

Water 2020
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

15/02/2016

Natural Resources Wales response to Ofwat's consultation on Water 2020: Regulatory framework for wholesale markets and the 2019 price review.

Natural Resources Wales welcomes the opportunity to comment on your consultation Water 2020: Regulatory framework for wholesale markets and the 2019 price review published in December 2015.

As the principle environmental regulator in Wales, our purpose is to ensure that the natural resources of Wales are sustainably maintained, enhanced and used, now and in the future.

We have set our consultation response in the context of the new legislative framework set out in the Wellbeing and Future Generations Act and the Environment (Wales) Bill. Together this legislation puts sustainable development at the heart of decision making across the public sector in Wales, including Welsh Ministers. The new natural resources framework introduces:

- The State of Natural Resources Report (SoNaRR), the first of which is to be published in autumn 2016 and will provide a comprehensive assessment of the state of natural resources in relation to Wales and will inform the development of the National Natural Resources Policy developed by Welsh Government.
- The National Natural Resources Policy (NNRP) issued by Welsh Ministers in Spring 2017 will set out the general and specific policies for contributing towards building resilience and will promote a joined-up approach to the policies that the Welsh Government develops, as well as supporting the achievement of the well-being goals in the Well-being of Future Generations (Wales) Act 2015 and the National Development Framework in the Planning (Wales) Bill.
- The Environment Bill states the primary objective of Area Statements is to facilitate the implementation of the National Natural Resources Policy. NRW may also use them in the exercise of any of their functions.

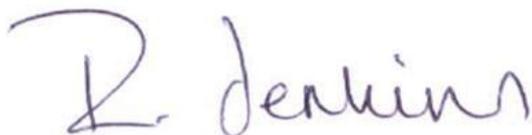
Alongside these new “products” we are required to apply the principles of sustainable management of natural resources across all our functions, while maximising our contribution to the seven wellbeing goals set out in the Wellbeing and Future Generations Act.

Against this backdrop, it is important that the next periodic review facilitates the implementation of the new ways of working set out by Welsh Ministers. Innovative approaches, which look at the root causes of problems, build resilience and seek solutions which deliver broader benefits will be a key feature of our advice to Ministers. Price controls will need to incentivise this way of working and avoid introducing barriers to considering the most sustainable options.

At Annex 1, we have responded to the consultation focussing on those issues that relate to our role and of particular importance to NRW at this time. For Ofwat’s convenience, we have incorporated our comments against the relevant groups of consultation questions. In particular, we’d like to draw Ofwat’s attention to our comments on: Water resources market design; Proposed approach to customer engagement and Outcomes and Programme implementation. Here we refer to the likelihood of uncertainties in the development of the Environment Programme to inform business plans and we would welcome further reassurance over how these issues will be managed.

We look forward to continuing to work with Ofwat during the review process. As part of this, Ceri Davies, Director for Knowledge Strategy and Planning; Ruth Jenkins, Head of Natural Resources and Natalie Hall, Water Manager will be meeting Georgina Mills on 23rd February. In the interim, should you wish to discuss our response, please contact Natalie Hall on 07769 278 425 or at Natalie.Hall@cyfoethnaturiolcymru.gov.uk.

Yours sincerely,

A handwritten signature in blue ink that reads "R. Jenkins". The signature is written in a cursive, flowing style.

Ruth Jenkins

Head of Natural Resources Strategy and Planning

Annex 1

Sludge Treatment, transport and disposal market design

Q1 Do you agree with our proposal to have one separate binding price control for sludge treatment, transport and disposal

Q2 Do you agree with our proposal to make a range of cost, price, capacity and location information available to facilitate the identification of trades? Do you agree that the data should be published on a STC and STW site level? Do you agree that it should be published annually? Do you agree with the categories of data that we are proposing are necessary and appropriate, as illustrated in the tables? Are any missing?

Q3 Do you agree that the information should also contain details of 'bids' in form the third party providers, and that there should be guideline for ensuring that such bids are assessed on a level playing field basis?

Q4 Do you agree that the data should be made available centrally through some form of information platform? Do you have any views as to how this might best be managed?

Q5 Do you agree with our proposals not to make any changes in the status quo in relation to system operations?

Q6 Do you agree with our proposals not to have any specific financial incentives to support trading in relation to sludge at this time?

In principle we agree that one separate binding price control for sludge treatment, transport and disposal would make it easier to develop markets.

NRW believes that the provision of information to mitigate potential market failure related to information asymmetry to be important.

There may be a need depending on how the sludge is managed to require more data that aligns with the waste sector.

With regard to whether the data should be made available centrally, at present NRW has no view as to how best this should be managed.

We agree with proposals not to have any specific financial incentives to support trading in relation to sludge at this time. There will have to be transparency across the waste management sector if the market is to work.

Water resources market design

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

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?

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?

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

Q11 Do you agree that measures should be introduced to increase transparency and certainty around security of supply for water trading? How can this objective best be achieved?

Water Resources Trading

Our role as an environmental regulator for Wales and advisor to Welsh Government means that one of our objectives is to ensure that water companies balance the needs of the environment and people; whilst ensuring the sustainable management of natural resources.

We welcome that you set out within your consultation the challenges faced by the sector over the long-term and that companies need to plan to address them. These include the need to provide services to an increasing population, improving environmental quality and developing and maintaining resilience in the face of climate change.

We recognise that water resources trading will go some way to address these challenges, as long as this is done in a sustainable way. However, we believe that opening up these markets has the potential to create additional environmental risks, which will need to be managed carefully, in particular when considering the Habitats Directive and Water Framework Directive. For example, additional trades developed through a water resources market must not cause Water Framework Directive (WFD) water body deterioration in status or any individual element deterioration. Therefore, we would welcome further clarification on how better sharing of water resources will deliver potential benefits of £1bn across England & Wales without causing deterioration in WFD water body status.

Within the water resources planning process, Natural Resources Wales supports Welsh Government's expectation that water companies (wholly or mainly in Wales) should only agree water sharing or trading where they can demonstrate that it would not be detrimental to their company, its customers, or to the ecosystem of the catchment area from where it is taken or it is transferred into, particularly where trading might be used to meet demand in England.

Where a water company's preferred solution to meet demand includes an option to transfer water from a water resource zone of a water company which is wholly or mainly in Wales, it should provide opportunity for Natural Resources Wales and Welsh Ministers to give representations on its plan. The expectation is that any proposals should be explored during the pre-consultation phase of developing a water resources management plan. If such options are likely to be considered as part of the preferred solution, water companies are expected to consult the Welsh Government on these options as early as possible in the process.

Therefore, we recommend that before sharing or water resources trades are agreed between water companies that the incumbent company ensures the following:

- Ensures that it minimises the potential impact to its own security of supply and in particular that no water resource zone is placed into deficit as a result of the trade*
- Ensures that it does not impede its ability to supply water during periods of drought*
- Continues to meet its customers' expectations with regards to levels of service*
- Ensures that their supply remains 'environmentally sustainable' ('no deterioration' of raw water source)*

Abstraction Reform in Wales

It would be beneficial if Ofwat recognised that the Welsh Government are also reforming the abstraction management system in Wales. The Welsh Government published its response to the 'Making the most of Every Drop, Reforming the Abstraction Management System' consultation on 15 January 2016. The response document sets out how the abstraction management system will evolve to meet the challenges of an increasing population and climate change, whilst still protecting the environment of Wales and the cross border catchments. Defra have also published their separate Government Response for England. We recommend that Ofwat review these documents to assess if their proposals support the Government's reform proposals.

With respect to trading, it is unclear how the options proposed by Ofwat, which are designed to provide water for incumbent or new public water suppliers, will be regulated or will ensure that non-water company abstractors within the catchments, who need additional water for their business are not unfairly disadvantaged. Concerns over market domination by large abstractors, including water companies, was raised by some abstractors in response to the 2013 Welsh Government / Defra joint consultation on reforming the abstraction management system. Both the Welsh Government and Defra recognise this point in their responses to consultation on reforming the Water Abstraction Management System. Whilst both Governments assess the risk as low, we are pleased to note that they intend to work with Ofwat and interested parties to examine how any remaining abstractor concerns can be addressed, which are not adequately covered by competition law.

It will also be important for Ofwat to continue to work with the Welsh Government, Defra, Natural Resources Wales and Environment Agency on the development of any future trading system. This is to ensure that it will work with a reformed abstraction management system, for example through the catchment rules that will be developed by NRW and the EA. It would also not be beneficial for abstractors to have to negotiate multiple trading platforms.

Availability of "spare" volumes for trading

The aim of reform in Wales, as set out in the Welsh Government's Response, is stated as:

".....The purpose of our reforms is to create an abstraction management system that:

- 1. allows more flexible and fairer responses to short term changes in flows;*
- 2. more effectively manages water resources by:
 - a. ensuring that abstraction permissions are based on reasonable need and do not unnecessarily 'lock up' water;*
 - b. encouraging efficient use of water;**
- 3. provides adequate certainty for long-term investment and growth whilst also protecting the environment; and*
- 4. is able to respond to future pressures such as climate change and population growth, supporting better catchment management and the area based management planning approach adopted for Wales."*

To help achieve this, as part of the transition into the reformed system Natural Resources Wales propose to review all existing abstraction licences. Where, for example, licensed volumes exceed an abstractor's requirements, those unused licenced volumes will be removed, either to protect the

environment or to free-up resources for other users. Natural Resources Wales will ensure that all abstractors and businesses receive permitted volumes that reflect current business use and/or, in the case of water companies, meet their security of supply obligations. This will reduce the risk of unsustainable abstraction and provide a more realistic view of the water resource availability in a catchment. Therefore the volumes of spare water assumed to be available may not be so. Clearly anyone wishing to apply to NRW for the licensable volumes liberated through the transition process can be applied for through the normal licencing process but the need for the water will have to be demonstrated at that time.

Discharges at a significant distance from the point of abstraction - some abstractors, mainly water companies, discharge waste water a significant distance from where it was abstracted, sometimes into a different catchment. Changes to this discharge pattern can affect both downstream abstractors and the environment. The Welsh Government and Defra therefore intend to introduce new controls requiring water companies that discharge to rivers to assess the impact of changes to discharges on the river, and therefore the abstractors and the environment and to agree a way to mitigate any impact that might occur, with the Natural Resources Wales or the Environment Agency. This will be an important consideration for any water company looking to make use of their current discharges, whether for the purpose of trading or reusing that resource.

Appendix 2, Page 4 of Ofwat's Water 2020 consultation refers to the 'Ownership of water resources'. This is misleading as an abstraction licence only provides a right to use water (if available) it does not give a right to the water itself.

We support measures to increase transparency and certainty concerning security of supply. The objective in Wales would best be achieved by collaboration with NRW and the Welsh Government.

Allocation of the Regulatory Capital Value

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

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

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

NRW recognises the very substantial discount of the RCV with respect to the MEAV and the issues this gives rise to when splitting the Water and Waste Water wholesale value chains into contestable upstream and monopoly network plus segments. Some form of allocation is inevitable and the proposed approach seems the most straightforward. We would nevertheless welcome some modelling to show the impact of the focussed approach to the allocation of RCV in the waste water wholesale value added chain on the residual RCV in the network plus segment, and the implications this would have for returns and investment for WaSCs operating wholly or mainly in Wales..

Measures to avoid stranded assets

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

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?

Q17 Do you agree with our proposed approach of an income guarantee recovered through the network plus control for protection against asset stranding if a mechanism is required? How do you consider that such a mechanism could be designed to provide a simple, transparent and largely ex-ante mechanism that preserves incentives for efficiency?

We believe the period embedded in the question to be too short. The probability should be assessed over the medium-term.

Furthermore, for sludge we are not convinced that there is no prospect for stranded assets, as this must depend on the current assets within the system. Possibly less of a risk around new assets planned and delivered within the period. This will be influenced by the economic viability of sludge treatment and disposal such as: continued government support for electricity generation; current regulatory regime; changing environmental risks, compliance, local authority contracts, etc.

Ofwat should seek to minimise any risks of stranded assets as this has, in addition to the economic, environmental risks. Were stranded assets to eventuate we believe there would be a non-trivial chance that public trust in the regulatory system would be damaged.

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?

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

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?

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

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

Q23 Do you support the development of high level guidelines as to how rival offers in relation to sludge treatment should be evaluated?

We answer these questions only in part.

We agree that there are additional areas that will inform any commercial negotiation and some of these may be based on regulatory and statutory requirements.

We believe that it is essential to develop high-level guidelines on how rival offers should be evaluated. The use of a standard technical guidance document supported by existing guidance

should exist to ensure consistency in standard and best practice across the sludge sector thus ensuring acceptable sludge quality and a transparent market environment whilst ensuring environmental protection.

Making greater use of direct procurement for customers

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

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

NRW can see potential benefits in harnessing innovative methods of contracting and co-opting with third parties and would wish to examine these in collaboration with Ofwat and the WaSC

Regulation of the wholesale part of the value added chains for water and waste water

Q26 Do you agree with our proposal for four binding price controls should apply to companies whose area is wholly or mainly in Wales, as well as to companies whose area is wholly or mainly in England?

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

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?

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

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

Natural Resources Wales would support the application of four binding price controls to companies whose area is wholly or mainly in Wales provided Ofwat pays due attention to the wellbeing goals set out in the Well-being of Future Generations (Wales) Act and the principles of sustainable management of natural resources (SMNR) defined in the Environment (Wales) Bill.

We consider that there are potential risks associated with exposing sludge activity completely to volume risks that perhaps need to be considered further and decisions could be deferred until a review of any sludge market has been undertaken. Catchment resilience may need to be further considered. There is a concern that sludge treatment and disposal will get disassociated from the sewage treatment process and this increases vulnerability to asset stranding and environmental risks.

There needs to be a some consistency across provision within similar sectors. This will need to involve assessing the regulatory controls that apply to water companies and waste companies.

Extent to which PR19 should be risk based

Q31 Do you agree with our proposal to retain our RBR approach for PR19?
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?)
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 with the proposal to reflect current performance in the RBR assessment and believe that this encourages companies to perform well. Performance should be interpreted broadly and include the degree to which performance aligns to the wellbeing goals and the principles of sustainable management of natural resource

We also agree that the RBR assessment should consider the extent to which the business plans are part of a longer term plan. Please see comments below on importance of a long term planning approach. Strategy is important but so too is learning and adaptive management.

Assessing cost efficiency

Q34 Do you agree that the consideration of disaggregated cost models is appropriate given the price control structure proposed?
Q35 Do you agree that the development of detailed cost allocation guidelines is appropriate?

No – response

Encouraging a long-term approach.

Q36 Do you agree with our proposals to retain the current timings of our price controls – that is, not change the duration of the wholesale price controls, not to stagger wholesale water and wastewater price controls and not seek to align further the timing of control with other planning processes?
Q37 Are there any other measures, not considered above, that could help encourage a long term approach?

On balance we concur with Ofwat that the wholesale water and waste water price controls should not be staggered. The interaction of the price review cycle with other planning cycles is problematic. However if smoothing mechanisms, in-period adjustments to ODI's and the adoption of multi-cycle projects and programmes proceed then these tensions should ease. It will require good will on both sides to negotiate these issues near term. We believe that Ofwat should continue to consider whether the timing of price controls could be better aligned with other planning processes to minimise uncertainty in the environment programme. See comments below in the implementation section below.

A more responsive regulatory framework

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

Yes, in order to minimise the need for end of period realignments as a result of changes to the NEP, for example.

Choice of index for future price controls (RPI or CPI)

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

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

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?

Q42 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? What steps could be taken to make this as credible as possible?

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?

Whilst we accept the arguments for an harmonic rather than arithmetic index, we would welcome reassurance from Ofwat that any proposed changes do not impact on the Companies' investment in the environment.

Unless we have misunderstood, there is no long-term commitment by Ofwat to retain the RPI in the inflation adjustment of the RCV, merely to phase it out hand in hand with the rundown in RPI indexed debt. In seeking to optimise the transition we hope that the impact of the non-indexed debt is considered, since that will have an impact on the cost of capital.

We would be concerned about any implications for a reduction in spend on the environment as a result of any proposals.

With regard to managing changes in the difference between RPI and CPS, NRW believes the solution should be co-produced with the companies but in principle we have no objection to Ofwat's proposed solution.

The balance of risk and reward between companies, investors, customers and the environment

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?

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

In seeking to balance risk and reward, NRW would be keen to ensure that the environment is fully considered. In particular we would want to avoid disincentives being given to investment and innovation to deal with issues such as further reducing sewer spills, and catchment solutions to improve water quality generally and reduce water treatment costs in particular. The environment is a stock of assets and a flow of services which are too often overlooked because of missing markets. It needs to be central to the allocation of scarce resources to meet insatiable need, and not to be viewed as a “nice to have” add on.

Proposed approach to customer engagement and outcomes

Q46 What does good customer engagement look like? What are your views on the principles outlined above? How could companies draw on good practice from within and outside the sector? 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?

Q47 What are your views in relation to our proposals on future CCG remit: scope; timetable; governance arrangements; and membership? 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? What are your views on the division of responsibilities between CCGs and Ofwat?

Q48 What are your views on our proposal to facilitate more collaboration between CCGs? What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early? Without inserting ourselves between companies and their customers, what else could we do to incentives and encourage good quality customer engagement?

The consultation recognises that the environment will also benefit indirectly as the efficiency gains resulting from Ofwat's proposals create scope for environmental improvements to be delivered while maintaining affordability. As above, whilst we understand the need to consider the impact on customers, we would be concerned if affordability drives short term decision making which costs more in the long term. The discussions at CCGs must enable all parties to fully understand the choices and consequences.

NRW would support a broad interpretation of customer engagement. Techniques might include the use of citizen juries, collaboration with the third sector to deliver social marketing, possibly integrated with more conventional advertising campaigns (the ground campaign supported by an air campaign so to speak), and participation in collaborative policy making (perhaps linked to the Area Statement process and more local, perhaps catchment based, initiatives).

Care needs to be taken in framing the questions used in stated preference surveys, and carefully crafted experiments might be considered as a partial substitute. We would welcome the use of revealed preference and subjective well-being analysis. We could even conceive of testing

customers' willingness to pay by them being given an opportunity to make voluntary contributions through their bills, perhaps incentivised by match funding from the company, to achieve SMNR outcomes. We are also very supportive of the role of Customer Challenge Groups.

We welcome that Ofwat wish to continue and build on the role of CCGs and will encourage companies to genuinely deepen their understanding of their different types of customers' needs and requirements and use this information to drive decision making at all levels of the business.

As the consultation document recognises, the CCG's place a significant time commitment on NRW and other bodies. We wish to avoid duplicating our efforts and therefore we welcome that Welsh Government plan to involve CCG chairs in their meetings. We are keen that our involvement in CCG's goes beyond simply supporting Companies engagement with customers in the traditional sense, but that the environment is equally viewed as a customer of the periodic review process. We would like to see more emphasis on this within the CCGs and that this should be reflected more in the documentation from Ofwat. The CCGs should be equally focussed on ensuring that the needs of the environment are met, now and in the future. As regards membership therefore, we consider that representation from environmental interest groups should be enhanced.

Beyond challenging the plans around the needs of the environment we believe that NRW can make a strong contribution to the CCGs:

- through challenging companies levels of ambition*
- by helping customers to understand the risk of short term investment decisions which store up problems for future generations and compromise ecosystem resilience.*
- through challenge to the cost-effectiveness of companies' solutions to deliver outcomes. This would be enhanced by improved transparency and understanding of companies' options appraisals. This should include the extent to which innovative, catchment solutions and collaborative working with partners to deliver outcomes have been sufficiently considered.*
- Though contributing to debates around trade-offs, where there are choices between difference elements of the programme.*

The development of corporate integrated reporting, which would embrace Natural Resource Accounting (also known as Corporate Natural Capital Accounting), should assist customer engagement. Were Ofwat to encourage such a development it would not be inserting itself between companies and their customers, but helping facilitate the dialogue.

Outcomes

Long term planning

Long term planning is another principles of SMNR, as is the need to take account of the short, medium and long term consequences of actions.

The Sustainable management of Natural resources is about ensuring that the way we manage and the rate of use of our natural resources is done in a way that does not lead to the long term decline of those resources and our supporting ecosystems. We wish to maintain and improve the condition of our ecosystems and emphasise the role of ecosystem benefits (or services) within the decision-making process.

The management and use of our natural resources should not diminish the ability of those resources or of ecosystems to be able to deliver multiple social, economic and environmental benefits over the long-term and to ensure that the impact of activities on our natural resources and ecosystems is considered in terms of how they affect the resilience of our ecosystems and consequently their ability to provide social, economic and environmental benefits for both current and future generations.

We therefore welcome that Ofwat are planning to place a greater incentives upon companies to respond flexibly to long-term and short-term challenges and are promoting a longer-term approach by encouraging companies to focus beyond the five-yearly price control cycle, by making the extent to which companies are putting their plans into a long-term context part of Ofwat's risk-based review assessment and by seeking customers' views on long-term issues; and asking customer challenge groups (CCGs) to report on the quality of customer engagement on longer-term issues to inform the risk-based assessment of company business plans.

A long term planning approach should help to manage uncertainties in the environment programme (below) and support the necessary long term investment to tackle issues over a number of periodic review cycles, with multi - period outcomes. That said, it should not be a mechanism to delay investment in issues that need to be addressed in the short term.

Abstraction Incentive Mechanism

The consultation document has referenced the abstraction incentive mechanism (AIM). It is worth us noting that currently no water company wholly or mainly in Wales has proposed an AIM site and the environmental information we currently have does not suggest there might be a need for them to do so. We therefore expect the AIM will only apply to water companies wholly or mainly in England.

Q49 How can the outcomes framework encourage a longer-term approach? Should we encourage or even mandate that certain measures – for example asset health – span more than a single regulatory period?

There is certainly merit in facilitating measures such as asset health spanning more than a single regulatory period.

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)?

We welcome Ofwat's intention to consult further on this. We agree with the commitment to encourage companies to commit to outcomes for the long term and to develop ODIs to support this, which can be adapted if necessary. Comparative information is helpful to Regulators, customers, CCGs and others to understand the relative performance of Companies and to understand and question how stretching the proposed performance commitments are. Financial rewards must be for truly stretching performance targets and will be required to ensure that the long term challenges that companies face are met. It will be essential for Ofwat to develop and set out a clear process so that parties understand how measures are derived, by whom and how they can be challenged (and available information to support this challenge), as well as clarity over how their comments are taken on board. This will be essential to ensure the right level of ambition.

We would welcome the opportunity to work with Ofwat and the Environment Agency on the development of any comparative measures.

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?

There is something of a catch 22 in considering outcomes before business plans but there might be merit in an iterative process.

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

There is merit in applying incentives on a more continuous basis so we would support Ofwat in seeking to modify licenses, particularly when other licence modifications are called for at the same time.

Implementation

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

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

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

We recognise the benefits for the environment achieved as a result of investment by water companies through delivery of the National Environment Programmes over successive periodic reviews. Whilst we value the process in securing such investment, we are aware of a number of issues which will prevent us from being able to provide a comprehensive set of information about the needs of the environment within the timescales.

We note that Ofwat do not propose to adjust the timing of its price controls to align with other industry planning cycles for PR19, but that you commit to working closely with us to align your price control processes in the run up to such reviews with other planning cycles and ensure that companies have the greatest clarity possible.

We welcome this, but remain aware that the date for submission of final business plans is July 2018, which presents a challenge in providing a fully comprehensive programme of environmental improvements.

For example:

Mis-match in timing with other planning cycles

- *We are of course conscious of the mismatch in timing between our periodic review planning and river basin planning through which improvements to the water environment with delivery partners are determined.*
- *Beyond this, the timescales for publication of SoNaRR in September 2016 and the National Natural Resource Policy (NNRP) in Spring 2017 will be helpful in setting out the priorities and opportunities for sustainable management of natural resources at a Wales wide scale. We will start preparing Area Statements following the publication of the NNRP in the Spring of 2017 and have committed to complete Area Statements for the whole of Wales by December 2019. The Area Statements may identify priorities and opportunities for action by water companies, some of which may be innovative or partnership projects.*
- *Furthermore requirements of applying the SMNR principles in Wales - with a focus on breaking down silos, collaborative working to develop the right solutions in the right place in an integrated way – is at odds with the development of an environment programme for water companies in isolation.*

New information, evidence and obligations

- *In addition, by 2018, many of the investigations scheduled in the current review period will not be reported,*
- *Revisions to the latest WFD classifications will unlikely be available, since we are reviewing the frequency of when we collate this data.*
- *In the current investment period Dwr Cymru are installing event and duration monitoring across their assets, which will better enable them to monitor what is going on across their networks and optimise more effectively. Installation of the event and duration monitoring programme is unlikely to be fully complete or data have been fully assessed over a sufficient period to make decisions by the desired timescales.*
- *Furthermore, where these reveal shortcoming in delivering statutory obligations or enable a revised assessment of the impact on the environment, we are conscious of the potential need to response to these “in-period” and not wait for a future planning cycle.*
- *Similarly the outcomes of infractions may have implications for “in-period” investment.*

Responding to change

As above, we recognise the value of the process in securing investment for the environment and will endeavour to develop a programme supported by strong evidence by the timescales for the

periodic review. We will also be as clear as we can be about the likely scale of any future environmental requirements and the timescale when this information will become available, in order to be included within the planning period. We will set this in the context of what we consider should be allowed for environmental improvement to deliver for the long term.

Never the less, all of the above issues impose a significant degree of uncertainty. Therefore it is likely that more requirements will be required within the investment period than we are able to confirm for the business plan development timeline.

We need to understand how Ofwat's approach can deal with new information and the need for additional or amended solutions so that the implications for the environment aren't prolonged and that financial barriers to companies responding to such risks are removed

For that reason we would encourage Ofwat to have strong mechanisms to allow for this and would like to understand more about how Ofwat propose to manage such in period adjustments to the size of companies' environmental obligations.