Customers are more aware of the inflation index used in relation to their bills than that used for indexation of the RCV, so such a move is likely to be welcomed, to the extent that customers would be aware of such a change.

Currently most of our costs are more closely linked to RPI than CPI. In part this is due to RPI-linked contracts, which could be replaced with CPI-linked contracts on renewal. Staff costs have also historically been more aligned with RPI, partially because this has been the figure used by trade unions in salary negotiations.

As Bristol Water does not have index-linked debt in excess of 50% of RCV, we are comfortable with Ofwat's proposal for PR19.

Q41 Do you agree with our proposal to transition to CPI over time, both in terms of the overall method and the specific proportions of the RCV we are suggesting would remain indexed by RPI?

We believe it would be beneficial for customers and the industry as a whole if a change in index did not result in an immediate movement in the level of customer bills and that changes are NPV neutral for both customer and company. As such, a phased approach is preferable to an immediate switch.

We hope that an additional consultation would take place before taking a decision to reduce the percentage of RCV linked to RPI below 50%, particularly in the absence of a CPI debt market or a mechanism for transition.

Q42 a) Do you agree with our commitment to ensuring that any such change is value and bill neutral in NPV terms over time in nominal terms?

We support the intention to make this change in an NPV neutral way.

We anticipate that the calculation is will be more difficult in practice. For example, mixing price bases can may present issues. This has been demonstrated by the move to year average RCV where year-end RCV was used previously.

The assessment of neutrality should also take into account the costs that would be incurred by companies in re-financing and taking out CPI-linked debt.

b) What steps could be taken to make this commitment as credible as possible?

Overall, we believe that it would be appropriate to explicitly review the treatment of each revenue building block to ensure NPV neutrality for customers and companies. Consider the approach for PAYG. It would also be preferable that PR19 guidance gives early clarity on an appropriate approach for PAYG.

Q43 Do you agree that we should calculate the RPI linked element of the RCV based on forecast RPI with a true up at the end of the period to protect companies from changes in the difference between RPI and CPI over the control period?

We would welcome some additional guidance on this element of the proposal. Overall, we would anticipate the RPI linked element of the RCV to operate in the same manner as under PR14.

Balance of risk

Q44 To what extent does the current balance of risk and opportunities vary across the proposed wholesale controls and how does this impact on the cost of capital?

Operating costs as a percentage of our MEAV can be used as an indication of operational gearing, Below are the 2014/15 operating costs across the wholesale controls, shown as percentages of MEAV, or RCV (with RCV allocated in accordance with MEAV values).

The higher gearing in network plus would suggest a higher cost of capital. When looking at the elements of network plus, water treatment has significantly higher risk.

		Network plus				
2014/15 data	Water resources	Raw Water distribution	Water Treatment	Treated Water distribution	Network plus	Total
	£m	£m	£m	£m	£m	£m
Operating costs	10	1	19	21	40	50
MEAV	712	70	197	1658	1925	2637
Op costs / MEAV	1.4%	1.3%	9.6%	1.2%	2.1%	1.9%
RCV	111	11	31	259	301	412
Op costs / RCV	8.7%	8.2%	61.2%	8.0%	13.4%	12.2%

Q45 To what extent would our proposed market and incentive reforms impact on the balance of risk and opportunities and the cost of capital and would this vary across the proposed wholesale controls?

We note the concerns expressed in Moody's note[2] on the potential impacts of the Water 2020 reforms, in particular that higher assets will give rise to higher risks and that existing finance arrangements might constrain reform.

Customer engagement and outcomes

Q46 a) What does good customer engagement look like?

Good customer engagement is when it leads to outcomes that demonstrate that companies have not acted independently of their customers, and that the views of customers are reflected in the planning and decision-making processes.

Good customer engagement allows the company to understand the real views of their customers, to be able to understand how business decisions will impact the value for money that customers believe they receive. It also allows the company to be aware of the changing customer priorities and puts them in a position to adapt quicker to changes. It comprises of open feedback between the company and customers across a range of channels, focused surveys and challenge from expert and interested stakeholders.

A logical end point of incorporation of good customer engagement into the price review process is that companies can reach agreement with their customers (or their representatives) on a business plan. This process would necessarily require a degree of regulatory input to ensure an appropriate level of challenge to costs and efficiency, but may ultimately reduce the level of regulatory burden. We would like to see further examination by Ofwat and the industry of innovations in customer engagement from other sectors including the efficacy of negotiated settlements in other utilities.

b) What are your views on the principles outlined above?

We are in agreement with all of the principles outlined in this document.

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[2] Transition to CPI creates risks for water and energy networks, Moody's, January 2016

We agree that WTP research needs to have more consistency across the industry. We believe it has a place but that it would benefit from a consistent methodology across all companies which would increase consumer and regulator confidence in plans. We feel it could be used to compliment the revealed preferences technique rather than using exclusively revealed preferences.

c) How could companies draw on good practice from within and outside the sector?

We agree that the water sector should continue to review and learn lessons from approaches adopted in other industries and also from lessons learned from the experience of customer engagement in the water sector in Scotland.

We are actively considering the following in improving our customer engagement at Bristol Water beyond reliance on day-today business engagement, specifically

- We are aware that in other sectors such as telecoms and financial services use has been made of behavioural experiments to improve the accuracy of customer research and behavioural experiments. Bristol Water benefits from access to local higher education establishments which we feel could facilitate similar techniques to reveal more accurate customer information and reflect customer biases. Commissioning benchmarking with other water companies
- Commissioning analysis of approaches used in other sectors both in the UK and overseas. In addition companies can use national bodies such as CCWater and the Institute of Customer Service benchmarking to compare how companies are performing on customer service measures both inside and outside the sector, and overseas. Maintaining relationships across different sectors and sharing best practices will also help to understand developments in technology, processes and understanding. We recognise a variety of approaches to customer engagement are possible, and seek to both draw on existing good practice and be innovative in development of new methods.
- We believe there would be merit in working with businesses that have a high reputation for customer service in order to understand how they engage with customers to deliver high levels of customer satisfaction.

d) How can companies make use of revealed preference techniques and information obtained in their day-to-day interactions with customers to develop a richer set of evidence of customers' needs and requirements?

The day to day feedback that companies capture is full of a wealth of data that can be used to understand customer priorities. Companies should use this as the basis of deciding business plan outcomes as it does expose a good opportunity to achieve fruitful results.

Revealed preferences are complex to do across a range of measures, used in addition to WTP research it adds a lot of value, used independently it could be timely and costly.

Q47 a) What are your views in relation to our proposals on future CCG remit; scope; timetable; governance arrangements; and membership?

We were involved in the recent UKWIR project that considered "The future role of customer and stakeholder engagement in the water industry". We supported the recommendations in this report and welcome Ofwat's definition of the role it sees CCGs performing for the PR19 price review. We also agree that customer engagement strategies and research are the areas where the CCGs can contribute the most value to the process.

The current proposal is for CCGs to submit their report at the same time as companies. Feedback we received from our CCG was that it felt it would have preferred to have seen the final version of our business plan before submitting its report. This may be less of an issue if the remit of the CCG is more focused this time.

We acknowledge the importance of establishing appropriate governance arrangements around the CCG to ensure they retain their independence and agree with the proposed approach of increased transparency around remuneration, Board access and publishing information relating to the CCG meetings.

In terms of the membership of CCGs, we concur that local circumstances and challenges will dictate the appropriate organisations for companies to invite to join its CCG. We would support a continued role of the Consumer Council for Water on CCGs due to the valuable contribution they made as part of PR14. We similarly valued the expert knowledge of the quality and environmental regulators on our CCG and will look at the best ways to ensure their views continue to be represented.

b) In relation to the quality of a company's customer engagement, do you agree with the above list of issues that should be covered by the CCG report?

We believe that the questions set out on p150 of the consultation sufficiently capture all the relevant areas CCGs should be reporting on to Ofwat.

c) What are your views on the division of responsibilities between CCGs and Ofwat?

We believe the division of responsibilities Ofwat has identified in the consultation are sensible and are in line with the recent UKWIR project on 'The Future Role of Customer and Stakeholder Engagement in the Water Industry'.

Q48 a) What are your views on our proposal to facilitate more collaboration between CCGs?

We agree that Ofwat has a role to play in ensuring CCGs have the tools to provide effective challenge to the companies. For example, Ofwat could maintain links to each CCG webpage through its own website in order to facilitate access to relevant discussions and information from other companies.

The greater amount of information Ofwat can share directly with CCGs on its processes and policies will also help to maintain their independence. Facilitating the discussion and sharing of good practices between CCG Chairs will also result in all customers benefiting as will enabling the CCG Chairs to establish their own network.

b) What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early?

We believe there is a clear customer benefit to early publication of information on WACC and outcome RoRE ranges as this helps frame the conversation with customers, particularly on bill impacts and incentives.

c) Without inserting ourselves between companies and their customers, what else could we do to incentivise and encourage good quality customer engagement?

Ofwat can encourage good quality customer engagement by ensuring that its risk based review criteria captures companies employing a range of good practices and that appropriate weight is given to this aspect of the business plans. This should provide sufficient incentive for companies seeking the regulatory benefits of enhanced status without the need for Ofwat to provide additional incentives.

Q49 a) How can the outcomes framework encourage a longer-term approach?

The recent UKWIR project on "Setting performance commitments and incentives to deliver best value for money" has considered how to implement long-term targets effectively. The project identified a number of important issues that would need to be addressed in order to successfully implement multi-period incentives, these included;

- whether Ofwat intends the framework to encourage companies to avoid penalties or chase rewards;
- whether incentive rates should be fixed;
- how to set long-term targets (fixed or become more challenging over time); and
- how the certainty of a multi-period incentive might alter companies' investment behaviour.

We would urge Ofwat to consider these issues as it develops its own approach for PR19.

b) Should we encourage, or even mandate, that certain measures - for example asset health – span more than a single regulatory control period?

In PR14, companies set out in table W1 their intended performance over both AMP6 and AMP7 for each performance measure. Therefore, it should be possibility to design Outcome Delivery Incentives that extend beyond a 5 year period.

We would suggest that asset health is one performance measure that particularly lends itself to long-term targets since no companies would intend for this to be anything other than stable performance. We agree with the UKWIR recommendation that a few measures could be trialled for PR19 as long term incentives.

Q50 What are your views on the proposed contents of our November 2016 consultation on outcomes (balance of bespoke versus comparative measures, and role of comparative information)?

In the interest of facilitating early customer and CCG engagement, it will be useful to understand Ofwat's thinking on the number and definition of comparative performance measures as well as how comparative information can be best used in discussions with customers about appropriate levels of service (performance targets).

It would also be useful in the November consultation if Ofwat could set out its thinking on the design of Outcome Delivery Incentives. Understanding whether this is likely to involve a top down or bottom up approach will help companies to shape their customer engagement strategies in a timely fashion.

Q51 What are your views on our proposal that companies submit the definitions – but not the targets or any associated incentives - for their performance commitments to us in early 2018 before they submit their business plans?

We believe this proposal will be useful in the development of business plans, as it will allow Ofwat to provide views on the appropriateness of proposed outcomes and performance measures ahead of the finalisation of business plans. We consider that these performance commitments should be established relatively early in the business plan process, and that submission in early 2018 should therefore be achievable. We suggest that indicative dates for provision of these definitions, and Ofwat's feedback, should be included in the proposed timetable for Water 2020.

Q52 What are your views on our proposal for a licence modification to allow for the in-period payment of outcome delivery rewards and penalties?

We recognise that in-period rewards and penalties could provide increased focus on delivery of outcome incentives, as the financial impact would be more immediate. However, we remain aware of the views expressed by customers at PR14 that increased bill levels to reward companies for good performance would not necessary be welcome. Moving to in-period adjustments could heighten awareness of this issue. Customers also expressed a preference for stability in bill levels, which could be adversely impacted through the application of in-period adjustments.

We suggest that a licence modification that permits in-period adjustments would be acceptable, but that the decision on whether to take that option should rest with individual companies and their customers rather than being imposed.

Licence changes and next steps

Q53 Do you agree with our summary of potential licence changes and the process for achieving these outlined in section 9.1 above?

We agree a separate price control for water resources will require a new licence condition.

We also agree that a change to the indexation approach would also require a change to condition B.

We suggest that alternative options should be explored before a new condition on market information database is introduced. The process required to establish such a database has not yet been defined, and the data requirements may evolve. As such, there may be valid reasons why companies are unable to be fully compliant with the database that do not warrant being regarded as licence breaches.

As per our response to Q52, we have no objection to the introduction of a condition to facilitate in period adjustments, but consider that this should be optional for companies based on the preferences of their customers.

We support Ofwat's intention to seek consensus before commencing formal routes to implement change through section 13 notices.

Q54 Do you agree with the next steps for establishing the necessary data for the 2019 price review outlined in section 9.2?

We welcome the establishment of the working group for cost assessment, and felt that the first meeting on 4th February set out some useful steps forward.

The consultation does not explicitly mention provision of annual data during AMP6 to support the development of cost models. It is procedurally better for companies to produce such data on an annual basis and incorporate it within the assurance process that supports the Annual Performance Report. As such we would welcome early clarity on any information requirements.

We note the intention set out in the consultation for publication of guidance on MEAV valuations in 2016, and for companies to carry out MEAV valuations in 2017, with assurance provided by specialist auditors. We would welcome confirmation as early as possible of the required information and deadline for submission, in order to incorporate this into our business planning.

Q55 Do you agree with our indicative timetable for the Water 2020 programme?

We believe that the submission date for PR19 business plans of summer 2018 should be achievable for companies.

The key change to the timetable in comparison to previous reviews is the increased amount of time for review and assessment of plans ahead of draft and final determinations. We would welcome further clarity on the planned review and engagement process during that time, and at what points companies may be required to provide further information to support the review.