South East Water’s Response to Ofwat’s Consultation on Regulatory framework for wholesale markets and the 2019 price review

February 2016

This paper sets out South East Water’s views in response to Ofwat’s recent consultation on Water 2020: Regulatory framework for Wholesale markets and the 2019 Price Review

1 INTRODUCTION

The following document provides South East Water's response to the regulatory framework for wholesale markets and the 2019 price review consultation. The responses written in this document are the same as the responses submitted in the excel spreadsheet as requested.

2 STRATEGIC QUESTIONS

Q1. Do you agree with our proposals for making a greater use of markets in relation to sludge and water resources?

We welcome the proposals on water resources outlined in the consultation document and are pleased that many of the elements from our Water Resources Paper from the Marketplace of Ideas have been adopted – particularly the focus on information asymmetry and the development of a market place of information.

We operate in a water-stressed area with limited new water resources opportunities, have a forecast future deficit in supply, and will have a high percentage of our existing, and future, supply derived from bulk supplies.

For these reasons, the proposals to develop a more robust, transparent and effective water resources 'market' is very positive – it offers us greater scope to identify and secure the most cost effective water resources solutions for customers.

We believe that further consideration should be given to see if the market information database concept could be extended to allow companies to include sub-optimal existing assets in the market to see if more economic new water resources options are available.

Related to this we also welcome the focus towards the development and use of markets and the recognition of the difference between this stated approach and previous approaches that were more focused on competition. Whilst the distinction may be just a matter of degree and timing it recognises that the proposed reform will inevitably be a multistage journey where learning is accumulated and utilised at each stage.

We also welcome that Ofwat has recognised the assertion we have been making that water trading enhances resilience due to the increase in interconnectivity that would naturally arise. We would add though that national water resource service levels would have a similar effect as highly resilient companies would inevitably be encouraged to share water rather retain it. We recognise that Defra alone have the ability to implement such standards but would urge Ofwat to ensure Defra are aware of the potential benefits national resilience standards would provide.

A key part of the water resources proposals is to ensure that efficient investment in water resources is protected for the life of investment undertaken, be this through the RCV or via an alternative agreed mechanism. Our response to the questions below outlines the risks we foresee if this protection is not provided. Of most concern are the incentives that may arise to reduce the exposure to water resource RCV by choosing short life schemes over long term more RCV intensive schemes creating a bias that may not be in the interests of the resilience of the industry. We would suggest there are questions that need testing such as would a reservoir ever be built given the proposed set of reforms and incentives in play?

In relation to water trading, in our response below we recommend that this should be encouraged both through improvements to the regulatory framework and underpinned by changes to company licences. Currently bulk supplies are managed via contracts between water companies and therefore priority will always be given to 'in area' supply over any water due to be supplied to a neighbouring water company. i.e. a licence is stronger than a contract and therefore until the strength of these is equalised contracted bulk supplies will be more risky and all things being equal will be less attractive.

If bulk supplies were covered within a company's licence, such that there were equal duties to that of the company's own area as well as the bulk supply we believe this would increase the amount of water traded.

Bulk supplies should also adequately reflect any ODIs and SIM targets a company has such that if an ODI penalty is triggered due to a failure to deliver the required water under the terms of a bulk supply, this reputational and financial penalty should be shared with the provider of the bulk supply.

Q2. Do you agree with our proposals in relation to the future form of regulation for the sector?

In the Water 2020 consultation Ofwat are clear on their intention to move from RPI to CPI yet the full cost/benefit case is less clear and there is no evidence yet that customers support the switch of indexation. Without a clear expression of the benefits it is difficult to fully assess the necessary trade-offs however what is apparent is there are a number of considerations and issues associated with the proposals.

The impact on the cost of debt and the cost of equity is a key consideration in the analysis of costs and benefits. For equity investors it is clear that they bought into the sector on the basis RCV was RPI linked and this change undoubtedly changes the risk profile of the original investment.

For debt investors the principle that 100% of the debt is linked to RPI through 50% of the RCV being linked to RPI is not value neutral. Debt investors value the current collateral they have where the RCV linked to RPI is larger than the debt lent against it. Under the Water 2020 proposal, there will be no headroom, with the RCV linked to RPI being roughly in line with the level of debt and therefore lenders would perceive a significant increase in risk as the extra headroom is not linked to RPI but another index which will be lower.

When considering CPI indexation there are two clear areas where this can be implemented:

- Indexation of revenue
- Indexation of RCV

We strongly believe that the indexation of the RCV by CPI, at this time, is the more significant issue for the industry and could impact the risk assessment and value that the whole investment community places on water companies. What seems to us to be also relevant here is that the majority of the benefits of changing the index can be achieved by only changing the index for adjusting revenues and there is no strong case for adjusting the index used for the RCV.

Indexation of the RCV to CPI will also lead to bill increases for customers in the short term unless regulatory mechanisms such as the pay as you go rate and run off rates are utilised. We are concerned about the use of these mechanisms to deal with CPI indexation as this would result in less flexibility to use these tools to deal with any other potential bill impacts driven by customer priorities.

We are also concerned that although Ofwat has made a statement that companies should be able to make this transition 'value neutral' and there should be 'no impact on the total (nominal) level of returns earned by investors,' we remain unconvinced that this can be done on equity returns over the longer term for each water company, at an actual or notional level. Greater clarity is needed from Ofwat about their use of the terms 'value neutral' and 'return neutral' how they define these and what mechanisms will be deployed to allow the proposed approach to be built into PR19 and subsequent price reviews.

We also believe that the WACC will need to be increased by more than the difference between RPI and CPI to ensure that it is value neutral for companies. This amongst other things reflects the additional hedging costs on index linked debt. In addition, while we understand that a less volatile bill profile is viewed by Ofwat as an argument in favour of the legitimacy of CPI use, we do not consider that a switch to CPI indexation could result in a lower cost of equity. Even if it was the case any impact arising from the lower volatility of CPI would be outweighed by the increase in hedging costs and financing risks.

Implementing only indexation of revenue to CPI would also resolve the immediate bill impact caused by the RCV indexation proposals described above.

If the proposal to index the RCV by CPI remains, we believe an adjustment should be made to the proposed transition mechanism. Currently the consultation proposes that 50% of the RCV is indexed to CPI. We strongly believe that CPI should be applied only to new investment with the existing 2020 RCV linked to RPI. This means that clarity on the pace of change to CPI indexation is set out to debt and equity investors over a period longer than the 5 year period, which matches better with the whole asset life time horizon of debt and equity investors. Furthermore there is a degree of flexibility over the pace of change under this solution which gives companies the opportunity to manage the individual hedge between their revenues and costs, and to also better align with the development of a CPI market. All of which are ultimately of benefit to customers.

We believe the proportion of RCV linked to CPI should not be prescriptive for two principal reasons.

Firstly, companies have very different levels of indexed linked debt and therefore the proposals will impact companies to a differing degree. The simple 50% split does not recognise this in any way and it does not reflect what seemed to be Ofwat's early view that WOCs and WASCs are exposed to this issue in different ways and should be dealt with separately, even at a notional level.

Secondly, as discussed above, if the regulatory tools of pay as you go rates and run off rates are fully utilised to deal with the bill impact caused by this regulatory change then this leaves no scope for them to be used to deal with any other customer priority issues at PR19. Furthermore, if these regulatory levers are used to manage the bill impact then the overall effect of the policy change would be to leave bills and company cashflows unchanged from the RPI indexation option. This would raise the question of why make such major changes to two fundamental parts of the regulatory methodology, i.e. the treatment of RCV and the depreciation allowance, when the changes offset each other. Moody's state in their note of 13th January that such change could undermine investors' confidence in the regulatory regime.

An alternative solution could be for the percentage of a company's RCV that is indexed by CPI to be proposed by each company as part of their business plan submission. This would allow each company to reflect their individual customer priorities and would enable them to have effective dialogue with customers about the overall package of services and bill impacts and the potential options for using regulatory tools to manage the impact on bills over time.

Independent assessment

We have worked with Water UK and NERA who have undertaken an independent study of the implications of a change to the index used in setting price controls. We support the findings from this report.

NERA's investigation of the different indexation options involved discussions with around twenty financial institutions active in the water and wider utility sector, including debt and equity investors, Standard and Poor's and Moody's Rating Agencies, as well as a selection of water companies Treasury teams, and a discussion with the Debt Management Office (DMO).

The report will have been circulated to Ofwat, however key conclusions from this work are summarised here.

- Investors are concerned about the impact of a shift to CPI on credit metrics and do not perceive that any change will be value neutral.
- Increases in financing costs will arise due to increased exposure to basis risk and the absence of a CPI government-led debt market.

In addition, all investors (without exception) considered that an efficient CPI market – for both corporate bonds and derivative products (e.g. swaps) – is unlikely to develop in advance of a decision by the DMO to develop a CPI ILD gilt market given the central role of sovereign debt in creating liquidity and a pricing benchmark. There were a number of reasons given in the report, (e.g. the stability of the CPI index, future government decisions on inflation measures, lack of urgency from DMO to issue CPI linked debt) which point to the likelihood that this market is not going to develop very quickly in the near term.

In the absence of any DMO intention to issue CPI gilts, investors considered that the market for CPI corporate debt would not develop into a sizeable efficient market. As a result, they see risks that financing costs will increase not just in the short-medium run but also over the long run since companies will be unable to properly hedge the CPI indexation risk in prices in their funding strategies.

We are not convinced that Ofwat has fully factored in these increases in risk and financing costs in its consideration of the customer benefit.

Overall

We strongly recommend that RPI indexation to the RCV is retained and that revenue should only be indexed by CPI. We have concerns on the application of CPI to the RCV before there is a mature CPI debt market.

If Ofwat is to proceed with indexing the RCV to CPI it should seek to address the above concerns by applying CPI indexation only to new additions to RCV. This solution gives clarity to debt and equity investors on the introduction of CPI over a longer timeframe than 5 years and allows a degree of flexibility on the introduction of CPI that acknowledges differences in WaSCs and WOCs' capital structures and allows for better management of the near term impact on customers' bills.

Risk based review (RBR)

We support the use of the RBR and it did provide a significant incentive in producing quality business plans for PR09. We believe these incentives could be strengthened with relatively minor changes to the approach largely by providing more transparency on the approach and making the rewards and penalties visible in advance.

Q3. Do you agree with our proposals in relation to customer engagement and outcomes?

CCG summary

We welcome the clarity the Water 2020 document gives to the remit of future CCGs. This clarity will crucially enable all parties to focus on the areas directly linked to their remit and provide best value in the process.

Our CCG played an active and crucial role in challenging us on the quality of our customer engagement throughout PR14. We have maintained this momentum since PR14 through the establishment of our own Customer Panel to monitor and challenge our delivery of our performance commitments up to 2020. We therefore support Ofwat's confirmation of the continuing role CCGs will have at PR19, and the regulator's expectation that this should dovetail with companies' ongoing engagement activities. Our aim in 2016/17 is to embark on developing our Panel into a new CCG for PR19 so that it can engage from early in the process.

We are pleased to report that the Customer Panel has continued to add a valuable contribution to South East Water and its customers in a similar way to how the CCG did in PR14. This has been particularly enabled by having continuity between the CCG and the Customer Panel from our independent Chair and a number of the members. We are also pleased that we were able to recruit new members to our Customer Panel including three household customers and a non-household customer representative. Ensuring we have a broad range of skills and experience on our Customer Panel is critical and we therefore had a specialist from the Citizens Advice Bureaux on both our CCG in PR14 and for our current Customer Panel.

Active discussion and dialogue with the CCG during a price review process and now with our Customer Panel is essential. We have already had a specific workshop with a sub-group of our Customer Panel on Water 2020 to ensure their views about future CCGs are represented in our response to this consultation document. This workshop also included early discussion about our thoughts on our customer engagement strategies and how we would involve them from the start.

Customer engagement summary

We believe ongoing, regular interaction with our customers is how we will continue to build trust and loyalty. We also believe that for this goal to be achievable it needs to be supported by the right form of incentives.

At PR14 we began the journey of implementing innovative customer facing incentives in the form of constant satisfaction assessments. Including these incentives has demonstrably changed our business to become significantly more customers focused. This has impacted all areas from a strategic rebranding to create a brand that says something to customers about the value we add to a range of culture change initiatives that are getting our staff right behind the new approach.

In relation to the proposals included in the consultation document we support the idea of introducing new customer engagement techniques. However, we believe these should be introduced alongside existing methods so that any differences can be fully understood. It is disappointing that our approach at PR14 which triangulated traditional willingness to pay techniques with less “black box” techniques was not more widely recognised at the time. We will build on this approach at PR19. For instance, we are exploring the scope for revealed preference methods to support willingness to pay surveys. We are also considering how result of more day to day customer interactions, complaints and surveys can usefully inform our investment and service strategy for PR19. These may help more in monitoring performance and setting high level priorities, whilst specific willingness to pay surveys, revealed preference and other assessments are still likely to be needed to determine our detailed PR19 investment plan, especially if a cost benefit assessment is employed in the business plan assessment.

We agree with Ofwat's consultation that understanding customers' views about longer term issues needs further emphasis at PR19. We note that the complexity of intergenerational impacts should not be underestimated and we need to consider carefully how customer engagement can contribute to long term planning. It is early days in the consideration of this issue and we are actively assessing the market to see what expertise is available to assist in this area.

Outcomes summary

The introduction of outcomes at PR14 provided the opportunity for companies to make a step change in how their performance is measured and targeted – encouraging companies to put customers at the heart of their business.

We embraced this new approach and challenged how we run the business to ensure customers are at the heart of everything we do. This is, demonstrated in the range of outcomes we included in our 2015-20 business plan, specifically with the inclusion of a suite of customer satisfaction outcomes.

Therefore we are pleased to see that it is proposed the outcomes framework will be substantially retained from PR14 and improved where possible.

Focusing outcomes on the longer term is important and we believe our balance of customer satisfaction outcomes and sustainability outcomes for PR14 made a good step towards promoting this.

We believe customer satisfaction is the ultimate long term measure. Targeting satisfaction is in itself a dynamic target as expectations change overtime. In our view these kind of measures lead to a longer term focus as there will be no ambiguity or opportunity to change tact as exists currently with other outcomes at each price review.

Introducing customer satisfaction measures across all aspects of a company's activities also means that customer's views and expectations are considered at every stage of a process and not just by the customer facing part of the business. We are finding that it drives us to understand at a more granular and ongoing level what pleases our customers and what causes customer dissatisfaction.

We believe SEW took the first step on this new approach and that further enhancements can be made to the range of outcomes the industry has with more focus being placed on measuring customers' views of their experience with their water company and the feelings they have towards their water company and the industry – this will fundamentally drive a shift in trust and confidence from all consumers. Focusing on customer satisfaction outcomes will result in customers giving their view on their direct interactions with a company but also their perceived view of the level of service the company provides. This more closely reflects the environment and pressures that would be seen in a competitive market. It will also encourage companies to consider not just their direct interactions with customers but also how they behave in the community they operate within.

We believe if outcomes are created and targeted with this focus, and in the right way, it has the potential to create another culture shift for the industry building on the steps that Ofwat introduced as part of PR14.

Q4. Do you agree with our proposal to extend protection of the RCV to 2020?

Whilst we welcome the position Ofwat has taken to protect efficient investment included in the RCV up to 31 March 2020 we feel that the lack of any commitment beyond this date will impact investor confidence. A significant proportion of the investment undertaken by companies is in long-life assets and therefore any protection of the RCV should recognise the length of the asset life. Any investment undertaken in the period up to March 2020, but whose asset life extends beyond this point, should also be protected.

We are concerned that if this investment remains unprotected then there is a risk that this will negatively impact investor confidence and may also alter the investment decisions companies take – for example if a company perceives a high risk of stranded assets then it may impact on the options chosen making them more short term and shorter asset life driven – this could lead to a negative impact on resilience and necessary long term investment. There is a particular risk of this for investment decisions made closer to the March 2020 threshold.

We recognise that Ofwat are looking to propose a mechanism that will guarantee a future return on this investment however at present this remains unclear. We believe that a firm commitment to protecting this investment is required from Ofwat to ensure that there is no unintended consequence of changing investment behaviour which subsequently impacts on resilience.

This commitment would need to address the following issues:

• How is 'efficient investment' to be determined? It should not permit any retrospective assessment of whether the investment was efficiently incurred, but should focus solely on the information at the point the investment was made.

• How would the RCV protection distinguish between post-2020 and pre-2020 assets. How would Ofwat determine that a post-2020 asset should be partly or completely stranded? Clarity on this process will be crucial for investors and companies.

The principle of the proposals in the consultation document seems to achieve the objective of avoiding stranded assets for the 2020-25 period however the level of protection beyond this date is not yet clear. As outlined in our response to question 15 we are concerned about the lack of clarity around investment in assets that extend beyond 2020 – 2025 and would seek a firm commitment from Ofwat to achieving an appropriate return on efficient investment over the life of the asset.

This proposal seems to meet the requirement of recovering a reasonable return on efficiently incurred investment over the life of the asset.

While further detail would be welcome, more important to companies and investors at this stage is a firm commitment that long term investment in water resources assets, particularly those made toward the end of the March 2020 period and into the 2020-25 period will be adequately remunerated over the life of the asset.

3 ANSWERS TO SPECIFIC CONSULTATION QUESTIONS:

Below are responses to the specific questions in the consultation.

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

N/A

Q2a. Do you agree with our proposal to make a range of cost, price, capacity and location information available to facilitate the identification of trades?

N/A

Q2b. Do you agree that the data should be published on a STC and STW site level?

N/A

Q2c. Do you agree that the data should be published annually?

N/A

Q2d. Do you agree with the categories of data that we are proposing are necessary and appropriate, as illustrated in the tables? Are any missing?

N/A

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

N/A

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

N/A

Q5. Do you agree with out proposals not to make any changes to the status quo in relation to system operation activities?

N/A

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

N/A

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

A separate price control will help to reveal more information for water resources and allow more targeted incentives. However this aim could be at least partially achieved with a requirement for separating the reporting of cost information rather than introducing a separate binding control.

Therefore the need for a separate binding control centres on the need for the implementation of access prices for use of an incumbent’s network. We comment on this in a later question.

Building on the experience for companies from the separation of the retail price controls in PR14 it will be essential that cost allocation methodologies and rules are clear from the start, that water resource assets are consistently considered and that there is a clear delineation between treatment, raw water transfer and water resources.

One important element to consider with a separate water resources price control is that there would need to be a greater degree of consistency between the Water Resource Management Plan process and the Price Review process – which as a minimum should be assessed using the same principles and guidelines. The proposal to use the market place for optioneering represents a significant change and we assume that this marketplace will be used for the creation of companies WRMP19 plans. If so this is not clear within the recently issued WRMP guidelines. This change also impacts on any proposal to shorten available time to create the WRMP as the process has to now deal with this worthwhile but complex change to the current WRMP process.

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 process reflect average costs?

In principle we support the introduction of an offset mechanism to ensure that entrants can recover the cost of new resources appropriately. Care must be taken to ensure that this mechanism is a fair and transparent method for both entrants and incumbents.

Further work is needed in this area to ensure all potential issues and identified and mitigated or resolved where possible. For example absolute transparency of all costs from new entrants and incumbents would be needed to prevent the potential for one party to overstate their cost estimates in order to be only marginally lower than the LRIC when the true underlying cost is lower. This would lead to the full benefit for customers not being realised.

In addition, the implementation of the access pricing and offset mechanism should ensure that there is equal treatment between the incumbent wholesaler and a non-household retailer when it comes to engaging with a new resource entrant. So it would not be appropriate of a new resource entrant to face a stronger incentive to contract with the retailer than to enter into a third party supply agreement with the wholesale incumbent. We believe a key issue with the current proposal is a possible distortion of the market created by potentially creating an overly positive incentive to trade through the access route rather than supplying the wholesaler direct.

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 support this proposal and are particular pleased that is very closely aligned with our own proposals as set out in the work we commissioned with Frontier Economics and published in the Marketplace for Ideas.

The proposals build on existing requirements in the Water Resource Management Plan processes relating to the consideration of third party options and offers greater scope to challenge existing and future bulk supply agreements.

We believe further consideration should be given to see if the market information database concept could be extended to allow companies to include sub-optimal existing assets in the market to see if more economic new water resources options are available. Iif this is not the case the assumption would be in effect that the current arrangements are optimal which is highly unlikely due to legacy arrangements. Whilst there is a risk that assets might be stranded using this approach the comparison of costs between the new and existing asset would need to consider the stranding costs before proceeding.

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

We support this proposal as it is important that the market information database is independent of the water industry. We believe this independence will help encourage new entrants to participate in the new market.

However, it is important that the scope and activities that are required to be undertaken by a third party are carefully controlled to ensure no unnecessary expenditure is incurred and that the risk is properly considered.

The cost of the third party organisation should be factored into the allowed cost for companies and should there be a mismatch between the allowed and actual expenditure an appropriate mechanism should be put in place to recover/adjust for and variance.

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?

We agree there needs to be transparency and certainty in relation to the security of supply for water trading. We are concerned that the burden of evidence may be a significant constraint to new entrants – a practical and acceptable solution of how this is addressed needs to be explored further.

We believe water trading should be encouraged both through improvements to the regulatory framework and underpinned by changes to company licences. Currently bulk supplies are managed via contracts between water companies and therefore priority will always be given to 'in area' supply over any water due to be supplied to a neighbouring water company. If bulk supplies were covered within a company's licence, such that there were equal duties to that of the company's own area as well as the bulk supply we believe this would increase the amount of water traded as it would equalise the operational risk between third party and 'in area' water.

Bulk supplies should also adequately reflect any ODIs and SIM targets a company has such that if an ODI penalty is triggered due to a failure to deliver the required water under the terms of a bulk supply, this reputational and financial penalty should be shared with the provider of the bulk supply.

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

We support the development of alternative approaches to accessing water resources and acknowledge the need to allocate a portion of the RCV to water resources as part of the mechanisms to facilitate this. Notwithstanding this our priority is for the appropriate guarantees and commitment to continuing to earn a return on water resources investment which is inherently long term in nature. We would also reiterate that the approach needs to ensure that it does not create an imbalance between the risk of a long life schemes and a short life schemes being built. Any such bias could negatively impact on the resilience of the industry.

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

N/A

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

We agree with the proposed approach of allocating RCV to the water resources using an unfocused method. Allocating RCV using a focused method would result in a material impact on the remaining RCV in water network plus price control.

Given the access pricing methodology and compensation payment the level of RCV allocated to resources should not affect the scope for an efficient new water resource entrant to enter the market. In that case the allocation of the RCV to water resources should be determined by the appropriate balance between managing RCV stranding risk, preserving a low risk regulatory model for investors and low prices for customers, while ensuring that the water resource business has adequate regulatory capital to absorb risk and respond to regulatory incentives. The unfocused method is the appropriate starting point for achieving this balance.

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?

Whilst we welcome the position Ofwat has taken to protect efficient investment included in the RCV up to 31 March 2020 we feel that the lack of any commitment beyond this date will impact investor confidence. A significant proportion of the investment undertaken by companies is in long-life assets and therefore any protection of the RCV should recognise the length of the asset life. Any investment undertaken in the period up to March 2020, but whose asset life extends beyond this point, should also be protected.

We are concerned that if this investment remains unprotected then there is a risk that this will negatively impact investor confidence and may also alter the investment decisions companies take – for example if a company perceives a high risk of stranded assets then it may impact on the options chosen making them more short term and shorter asset life driven – this could lead to a negative impact on resilience and necessary long term investment. There is a particular risk of this for investment decisions made closer to the March 2020 threshold.

We recognise that Ofwat are looking to propose a mechanism that will guarantee a future return on this investment however at present this remains unclear. We believe that a firm commitment to protecting this investment is required from Ofwat to ensure that there is no unintended consequence of changing investment behaviour which subsequently impacts on resilience.

This commitment would need to address the following issues:

- How is 'efficient investment' to be determined? It should not permit any retrospective assessment of whether the investment was efficiently incurred, but should focus solely on the information at the point the investment was made.
- How would the RCV protection distinguish between post-2020 and pre-2020 assets. How would Ofwat determine that a post-2020 asset should be partly or completely stranded? Clarity on this process will be crucial for investors and companies.

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 2020-2025 period?

The principle of the proposals in the consultation document seems to achieve the objective of avoiding stranded assets for the 2020-25 period however the level of protection beyond this date is not yet clear. As outlined in our response to question 15 we are concerned about the lack of clarity around investment in assets that extend beyond 2020 – 2025 and would seek a firm commitment from Ofwat to achieving an appropriate return on efficient investment over the life of the asset.

Q17. 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? 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 proposal seems to meet the requirement of recovering a reasonable return on efficiently incurred investment over the life of the asset.

While further detail would be welcome, more important to companies and investors at this stage is a firm commitment that long term investment in water resources assets, particularly those made toward the end of the March 2020 period and into the 2020-25 period will be adequately remunerated over the life of the asset.

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?

We agree that the proposals, if implemented correctly, should result in the correct incentives for efficient new water resources.

Q19a. In relation to access process for water resources, do you agree with our proposal that companies should be responsible for calculating and publishing these?

In principle we support this proposal however it should not be underestimated the amount of time companies will need to invest to ensure that access prices are robust.

Q19b. Do you agree they should be published by water resource zone, with network distribution and treatment costs separately identified?

It will be important to balance the amount of work required with the potential use of this mechanism by third parties. Further consideration should be given to allow companies to publish indicative prices at a regional level (larger region than water resource zone) and then provide more specific prices on request.

We note, however, that any move to provide access prices by water resource zone should not lead to disaggregation of end-user charges.

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?

See response to question 8.

The LRIC method has advantages in principles but will need careful consideration if it is not to distort the decisions of entrants and incumbents. The use of AIC data to proxy the LRIC raises a number of questions. These include but are not limited to:

- The treatment of environmental and social costs in the LRIC calculation;
- The treatment of the cost of headroom and outages into the access price;
- Whether non-network schemes such as demand management should be included in the assessment of LRIC;
- The time horizon for reviewing the LRIC calculations and the certainty that this provides for entrants;
- The link between network investment and water resource zone LRIC, i.e. would access prices be revised if an incumbent invests in connecting two zones together.

These issues, and others, need further detailed consideration for this methodology to be effective.

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?

See response to question 8 and 20. Yes, provided that the LRIC methodology is implemented correctly.

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 preciously set out?

N/A

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 evaluate?

N/A

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

South East Water will consider all options for delivering services to customers as efficiently as possible, including direct procurement. We highlight though that the transaction costs associated with direct procurement options mean that, in practice, efficiencies through this route will be challenging for smaller projects.

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?

No specific view but seems a reasonable value.

Q26. Do you agree that our proposal for four binding wholesale 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?

N/A

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

We support this proposal. The costs incurred in the water network are almost completely independent of the volumes delivered in the short and medium term. Therefore a revenue control is an appropriate regulatory model.

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?

N/A

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

It is our view that in the South East of England, due to the relatively limited availability of new supplies the benefits of long life investment, through added resilience for companies and customers, are likely to significantly outweigh the benefits achieved through markets and contestability. We believe that a level of regulatory commitment will still be needed to support this long life investment. On this basis we see limited benefits in changing from the current level and nature of remuneration for efficiently incurred long term investment up to 2020 and beyond.

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?

The primary objective here must be to prevent stranding of efficient investment and entry of long term solutions. There is a trade off and tension here between contestability on the one hand, which may result in lower bills to customers - and the need for long life solutions to improve resilience. A careful balance needs to be struck that achieves both by considering the benefits achieved through long life investment against the potential benefits from contestability.

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

We support the proposal to retain the RBR approach for PR19. However we believe there are some improvements that could be made for PR19 as shown below:

- Specific criteria for the assessment between enhanced, standard and resubmit should be published in advance of companies submitting business plan
- The reward package for achieving enhanced should published in advance of companies submitting business plan to provide the appropriate incentive
- Early view on the cost of capital – for CCGs and companies to allow a more robust dialogue with customers about the likely change in price and service
- Assessment of companies plans against the RBR criteria should be carried out after any model adjustments are made to recognise any company specific factors

We support the proposal to retain the resubmit category as this provides a strong incentive for companies to ensure plans are of a good standard.

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 support the proposal for current performance to be included in the RBR – subject to the following observations:

- Consideration should be given for atypical events that have disproportionately affected company performance – companies should demonstrate the impact of any event and provide evidence to support its atypical nature.
- A balance needs to be struck across all of a company's performance commitments (with appropriate emphasis to different measures) so that an overall view of company performance can be ascertained and not disproportionately skewed by performance on a specific measure (positive or negative).
- Maturity of the measures included in the assessment should be taken into consideration such that the development of new innovative measures is not discouraged in the future
- Performance should be based on the targets outlined in each individual company's final determination with consideration given to the gap between company performance at the start of 2015 and where the company is performing by the end of 2020. This would then directly consider the size of the improvement made in the current five year period.

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

We support this proposal, however clarity should be given on the assessment criteria for this aspect.

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

We agree that the consideration of disaggregated cost models is appropriate. However it is imperative that the overall model strength is high and that costs are properly explained and that a fair and robust approach is used to consider factors unique to one or more company that are not properly reflected in the model.

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

We support this proposal as it has been our long standing view the detailed cost allocation guidelines are published and not left to interpretation. For comparative models consistency should be one of the primary objectives.

Q36. Do you agree with our proposal to retain the current timings of our price controls – that is, **not** change the duration of wholesale price controls, **not** to stagger wholesale water and wastewater price control and **not** seek to further align the timing of controls with other planning processes?

We agree with the proposal to retain a five year price control, however we believe that the price review process needs to be aligned with the Water Resource Management Plan (WRMP) process.

The current proposed timetable results in companies submitting their business plans whilst at the same time companies, under the statutory water resources planning process, will be in the middle of their consultation on their draft WRMPs.

Following consultation on the draft WRMP we will receive representations from the Secretary of State on our plan, including from Ofwat, that may require us to change our plan and submit a revised plan. We believe publishing a business plan for the price review before the end of this process is completed would be very problematic.

In addition we have a strict deadline to deliver the NEP programme investigations by 2018 so that these feed into the WRMP and Business Planning process. It will not be possible to deliver the NEP any earlier, and therefore it would not be possible to feed into a Business Plan submitted in July/August 2018. This would be a significant omission.

A possible option would be to bring the WRMP19 process forward into 2017; however this would not solve the issue with the NEP described above.

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

As outlined in question 49 we believe the outcomes framework could benefit from more emphasis being placed on measuring customers' views of their experience with their water company and the feelings they have towards their water company and the industry.

We believe customer satisfaction is the ultimate long term measure and that targeting satisfaction is a dynamic target as expectations change overtime. In our view these kind of satisfaction measures naturally lead to a longer term focus.

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

We agree in principle with the need for licence changes for these purposes.

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

When considering CPI indexation there are two clear areas where this can be implemented:

- Indexation of revenue
- Indexation of RCV

We strongly believe that the indexation of the RCV by CPI, at this time, is the more significant issue for the industry and could impact the valuations that the debt and equity investment community place on water companies and ultimately via elevated financing costs increase bills for customers.

Indexation of the RCV to CPI will also lead to bill increases for customers in the short term unless regulatory mechanisms such as the pay as you go rate and run off rates are utilised. We are concerned about the use of these mechanisms to deal with CPI indexation as this would leave these tools unavailable to deal with any other potential bill impacts driven by customer priorities. Furthermore we note that Moody's have stated that using these tools to deal with bill impacts could erode confidence in the regulatory framework, which is detrimental for investors and customers.

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

Overall we do not consider that implementing CPI indexation of the RCV achieves any additional benefits compared to the option where prices / revenues are indexed by CPI and RCV continues to be indexed by RPI.

If indexing the RCV by CPI is implemented by Ofwat then it is essential a transition process is part of this change. However, we believe an adjustment should be made to the proposed transition mechanism.

Currently the consultation proposes that 50% of the RCV is indexed to CPI in the 2020-2025 period. We strongly believe that CPI should be applied only to new investment with the existing 2020 RCV linked to RPI. This means that clarity on the pace of change to CPI indexation is set out to debt and equity investors over a period longer than the 5 year period, which matches better with the time horizon of debt and equity investors. Furthermore there is a degree of flexibility over the pace of change under this solution which allows companies the opportunity to manage the individual hedge between their revenues and costs and the impact on bill profile which is ultimately of benefit to customers.

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?

Our preferred option would be for the RCV to remain indexed to RPI.

As outlined in our response to question 40 we believe an adjustment to the transition mechanism should be made.

We recommend that CPI should be applied only to new investment with the existing 2020 RCV linked to RPI. This means that clarity on the pace of change to CPI indexation is set out to debt and equity investors over a period longer than the 5 year period, which matches better with the whole asset life time horizon of debt and equity investors. Furthermore there is a degree of flexibility over the pace of change under this solution which allows companies the opportunity to manage the individual hedge between their revenues and costs and the bill profile which is ultimately of benefit to customers.

An alternative solution is for the percentage of a company's RCV that is indexed by CPI to be proposed by each company as part of their business plan submission. This would allow each company to reflect their individual customer priorities and would enable them to have effective dialogue with them about the overall package of services and bill impacts and the potential options for using regulatory tools to manage the impact on any bills over time.

It is essential that any change implemented is done so in a 'value neutral' way. An amendment to the transition process as described above strengthens the value neutrality intention.

An important factor to any transition mechanism is that it needs to be able to work across multiple price control periods and give certainty to investors and the industry that this is the case. We believe Ofwat needs to investigate this further so that the solution provides clarity for any mechanism introduced in PR19 and beyond.

Q42. Do you agree with our commitment to ensuring that any such changes is value and bill neutral in NPV terms over time in nominal terms? What steps could be taken to make this commitment as credible as possible?

It is essential that any change implemented is done so in a 'value neutral' and '(nominal) return neutral' way.

We are concerned that although Ofwat has made a statement that companies should be able to make this transition 'value neutral' and there should be 'no impact on the total (nominal) level of returns earned by investors,' we remain unconvinced that this can be done over the longer term for each water company. Greater clarity is needed from Ofwat about their use of the terms 'value neutral' and 'return neutral' and how they define this and what mechanisms will be deployed to allow the proposed approach to be built into PR19 and subsequent price reviews.

We also believe that the WACC will need to be increased by more than the difference between RPI and CPI to ensure that it is value neutral for companies. This amongst other things reflects the additional hedging costs on index linked debt. In addition, while we understand that a less volatile bill profile is viewed by Ofwat as an argument in favour of the legitimacy of CPI use, we do not consider that a switch to CPI indexation could result in a lower cost of equity. Even if it was the case any impact arising from the lower volatility of CPI would be outweighed by the increase in hedging costs and financing risks.

As outlined in our response to question 41 we believe that Ofwat needs to provide long term certainty over this statement such that the industry can be confident that value neutrality can be achieved over the longer term. For example, this should include a commitment to transparency over the following parameters:

- The value neutrality definition:
  - The time period over which value neutrality is measured;
  - The neutrality on the basis of all cash flows and asset base, not just revenues; and
  - On a notional basis or company specific basis;
- Underlying mechanisms to reach value and nominal return neutrality;
- The application of those mechanisms in subsequent price reviews;
- The real WACC measured against both RPI and CPI – so that investors can understand the evolution of the return on investment; and
- The assumed differential between the RPI and CPI, how this is derived and how it will be treated in the regulatory methodology.

For the calculation to be value and nominal return neutral, the calculation needs to be made over the whole life of the assets. A lack of clarity in the calculation for the period beyond 2025 is detrimental to value and returns.

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 believe that it is appropriate that the risk of the forecasting of the RPI-CPI wedge should be borne by customers as it is now. This is consistent with the existing licence parameters and therefore an adjustment should be made. The lack of an effective true up would challenge the deliverability of value and return neutrality.

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?

The assessment of how risks vary across parts of the value chain, set out in 6.3 of the consultation paper, provides an interesting but partial initial analysis. The assessment does not take account of the fact that the regulatory method and the form of control is a fundamental driver of risk for each part of the value chain. Differences in business risks and operational gearing are relevant but generally less important than the regulatory incentives and risk mechanisms and the investor perception of RCV risk in each part of the value chain.

Therefore it is important that Ofwat considers the impact on the cost of capital of its proposals as it develops its proposals and that the assessment of different costs of capital in each value reflects both the underlying characteristics and the regulatory model.

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?

It is likely the balance of risk and opportunities would overall deteriorate as a result of the proposed market and incentive reforms.

In particular, the proposal to change the inflation indices offers no opportunity for additional efficiency or outperformance for companies but will result in an increase in the cost of funding for companies until the CPI index linked debt market is fully developed and the confidence of investors in the regulatory framework is returned.

The proposed market and incentive reforms will result in an increase in the variance of performance of companies in the industry, which in the short-term will result in an overall increase in risk which will only be off-set in the long-term if the industry can deliver further efficiencies than would otherwise be delivered under the status quo.

Q46a. What does customer engagement look like?

We see good customer engagement as understanding and valuing customer opinions and using them to shape the strategy of the business for the mutual benefit of both the customer and the organisation.

'Understanding' is a two-way process. To be effective, an organisation needs to listen to the opinions of those with whom it deals and not solely provide information. Two-way engagement is vital for good customer engagement and we are pleased this is at the heart of the engagement proposals for PR19 within this consultation.

We are already learning a lot more about our customers through our monthly surveys as part of our innovative satisfaction ODIs from PR14, and believe the insights we get from this will help us improve our engagement with customers as a business as usual activity every day. This is a new approach for the industry and therefore still in the early stages, we hope the regular results will give us a better understanding over time to measure and benchmark against.

We agree that good quality customer engagement also involves understanding and responding to the distinct needs and requirements of different types of customers, including (but not limited to) customers in vulnerable circumstances.

Q46b. What are your views on the principles outlined above?

We agree that customer engagement should be a priority for PR19 as we want to build on the innovative approach we took in PR14 and build on our customer satisfaction ODIs. We agree with the Ofwat's proposal to include new research methodologies into PR19 and we indeed begun some time ago looking at how we will evolve new techniques and introduce these alongside existing methods so that we can achieve a balanced view across the different types of engagement we plan to undertake.

Q46c. How could companies draw on good practice from within and outside the sector?

We continue to support the work of UKWIR to research into good practice within the industry and were pleased to be contributors to the customer liaison research "The future role of customer and stakeholder engagement in the water industry". We also support the continued use of the market place of ideas to help identify good practice and new ideas.

Q46d. 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?

As outlined above we support the proposals to include new research methodologies into PR19, supported by existing methods and our day-to-day interactions with customers. We see this 'basket' of research will help all companies improve their understanding of their customers' needs and requirements.

Providing customers with context and comparative data will be important in the customer engagement that is undertaken however care should be taken to ensure that where comparisons are made that measures are truly comparable, on an equal basis and the definition of metrics is clear. However care has to be taken not to create unrepresentative customers using this approach. We do however fully support the use of comparative information to inform CCG activities. Comparison of information where the metrics are not consistent or the underlying level of service differs due to customer priorities and willingness to pay may lead to an incorrect understanding of performance for some companies. The most reliable comparator for customers will be against the performance commitments each company has committed to over the period 2015 to 2020.

We welcome the creation of the Marketplace of Ideas as a hub for industry sharing of good practice approaches and look forward to working with the industry colleagues, our customers and employees to develop a really strong approach to engagement for PR19.

Q47a. What are your views in relation to our proposals on future CCG remit; scope; timetable; governance arrangements; and membership?

Remit and scope

We welcome the clarity the Water 2020 document gives to the remit of future CCGs. It is imperative that the scope of the CCG is clearly understood by all parties so that they can focus on the areas directly linked to their remit and provide best value in the process.

Our CCG played an active and crucial role in challenging us on the quality of our engagement throughout PR14 and we support the continuing role they will have in this area.

Timetable

We have discussed this issue with a sub-group and the Chair of our Customer Panel (who was also the Chair of our CCG at PR14). Based on their experience during PR14 there are a number of practical difficulties with the proposal that CCGs provide a report to Ofwat at the same time as the companies submit their business plans, these practical difficulties have been communicated to Ofwat both during and after PR14 and these concerns should not be ignored. They recommend that there should be a period of 2 weeks between the company's business plan submission and the CCG's report submission. We support this recommendation.

Governance and membership

We support the use of an independent Chair for the CCGs and also the inclusion of a debt advisory body in the membership as recommended in the Water 2020 consultation. We recognised the importance of having an independent Chair when we formed our CCG for PR14 and we have continued this for our current Customer Panel. We have also had the benefit of a specialist from the Citizens Advice Bureaux being an active member on both our PR14 CCG and our Customer Panel.

CCG reports- scope and remit

We support the list of issues proposed on page 150 of the consultation document for inclusion in the CCG report.

We have discussed the use of comparative information with a sub-group of our Customer Panel and we agree with them that this could be beneficial where measures are reliably comparable and the definition of metrics is clear. However, comparison of information where the metrics are not consistent or the underlying level of service will differ due to customer priorities and willingness to pay may lead to an incorrect understanding of performance for some companies as Ofwat's consultation notes. There may therefore need to be a clear hierarchy of information indicating reliability of use as comparators. The most reliable comparator for customers will be against the performance commitments each company has committed to over the period 2015 to 2020.

Role of CCG in monitoring delivery performance

We have also had a good discussion with our Customer Panel about how we can improve the visibility of our performance on range of measures, including our innovative customer satisfaction ODIs, such that customers would be informed of our performance more frequently than in our Annual Performance Report. We have fed the outcome of these discussions into our Customer Engagement and Involvement Strategy. Our intention is to continue the engagement to develop an agreed range of initiatives that will improve the visibility of our performance to our customers and stakeholders.

Q47b. 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 support the list of issues proposed on page 150 of the consultation document for inclusion in the CCG report.

Also see answer to Q47a.

Q47c. What are your views on the division of responsibilities between CCGs and Ofwat?

We welcome the dialogue that Ofwat has had with CCG chairs about their respective roles and support the proposal that this dialogue continues through a series of workshops.

Q48a. What are your views on our proposal to facilitate more collaboration between CCGs?

We support this proposal and welcome the regular meetings that CCG chairs are having already. We see this as an essential part of the PR19 process and builds on the ideas championed by the chair of our CCG at PR14. We consider the dialogue between chairs to be useful in enabling individual CCG chairs to compare best practice.

Q48b. What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early?

We support this proposal however it is essential that any WACC figure proposed is set at a fair and equitable level and publication of any information does not prejudice any consultation or discussions the companies would want to have with OFWAT. The conversation with customers will be better informed if we are using prices that are built on a WACC and RORE likely to be used within price setting.

Q48c. Without inserting ourselves between companies and their customers, what else could we do to incentivise and encourage good quality customer engagement?

Incentivising and encouraging good quality customer engagement

Good quality, and continuous, customer engagement is at the heart of our approach within South East Water. This is particularly supported by our new innovative customer satisfaction

ODIs that continually test the views of our customers so that we ensure their needs and priorities and central to how we operate.

We believe the risk based review process, including taking the CCGs views into consideration, is a good way to ensure companies are incentivised to undertake good quality engagement. We would recommend that clarity is given to the benefits and incentives to companies for achieving enhanced status so that this further encourages companies to continually improve.

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 control period?

In our experience regularly changing or unclear targets for long term investment areas i.e pressure, interruptions, water quality, security of supply etc are unhelpful. We would welcome fixed targets in these areas preferably over 10 years or longer as this would enable sensibly paced, procured and delivered strategies to be created and delivered, benefiting customers and companies.

At PR14 we consider some outcomes targets were set with step changes in performance not being phased in to allow the full suite of solutions to be assessed. For example a material change in a target level coming in to effect after only 2 years means less options are capable of delivering those targets as they would take too long to implement. For example for South East Water, included in our Final Determination was a particularly steep target in relation to discolouration contacts which encourages easily deployable, quick delivery solutions which may not be economic in the longer term. A smoother path over a longer period would mean this and other long term solutions could be considered.

We believe customer satisfaction is the ultimate long term measure and that targeting satisfaction is a dynamic target as expectations change overtime. In our view these kind of satisfaction measures naturally lead to a longer term focus. It also encourages companies to take ownership of and respond to issues raised in the press and by government such as leakage and financing as a satisfaction based framework means you are concerned with any impact on your brand irrespective of where it originates. It encourages companies to enter these debates with their customers and to not hide behind the regulators or rules.

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 support the need for a separate consultation on outcomes – specifically addressing the balance of bespoke versus comparative measures and the role of comparative information.

We understand the need for and support the principle of comparative information and outcomes in some areas however care should be taken to ensure that where comparisons are made that measures are truly comparable, on an equal basis and the definition of metrics is clear.

Drawing on comparisons is most appropriate in our view where customer priorities align nationally. Whilst league tables may be useful where the data is properly comparable, both in terms of the measures and underlying customer priorities, where there is a country wide priority to reduce leakage or improve resilience they would serve a stronger purpose. Ultimately comparators are useful where they create economically sound incentives to drive the best interests of customers. It could be argued that some of the incentives created by comparisons at PR14 went beyond what customers wanted and in some cases may also be uneconomic – for example interruption targets which appear to drive performance beyond that which customers are willing to pay for.

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?

Although we understand the reasons why the consultation document proposes early submission of performance commitments we are concerned that this might lead to companies submitting very similar commitments to PR14 and would result in fewer innovative measures being introduced.

We could see a benefit of submitting these definitions earlier in the process if the business plan submission is moved back to address the timetabling issues we discuss in our response to question 55.

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 agree in principle with the need for licence changes for these purposes.

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

The summary covers the main areas that would require a change, although it is likely that other consequential amendments will also be required. The key aspect to consider for the licence change process is that the proposed licence changes should be specific and proportionate and should be designed to enable clearly defined policy proposals and regulatory mechanism to allow companies and all other stakeholders to assess their impact.

Consultation on mechanisms and licence change should be well coordinated. Although licence changes may allow for sufficient flexibility they should not be so general as to become speculative.

Our preference is that changes are made through the section 13 process as the need for a consent provides an incentive to ensure that the proposals are specific and that all stakeholders have the opportunity to provide and receive feedback.

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

We agree with the next steps outlined.

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

As outlined in our response to question 36 we believe that the price review process needs to be aligned with the Water Resource Management Plan (WRMP) process.

The current proposed timetable results in companies submitting their business plans whilst at the same time companies, under the statutory water resources planning process, will be in the middle of their consultation on their draft WRMPs.

Following consultation on the draft WRMP we will receive representations from the Secretary of State on our plan, including from Ofwat, that may require us to change our plan and submit a revised plan. We believe publishing a business plan for the price review before the end of this process is completed would be very problematic.

In addition we have a strict deadline to deliver the NEP programme investigations by 2018 so that these feed into the WRMP and Business Planning process. It will not be possible to deliver the NEP any earlier, and therefore it would not be possible to feed into a Business Plan submitted in July/August 2018. This would be a significant omission.

A possible option would be to bring the WRMP19 process forward into 2017; however this would not solve the issue with the NEP described above.

An obvious compromise solution would be to bring forward the WRMP by two to three months and to move back the Business Plan submission date by the same period. We believe this balances the risk across all concerned parties and will ensure quality plans with sufficient determination time to support them.

4 IMPACT ASSESSMENT QUESTIONS

Q1. Do you agree with the benefit and cost impact categories we have identified?

Comments will be provided based on the quantitative impact assessment due to be included in the May 2016 document.

Q2. Are there any impact categories you think we have not included that are relevant, or any we have included that should be omitted?

Comments will be provided based on the quantitative impact assessment due to be included in the May 2016 document.

Q3. What are your views on the indicative scale of the impacts we have identified?

Comments will be provided based on the quantitative impact assessment due to be included in the May 2016 document.

Q4. Are you able to provide any evidence on any of the impacts in relation to our proposals?

Comments will be provided based on the quantitative impact assessment due to be included in the May 2016 document.