Water 2020: Regulatory framework for wholesale markets and the 2019 price review

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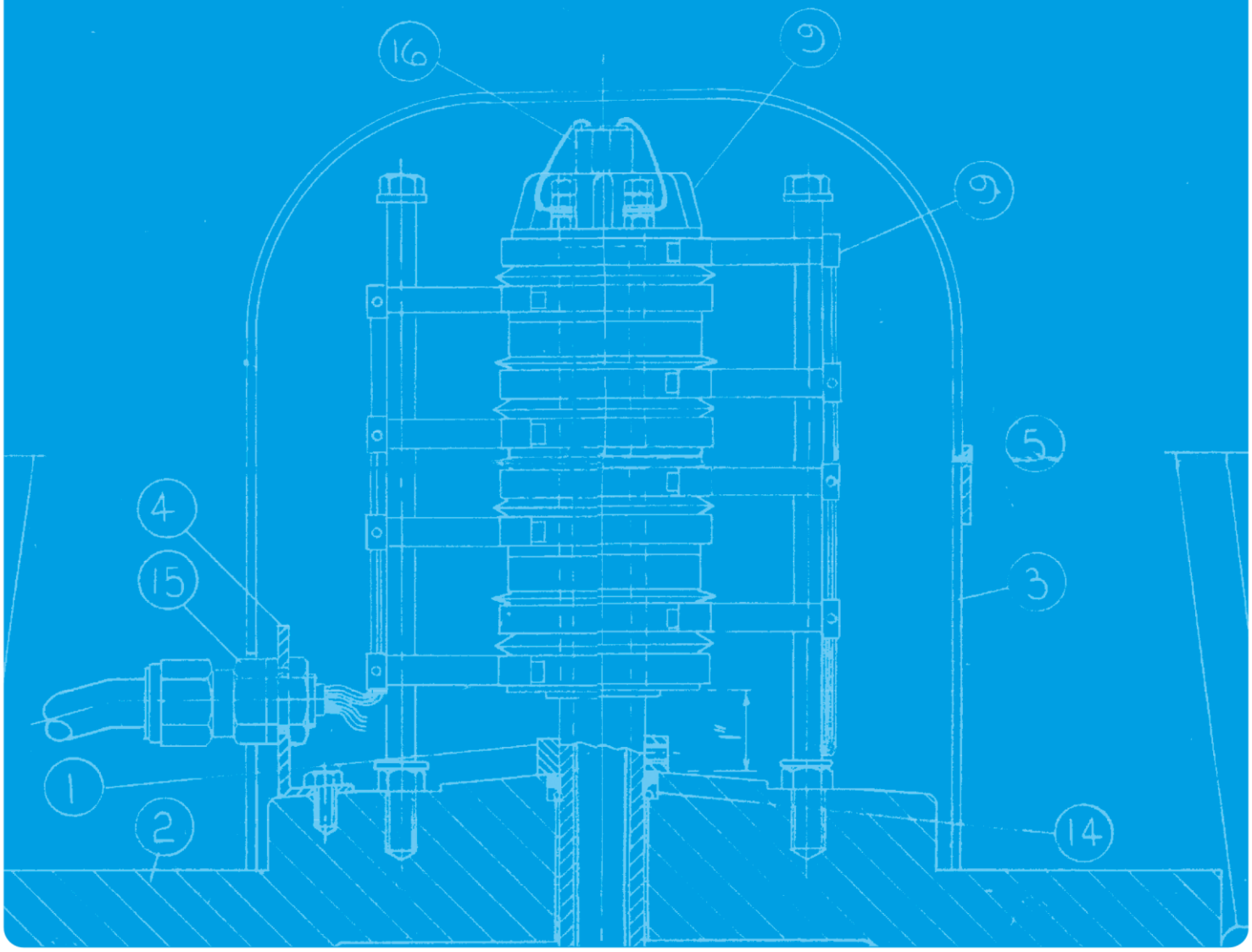

Water 2020: Regulatory framework for wholesale markets and the 2019 price review

Summary of our response

The water sector is at an exciting time. There is now a far greater focus in the sector on customer outcomes, with PR14 delivering a reduction in bills and far stronger incentives for companies to become efficient and deliver better services for customers.

Since PR14 some very significant strides have been taken by Ofwat to further develop the regulatory framework that underpins the sector. Critically, companies have responded, including through the market place for ideas.

We recognise that the water sector needs to continually evolve if we are to continue to be effective in delivering what customers want in the future. Our vision is that by 2020 we are the most trusted water company; by delivering outstanding customer experience; the best value for money; and environmental leadership. This means that we need to:

- better understand the priorities of our customers and embed these at the heart of all we do; and
- drive operational excellence so that we can deliver higher service levels where our customers value them most, whilst keeping bills low.

Ofwat's overall proposed framework for wholesale markets and the 2019 price review will help us deliver our vision by creating a much stronger emphasis on companies competing to deliver the best service for their customers. This applies to direct competition between companies to deliver sludge and water resource services; and more widely through the use of comparative competition to identify and reward the best performing companies. The need to challenge ourselves is something we have embraced and we have set ourselves the goal of delivering at least upper quartile performance for both total expenditure and customer services by 2020. We therefore fully support Ofwat's proposals to drive a more competitive and customer-centric sector.

Overall we think the reforms proposed by Ofwat have the potential to deliver enormous benefits to customers through lower prices and higher service levels. The ideas around sludge competition are perhaps the most exciting given recent technological developments and we think will help promote a more innovative and sustainable sector.

Whilst we support all of Ofwat's principles there is one specific proposal, the proposed use of CPI indexation, which we do not agree with. We have also identified a small number of proposals where we think Ofwat can deliver better outcomes through less intervention, namely the information requirements for the sludge market and how schemes are tendered.

CPI indexation

We do not believe the current proposals relating to CPI indexation will deliver the best outcome for customers. Bills and service levels will remain the same, and whilst bill volatility will be reduced, it will come at a cost of:

- reduced transparency;
- additional costs; and
- undermining investor confidence, most notable since we are asking them to fund long term investments whilst they are only offered 5 years of certainty about indexation.

To deliver the best result for customers, it will be important that bill volatility is reduced whilst investor confidence in the regulatory regime is maintained. This could be achieved by indexing bills and new additions to the RCV by CPI, and indexing historical (pre-2020) RCV by RPI. This would also have the added benefit of providing a clear timeframe for the termination of RPI indexation which the current proposals lack.

Delivering better outcomes for customers

We are very supportive of sludge competition and, like Ofwat, think it will help unlock better capacity utilisation and drive the development and adoption of new technologies. To drive the best outcome for customers it's critical that there is genuine competition between companies and third parties. We think further thought is needed about the information requirements otherwise it could have the adverse effect of undermining competitive behaviour.

We also support Ofwat's desire to introduce competition in the procurement of services. This will help ensure that customers pay the lowest possible price for their water and waste services.

The current proposals can only apply to large stand-alone schemes, of which there are likely to be very few and while the £100m threshold might be appropriate for the largest companies a lower threshold might be appropriate for smaller companies. We also note that this mechanism is only likely to work effectively where it relates to investment that is readily separable from existing activities and does not involve intervention from multiple regulators. As such we believe Ofwat should also consider applying different forms of tendering to large integrated assets.

Next steps

We are supportive of the overall framework proposed by Ofwat, but believe the proposal in relation to the use of CPI need to be reconsidered.

Our support of the package today is in the context that some of the proposals could potentially disadvantage Severn Trent. However in the round we consider that the package (excluding CPI) is appropriate. Looking forward it will be important to consider how the methodology that is ultimately applied adopts the right balance of risk and reward.

Our response to the consultation is attached in the accompanying template. For the proposals relating to CPI indexation and direct procurement we have also attached separate papers.

Appendix – Ofwat questions

Overview document

SQ1. Do you agree with our proposals for making a greater use of markets in relation to sludge and water resources?

We are very supportive of the proposals for sludge and (new) water resource markets. Like Ofwat, we strongly believe that competition, deployed in the right way, will increase the incentives for companies to realised efficiencies and ultimately deliver lower bills for our customers.

In our recent publication in our changing course series 'Charting a Sustainable Course' one of the key policy questions we raised was how do we deliver innovation and introduce market solutions for the benefit of customers? We asked this question because we recognise that how competition is utilised can have a significant impact on customers – through lower bills if done right, or through higher bills if delivered badly.

We think that Ofwat's focus on introducing competition for sludge and new water resources is right. There are significant opportunities for sludge competition to deliver benefits to customers, particularly though better utilisation of capacity and applying new technologies. We also consider that the barriers to sludge competition are much lower because companies can more readily reconfigure their networks. However we would emphasise that delivering benefits to customers requires genuine rivalry between companies and third parties.

To promote competition we agree that the provision of some data is necessary – this will help reveal market opportunities and allow parties to make better decisions. However we are concerned that the volume of data required and approach to asset valuations could have the unintended effect of undermining competitive behaviour. This could occur by reducing the ability of companies to compete aggressively on price/service and raising the cost of operating in the market.

For water resources, we support the proposal that there should be competition for the provision of new capacity. Given the challenges with reconfiguring networks and high sunk costs, competition for existing capacity would not deliver benefits to customers and instead would simply increase bills. We are therefore very supportive of Ofwat's focus on ensuring that the measurement of the Long Run Incremental Cost is done in a way that promotes efficient entry (i.e. where it displaces more expensive proposed supplies).

SQ2. Do you agree with our proposals in relation to the future form of regulation for the sector?

We are very supportive with the principles of the consultation and all but one proposal, CPI indexation. Leaving to one side CPI indexation, for all other proposals it's apparent how they will deliver lower bills and/or higher service levels to customers.

The proposals around CPI indexation are however different. We don't agree that this is the best way to improve transparency; the changes proposed will create additional costs and undermine investor confidence. We think that Ofwat can better reduce bill volatility and transition away from RPI by indexing revenues and new RCV by CPI and old RCV by RPI. This approach will also provide investors

with certainty about the transition away from RPI, whereas at present there is only 5 years of certainty.

We also support Ofwat's desire to promote more tendering. We think the proposal can be improved because at present the direct tendering proposal would only be applicable to a small number of discrete stand-alone schemes like reservoirs. We think applying different types of tendering to different types of assets would help deliver additional benefits to customers.

Finally we think there are opportunities for Ofwat to reduce the regulatory burden and in doing so, increase the level of competitive behaviour. This is particularly relevant for sludge where trading guidelines and large information requirements might encourage companies to adopt very risk-averse strategies instead of vigorously competing for market share

See individual responses to more detailed consultation questions below.

SQ3. Do you agree with our proposals in relation to customer engagement and outcomes?

We are fully supportive of the challenge from Ofwat that companies need to improve how they engage with customers and how they then use the views expressed by customers in developing their business plans. Customers are at the heart of our new strategic framework. In order to deliver our strategic ambition, truly put our customers first and be trusted by them, we need an increased understanding of what is really important to them.

A notable feature of the W2020 consultation is that Ofwat is setting expectations rather than defining specific actions or initiatives (as per sludge competition). We support this approach as we don't think there is a definitive answer as to what good customer engagement looks like. Instead companies will need to try new methods and continually adapt their tools and processes to learn from their experiences. If Ofwat sets specific actions or initiatives then it would have the potential to deter companies from trying new things, and lead to the lowest common denominator.

We also support the expectation that companies need to broaden how they understand customer priorities. We have challenged ourselves in this area and will be utilising information from multiple sources of evidence, particularly from our daily interactions, to reduce reliance on stated preference (although we expect these sources to be additive to stated preference).

We also welcome the challenge that customers should be engaged as 'partners who drive decision-making on an on-going basis'. This means that we (and other companies) will need to improve on PR14 and clearly demonstrate and evidence the golden thread from customer engagement to investment decisions.

Finally we support the principle that the CCG should challenge the company about how it has sought to understand customer views, balance different views and subsequently represent those views in the plan. The CCG should not be a substitute voice for customers or stakeholders in its own right. Similarly the CCG is not a substitute for Board ownership of a business plan. We comment below on the specific role of the CCG.

SQ4. Do you agree with our proposal to extend protection of the RCV to 2020?

The RCV is one of the central features of the regulatory framework. It helps to underpin investor confidence by acting as a commitment device which ensures that invested capital is remunerated. Whilst protection of the 2020 RCV is important, investor confidence associated with the RCV depends on two things:

- regulatory support and protection of the RCV itself; and
- what is applied against the RCV – specifically the real return and RPI indexation (which equals the nominal return in total)

Therefore to deliver investor confidence and ensure that the sector can continue to attract finance at a low cost Ofwat needs consider its approach to indexation. The current proposal creates a lot of uncertainty for investors given the lack of clarity about what happens to the RCV after 2025. We think greater clarity could be given to investors, whilst reducing bill volatility, by indexing revenues and new RCV by CPI and indexing old RCV by RPI.

Sludge

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

Sludge competition has enormous potential to deliver benefits to customers and we want to be one of the leading players in this market. We consider that this market will only work if there is genuine rivalry between parties. In the context of maximising competitive behaviour we comment below on:

- the form of the control, including service definition; and
- the approach to cost allocation and asset revaluation.

We very much support the proposal for a separate binding control covering the sludge activities. The definition should cover transportation, treatment and disposal as it is the optimisation of this entire system (and its associated costs) that can be achieved through markets. There are short and long term trade-offs between transportation costs and optimal selection of capacity. If transportation were to be excluded and kept in 'network plus', it would presume that the current locations of sludge treatment centres is optimal both now and in the future. This seems unlikely and we think customers would miss out on benefits from a narrow definition.

In relation to cost allocation we think there are two key issues to be addressed:

- ensuring companies can compete on a level playing field, and
- not undermining price competition.

We welcome Ofwat's review of cost allocation in the sludge area and support a targeted revaluation based on the economic value of the underlying assets (age and condition) to support focussed RCV allocation. This distinction in valuations is important otherwise it could distort the market and prevent companies from pricing competitively due to concerns about margin squeeze.

Valuing old assets on a modern equivalent basis is relevant for areas of the value chain where long term replacement rates are relevant but are not where markets and rapid technology advancement

are present. For a level playing field to exist between suppliers (both WASCs and potential new entrants), the assets in use should be valued and priced based on their current condition.

For example, consider a situation where we owned an old anaerobic digestion (AD) site worth £10m on a current condition basis, but the modern equivalent (for latest technology) was £30m. The proposed rules would require us to set prices based on a £30m asset which is only worth £10m in the market. The undesirable results are:

A. Foreclose the market to purchase assets at cost effective prices from WASCs.
B. Drive up prices to customers by preventing WASCs making cost effective decisions to replace old capacity when it came due as they would need to write off overvalued assets - driving an incentive to run inefficient for longer than is economical.
C. Charge customers of sludge processing services more for the use of old assets than they need to.

These effects would distort the market. Moving asset valuation to a current condition basis removes these.

Due to the contemporary nature of sludge assets (the majority of which have been added since privatisation) a focussed allocation sends the best price signals to the market as the discount on the MEAV included in the RCV will be much lower than other areas within the price control (unlike water resources where the assets will predate privatisation).

2a. Do you agree with our proposal to make a range of cost, capacity and location information available in order to facilitate the identification of trades?

We support the provision of some information to facilitate this market as we consider that current information asymmetries limit the scope for effective trading. Revealing more sludge related information, particularly around capacities, will help parties identify alternative treatment options and opportunities for reducing costs.

However we also note that providing information is not a costless activity and there are two key risks:

- providing too much information could weaken competition because it could undermine commercial behaviour (see 2d); and
- there is a significant cost associated with collecting, assuring and reporting data.

On the latter point, we do not think the information requirements should be extended to other upstream assets such as sewage treatment works. This is because:

- it would not help inform decisions about capacity utilisation;
- sludge investment decisions can be informed by the capacity utilisation of existing sludge treatment facilities; and
- would create a significant data burden which would translate into higher costs.

If Ofwat considers that information from sewage treatment works is needed to inform investment decisions about where to locate sludge works – then it will be important that size of the facility is taken into account. The scope for sludge competition does not extend to 3rd party operators

accessing unmanned sewerage treatment sites in order to remove sludge for processing. Hence the sludge being taken for processing is transported by the WASCs and the scope for competition is understanding where best to treat that sludge. Hence we only need visibility of the capacity and costs at sludge treatment centres

2b. Do you agree that the data should be published on a STC and STW site level?

We support publishing the information on sludge treatment sites as this will allow parties to identify the lowest cost solution.

We think publishing information based on sewage treatment works is unnecessary and disproportionate to the potential benefits. We currently operate over 1,019 sewage treatment works and provision of detailed information for all would be a significant burden generating significant costs. Furthermore information on sewage treatment works is not necessary for the success of the market. Provided information about sludge treatment sites, including capacity, is accessible then companies will be able to identify both (i) lowest cost solution; and (ii) areas for future investment.

2c. Do you agree that the data should be published annually?

We support the annual publication of the data.

2d. Do you agree with the categories of data that we are proposing are necessary and appropriate, as illustrated in the tables? Are any missing?

We agree with the inclusion of data on location of sites, capacity (m3/day) and on sludge quality, including organic content and water content. We would challenge that giving very specific information on treatment and transport costs or prices (£s per tonne of dry solids) could put the incumbent at a commercial disadvantage.

An alternative would be to set a commercial gate fee for each sludge treatment centre based on the price of treating and disposing sludge, relevant capital charges and capital return for that works. This would:

- provide a clear price signal to the market to inform decisions about sludge treatment and investment;
- it wouldn't reveal commercially sensitive cost information and hence undermine commercial behaviour;
- it would create an incentive for sewage treatment works to produce optimum quality sludge;
- it would create an incentive for efficient works to optimise their processes and free up capacity; and
- it would allow tankering operations to be optimised based on the combination of transportation costs and sludge treatment charges.

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

As we have explained, we are very supportive of sludge competition – it offers enormous opportunities and also provides Ofwat with the potential to roll back its regulation. In this context we think Ofwat should avoid imposing this obligation on companies. The purpose of creating a market based framework is for letting a market develop and flourish without regulatory intervention.

The current proposal implicitly assumes that all participants do not compete and therefore requires regulatory intervention. This scenario is unlikely and instead intervention should be focused on those that choose not to compete.

We also think intervention distorts behaviours between WASCs, new entrants and providers of other organic waste (OOW) treatment providers. We disagree with guidelines and would rather Ofwat create the mechanisms for a market to operate effectively. If that fails, then Ofwat can use its extensive powers to investigate and intervene on a targeted basis. Ofwat have competition powers to enforce compliance with competition law should that be required. Effort should be spent on designing the market structure and preventing any misaligned incentives or regulatory distortions between incumbents and new entrants. If the economic incentives are well designed there would be no incentive to discriminate against new entrants.

4. 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?

We think information should be made available on a consistent basis between WASCs. However, we don't think an information platform designed by the water and sewerage sector is the answer. The reason being that sludge is a subset of a much wider organic waste market. Designing an information platform to reveal sludge information misses the wider scope for trading that may emerge over time. We can foresee a world where pricing and capacity information becomes more dynamic (at the limit on an hourly basis) with multiple third party operators providing data services to multiple parties. The key issue is to get the right information out, but let the platform remain an opportunity for innovation and markets to deliver.

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

We support Ofwat's position and the proposal that system operation accountability should remain with the wholesaler. We will however be looking to develop ideas around this in the future.

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

We think Ofwat should avoid intervening in this market, beyond setting up the framework (mandating certain information is published and creating the price control). This is because interventions could have unforeseen consequences and also raise the cost of participating in the market.

Our preference is that Ofwat does not apply additional incentives OR trading guidelines. Instead the market should be allowed to develop and if Ofwat observed inappropriate conduct then it should consider either (i) using its CA98 powers; or (ii) apply guidelines in period. This would be a useful regulatory tool that could deliver the same objective without intervention.

Water resources

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

We are very supportive of Ofwat's proposal for competition for new water resource capacity. Making it easier to access and trade water resources could have significant economic benefits, as previous work undertaken by Severn Trent and others (including Ofwat) has shown.

We think that the current proposals around access pricing on a WRZ basis should help to unlock water resource markets. We are uncertain as to whether the use of a separate binding price control is necessary for the creation of this market. In particular access price will be set using AICs (not costs in the water resource control). Therefore in the context of markets having a separate control with allocated RCV might be unnecessary to unlock the benefits of water resource markets.

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

We are supportive of this approach. Like Ofwat we think customers will benefit if this mechanism is applied to new resources capacity, rather than displacing existing capacity (which would facilitate inefficient entry and increase costs for customers).

9. 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 are very supportive of Ofwat's desire to facilitate competition through the provision of better information (although this doesn't necessarily imply more data). There is a need for a greater degree of transparency and an appropriate level of information for markets to operate effectively. Without this information it is difficult for new entrants to evaluate opportunities for entry and more difficult for companies to demonstrate a level playing field.

We believe a market information database would help reveal the lowest cost solution to supply-demand gaps. However it's important that this is kept simple otherwise the volume of data could be significant and it would make it difficult for entrants to assess opportunities. We also think consideration needs to be given to the timing of the publication. Unlike sludge this market will require significantly less frequent information.

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

The provision of information is a critical tool to improve decision making and ultimately deliver efficiencies to the benefit of customers. In the context of water resources what is important is:

- the accessibility of the information – in particular there should not be high transaction costs associated with finding and using the information; and
- the cost of making the data available.

We consider that having a third party host the information platform would clearly make the data accessible. However there is the potential for some administrative costs if the third party needs to be established (with associated governance developed). Therefore we think an alternative proposal would be more appropriate whereby:

- companies publish the data on their websites; and
- either Ofwat or CCW creates a landing page that links to all the company data.

This option would maximise the accessibility of the data but also minimise the cost as existing infrastructure could be used.

11. 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 are particularly supportive of Ofwat's proposal to increase transparency and certainty around security of supply. In our previous work on water trading we noted that the lack of transparency was one of the barriers holding water trading back. Therefore setting clear expectations around security of supply, including in Water Resource Management Plans, will help facilitate trades as all parties will have a better understanding of the supply/demand requirements and can factor this into buy/sell decisions.

Allocation of the RCV

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

We agree with the rationale for allocating the RCV to sludge. We are less certain that allocation needs to occur for water resources.

The RCV is a fundamental feature of the regulatory framework in the water and wastewater sector. It has helped create a stable regulatory framework which has led to over £116 billion in investment since privatisation. Given its critical nature any proposal impacting the RCV needs to be handled with care.

In relation to sludge, we support Ofwat's position that capital costs should be reflected in the sludge charge to provide appropriate price signals to all parties. Allocating the RCV to sludge on a focused basis will help deliver the objective of market reflective prices. However as we noted earlier, it's important that the revaluation of assets reflects the age and condition of assets. If this doesn't happen too much RCV will be allocated to old assets (based on new replacement prices) and it would reduce the level of price competition and scope for efficiency, which will cost customers in the long run.

In the context of water resource competition, we are less certain whether there is a need to allocate the RCV. This is because the approach to setting access prices is not dependant on the RCV, but rather the forward looking costs. Given the importance of the RCV to investors, proposals that impact the RCV can also have unintended consequences. For example, despite the clear assertions in

the Water 2020 proposal that there is no stranding risk in relation to water resources, we have observed some investors noting that the water resource RCV is at risk. Therefore if Ofwat does not need allocate the RCV to water resources to drive competition, then we would support it being retained in the network plus control.

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

We are very supportive of the focused allocation of the RCV to sludge given that the approach to pricing depends on this allocation. However as we have stated earlier, it's important that if/when the assets are revalued they are done on a basis that reflects the age and conditions of the assets to ensure a level playing field.

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

As we noted previously, we think it's critical that access prices send the right signal to promote efficient entry. This is why we are supportive of the approach to allocating the RCV to sludge. We are however less certain that the RCV needs to be allocated to water resources. However if the RCV needs to be allocated to water resources, then we support an unfocused approach.

Protection of RCV

15. 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?

The RCV is one of the central features of the regulatory framework. It helps to underpin investor confidence by acting as a commitment device which ensures that invested capital is remunerated. Whilst protection of the 2020 RCV is important, investor confidence associated with the RCV depends on two things:

- regulatory support and protection of the RCV itself; and
- what is applied against the RCV – specifically the real return and RPI indexation (which equals the nominal return in total)

Therefore to deliver investor confidence and ensure that the sector can continue to attract finance at a low cost Ofwat also needs consider its approach to indexation. The current proposal creates a lot of uncertainty for investors given the lack of clarity about what happens to the RCV after 2025. We think greater clarity could be given to investors, whilst reducing bill volatility, by indexing revenues and new RCV by CPI and indexing old RCV by RPI.

16. 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?

Water resources - by applying a revenue control we consider that there is no prospect for stranded assets for the period 2020-25.

Sludge - the scope for stranding over 2020-25 would seem to depend on a number of factors including the quality of the information being shared by market participants and how technology develops. Whilst the prospect for stranding could be low, we don't think it is zero and we could envisage scenarios where assets are stranded. For example a third party could enter the market in

2024 with new treatment that generates additional energy – this could displace any new capacity built by the incumbent.

17. 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?

We are very supportive of Ofwat's efforts to mitigate risk associated with sunk investments at 2020.

Water resources - we actually think Ofwat might not need a separate mechanism given the application of a revenue control (and our expectation that it would operate in a similar manner to WRFIM, albeit the revenue shortfall or excess would be recovered via the network plus control given other statements in the document).

Sludge - an ex-ante revenue guarantee based on the (I) fixed element; and (ii) the implied volumetric rate from the PR19 FD sounds the most sensible and pragmatic solution to deliver a price control with guarantee on the RCV

Access pricing

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

We are very supportive of Ofwat's approach to access pricing. For upstream entry to occur, we agree that its vital efficient entrants can compete on level terms, which includes the ability to access an incumbent's pipes to supply their customers. This is something we strongly advocated in our contribution to the market place of ideas (see Options for access pricing methodology – Oxera).

Given the need to access an incumbent's network, the proposal to set access prices by reference to the average cost of the incumbent's network plus activities makes a lot of sense. Whilst further disaggregation of the network plus control is possible (i.e. not using the average) we think locational signals could be better set through connection charges.

19a. In relation to access prices for water resources, do you agree with our proposal that companies should be responsible for calculating and publishing these?

We very much support Ofwat's proposal that incumbents should be responsible for calculating access price.

Promoting markets for new water resource require a number of reforms, most importantly access prices that reflect forward looking costs and better information. At present only incumbents have the data necessary to:

- forecast long term demand under different scenarios; and
- calculate the long term supply capacity under different scenarios (eg climate variability).

This information asymmetry requires that incumbents are responsible for setting access prices.

19b. Do you agree they should be published by water resource zone, with network distribution and treatment costs separately identified?

Water resource markets have the potential to promote productive and dynamic efficiencies through the better use of water resources. However to realise these efficiencies it's important that entry occurs in the right places – specifically where there is a projected shortfall of water resources.

We are therefore very supportive of Ofwat's proposal for locational based signals, using water resource zones as the central component. This is something we advocated in our work on access prices (see market place of ideas) and was something that the Cave Review proposed when considering the scope for upstream competition.

However we would also urge that geographical averaging of prices for end-users is maintained. The tension between localised access prices and averaged end-user tariffs has been managed in other sectors to great success. There is no reason why it should not be possible in the water sector.

In terms of specific charge components, we consider that the charge should reflect the form of competition that is available under the legislation and licence conditions.

20. 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?

We support the proposal to implement a mechanism that offsets the difference between the LRIC of new resource and the prevailing average cost of resource.

For upstream entry to occur, it is vital that access prices enable efficient entrants to compete on level terms. Offsetting the difference between LRIC of new resource and the prevailing average cost of resource would ensure that third parties with LRICs less than the incumbent would be able to profitably enter the market. This will help deliver the lowest cost water to customers and thereby reduce bills relative to the counterfactual of no entry.

We also support Ofwat's position (page 22 of the appendix) that care needs to be taken in how the AIC is measured, otherwise there could be inefficient entry. This would arise if the mechanism incentivised parties to supply new resources when there is no need. Therefore additional measures/rules should be adopted to promote entry only when there is a need for new capacity. For example it might be helpful to have additional rules over how the AIC is measured. In particular the AIC used for access pricing should be based on a stacked schemes that a company is proposing to build over the relevant planning period (which could be 5-10 years).

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

We support Ofwat's proposal that access prices should be set on the basis of the incumbent's LRIC rather than the entrant's. This will helps deliver a price signal that promote efficient entry (i.e. cheaper water to be supplied). This is because the entrant would only be able to profitably enter the market if its LRIC is lower than the incumbent's.

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

As we have noted in our response, we are very supportive of Ofwat's proposal to promote sludge competition. We think this is a market where significant customer benefits are likely to be realised through better use of capacity and new technologies. We recognise that it will require some regulatory intervention (i.e. the price cap) however we fully support the principle that the market (incl. contractual terms) should develop through commercial negotiation as opposed to regulation.

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

One of the key impediments to sludge markets is information asymmetry. To make the optimal decision about how sludge is treated it is necessary to understand (i) what options exist; and (ii) the price of using alternate options. Provided this information is published, companies will be able to identify the lowest cost solution. This solution could involve treating sludge themselves, or using another company or third parties facilities. The key point is that provided a company can identify a lower cost solution it will have a strong financial incentive to adopt that solution.

In light of the strong financial incentive we don't think trading guidelines are needed. Whilst we recognise Ofwat's point that companies are monopoly sellers of sludge, there are strong financial incentives to procure the lowest cost solution. Therefore we do not think guidelines are necessary, at least at this stage. Instead Ofwat might consider closely monitoring the market to understand if there is an issue before deciding to intervene.

Making greater use of direct procurement

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

See note.

25. 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?

See note.

The implications of making better use of markets

26. 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?

We think having a consistent regulatory framework across England and Wales is beneficial in that it:

- maximise the number of comparators available for benchmarking, which would improve the robustness of the wholesale econometric modelling and the setting of performance targets for horizontal ODIs; and
- reduces the cost of regulation per customer.

However we strongly respect the decisions of the Welsh Government to choose the form of regulation that should apply to its citizens and we will work with whatever framework is decided upon.

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

We are very supportive of revenue controls for the network plus services – this is because they will help reduce risk and ultimately keep customer bills low through a low cost of capital.

In the water and wastewater sectors one of the key cost drivers is the cost of capital. A significant proportion of customers' bills over the 2015-20 period – around 20% or about £80 average per customer per year – will be associated with financing new and past investment. Maintaining a low cost of capital is critical to keeping bills low. In the context of the form of control, the use of a revenue control or a price control can have a significant impact on risk and hence the WACC.

Under a price control companies are exposed to changes in demand and volume, whereas under a revenue control companies are not exposed to that risk (instead it sits with customers). Setting network plus and water resource revenue controls does not expose companies to additional (volume and demand) risks. Given that these are most likely to be influenced by weather patterns and are outside company control, this proposal will reduce risk exposure and ultimately keep bills lower.

We also consider that the revenue controls should provide an incentive for companies to back-bill. We believe that customer want us to pursue bad debt and back-bill customers as this means the cost of services are more evenly spread. At present there is a disincentive to back-bill given the rate of bad debt exceeds the additional revenue that retail collects. Therefore we would support a revenue control with some adjustment to incentivise back billing and which would allow companies and customers to share the benefit. This could also include a requirement that companies can only claim the additional revenue if performance in related areas, such as bad debt, is at the UQ level.

As part of the market place for ideas we are proposing to investigate in-period incentives for PR19, which would include back-billing.

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

We support the principle that of applying a price control to sludge. Unlike water resources, we consider that sludge volumes are more likely to be driven by gains and losses in market share. Therefore applying a price control (instead of a revenue control) will:

- incentivise companies to compete because they will get to retain the difference; and
- ensure that customers do not pay for inefficient investments as customers will only pay a fixed price.

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

We believe that new investments should be remunerated by a return on the RCV. As we have noted the RCV is one of the central features of the regulatory framework and is well understood by investors. It helps to underpin investor confidence because it represents a commitment device which ensures that invested capital is remunerated.

Whilst there will inevitably be some risk of stranding for new investments (at least for sludge), there will still need a need for significant investment in these areas. Maintaining the use of an RCV, albeit reported separately to old RCV, will give investors' confidence that provided incumbents' volumes reflect forecast they will be able to earn their return.

30. 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 most important tool to promote market based solutions is the establishment of the price cap. This will incentivise companies to look beyond their borders.

We also consider that assessing the financeability of the sludge control on a stand-alone basis would also help promote a level playing field as it would help promote charges that reflect the costs that a standalone business would need to recover.

Incentivising monopolies to discover and reveal information on efficient costs

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

We are very supportive of the Risk Based Review (RBR). This is something we advocated following PR09 after observing that the CIS menus did not having the incentive properties that were predicted. For the RBR to deliver the best outcome for customers, we think Ofwat needs to consider:

- the size of the financial rewards; and
- sharing information (WACC and cost models or key components) in advance of submission to promote more effective customer engagement.

The RBR will deliver the best outcome for customers if there are strong financial incentives that reward companies for taking the risk of submitting challenging plans. At PR14 the size of the incentives was unknown and Ofwat had the luxury of being able to set quite a small reward, particularly when compared to the size of the rewards in energy. Looking forward we think Ofwat will get a much stronger response to the RBR, particularly at Board level, if it sets a much stronger financial incentive for enhanced, similar to Ofgem.

The RBR will also likely to be more effective if Ofwat shares in advance of business plan submission its expectations about the WACC and cost models. This is because the WACC and cost models in particular have such a strong impact on bills. By providing this information in advance we can more accurately present our customers scenarios that reflect what priorities could be achieved under different affordability constraints.

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

We agree that the credibility of the risk based review is critical to its long term success. If stakeholders do not view enhanced companies as genuinely being top-performing companies then the reputational benefits will be diminished significantly.

We therefore support Ofwat's proposal that current performance should be reflected in the RBR assessment. We think this proposal will help maintain the credibility of enhanced status. This assessment should make a distinction between:

- systemic poor performance and poor performance on a small number of measures with very good performance across other measures; and
- how the company has responded including via engagement with its customers; and
- how it plans to improve performance.

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

We are very supportive of increasing the focus of the assessment to the long term. One of the biggest challenges confronting the sector is ensuring that we are on a sustainable course. This means delivering the service improvements customers wish to see and a healthier environment, all at an affordable price, and in a way that the sector can continue to be financed in the long term.

We therefore welcome Ofwat's desire to take into consideration long term planning, when assessing business plans at PR19. In making this assessment we think Ofwat will need to draw on a range of evidence including:

- Engagement with customers about the medium-long term priorities, including how those priorities are balanced against affordability constraints;
- Challenge from CCGs about how companies reflect customer views about the long term in business plans;
- Assessment of total system risk/resilience in the medium-long term and what steps companies plan on taking to maintain their outcomes;
- Wholesale costs that reflect the upper quartile efficiency level;
- Incentives that reward companies for outperforming when delivering the service levels customers want; and similarly penalising companies when they fail to deliver the services customers value; and
- High quality Board assurance about the long term viability of the plans.

Assessing cost efficiency

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

We are very supportive of Ofwat's use of benchmarking to assess and set cost allowances, including the application of a UQ efficiency challenge.

Assessing the efficiency of expenditure is not a straightforward exercise, particularly in a sector where price reviews determine revenues in excess of £40 billion. Econometrics have become the established way of comparing efficiency as it allows Ofwat to efficiently benchmark performance and reward high performers whilst challenging poor performing companies to improve.

We support the position that top-down econometric models will need some separation into the different controls. The econometric modelling should seek to build on the successful PR14 models and:

- more explicitly take account of the underlying level of service (output), as this will help all parties assess whether additional cost allowances are required for enhanced levels of service;
- should not cap the frontier company, otherwise it could reduce incentive to submit challenging plans;
- reflect changes to long term needs such as adapting to climate change; and
- not create an overly burdensome data requirement.

It will also be important to undertake some form of high level review 'in the round' to ensure that the efficiency challenge is sensible when viewed in aggregate, particularly if the financeability assessment is being undertaken in aggregate. This is particularly relevant in relation to the resource control. Many costs in resources are uncontrollable (e.g. EA fees) and they are not evenly applied across the UK so simple benchmarking would not reveal inefficiencies. We also note that other costs, such as MOSL fees are levied in this way and it would be useful for the modelling to separately adjust for regulatory fees.

We also consider that Ofwat should continue with its approach at PR14 and set a UQ efficiency challenge. Whilst Ofwat could consider adopting the CMA's approach of an average efficiency challenge with an on-going annual target, we the UQ challenge better resonates with stakeholders.

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

We are extremely supportive of Ofwat issuing new cost allocation guidance that supersedes all previous iterations and versions.

A large challenge confronting companies is that cost guidance has been issued piecemeal without a comprehensive update. This requires companies to maintain a corporate 'memory' and ensure that all updates are identified and incorporated. This can lead to mistakes if an element/update is missed. Often this also requires judgement, where different guidance documents appear to conflict (as occurred in relation to CIS). Therefore we would welcome complete and thorough guidance.

We also note that there are areas where it may be appropriate for different measurement between companies, so the guidance should include requirements on companies to make clear how items are measured, not just what is included where. Where Ofwat is proposing to use comparative ODIs, then there should be a comprehensive audit of how these performance levels are measured and issued so that the sector can look to improve.

Finally it's important that the timing of the guidance is provided early to ensure companies have sufficient time to ensure cost capture systems can be aligned.

Encouraging a long term approach

36. 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 controls and not seek to further align the timing of controls with other planning processes?

The length of the price control needs to strike an importance balance between providing stability for long term investments, whilst minimising the risk that the economic fundamentals underpinning a determination change. In light of the proposals around water resources and sludge, we think there is merit in Ofwat considering the pros and cons of a longer period, similar to Ofgem's 8 year control.

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

We welcome the commitment to work "closely with Defra, the Environment Agency, Natural Resources Wales and companies to align our price control processes in the run up to such reviews with other planning cycles and ensure that companies have the greatest clarity possible." We also think that Ofwat needs to work closely with the DWI to understand the long term challenges facing the sector.

It would be useful to understand in more detail how aligning the different planning cycles would work in practise. For example this could be achieved through a published agreed statement of principles and guidelines about coordination of statutory submissions and processes.

We also think Ofwat is right in setting out the challenge about long term planning, rather than trying to come up with the answer. The responsibility should be on companies to demonstrate how they are promoting a long term approach and we expect a range of approaches will be trialled at PR19. At the end of the next price review Ofwat should consider the different approaches and if there are some stand out methods, consider promoting those for PR24.

A more responsive regulatory framework

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

We strongly support taking rewards and penalties in period as this strengthens the incentive of delivery for customers. We requested this licence change at PR14 and it's been hugely benefit to our company and customers because it strengthens the incentives. For example we have seen a step change in performance against most ODIs as reported in our interim result. The focus on performance creates greater urgency in delivery of enhancement investment and greater management focus on performance.

We support the license changes for ODIs and revenue (but not CPI indexation). We can also see benefit in having the rewards and penalties from totex cost sharing being made in period. However this would need to be applied flexibly so companies can manage (i) bill volatility; (ii) change in the profile of expenditure. This would suggest that we should avoid applying a WRFIM type rule and instead allow companies to take more ownership about how they make adjustments, given the objective of bill stability.

CPI indexation

Questions 39 to 43 – see our attached response

Impact of the balance of risk and reward on the cost of capital

44. 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?

While there are a number of factors that mean that risks and opportunities will vary for different parts of the value chain, this does not have straightforward implications for assessing the cost of capital. The key issue in terms of cost of capital impacts is the extent to which there are materially different levels of systematic risk associated with different activities.

The PwC report presents the view that systematic risk is higher for sludge as compared with wholesale activities as a whole. We do not consider that PwC's analysis provides an adequate basis to draw this conclusion. PwC's view is largely based on the assessment of (i) energy costs; and (ii) operational leverage.

In terms of energy costs, a key concern we have is that the PwC assessment does not provide a robust basis for concluding that higher energy costs in sludge translate into a higher beta. PwC's conclusion seems to rest heavily on a highly simplified comparison between the average identified equity betas of two sets of companies that are identified as having different energy use levels. However, without examining the characteristics of these companies (and differences between them) in more detail, this provides an extremely limited basis for comparison. There are many factors that could materially affect identified equity betas (including gearing levels, given that the analysis considers equity rather than asset betas) and simply attributing this high level difference between groups to differences in energy consumption does not provide a robust basis on which to draw and/or support the conclusion reached for sludge.

We consider that much more analysis would be needed before any robust conclusions could be drawn from this analysis if Ofwat chooses to adopt this methodology.

We also consider that the level of relevant energy costs for the assessment of systematic risk in sludge requires further attention before robust conclusions can be drawn. In particular, given the use of sludge as an input into energy generation, the impact of energy price movements on returns will depend on the net impact of these movements on revenues as well as costs. In line with this, we would question the extent to which volatility in the UK industrial electricity price index would impact on relevant power costs given energy generation levels and the implications this has for energy self-sufficiency.

We also have concerns with the analysis of the relation between asset beta and capital intensity. The analysis by PwC is limited and ignores other factors that could be impact on the asset beta – although PwC does acknowledge this point.

Overall we think considerable more analysis is required before concluding that the asset beta of sludge is materially different to the wholesale business. In the absence of this evidence we would

support applying the same asset beta, ahead of the consideration of the impact that market and incentive reforms may have (see below).

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

Under the proposed reforms a wide range of different issues could arise, but for the purpose of this response we focus our comments on the proposed market and incentive reforms related to sludge. We will comment on other potential issues (for example, associated with the development of ODIs) as further proposals are developed.

In terms of the sludge proposals, there look to be two key issues to consider. Firstly, as recognised in the consultation, the movement to a price cap increases the intensity of regulation and involves an overall increase in the risk borne by companies as opposed to customers. That is, companies will be exposed to volume risk, including volume risk that stems from overall movements in market conditions (rather than gains and losses from competition, which are discussed below).

We agree that this change has the potential to increase systematic risk, and thus increase the appropriate cost of capital for the sludge business (over and above the level that might be identified from separating the sludge control but retaining the current form of control).

The other key potential source of impact on risk and the cost of capital is from competition. We agree with PwC that it would seem unlikely competition will impact on systematic risk. This is because investors can diversify their portfolio and therefore not be exposed to a reduction in overall returns.

However, competition does introduce greater downside risks for companies, and this means that there will have to be correspondingly significant opportunities for upside benefit for companies to be able to expect to earn their cost of capital. The appropriate way of addressing this will depend on the overall package of arrangements that is developed, but consideration should be given to the use of an uplift on the WACC, and more generally to the importance of providing opportunities for upside benefits to be realised.

We do not agree that this issue arises only after 2025 when the likelihood of lower returns will be greater, as expectations of future returns will be relevant for decisions concerning the provision of sludge capacity from the point at which the reforms commence (and RCV protection is removed). We consider this important to recognise. While asset lives in sludge are much shorter than those in water resources, sludge investments can nevertheless be long-lived by the standards that would be considered to apply in most sectors (water resource asset lives are often extremely long-lived and it is this that makes sludge asset lives look relatively short). Investment incentives should be considered therefore from the outset of the reforms.

Customer engagement and outcomes

46a. What does good customer engagement look like?

We are fully supportive of the challenge from Ofwat that companies need improve how they engage and use customer views. In our strategic framework we have challenged ourselves to embed

customers at the heart of all we do. And this means we'll need to improve the way in which we engage with customers, through improved insight and understanding of what's important to them.

In terms of "what does good customer engagement look like" – we don't think there is a simple answer to this question like there is when assessing other aspects of company performance. We know what the outcome of good customer engagement looks like – which is a real understanding of what customers want and value over the short, medium and long term. How this outcome is achieved will require that companies try new methods and continually adapting their tools and processes. We think some of the characteristics of good customer engagement include:

- the use of research that openly explores what customers want – or could want, as opposed to starting with preconceived views or constrained question. Importantly companies need to accept what is heard back;
- the use of new channels to access different demographics, including digital channels
- the use of new methods, such as experiments to reveal customer preferences rather than simply asking customers directly about their preferences;
- the use of new data sources, rather than just utilising surveys/focus groups and responses to consultations. This includes analysing information generated from everyday interactions;
- better contextualisation of subjects and choices. For example, customer views on ODIs first had to be placed in the context of how they would work in reality, not simply the theory behind them. Issues should be presented so that customers can relate to them easily and can draw on their own experiences.
- on-going process which provides companies with an opportunity to learn and develop plans, commitments and outcomes that reflect customers' long term wishes.

46b. What are your views on the principles outlined above?

We are very supportive of the principles relating to the role of companies and CCGs. Below we share our specific thoughts on each of the key points raised in the consultation.

Role of companies:

- We agree that it should be the responsibility of individual companies to understand the priorities of their customer base.
- We agree that multiple sources of evidence should be used to form a detailed view of customers' priorities and views and that a reliance on stated preference measures needs to reduced (although stated preference will still form an important part of the evidence base).
- We agree that sources of information should be broad and include the everyday interactions that we have with customers.
- We agree that we need to ensure that different types of customers are consulted and engaged and on range of subjects from the immediate, short term through to long term issues.
- We agree that engagement should be a two way process with customers being part of an active two way dialogue.

Role of CCGs:

- We agree that the role of the CCG should be to challenge and assure the companies approach to customer engagement and not act as a substitute for them.
- We support the approach advocated to setting expectations of CCGs as to their role in the quality of their challenge and assurance.
- We suggest that CCGs take their own view as to the extent to which they require comparative information about other companies' customer engagement in order to take a view on their own (although we support Ofwat making the horizontal PC/ODI data accessible).
- It's important that CCGs are not seen as a substitute for customer engagement, particularly after the RBR.
- Similarly it's important that CCGs are not seen as a substitute for Board ownership - the role of CCGs is to challenge, but the Boards need to own the plans. So we welcome your statement that a CCG and company disagreeing is not a failing of the process provided that the rationale is well documented.

Composition of CCGs/Transparency:

- We agree that companies are best left to determine the composition of the CCG.
- We agree that CCWater representation on CCGs is important for the credibility of the challenge groups.
- We think transparency about the appointment process, funding and governance is equally important to promote credibility in the CCGs.

Collaboration of CCGs/Publication of information:

- We believe there is value in CCGs and their chairs working together to establish better ways of working (such as sharing lessons on governance).
- However, when it comes to best practice customer engagement we believe this is a matter for individual company CCGs to work with companies directly, rather than seeking to develop, for example, best practice approaches to any particular research challenge.
- We add this caveat as we believe that it is down to individual companies to interpret and innovate around customer engagement and be rewarded for those efforts.
- For this reason we support the sharing of information between a company and its CCG but would reserve the right for companies to decide what publication is made public or shared with other CCGs.
- Ultimately the RBR is a competitive process so care needs to be taken not to undermine that competition.

46c. How could companies draw on good practice from within and outside the sector?

The spreading of best practice can occur through a number of ways. For example:

- recruit talent from other sectors that have a strong track record of innovative customer engagement;

- use of tendering to bring in other organisations that can offer an alternative perspective of how to reveal customer priorities;
- compare performance against wider benchmarks (i.e. not just water);
- share more comparative information about company approaches at the conclusion of each price review (this could be shared informally).

We don't think Ofwat should be responsible for spreading best practice, beyond setting its expectations. Responsibility for identifying and adopting best practice sits with water companies and companies that are good at this can get obtain a competitive advantage.

46d. 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?

We think one of the principle challenges facing companies will be how they integrate information from a range of different sources to develop a clear picture of customer priorities.

As we have commented earlier in our response, we have challenged ourselves to improve the way in which we engage with customers. This will require applying new tools and methods to reveal customer priorities. We think it's highly likely that this will generate unusual results and potentially conflicting results. Therefore validating the results will be crucial to ensuring that we deliver the priorities value most. We think this validation can occur in a number of ways, for example:

- seeking third party assurance about the different approaches applied, particularly innovative methods;
- applying iterative rounds of testing and refinement using as many means of engagement and information exchange as the companies deems practical;
- engaging with other organisations (not just water companies) to test both (i) the way the tools are used; and (ii) the results to sense check them.

Ultimately we think some judgment will be required. Therefore it will be important that companies have both (i) there is sufficient evidence to justify the position; and (ii) clear audit trail of how/why they have made decisions.

47a. What are your views in relation to our proposals on future CCG remit; scope; timetable; governance arrangements; and membership?

Remit and scope - see earlier answers.

Timetable - we support the submission of the first report at the time the companies submit the business plan. We also agree with the notion of the second report but it's important that this doesn't creep into areas outside CCG remit (e.g. it should focus on how we have taken into account customers' views and represented those).

Membership - we agree that companies should choose the membership that would deliver the most effective challenge.

Governance - we agree that companies should consider the most appropriate governance. What is critical is that the governance arrangements are transparent.

47b. 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?

For the most part we agree with the list, although there are two areas which merit further consideration (i) performance related payments; and (ii) engagement about solutions.

We welcome the challenge from our customers on performance but consider that rewards or penalties should be as per the risk reward framework and existing GSS mechanisms agreed with our customers and Ofwat at PR14. We recognise that there could be exceptional circumstances that warrant deviating from the agreed framework, but in general we think companies and Ofwat should strive to get the framework right – for example our current rewards are calibrated to ensure 50% sharing with customers, consistent with the totex cost sharing. This is because a clear framework with clear incentives will drive the right behaviour and deliver the best outcomes for customers.

We also question the extent to which companies should be engaging with customers on options/solutions to deliver the desired outcomes. Although we recognise that in some areas, such as supply-demand balance, the applicable options are an emotive topic and therefore could warrant specific conversations. This however should be up to the company rather than being mandated across the board.

Our concern is that the requirement could creep into other areas. For example it would seem unusual for companies to engage with customers on their preferred option to minimise discolouration complaints, such as changing the chemical composition of lime. Instead companies should be engaging on what is the right level of performance based on options around pricing and bill impacts. We therefore think companies should choose whether they engage with customers on specific solutions rather than having it mandated.

47c. What are your views on the division of responsibilities between CCGs and Ofwat?

We support Ofwat's proposal that the CCG should be focused on challenging how companies have engaged with their customers and reflected that engagement in the business plan.

We think that if these activities are undertaken appropriately then Ofwat should be able to focus on assessing the efficiency of the cost proposals and the balance of risk and reward (as opposed to intervening in relation to the scope and level of PCs and ODIs).

48a. What are your views on our proposal to facilitate more collaboration between CCGs?

We support collaboration between CCGs on issues of governance and process.

We are uncertain whether collaboration should occur at a more detailed level – such as how companies are revealing customer priorities. We can see benefits in collaboration (i.e. sharing best practice) however it would also reduce the competition between companies to develop the best plan. Therefore a balance needs to be struck between these competing objectives.

We also think recognition needs to be given to confidentiality agreements between the CCG and companies. We also have concerns on the frequency of the workshops, our CCG chair is contracted for a limited number of days per year, has a number of other commitments and their time will be best utilised challenging how we engage with our customers and how we reflect the priorities in our plans. We think this needs to be a consideration when developing the programme of CCG / Ofwat workshops.

48b. What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early?

As per question 31, we are very supportive of Ofwat sharing information such as the WACC, RORE range and cost models ahead of business plan submission.

Sharing this information whilst plans are being developed will allow companies to more accurately engage with customers about how priorities should be balanced. This is because the WACC and cost models in particular have such a strong impact on bills. By providing this information in advance we can more accurately present our customers scenarios that reflect what priorities could be achieved under different affordability constraints.

48c. Without inserting ourselves between companies and their customers, what else could we do to incentivise and encourage good quality customer engagement?

We think Ofwat is right to put the onus on companies to develop great customer engagement. Ofwat can still play a really important role by supporting companies that deliver ODIs.

The introduction of outcomes and ODIs was a revolutionary idea for water regulation and we recognise that Ofwat faced significant opposition. We can now see that Ofwat was right to introduce these incentives because they are focusing company performance on services that customers value most. At Severn Trent this has translated into improver performance across a number of outcomes at a very low cost.

Looking forward we think there is a risk the sector could come under pressure to abolish ODIs or reduce their strength – this would be a mistake as customers would suffer. Therefore it will be important for the credibility of the regulatory regime that Ofwat comes out strongly in support of companies that over-deliver on ODIs during this control period.

49. 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?

We are very supportive of Ofwat's desire to promote a longer term approach to (i) its regulation; and (ii) planning by companies. This is critical because the water sector is characterised by assets that span multiple control periods. In this context we think there are opportunities to enhance long term planning through:

- Articulating what level of resilience/asset health is reflected by the totex models. Depending on customers priorities it's possible that customers might want a higher level of (asset/network) resilience than is currently offered. To support the delivery of this,

companies may need to make special cost claims to increase investment. Therefore revealing the embedded level of resilience from the models will help companies engage with customers and make informed investment decisions.

- Long term outcomes, PCs and ODIs - we can see the benefit of such measures. However if performance targets span multiple AMPs and funding doesn't then it changes the risk and reward balance. Therefore any framework that accommodates multi AMP ODIs should be linked to a commitment on the funding.
- Mandated PCs and ODIs - there will be a need to mandate those PCs and ODIs that Ofwat will use for comparative purposes. However we do not think Ofwat should mandate additional measures. Adopting a one size fits all approach would reduce the scope for innovation and prevent new leading indicators from being designed. Instead we think Ofwat should be prepared to intervene if there is insufficient coverage and assurance about the asset health measures

50. 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 think it's really valuable to have advance warning about upcoming consultations. For the November consultation we think it should cover:

- the split between bespoke and comparative ODIs;
- the timetable for when the list of comparative ODIs will be defined ;
- expectations about RoRE ranges;
- how PCs and ODIs interact given separate sludge and water resource controls; and
- standardising the measurement of comparative PCs and ODIs.
- wholesale cost assessment – with a focus on (i) the models and (ii) treatment of frontier performance – ie, as per the December consultation – a focus on the potential not to cap the results of the frontier companies

51. 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?

In relation to outcomes, we think it's important to differentiate between the standardised PCs/ODIs and the bespoke measures.

For the standardised measures, we fully support having the definitions agreed early – ideally by 2017. This is important because if there are changes in the definition, it could impact the resulting service level and therefore:

- companies will need time to ensure they have appropriate plans to deliver to UQ or higher service levels; and
- companies may need to reengage with customers in relation to forward looking plans (i.e. because comparative rankings could change and hence customers might have different expectations about the service level that should be provided).

For non-comparative PCs and ODIs we don't think there is a need to provide the definitions except at the time of submission. This is important because the definition of these measures could evolve through iterative customer engagement and testing. Therefore it would be unhelpful to be bound to a certain definition before we have finished our customer engagement.

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

As per question 38, we strongly support the use of in period ODIs to strengthen the incentive of delivery for customers. We requested this licence change at PR14 and it's been hugely benefit to our company and customers because it strengthens the incentives. For example we have seen a step change in performance against most ODIs as reported in our interim result. The focus on performance creates greater urgency in delivery of enhancement investment and greater management focus on performance.

Licence modifications

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

We fully support 4 out of 5 of the licence changes. We do not support the amendment relating to the application of CPI indexation.

We also note that the licence that underpins each water company is a cornerstone of the regulatory framework. Like the RCV, investors regard the licence as one of the defining features of a company. Licence stability helps to minimise (regulatory) risk and ultimately allow companies to access cheap finance, thereby keeping bills low whilst allowing service levels to improve. It is in this context that we think Ofwat needs to be mindful about the volume of licence changes, particularly those that have a knock-on impact on its approach to remunerating returns.

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

The timetable for the review of costs and assets seems sensible. We emphasise our position that any asset revaluation needs to reflect the age and condition of the assets

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

We are very supportive of the indicative timetable for Water 2020, except that relating to CPI indexation.

We also think that there are opportunities for further transparency around:

- key process and work streams within Water 2020 such as issuance of the financial model;
- approach to risk and reward including debt indexation; and
- the "further November consultation" that is listed but not specified.

This information will help us develop our internal plans and resources. Furthermore additional clarity about the November "further consultations" would be helpful.

Finally we are receiving a number of “ad-hoc” requests for data. Although these requests state that the information is to be provided on an unassured and unaudited basis (given very tight timeframes), we are increasingly concerned about how this data is being used. For example is it feeding into the company monitoring framework? We would like to see more structure to how data is being requested and reasons for sharing, with appropriate lead in times so we can assure the data.

Water 2020: Regulatory framework for wholesale markets and the 2019 price review consultation response

Please respond to the consultation questions by filling out the template on the following sheet. Responses will need to be received by 10th February 2016. While we would be grateful if you could use this template, responses will be accepted in other formats. Please send to water2020@ofwat.gsi.gov.uk.

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Date:	10/02/2016

Water 2020: Regulatory framework for wholesale markets and the 2019 price review consultation questions

Question				Comments
Overveiw document	SQ1	Do you agree with our proposals for making a greater use of markets in relation to sludge and water resources?	Strongly Agree	**We are very supportive of the proposals for sludge and (new) water resource markets. Like Ofwat, we strongly believe that competition, deployed in the right way, will increase the incentives for companies to realised efficiencies and ultimately deliver lower bills for our customers.** **In our recent publication in our changing course series 'Charting a Sustainable Course' one of the key policy questions we raised was how do we deliver innovation and introduce market solutions for the benefit of customers? We asked this question because we recognise that how competition is utilised can have a significant impact on customers – through lower bills if done right, or through higher bills if delivered badly.** **We think that Ofwat's focus on introducing competition for sludge and new water resources is right. There are significant opportunities for sludge competition to deliver benefits to customers, particularly though better utilisation of capacity and applying new technologies. We also consider that the barriers to sludge competition are much lower because companies can more readily reconfigure their networks. However we would emphasise that delivering benefits to customers requires genuine rivalry between companies and third parties.** **To promote competition we agree that the provision of some data is necessary – this will help reveal market opportunities and allow parties to make better decisions. However we are concerned that the volume of data required and approach to asset valuations could have the unintended effect of undermining competitive behaviour. This could occur by reducing the ability of companies to compete aggressively on price/service and raising the cost of operating in the market.** **For water resources, we support the proposal that there should be competition for the provision of new capacity. Given the challenges with reconfiguring networks and high sunk costs, competition for existing capacity would not deliver benefits to customers and instead would simply increase bills. We are therefore very supportive of Ofwat's focus on ensuring that the measurement of the Long Run Incremental Cost is done in a way that promotes efficient entry (i.e. where it displaces more expensive proposed supplies).**
Overveiw document	SQ2	Do you agree with our proposals in relation to the future form of regulation for the sector?		We are very supportive with the principles of the consultation and all but one proposal, CPI indexation. Leaving to one side CPI indexation, for all other proposals it's apparent how they will deliver lower bills and/or higher service levels to customers. The proposals around CPI indexation are however different. We don't agree that this is the best way to improve transparency; the changes proposed will create additional costs and undermine investor confidence. We think that Ofwat can better reduce bill volatility and transition away from RPI by indexing revenues and new RCV by CPI and old RCV by RPI. This approach will also provide investors with certainty about the transition away from RPI, whereas at present there is only 5 years of certainty. We also support Ofwat's desire to promote more tendering. We think the proposal can be improved because at present the direct tendering proposal would only be applicable to a small number of discrete stand-alone schemes like reservoirs. We think applying different types of tendering to different types of assets would help deliver additional benefits to customers. Finally we think there are opportunities for Ofwat to reduce the regulatory burden and in doing so, increase the level of competitive behaviour. This is particularly relevant for sludge where trading guidelines and large information requirements might encourage companies to adopt very risk-averse strategies instead of vigorously competing for market share See individual responses to more detailed consultation questions below.
Overveiw document	SQ3	Do you agree with our proposals in relation to customer engagement and outcomes?	Strongly Agree	**We are fully supportive of the challenge from Ofwat that companies need to improve how they engage with customers and how they then use the views expressed by customers in developing their business plans. Customers are at the heart of our new strategic framework. In order to deliver our strategic ambition, truly put our customers first and be trusted by them, we need an increased understanding of what is really important to them.** **A notable feature of the W2020 consultation is that Ofwat is setting expectations rather than defining specific actions or initiatives (as per sludge competition). We support this approach as we don't think there is a definitive answer as to what good customer engagement looks like. Instead companies will need to try new methods and continually adapt their tools and processes to learn from their experiences. If Ofwat sets specific actions or initiatives then it would have the potential to deter companies from trying new things, and lead to the lowest common denominator.** **We also support the expectation that companies need to broaden how they understand customer priorities. We have challenged ourselves in this area and will be utilising information from multiple sources of evidence, particularly from our daily interactions, to reduce reliance on stated preference (although we expect these sources to be additive to stated preference).** **We also welcome the challenge that customers should be engaged as 'partners who drive decision-making on an on-going basis'. This means that we (and other companies) will need to improve on PR14 and clearly demonstrate and evidence the golden thread from customer engagement to investment decisions.** **Finally we support the principle that the CCG should challenge the company about how it has sought to understand customer views, balance different views and subsequently represent those views in the plan. The CCG should not be a substitute voice for customers or stakeholders in its own right. Similarly the CCG is not a substitute for Board ownership of a business plan. We comment below on the specific role of the CCG**
Overveiw document	SQ4	Do you agree with our proposal to extend protection of the RCV to 2020?		The RCV is one of the central features of the regulatory framework. It helps to underpin investor confidence by acting as a commitment device which ensures that invested capital is remunerated. Whilst protection of the 2020 RCV is important, investor confidence associated with the RCV depends on two things: • regulatory support and protection of the RCV itself; and • what is applied against the RCV – specifically the real return and RPI indexation (which equals the nominal return in total) Therefore to deliver investor confidence and ensure that the sector can continue to attract finance at a low cost Ofwat needs consider its approach to indexation. The current proposal creates a lot of uncertainty for investors given the lack of clarity about what happens to the RCV after 2025. We think greater clarity could be given to investors, whilst reducing bill volatility, by indexing revenues and new RCV by CPI and indexing old RCV by RPI.
Sludge treatment, transport and disposal market design	1	Do you agree with our proposal to have one separate binding price control for sludge treatment, transport and disposal?	Strongly Agree	**Sludge competition has enormous potential to deliver benefits to customers and we want to be one of the leading players in this market. We consider that this market will only work if there is genuine rivalry between parties. In the context of maximising competitive behaviour we comment below on:** **• the form of the control, including service definition; and** **• the approach to cost allocation and asset revaluation.** **We very much support the proposal for a separate binding control covering the sludge activities. The definition should cover transportation, treatment and disposal as it is the optimisation of this entire system (and its associated costs) that can be achieved through markets. There are short and long term trade-offs between transportation costs and optimal selection of capacity. If transportation were to be excluded and kept in 'network plus', it would presume that the current locations of sludge treatment centres is optimal both now and in the future. This seems unlikely and we think customers would miss out on benefits from a narrow definition.** **In relation to cost allocation we think there are two key issues to be addressed:** **• ensuring companies can compete on a level playing field, and** **• not undermining price competition.** **We welcome Ofwat's review of cost allocation in the sludge area and support a targeted revaluation based on the economic value of the underlying assets (age and condition) to support focussed RCV allocation. This distinction in valuations is important otherwise it could distort the market and prevent companies from pricing competitively due to concerns about margin squeeze.** **Valuing old assets on a modern equivalent basis is relevant for areas of the value chain where long term replacement rates are relevant but are not where markets and rapid technology advancement**
Sludge treatment, transport and disposal market design	2a	Do you agree with our proposal to make a range of cost, capacity and location information available in order to facilitate the identification of trades?		We support the provision of some information to facilitate this market as we consider that current information asymmetries limit the scope for effective trading. Revealing more sludge related information, particularly around capacities, will help parties identify alternative treatment options and opportunities for reducing costs. However we also note that providing information is not a costless activity and there are two key risks: • providing too much information could weaken competition because it could undermine commercial behaviour (see 2d); and • there is a significant cost associated with collecting, assuring and reporting data. On the latter point, we do not think the information requirements should be extended to other upstream assets such as sewage treatment works. This is because: • it would not help inform decisions about capacity utilisation; • sludge investment decisions can be informed by the capacity utilisation of existing sludge treatment facilities; and • would create a significant data burden which would translate into higher costs. If Ofwat considers that information from sewage treatment works is needed to inform investment decisions about where to locate sludge works – then it will be important that size of the facility is taken into account. The scope for sludge competition does not extend to 3rd party operators accessing unmanned sewerage treatment sites in order to remove sludge for processing. Hence the sludge being taken for processing is transported by the WASCs and the scope for competition is understanding where best to treat that sludge. Hence we only need visibility of the capacity and costs at sludge treatment centres

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Question				Comments
Sludge treatment, transport and disposal market design	2b	Do you agree that the data should be published on a STC and STW site level?		**We support publishing the information on sludge treatment sites as this will allow parties to identify the lowest cost solution.** **We think publishing information based on sewage treatment works is unnecessary and disproportionate to the potential benefits. We currently operate over 1,019 sewage treatment works and provision of detailed information for all would be a significant burden generating significant costs. Furthermore information on sewage treatment works is not necessary for the success of the market. Provided information about sludge treatment sites, including capacity, is accessible then companies will be able to identify both (i) lowest cost solution; and (ii) areas for future investment.**
Sludge treatment, transport and disposal market design	2c	Do you agree that the data should be published annually?	**Agree**	We support the annual publication of the data
Sludge treatment, transport and disposal market design	2d	Do you agree with the categories of data that we are proposing are necessary and appropriate, as illustrated in the tables? Are any missing?		**We agree with the inclusion of data on location of sites, capacity (m3/day) and on sludge quality, including organic content and water content. We would challenge that giving very specific information on treatment and transport costs or prices (£s per tonne of dry solids) could put the incumbent at a commercial disadvantage.** **An alternative would be to set a commercial gate fee for each sludge treatment centre based on the price of treating and disposing sludge, relevant capital charges and capital return for that works. This would:** **• provide a clear price signal to the market to inform decisions about sludge treatment and investment;** **• it wouldn't reveal commercially sensitive cost information and hence undermine commercial behaviour;** **• it would create an incentive for sewage treatment works to produce optimum quality sludge;** **• it would create an incentive for efficient works to optimise their processes and free up capacity; and** **• it would allow tankering operations to be optimised based on the combination of transportation costs and sludge treatment charges.**
Sludge treatment, transport and disposal market design	3	Do you agree that the information should also contain details of 'bids' in from entrants, and that there should be guidelines for ensuring that such bids are assessed on a level playing field basis?		As we have explained, we are very supportive of sludge competition – it offers enormous opportunities and also provides Ofwat with the potential to roll back its regulation. In this context we think Ofwat should avoid imposing this obligation on companies. The purpose of creating a market based framework is for letting a market develop and flourish without regulatory intervention. The current proposal implicitly assumes that all participants do not compete and therefore requires regulatory intervention. This scenario is unlikely and instead intervention should be focused on those that choose not to compete. We also think intervention distorts behaviours between WASCs, new entrants and providers of other organic waste (OOW) treatment providers. We disagree with guidelines and would rather Ofwat create the mechanisms for a market to operate effectively. If that fails, then Ofwat can use its extensive powers to investigate and intervene on a targeted basis. Ofwat have competition powers to enforce compliance with competition law should that be required. Effort should be spent on designing the market structure and preventing any misaligned incentives or regulatory distortions between incumbents and new entrants. If the economic incentives are well designed there would be no incentive to discriminate against new entrants.
Sludge treatment, transport and disposal market design	4	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?	**Disagree**	**We think information should be made available on a consistent basis between WASCs. However, we don't think an information platform designed by the water and sewerage sector is the answer. The reason being that sludge is a subset of a much wider organic waste market. Designing an information platform to reveal sludge information misses the wider scope for trading that may emerge over time. We can foresee a world where pricing and capacity information becomes more dynamic (at the limit on an hourly basis) with multiple third party operators providing data services to multiple parties. The key issue is to get the right information out, but let the platform remain an opportunity for innovation and markets to deliver.**
Sludge treatment, transport and disposal market design	5	Do you agree with our proposals not to make any changes to the status quo in relation to system operation activities?	**Agree**	We support Ofwat's position and the proposal that system operation accountability should remain with the wholesaler. We will however be looking to develop ideas around this in the future.

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Question				Comments
Sludge treatment, transport and disposal market design	6	Do you agree with our proposals not to have any specific financial incentives to support trading in relation to sludge at this time?	**Agree**	**We think Ofwat should avoid intervening in this market, beyond setting up the framework (mandating certain information is published and creating the price control). This is because interventions could have unforeseen consequences and also raise the cost of participating in the market.** **Our preference is that Ofwat does not apply additional incentives OR trading guidelines. Instead the market should be allowed to develop and if Ofwat observed inappropriate conduct then it should consider either (i) using its CA98 powers; or (ii) apply guidelines in period. This would be a useful regulatory tool that could deliver the same objective without intervention.**
Water resources market design	7	Do you agree with our proposal to have a separate binding price control for water resources?	**Disagree**	We are very supportive of Ofwat's proposal for competition for new water resource capacity. Making it easier to access and trade water resources could have significant economic benefits, as previous work undertaken by Severn Trent and others (including Ofwat) has shown. We think that the current proposals around access pricing on a WRZ basis should help to unlock water resource markets. We are uncertain as to whether the use of a separate binding price control is necessary for the creation of this market. In particular access price will be set using AICs (not costs in the water resource control). Therefore in the context of markets having a separate control with allocated RCV might be unnecessary to unlock the benefits of water resource markets.
Water resources market design	8	Do you agree with our proposal to implement an offset mechanism to ensure that entrants can recover the cost of new resources appropriately, whilst also ensuring that prices reflect average costs?	**Agree**	**We are supportive of this approach. Like Ofwat we think customers will benefit if this mechanism is applied to new resources capacity, rather than displacing existing capacity (which would facilitate inefficient entry and increase costs for customers).**
Water resources market design	9	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?	**Agree**	We are very supportive of Ofwat's desire to facilitate competition through the provision of better information (although this doesn't necessarily imply more data). There is a need for a greater degree of transparency and an appropriate level of information for markets to operate effectively. Without this information it is difficult for new entrants to evaluate opportunities for entry and more difficult for companies to demonstrate a level playing field. We believe a market information database would help reveal the lowest cost solution to supply-demand gaps. However it's important that this is kept simple otherwise the volume of data could be significant and it would make it difficult for entrants to assess opportunities. We also think consideration needs to be given to the timing of the publication. Unlike sludge this market will require significantly less frequent information.
Water resources market design	10	Do you agree that a third party organisation may be best placed to manage the information database?	**Disagree**	**The provision of information is a critical tool to improve decision making and ultimately deliver efficiencies to the benefit of customers. In the context of water resources what is important is:** **• the accessibility of the information – in particular there should not be high transaction costs associated with finding and using the information; and** **• the cost of making the data available.** **We consider that having a third party host the information platform would clearly make the data accessible. However there is the potential for some administrative costs if the third party needs to be established (with associated governance developed). Therefore we think an alternative proposal would be more appropriate whereby:** **• companies publish the data on their websites; and** **• either Ofwat or CCW creates a landing page that links to all the company data.** **This option would maximise the accessibility of the data but also minimise the cost as existing infrastructure could be used.**
Water resources market design	11	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?	**Strongly Agree**	We are particularly supportive of Ofwat's proposal to increase transparency and certainty around security of supply. In our previous work on water trading we noted that the lack of transparency was one of the barriers holding water trading back. Therefore setting clear expectations around security of supply, including in Water Resource Management Plans, will help facilitate trades as all parties will have a better understanding of the supply/demand requirements and can factor this into buy/sell decisions.

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Question				Comments
Allocation of the RCV	12	Do you agree with our rationale for allocating the RCV?		**We agree with the rationale for allocating the RCV to sludge. We are less certain that allocation needs to occur for water resources.** **The RCV is a fundamental feature of the regulatory framework in the water and wastewater sector. It has helped create a stable regulatory framework which has led to over £116 billion in investment since privatisation. Given its critical nature any proposal impacting the RCV needs to be handled with care.** **In relation to sludge, we support Ofwat's position that capital costs should be reflected in the sludge charge to provide appropriate price signals to all parties. Allocating the RCV to sludge on a focused basis will help deliver the objective of market reflective prices. However as we noted earlier, it's important that the revaluation of assets reflects the age and condition of assets. If this doesn't happen too much RCV will be allocated to old assets (based on new replacement prices) and it would reduce the level of price competition and scope for efficiency, which will cost customers in the long run.** **In the context of water resource competition, we are less certain whether there is a need to allocate the RCV. This is because the approach to setting access prices is not dependant on the RCV, but rather the forward looking costs. Given the importance of the RCV to investors, proposals that impact the RCV can also have unintended consequences. For example, despite the clear assertions in the Water 2020 proposal that there is no stranding risk in relation to water resources, we have observed some investors noting that the water resource RCV is at risk. Therefore if Ofwat does not need allocate the RCV to water resources to drive competition, then we would support it being retained in the network plus control.**
Allocation of the RCV	13	Do you agree with our proposed approach for allocating the RCV for sludge?	**Agree**	We are very supportive of the focused allocation of the RCV to sludge given that the approach to pricing depends on this allocation. However as we have stated earlier, it's important that if/when the assets are revalued they are done on a basis that reflects the age and conditions of the assets to ensure a level playing field.
Allocation of the RCV	14	Do you agree with our proposed approach for allocating the RCV for water resources?		**As we noted previously, we think it's critical that access prices send the right signal to promote efficient entry. This is why we are supportive of the approach to allocating the RCV to sludge. We are however less certain that the RCV needs to be allocated to water resources. However if the RCV needs to be allocated to water resources, then we support an unfocused approach.**
Protection and treatment of the RCV: managing transition and our approach to new investment	15	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?		The RCV is one of the central features of the regulatory framework. It helps to underpin investor confidence by acting as a commitment device which ensures that invested capital is remunerated. Whilst protection of the 2020 RCV is important, investor confidence associated with the RCV depends on two things: • regulatory support and protection of the RCV itself; and • what is applied against the RCV – specifically the real return and RPI indexation (which equals the nominal return in total) Therefore to deliver investor confidence and ensure that the sector can continue to attract finance at a low cost Ofwat also needs consider its approach to indexation. The current proposal creates a lot of uncertainty for investors given the lack of clarity about what happens to the RCV after 2025. We think greater clarity could be given to investors, whilst reducing bill volatility, by indexing revenues and new RCV by CPI and indexing old RCV by RPI.
Protection and treatment of the RCV: managing transition and our approach to new investment	16	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?	**Disagree**	**Water resources - by applying a revenue control we consider that there is no prospect for stranded assets for the period 2020-25.** **Sludge - the scope for stranding over 2020-25 would seem to depend on a number of factors including the quality of the information being shared by market participants and how technology develops. Whilst the prospect for stranding could be low, we don't think it is zero and we could envisage scenarios where assets are stranded. For example a third party could enter the market in 2024 with new treatment that generates additional energy – this could displace any new capacity built by the incumbent.**
Protection and treatment of the RCV: managing transition and our approach to new investment	17	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?	**Strongly Agree**	We are very supportive of Ofwat's efforts to mitigate risk associated with sunk investments at 2020. Water resources - we actually think Ofwat might not need a separate mechanism given the application of a revenue control (and our expectation that it would operate in a similar manner to WRFIM, albeit the revenue shortfall or excess would be recovered via the network plus control given other statements in the document). Sludge - an ex-ante revenue guarantee based on the (I) fixed element; and (ii) the implied volumetric rate from the PR19 FD sounds the most sensible and pragmatic solution to deliver a price control with guarantee on the RCV

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Question				Comments
Our approach to access pricing	18	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?	Strongly Agree	**We are very supportive of Ofwat's approach to access pricing. For upstream entry to occur, we agree that its vital efficient entrants can compete on level terms, which includes the ability to access an incumbent's pipes to supply their customers. This is something we strongly advocated in our contribution to the market place of ideas (see Options for access pricing methodology – Oxera).** **Given the need to access an incumbent's network, the proposal to set access prices by reference to the average cost of the incumbent's network plus activities makes a lot of sense. Whilst further disaggregation of the network plus control is possible (i.e. not using the average) we think locational signals could be better set through connection charges.**
Our approach to access pricing	19a	In relation to access prices for water resources, do you agree with our proposal that companies should be responsible for calculating and publishing these?	Strongly Agree	We very much support Ofwat's proposal that incumbents should be responsible for calculating access price. Promoting markets for new water resource require a number of reforms, most importantly access prices that reflect forward looking costs and better information. At present only incumbents have the data necessary to: • forecast long term demand under different scenarios; and • calculate the long term supply capacity under different scenarios (eg climate variability). This information asymmetry requires that incumbents are responsible for setting access prices.
Our approach to access pricing	19b	Do you agree they should be published by water resource zone, with network distribution and treatment costs separately identified?	Strongly Agree	**Water resource markets have the potential to promote productive and dynamic efficiencies through the better use of water resources. However to realise these efficiencies it's important that entry occurs in the right places – specifically where there is a projected shortfall of water resources.** **We are therefore very supportive of Ofwat's proposal for locational based signals, using water resource zones as the central component. This is something we advocated in our work on access prices (see market place of ideas) and was something that the Cave Review proposed when considering the scope for upstream competition.** **However we would also urge that geographical averaging of prices for end-users is maintained. The tension between localised access prices and averaged end-user tariffs has been managed in other sectors to great success. There is no reason why it should not be possible in the water sector.** **In terms of specific charge components, we consider that the charge should reflect the form of competition that is available under the legislation and licence conditions.**
Our approach to access pricing	20	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?	Agree	We support the proposal to implement a mechanism that offsets the difference between the LRIC of new resource and the prevailing average cost of resource. For upstream entry to occur, it is vital that access prices enable efficient entrants to compete on level terms. Offsetting the difference between LRIC of new resource and the prevailing average cost of resource would ensure that third parties with LRICs less than the incumbent would be able to profitably enter the market. This will help deliver the lowest cost water to customers and thereby reduce bills relative to the counterfactual of no entry. We also support Ofwat's position (page 22 of the appendix) that care needs to be taken in how the AIC is measured, otherwise there could be inefficient entry. This would arise if the mechanism incentivised parties to supply new resources when there is no need. Therefore additional measures/rules should be adopted to promote entry only when there is a need for new capacity. For example it might be helpful to have additional rules over how the AIC is measured. In particular the AIC used for access pricing should be based on a stacked schemes that a company is proposing to build over the relevant planning period (which could be 5-10 years).
Our approach to access pricing	21	Do you further agree that it is the incumbent's, rather than the entrant's LRIC, that should form the basis of the payment, in order to provide a stronger incentive for entry?	Agree	**We support Ofwat's proposal that access prices should be set on the basis of the incumbent's LRIC rather than the entrant's. This will helps deliver a price signal that promote efficient entry (i.e. cheaper water to be supplied). This is because the entrant would only be able to profitably enter the market if its LRIC is lower than the incumbent's.**
Our approach to access pricing	22	In relation to sludge, do you agree that price and non-price terms should be the outcome of commercial negotiation, supported by the cost or price and capacity information previously set out?	Agree	As we have noted in our response, we are very supportive of Ofwat's proposal to promote sludge competition. We think this is a market where significant customer benefits are likely to be realised through better use of capacity and new technologies. We recognise that it will require some regulatory intervention (i.e. the price cap) however we fully support the principle that the market (incl. contractual terms) should develop through commercial negotiation as opposed to regulation.

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Question				Comments
Our approach to access pricing	23	Do you support our proposals to develop high level guidelines as to how rival offers in relation to sludge treatment, transport and disposal should be evaluated?	**Disagree**	**One of the key impediments to sludge markets is information asymmetry. To make the optimal decision about how sludge is treated it is necessary to understand (i) what options exist; and (ii) the price of using alternate options. Provided this information is published, companies will be able to identify the lowest cost solution. This solution could involve treating sludge themselves, or using another company or third parties facilities. The key point is that provided a company can identify a lower cost solution it will have a strong financial incentive to adopt that solution.** **In light of the strong financial incentive we don't think trading guidelines are needed. Whilst we recognise Ofwat's point that companies are monopoly sellers of sludge, there are strong financial incentives to procure the lowest cost solution. Therefore we do not think guidelines are necessary, at least at this stage. Instead Ofwat might consider closely monitoring the market to understand if there is an issue before deciding to intervene.**
Making greater use of direct procurement for customers	24	Do you agree with our proposals relating to the use of direct procurement on behalf of customers?		See separate note.
Making greater use of direct procurement for customers	25	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?		**See separate note.**
The implications of making more use of markets	26	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?	**Agree**	We think having a consistent regulatory framework across England and Wales is beneficial in that it: • maximise the number of comparators available for benchmarking, which would improve the robustness of the wholesale econometric modelling and the setting of performance targets for horizontal ODIs; and • reduces the cost of regulation per customer. However we strongly respect the decisions of the Welsh Government to choose the form of regulation that should apply to its citizens and we will work with whatever framework is decided upon.
The implications of making more use of markets	27	Do you agree with our initial view that the network plus controls for water and wastewater and the water resources controls should be total revenue controls?	**Strongly Agree**	**We are very supportive of revenue controls for the network plus services – this is because they will help reduce risk and ultimately keep customer bills low through a low cost of capital.** **In the water and wastewater sectors one of the key cost drivers is the cost of capital. A significant proportion of customers' bills over the 2015-20 period – around 20% or about £80 average per customer per year – will be associated with financing new and past investment. Maintaining a low cost of capital is critical to keeping bills low. In the context of the form of control, the use of a revenue control or a price control can have a significant impact on risk and hence the WACC.** **Under a price control companies are exposed to changes in demand and volume, whereas under a revenue control companies are not exposed to that risk (instead it sits with customers). Setting network plus and water resource revenue controls does not expose companies to additional (volume and demand) risks. Given that these are most likely to be influenced by weather patterns and are outside company control, this proposal will reduce risk exposure and ultimately keep bills lower.** **We also consider that the revenue controls should provide an incentive for companies to back-bill. We believe that customer want us to pursue bad debt and back-bill customers as this means the cost of services are more evenly spread. At present there is a disincentive to back-bill given the rate of bad debt exceeds the additional revenue that retail collects. Therefore we would support a revenue control with some adjustment to incentivise back billing and which would allow companies and customers to share the benefit. This could also include a requirement that companies can only claim the additional revenue if performance in related areas, such as bad debt, is at the UQ level.** **As part of the market place for ideas we are proposing to investigate in-period incentives for PR19, which would include back-billing.**
The implications of making more use of markets	28	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?	**Agree**	We support the principle that of applying a price control to sludge. Unlike water resources, we consider that sludge volumes are more likely to be driven by gains and losses in market share. Therefore applying a price control (instead of a revenue control) will: • incentivise companies to compete because they will get to retain the difference; and • ensure that customers do not pay for inefficient investments as customers will only pay a fixed price.

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Question				Comments
The implications of making more use of markets	29	In your view, how should new investments be remunerated in the sludge and water resources controls from 2020?		**We believe that new investments should be remunerated by a return on the RCV. As we have noted the RCV is one of the central features of the regulatory framework and is well understood by investors. It helps to underpin investor confidence because it represents a commitment device which ensures that invested capital is remunerated.** **Whilst there will inevitably be some risk of stranding for new investments (at least for sludge), there will still need a need for significant investment in these areas. Maintaining the use of an RCV, albeit reported separately to old RCV, will give investors' confidence that provided incumbents' volumes reflect forecast they will be able to earn their return.**
The implications of making more use of markets	30	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 most important tool to promote market based solutions is the establishment of the price cap. This will incentivise companies to look beyond their borders. We also consider that assessing the financeability of the sludge control on a stand-alone basis would also help promote a level playing field as it would help promote charges that reflect the costs that a standalone business would need to recover.
Incentivising monopolies to discover and reveal information on efficient costs	31	Do you agree with our proposal to retain our RBR approach for PR19?	**Strongly Agree**	**We are very supportive of the Risk Based Review (RBR). This is something we advocated following PR09 after observing that the CIS menus did not having the incentive properties that were predicted.** **For the RBR to deliver the best outcome for customers, we think Ofwat needs to consider:** **• the size of the financial rewards; and** **• sharing information (WACC and cost models or key components) in advance of submission to promote more effective customer engagement.** **The RBR will deliver the best outcome for customers if there are strong financial incentives that reward companies for taking the risk of submitting challenging plans. At PR14 the size of the incentives was unknown and Ofwat had the luxury of being able to set quite a small reward, particularly when compared to the size of the rewards in energy. Looking forward we think Ofwat will get a much stronger response to the RBR, particularly at Board level, if it sets a much stronger financial incentive for enhanced, similar to Ofgem.** **The RBR will also likely to be more effective if Ofwat shares in advance of business plan submission its expectations about the WACC and cost models. This is because the WACC and cost models in particular have such a strong impact on bills. By providing this information in advance we can more accurately present our customers scenarios that reflect what priorities could be achieved under different affordability constraints.**
Incentivising monopolies to discover and reveal information on efficient costs	32	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?)	**Agree**	We agree that the credibility of the risk based review is critical to its long term success. If stakeholders do not view enhanced companies as genuinely being top-performing companies then the reputational benefits will be diminished significantly. We therefore support Ofwat's proposal that current performance should be reflected in the RBR assessment. We think this proposal will help maintain the credibility of enhanced status. This assessment should make a distinction between: • systemic poor performance and poor performance on a small number of measures with very good performance across other measures; and • how the company has responded including via engagement with its customers; and • how it plans to improve performance.
Incentivising monopolies to discover and reveal information on efficient costs	33	Do you agree that the RBR assessment should consider the extent to which the business plans are part of a longer term plan?	**Strongly Agree**	**We are very supportive of increasing the focus of the assessment to the long term. One of the biggest challenges confronting the sector is ensuring that we are on a sustainable course. This means delivering the service improvements customers wish to see and a healthier environment, all at an affordable price, and in a way that the sector can continue to be financed in the long term.** **We therefore welcome Ofwat's desire to take into consideration long term planning, when assessing business plans at PR19. In making this assessment we think Ofwat will need to draw on a range of evidence including:** **• Engagement with customers about the medium-long term priorities, including how those priorities are balanced against affordability constraints;** **• Challenge from CCGs about how companies reflect customer views about the long term in business plans;** **• Assessment of total system risk/resilience in the medium-long term and what steps companies plan on taking to maintain their outcomes;** **• Wholesale costs that reflect the upper quartile efficiency level;** **• Incentives that reward companies for outperforming when delivering the service levels customers want; and similarly penalising companies when they fail to deliver the services customers value; and** **• High quality Board assurance about the long term viability of the plans.**
Assessing cost efficiency	34	Do you agree that the consideration of disaggregated cost models is appropriate given the price control structure proposed?		We are very supportive of Ofwat's use of benchmarking to assess and set cost allowances, including the application of a UQ efficiency challenge. Assessing the efficiency of expenditure is not a straightforward exercise, particularly in a sector where price reviews determine revenues in excess of £40 billion. Econometrics have become the established way of comparing efficiency as it allows Ofwat to efficiently benchmark performance and reward high performers whilst challenging poor performing companies to improve. We support the position that top-down econometric models will need some separation into the different controls. The econometric modelling should seek to build on the successful PR14 models and: • more explicitly take account of the underlying level of service (output), as this will help all parties assess whether additional cost allowances are required for enhanced levels of service; • should not cap the frontier company, otherwise it could reduce incentive to submit challenging plans; • reflect changes to long term needs such as adapting to climate change; and • not create an overly burdensome data requirement. It will also be important to undertake some form of high level review 'in the round' to ensure that the efficiency challenge is sensible when viewed in aggregate, particularly if the financeability assessment is being undertaken in aggregate. This is particularly relevant in relation to the resource control. Many costs in resources are uncontrollable (e.g. EA fees) and they are not evenly applied across the UK so simple benchmarking would not reveal inefficiencies. We also note that other costs, such as MOSL fees are levied in this way and it would be useful for the modelling to separately adjust for regulatory fees. We also consider that Ofwat should continue with its approach at PR14 and set a UQ efficiency challenge. Whilst Ofwat could consider adopting the CMA's approach of an average efficiency challenge with an on-going annual target, we the UQ challenge better resonates with stakeholders.

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Question				Comments
Assessing cost efficiency	35	Do you agree that the development of detailed cost allocation guidelines is appropriate?	Strongly Agree	**We are extremely supportive of Ofwat issuing new cost allocation guidance that supersedes all previous iterations and versions.** **A large challenge confronting companies is that cost guidance has been issued piecemeal without a comprehensive update. This requires companies to maintain a corporate 'memory' and ensure that all updates are identified and incorporated. This can lead to mistakes if an element/update is missed. Often this also requires judgement, where different guidance documents appear to conflict (as occurred in relation to CIS). Therefore we would welcome complete and thorough guidance.** **We also note that there are areas where it may be appropriate for different measurement between companies, so the guidance should include requirements on companies to make clear how items are measured, not just what is included where. Where Ofwat is proposing to use comparative ODIs, then there should be a comprehensive audit of how these performance levels are measured and issued so that the sector can look to improve.** **Finally it's important that the timing of the guidance is provided early to ensure companies have sufficient time to ensure cost capture systems can be aligned.**
Encouraging a longer-term approach	36	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 controls and **not** seek to further align the timing of controls with other planning processes?	**Disagree**	The length of the price control needs to strike an importance balance between providing stability for long term investments, whilst minimising the risk that the economic fundamentals underpinning a determination change. In light of the proposals around water resources and sludge, we think there is merit in Ofwat considering the pros and cons of a longer period, similar to Ofgem's 8 year control.
Encouraging a longer-term approach	37	Are there any other measures, not considered above that could help to encourage a longer term approach?		**We welcome the commitment to work "closely with Defra, the Environment Agency, Natural Resources Wales and companies to align our price control processes in the run up to such reviews with other planning cycles and ensure that companies have the greatest clarity possible." We also think that Ofwat needs to work closely with the DWI to understand the long term challenges facing the sector.** **It would be useful to understand in more detail how aligning the different planning cycles would work in practise. For example this could be achieved through a published agreed statement of principles and guidelines about coordination of statutory submissions and processes.** **We also think Ofwat is right in setting out the challenge about long term planning, rather than trying to come up with the answer. The responsibility should be on companies to demonstrate how they are promoting a long term approach and we expect a range of approaches will be trialled at PR19. At the end of the next price review Ofwat should consider the different approaches and if there are some stand out methods, consider promoting those for PR24.**
A more responsive regulatory framework	38	Do you agree that we should amend the licence to allow for in period adjustments for some or all of the following: outcome delivery incentives, revenues and cost sharing?	**Agree**	We strongly support taking rewards and penalties in period as this strengthens the incentive of delivery for customers. We requested this licence change at PR14 and it's been hugely benefit to our company and customers because it strengthens the incentives. For example we have seen a step change in performance against most ODIs as reported in our interim result. The focus on performance creates greater urgency in delivery of enhancement investment and greater management focus on performance. We support the license changes for ODIs and revenue (but not CPI indexation). We can also see benefit in having the rewards and penalties from totex cost sharing being made in period. However this would need to be applied flexibly so companies can manage (i) bill volatility; (ii) change in the profile of expenditure. This would suggest that we should avoid applying a WRFIM type rule and instead allow companies to take more ownership about how they make adjustments, given the objective of bill stability.
Indexation of future price controls (RPI versus CPI)	39	Do you agree with our proposal to move to CPI (subject to the UKSA's final recommendations)?		**Questions 39 to 43 – see our separate response**
Indexation of future price controls (RPI versus CPI)	40	Do you agree with our proposal to implement a CPI based approach, for both revenues (prices) and the RCV, subject to a transition process?		Questions 39 to 43 – see our separate response

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Question				Comments
Indexation of future price controls (RPI versus CPI)	41	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?		**Questions 39 to 43 – see our separate response**
Indexation of future price controls (RPI versus CPI)	42	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 commitment as credible as possible?		Questions 39 to 43 – see our separate response
Indexation of future price controls (RPI versus CPI)	43	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?		**Questions 39 to 43 – see our separate response**
Impact of the balance of risk and reward on the cost of capital	44	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?		While there are a number of factors that mean that risks and opportunities will vary for different parts of the value chain, this does not have straightforward implications for assessing the cost of capital. The key issue in terms of cost of capital impacts is the extent to which there are materially different levels of systematic risk associated with different activities. The PwC report presents the view that systematic risk is higher for sludge as compared with wholesale activities as a whole. We do not consider that PwC's analysis provides an adequate basis to draw this conclusion. PwC's view is largely based on the assessment of (i) energy costs; and (ii) operational leverage. In terms of energy costs, a key concern we have is that the PwC assessment does not provide a robust basis for concluding that higher energy costs in sludge translate into a higher beta. PwC's conclusion seems to rest heavily on a highly simplified comparison between the average identified equity betas of two sets of companies that are identified as having different energy use levels. However, without examining the characteristics of these companies (and differences between them) in more detail, this provides an extremely limited basis for comparison. There are many factors that could materially affect identified equity betas (including gearing levels, given that the analysis considers equity rather than asset betas) and simply attributing this high level difference between groups to differences in energy consumption does not provide a robust basis on which to draw and/or support the conclusion reached for sludge. We consider that much more analysis would be needed before any robust conclusions could be drawn from this analysis if Ofwat chooses to adopt this methodology. We also consider that the level of relevant energy costs for the assessment of systematic risk in sludge requires further attention before robust conclusions can be drawn. In particular, given the use of sludge as an input into energy generation, the impact of energy price movements on returns will depend on the net impact of these movements on revenues as well as costs. In line with this, we would question the extent to which volatility in the UK industrial electricity price index would impact on relevant power costs given energy generation levels and the implications this has for energy self-sufficiency. We also have concerns with the analysis of the relation between asset beta and capital intensity. The analysis by PwC is limited and ignores other factors that could be impact on the asset beta – although PwC does
Impact of the balance of risk and reward on the cost of capital	45	To what extent would our proposed market and incentive reforms impact on the balance of risk and opportunities and the cost of capital and whether this would vary across the proposed wholesale controls?		**Under the proposed reforms a wide range of different issues could arise, but for the purpose of this response we focus our comments on the proposed market and incentive reforms related to sludge. We will comment on other potential issues (for example, associated with the development of ODIs) as further proposals are developed.** **In terms of the sludge proposals, there look to be two key issues to consider. Firstly, as recognised in the consultation, the movement to a price cap increases the intensity of regulation and involves an overall increase in the risk borne by companies as opposed to customers. That is, companies will be exposed to volume risk, including volume risk that stems from overall movements in market conditions (rather than gains and losses from competition, which are discussed below).** **We agree that this change has the potential to increase systematic risk, and thus increase the appropriate cost of capital for the sludge business (over and above the level that might be identified from separating the sludge control but retaining the current form of control).** **The other key potential source of impact on risk and the cost of capital is from competition. We agree with PwC that it would seem unlikely competition will impact on systematic risk. This is because investors can diversify their portfolio and therefore not be exposed to a reduction in overall returns.** **However, competition does introduce greater downside risks for companies, and this means that there will have to be correspondingly significant opportunities for upside benefit for companies to be able to expect to earn their cost of capital. The appropriate way of addressing this will depend on the overall package of arrangements that is developed, but consideration should be given to the use of an uplift on the WACC, and more generally to the importance of providing opportunities for upside benefits to be realised.** **We do not agree that this issue arises only after 2025 when the likelihood of lower returns will be greater, as expectations of future returns will be relevant for decisions concerning the provision of sludge capacity from the point at which the reforms commence (and RCV protection is removed). We consider this important to recognise. While asset lives in sludge are much shorter than those in**
Customer engagement	46a	What does good customer engagement look like?		We are fully supportive of the challenge from Ofwat that companies need improve how they engage and use customer views. In our strategic framework we have challenged ourselves to embed customers at the heart of all we do. And this means we'll need to improve the way in which we engage with customers, through improved insight and understanding of what's important to them. In terms of "what does good customer engagement look like" – we don't think there is a simple answer to this question like there is when assessing other aspects of company performance. We know what the outcome of good customer engagement looks like – which is a real understanding of what customers want and value over the short, medium and long term. How this outcome is achieved will require that companies try new methods and continually adapting their tools and processes. We think some of the characteristics of good customer engagement include: • the use of research that openly explores what customers want – or could want, as opposed to starting with preconceived views or constrained question. Importantly companies need to accept what is heard back; • the use of new channels to access different demographics, including digital channels • the use of new methods, such as experiments to reveal customer preferences rather than simply asking customers directly about their preferences; • the use of new data sources, rather than just utilising surveys/focus groups and responses to consultations. This includes analysing information generated from everyday interactions; • better contextualisation of subjects and choices. For example, customer views on ODIs first had to be placed in the context of how they would work in reality, not simply the theory behind them. Issues should be presented so that customers can relate to them easily and can draw on their own experiences. • on-going process which provides companies with an opportunity to learn and develop plans, commitments and outcomes that reflect customers' long term wishes.

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Question				Comments
Customer engagement	46b	What are your views on the principles outlined above?		**We are very supportive of the principles relating to the role of companies and CCGs. Below we share our specific thoughts on each of the key points raised in the consultation.** **Role of companies:** **• We agree that it should be the responsibility of individual companies to understand the priorities of their customer base.** **• We agree that multiple sources of evidence should be used to form a detailed view of customers' priorities and views and that a reliance on stated preference measures needs to reduced (although stated preference will still form an important part of the evidence base).** **• We agree that sources of information should be broad and include the everyday interactions that we have with customers.** **• We agree that we need to ensure that different types of customers are consulted and engaged and on range of subjects from the immediate, short term through to long term issues.** **• We agree that engagement should be a two way process with customers being part of an active two way dialogue.** **Role of CCGs:** **• We agree that the role of the CCG should be to challenge and assure the companies approach to customer engagement and not act as a substitute for them.** **• We support the approach advocated to setting expectations of CCGs as to their role in the quality of their challenge and assurance.** **• We suggest that CCGs take their own view as to the extent to which they require comparative information about other companies' customer engagement in order to take a view on their own (although we support Ofwat making the horizontal PC/ODI data accessible).** **• It's important that CCGs are not seen as a substitute for customer engagement, particularly after the RBR.**
Customer engagement	46c	How could companies draw on good practice from within and outside the sector?		The spreading of best practice can occur through a number of ways. For example: • recruit talent from other sectors that have a strong track record of innovative customer engagement; • use of tendering to bring in other organisations that can offer an alternative perspective of how to reveal customer priorities; • compare performance against wider benchmarks (i.e. not just water); • share more comparative information about company approaches at the conclusion of each price review (this could be shared informally). We don't think Ofwat should be responsible for spreading best practice, beyond setting its expectations. Responsibility for identifying and adopting best practice sits with water companies and companies that are good at this can get obtain a competitive advantage.
Customer engagement	46d	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?		**We think one of the principle challenges facing companies will be how they integrate information from a range of different sources to develop a clear picture of customer priorities.** **As we have commented earlier in our response, we have challenged ourselves to improve the way in which we engage with customers. This will require applying new tools and methods to reveal customer priorities. We think it's highly likely that this will generate unusual results and potentially conflicting results. Therefore validating the results will be crucial to ensuring that we deliver the priorities value most. We think this validation can occur in a number of ways, for example:** **• seeking third party assurance about the different approaches applied, particularly innovative methods;** **• applying iterative rounds of testing and refinement using as many means of engagement and information exchange as the companies deems practical;** **• engaging with other organisations (not just water companies) to test both (i) the way the tools are used; and (ii) the results to sense check them.** **Ultimately we think some judgment will be required. Therefore it will be important that companies have both (i) there is sufficient evidence to justify the position; and (ii) clear audit trail of how/why they have made decisions.**
Customer engagement	47a	What are your views in relation to our proposals on future CCG remit; scope; timetable; governance arrangements; and membership?		Remit and scope - see earlier answers. Timetable - we support the submission of the first report at the time the companies submit the business plan. We also agree with the notion of the second report but it's important that this doesn't creep into areas outside CCG remit (e.g. it should focus on how we have taken into account customers' views and represented those). Membership - we agree that companies should choose the membership that would deliver the most effective challenge. Governance - we agree that companies should consider the most appropriate governance. What is critical is that the governance arrangements are transparent.
Customer engagement	47b	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?		**For the most part we agree with the list, although there are two areas which merit further consideration (i) performance related payments; and (ii) engagement about solutions.** **We welcome the challenge from our customers on performance but consider that rewards or penalties should be as per the risk reward framework and existing GSS mechanisms agreed with our customers and Ofwat at PR14. We recognise that there could be exceptional circumstances that warrant deviating from the agreed framework, but in general we think companies and Ofwat should strive to get the framework right – for example our current rewards are calibrated to ensure 50% sharing with customers, consistent with the totex cost sharing. This is because a clear framework with clear incentives will drive the right behaviour and deliver the best outcomes for customers.** **We also question the extent to which companies should be engaging with customers on options/solutions to deliver the desired outcomes. Although we recognise that in some areas, such as supply-demand balance, the applicable options are an emotive topic and therefore could warrant specific conversations. This however should be up to the company rather than being mandated across the board.** **Our concern is that the requirement could creep into other areas. For example it would seem unusual for companies to engage with customers on their preferred option to minimise discolouration complaints, such as changing the chemical composition of lime. Instead companies should be engaging on what is the right level of performance based on options around pricing and bill impacts. We therefore think companies should choose whether they engage with customers on specific solutions rather than having it mandated.**
Customer engagement	47c	What are your views on the division of responsibilities between CCGs and Ofwat?		We support Ofwat's proposal that the CCG should be focused on challenging how companies have engaged with their customers and reflected that engagement in the business plan. We think that if these activities are undertaken appropriately then Ofwat should be able to focus on assessing the efficiency of the cost proposals and the balance of risk and reward (as opposed to intervening in relation to the scope and level of PCs and ODIs).

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Question				Comments
Customer engagement	48a	What are your views on our proposal to facilitate more collaboration between CCGs?		**We support collaboration between CCGs on issues of governance and process.** **We are uncertain whether collaboration should occur at a more detailed level – such as how companies are revealing customer priorities. We can see benefits in collaboration (i.e. sharing best practice) however it would also reduce the competition between companies to develop the best plan. Therefore a balance needs to be struck between these competing objectives.** **We also think recognition needs to be given to confidentiality agreements between the CCG and companies. We also have concerns on the frequency of the workshops, our CCG chair is contracted for a limited number of days per year, has a number of other commitments and their time will be best utilised challenging how we engage with our customers and how we reflect the priorities in our plans.** **We think this needs to be a consideration when developing the programme of CCG / Ofwat workshops.**
Customer engagement	48b	What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early?	**Agree**	As per question 31, we are very supportive of Ofwat sharing information such as the WACC, RORE range and cost models ahead of business plan submission. Sharing this information whilst plans are being developed will allow companies to more accurately engage with customers about how priorities should be balanced. This is because the WACC and cost models in particular have such a strong impact on bills. By providing this information in advance we can more accurately present our customers scenarios that reflect what priorities could be achieved under different affordability constraints.
Customer engagement	48c	Without inserting ourselves between companies and their customers, what else could we do to incentivise and encourage good quality customer engagement?		**We think Ofwat is right to put the onus on companies to develop great customer engagement. Ofwat can still play a really important role by supporting companies that deliver ODIs.** **The introduction of outcomes and ODIs was a revolutionary idea for water regulation and we recognise that Ofwat faced significant opposition. We can now see that Ofwat was right to introduce these incentives because they are focusing company performance on services that customers value most. At Severn Trent this has translated into improver performance across a number of outcomes at a very low cost.** **Looking forward we think there is a risk the sector could come under pressure to abolish ODIs or reduce their strength – this would be a mistake as customers would suffer. Therefore it will be important for the credibility of the regulatory regime that Ofwat comes out strongly in support of companies that over-deliver on ODIs during this control period.**
Outcomes	49	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?		We are very supportive of Ofwat's desire to promote a longer term approach to (i) its regulation; and (ii) planning by companies. This is critical because the water sector is characterised by assets that span multiple control periods. In this context we think there are opportunities to enhance long term planning through: • Articulating what level of resilience/asset health is reflected by the totex models. Depending on customers priorities it's possible that customers might want a higher level of (asset/network) resilience than is currently offered. To support the delivery of this, companies may need to make special cost claims to increase investment. Therefore revealing the embedded level of resilience from the models will help companies engage with customers and make informed investment decisions. • Long term outcomes, PCs and ODIs - we can see the benefit of such measures. However if performance targets span multiple AMPs and funding doesn't then it changes the risk and reward balance. Therefore any framework that accommodates multi AMP ODIs should be linked to a commitment on the funding. • Mandated PCs and ODIs - there will be a need to mandate those PCs and ODIs that Ofwat will use for comparative purposes. However we do not think Ofwat should mandate additional measures. Adopting a one size fits all approach would reduce the scope for innovation and prevent new leading indicators from being designed. Instead we think Ofwat should be prepared to intervene if there is insufficient coverage and assurance about the asset health measures
Customer engagement and outcomes in the face of change	50	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 think it's really valuable to have advance warning about upcoming consultations. For the November consultation we think it should cover:** **• the split between bespoke and comparative ODIs;** **• the timetable for when the list of comparative ODIs will be defined ;** **• expectations about RoRE ranges;** **• how PCs and ODIs interact given separate sludge and water resource controls; and** **• standardising the measurement of comparative PCs and ODIs.** **• wholesale cost assessment – with a focus on (i) the models and (ii) treatment of frontier performance – ie, as per the December consultation – a focus on the potential not to cap the results of the frontier companies**
Customer engagement and outcomes in the face of change	51	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?		In relation to outcomes, we think it's important to differentiate between the standardised PCs/ODIs and the bespoke measures. For the standardised measures, we fully support having the definitions agreed early – ideally by 2017. This is important because if there are changes in the definition, it could impact the resulting service level and therefore: • companies will need time to ensure they have appropriate plans to deliver to UQ or higher service levels; and • companies may need to reengage with customers in relation to forward looking plans (i.e. because comparative rankings could change and hence customers might have different expectations about the service level that should be provided). For non-comparative PCs and ODIs we don't think there is a need to provide the definitions except at the time of submission. This is important because the definition of these measures could evolve through iterative customer engagement and testing. Therefore it would be unhelpful to be bound to a certain definition before we have finished our customer engagement.

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Question				Comments
Customer engagement and outcomes in the face of change	52	What are your views on our proposal for a licence modification to allow for the in-period payment of outcome delivery rewards and penalties?	Strongly Agree	**As per question 38, we strongly support the use of in period ODIs to strengthen the incentive of delivery for customers. We requested this licence change at PR14 and it's been hugely benefit to our company and customers because it strengthens the incentives. For example we have seen a step change in performance against most ODIs as reported in our interim result. The focus on performance creates greater urgency in delivery of enhancement investment and greater management focus on performance.**
Implementing our proposals: licensing and next steps	53	Do you agree with our summary of potential licence changes and the process for achieving these outlined in section 9.1 above?		We fully support 4 out of 5 of the licence changes. We do not support the amendment relating to the application of CPI indexation. We also note that the licence that underpins each water company is a cornerstone of the regulatory framework. Like the RCV, investors regard the licence as one of the defining features of a company. Licence stability helps to minimise (regulatory) risk and ultimately allow companies to access cheap finance, thereby keeping bills low whilst allowing service levels to improve. It is in this context that we think Ofwat needs to be mindful about the volume of licence changes, particularly those that have a knock-on impact on its approach to remunerating returns.
Implementing our proposals: licensing and next steps	54	Do you agree with the next steps for establishing the necessary data for the 2019 price review outlined in section 9.2?	**Agree**	**The timetable for the review of costs and assets seems sensible. We emphasise our position that any asset revaluation needs to reflect the age and condition of the assets**
Implementing our proposals: licensing and next steps	55	Do you agree with our indicative timetable for the Water 2020 programme?	**Agree**	We are very supportive of the indicative timetable for Water 2020, except that relating to CPI indexation. We also think that there are opportunities for further transparency around: • key process and work streams within Water 2020 such as issuance of the financial model; • approach to risk and reward including debt indexation; and • the "further November consultation" that is listed but not specified. This information will help us develop our internal plans and resources. Furthermore additional clarity about the November "further consultations" would be helpful. Finally we are receiving a number of "ad-hoc" requests for data. Although these requests state that the information is to be provided on an unassured and unaudited basis (given very tight timeframes), we are increasingly concerned about how this data is being used. For example is it feeding into the company monitoring framework? We would like to see more structure to how data is being requested and reasons for sharing, with appropriate lead in times so we can assure the data.
Impact Assessment	IA1	Do you agree with the benefit and cost impact categories we have identified?		
Impact Assessment	IA2	Are there any impact categories you think we have not included that are relevant, or any we have included that should be omitted?		

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Question				Comments
Impact Assessment	IA3	What are your views on the indicative scale of the impacts we have identified?		
Impact Assessment	IA4	Are you able to provide any evidence on any of the impacts in relation to our proposals?		

Making greater use of direct procurement

The proposals relating to tendering are driven by Ofwat's objective to protect customers by ensuring that every pound of expenditure reflects efficient costs. We are therefore very supportive of Ofwat proposal that companies should make greater use of tendering to deliver cost efficiencies associated with the construction of new assets.

During the current control period we have increased the use of tendering for large schemes and large blocks of schemes. We see this as a way to leverage more innovation, expertise and ultimately deliver value for our customers through lower costs. We are therefore very supportive of the principle behind Ofwat's proposal.

Below we set out our thoughts on the benefits and costs of tendering under different scenarios. This has helped inform how we think requirements for tendering should be applied in the water sector. This assumes a similar size eligibility threshold as proposed in the consultation (£100m), although it's possible that different size thresholds could be applied to different companies.

Benefits of tendering

As Ofwat has noted, tendering can be implemented in a number of ways – narrowly (construction tendering focused on cost efficiencies) or broadly (construction and finance tendering focused on cost and finance efficiencies). To understand what form of tendering is best suited to the different types of assets in the sector we have looked at tendering models in other sectors.

Based on our assessment of the energy and water regulatory frameworks, the underlying asset will inform the suitability of what is being tendered (i.e. finance and/or construction). In particular:

- Construction and finance tendering is best suited to:
    - large discrete assets that can be constructed on a stand-alone basis before being connected to a network (e.g. offshore transmission, or new reservoirs in the case of water) – this is because the bidders are not exposed to significant construction or operational risk and hence can bid in a low WACC;
    - extremely large assets that have some on-going EA/DWI interaction and operational risk, but where the size is so large that the added risk (and cost) is more than offset by the size of the potential efficiencies (e.g. Tideway).
- Construction tendering is best suited to assets that are already connected to the network and cannot be shut-down (at least for significant periods); and the operation of these assets requires on-going interactions with other regulators such as the DWI and EA (e.g. distribution assets and treatment works). For these assets the significant operational and system risk is best allocated to incumbents.

In the water sector the vast majority of (enhancement) capex relates to assets that are already connected to the network and involve significant coordination with existing operations and the other regulators to build/upgrade.

This suggests that Ofwat should give companies the flexibility to consider what form of tendering is best suited to qualifying assets. This will give greater scope as to what could be sensibly tendered and maximise benefits to customers.

For construction tendering this approach would have the advantage of reducing the reliance on econometric modelling for large enhancement spend, which is technically challenging. Tendering could be used as part of the cost evidence for the exclusions from the modelled costs providing a more robust view of costs, reducing risk for companies and customers.

We think further consideration will be needed on how the tender process and resulting costs can be practically integrated into the price review timetable. Currently most tendering takes place after the price review process is concluded. Whilst it's possible some tendering could be brought forward, it would be challenging given the customer engagement and optioneering that needs to occur before hand.

Costs of tendering

In assessing what form of tendering should be applied to different assets Ofwat and companies also need to consider the costs. These include:

- Setting up the framework;
- Establishing a new boundary;

Setting up the framework

The establishment of the tendering framework – which includes the contractual framework and where applicable changes to the legal/regulatory framework – could take significant resource and time to develop (if never applied before). This is particularly relevant under a broad definition which includes finance tendering because the legal and regulatory framework may need to be modified to transfer risks away from the bidder to other parties (such as the Government or customers).

The costs associated with the broad definition of tendering can be illustrated by the TTT and OFTO framework, for example:

- Under the TTT and OFTO each market framework examined is governed by a bespoke license which sets out the detailed terms governing the new licensee's operation, its obligations and its revenue stream and future regulation.
- The bespoke licence requires the establishment of a new legal and regulatory framework with specific rules that apply to the winning bidder. For water this meant that Ofwat was unable to apply its PR14 framework and instead needed to develop a new set of rules that applied to the single party.
- In terms of time, the OFTO generator build was first consulted on in 2005 and the first tender occurred 4 years later in 2009.
- For TTT the first consultation on phase 1 by Thames Water occurred in 2010. IP tender process began 2015, a gap of 5 years. Although we note that Ofwat was discussing options for the regulatory framework for the TTT as early as 2005.

In contrast under a narrow definition of procurement, the additional costs are likely to be significantly lower. This is because:

- some companies will be able to modify existing frameworks to tender schemes, therefore the incremental costs will be quiet low; and
- Ofwat would not need to establish a bespoke regulatory framework that could be applied to the new schemes. This is because risks are not being transferred away from the incumbent and revenue certainties are not being changed. Instead Ofwat would apply its PR19 framework to the incumbent.

Overall we think there are likely to be significant differences in tendering costs depending on what is being tendered. Therefore consideration of the approach should take into account both (i) the asset characteristics; and (ii) what costs would be incurred to deliver benefits to customers.

A new boundary will create externalities

Depending on the form of tendering, it's possible that it could reduce the scope for network optimisation if it resulted in the introduction of separate ownership or management.

For example where ownership is tendered, the direct provider will have less incentive to go further than the defined scope of the scheme as it will not own the benefits from any remedial or incremental investment. In contrast the incumbent is incentivised to deliver benefits throughout the whole value chain. Theoretically any externalities could be internalised through commercial mechanisms and frameworks but in practise this could be very complicated, difficult to achieve and add costs for both parties.

Another consideration is whether a third party has the financial headroom to absorb financial shocks in construction of new assets. A single asset owner does not have the scope to dissipate shocks across a broader investment programme whereas an incumbent provider is better placed to absorb cost shock such as a considerable overspend on a specific scheme as it can recover this across the wider investment programme.

Considering these issues as part of the benefits cases for identifying large direct procurement schemes could limit the number of schemes where the costs outweigh the benefits of direct procurement by a third party.

Conclusion

We agree with Ofwat that tendering has the potential deliver significant benefits to customers in the form of lower bills. The form of tendering that should be applied will be dependent on the characteristics of the assets and associated costs with setting up the tendering framework.

We think Ofwat should give companies flexibility to choose the form of tendering that is best suited to the applicable assets (ie, those above the qualifying threshold). This will allow the benefits of tendering to be maximised whilst minimising the costs.

CPI Indexation

We do not support Ofwat's proposal to apply CPI indexation to revenues and the RCV, with a transition period involving RPI indexation to 50% of the RCV for 2020-2025.

The indexation of revenues and the Regulatory Capital Value (RCV) to RPI has been a significant feature of the regulatory framework for a considerable time. It is well understood by stakeholders, particularly investors, and therefore any changes need to be applied carefully.

We have examined the Ofwat proposal in detail, and unlike all of the other proposals in the Water 2020 consultation (which we support) we do not support this proposal because we do not believe it will deliver the best outcome for our customers.

Under the Ofwat proposal bills and service levels will remain the same, and whilst bill volatility will be reduced, it will be significantly outweighed by costs associated with:

- **reduced transparency for customers** – companies will need to offset the price impact through the use of PAYG levers. This itself raises issues as Moody's have expressed concerns that continuous use of regulatory levers to offset bill increase could weaken confidence in the regulatory framework effecting credit quality and ultimately increasing the cost of debt;
- **additional risks for companies** – due to the mismatch between costs and revenues which creates basis risk and hedging costs; and
- **increased uncertainty for investors –** because there is only clarity about how indexation will be applied for the 2020-25 period; and because rating agencies do not recognise the use of PAYG (thereby creating risk of downgrades).

We consider that there are better tools available to reduce volatility and create an orderly transition away from the use of RPI – for example indexing old RCV by RPI and new RCV by CPI.

We are particularly concerned about the uncertainty that this proposal creates. In particular:

- there is no clarity about the transition period and instead the proportion of the RCV indexed by RPI would be subject to debate at each price control; and
- there is no certainty about when the alternative debt market for CPI linked debt will materialise. For example none of the three CPI linked debt issues to date are a robust enough benchmarks to indicate an emerging market. The Debt Management Office has stated that it sees no pressing case to issue CPI linked GILTs, widely accepted as the key step to establish a liquid CPI linked market.

This uncertainty comes at a time of significant regulatory change. For example in a 5 year period it is likely that competition will be introduced for (i) non-household retail services; (ii) sludge treatment and disposal; (iii) water resource capacity; and (iv) household retail services. Given the continued need for investment to meet the challenges facing the sector (see Ofwat July consultation), it doesn't make sense to unnecessarily increase uncertainty and risk.

This moves us away from 20+ year interest certainty model to a five year model. This distinction is important because the RCV represents a long term investment – ie, 20-30 plus years. By reducing the time horizon over which investors can see how their investment is remunerated, it undermines confidence in the regulatory framework and raises the cost of attracting new finance.

We think that Ofwat should consider a more structured transition away from RPI. This would involve differentiating between new and old RCV. This would:

- **be cheaper for customers as** it avoids the issues on the cost of debt and gives time for the CPI market to develop; and
- **underpins confidence in the regulatory framework** as historical investments will be remunerated on the basis in which the investments were made;
- **creates a clear transition plan** so investors understand how capital will be treated going forward.

Review of Ofwat proposal

Below we comment on the key aspects of the Ofwat proposal, covering (i) NPV neutrality; (ii) pace of transition; (iii) emergency of CPI linked debt market; and (iv) use of regulatory levers.

NPV neutrality

NPV neutrality is a key aspiration but it is reasonable for there to be doubt in companies' and investors' minds about the likelihood of actually achieving an NPV-neutral transition to CPI indexation. This is in part due to the technical complexity but also perceived pressure on Ofwat to reduce returns in light of bill increase during transition. We estimate that a 50% move to CPI could lead to a 3-4% increase in customer bills (using the methodology developed by First Economics). In light of the fact the next price review will likely coincide with the next election it is not unreasonable to expect the regulators to be under considerable political pressure to keep bill down.

Pace of transition

The use of RPI linked debt gives companies certainty on their interest cost over the life of the investment in the RCV. While Ofwat's proposal may mitigate some exposure by retaining sufficient RPI linked RCV for the next period there is still uncertainty around the period of transition and impact beyond 2025.

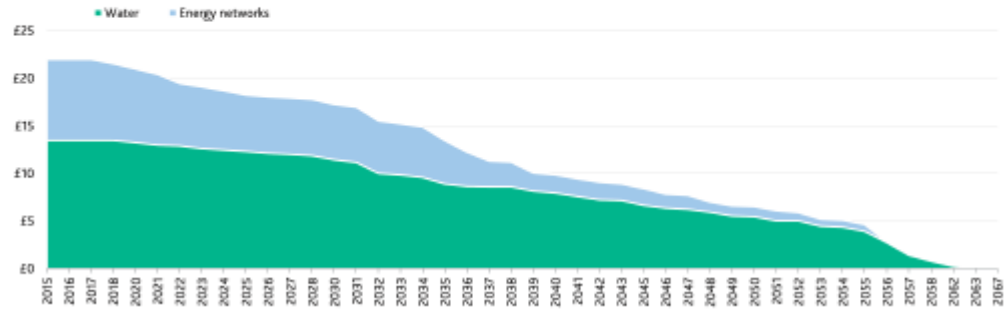
We currently have £1.2bn of index link debt, the fair value premium of the debt in last year's accounts was [£89m] and much of the debt is long dated (85% ending after 2050). While we hold relatively lower levels of index linked debt than some of our industry peers we are would still be likely to face some exposure to basis risk if Ofwat chose to transition over a 3 AMP period. Moody's note on transition to CPI (January 2016) addresses a similar issue. Their analysis indicates that by 2025 only 9% of RPI linked bonds will have matured.

Ofwat's phase-in period will delay, not resolve, the mismatch

Ofwat has proposed to phase in CPI by indexing the RAB to a blend of CPI and RPI for the 2020-25 period. This transitional arrangement is intended "to provide time for existing RPI linked debt to unwind". However, by 2025 only 9% of RPI-linked bonds issued by water companies will have matured, and a material portion of debt will be outstanding into the 2050s (Exhibit 10).

Exhibit 10

Maturity profile of outstanding RPI-linked bonds (£ billions, current prices)



Source: Bloomberg, Moody's Investors Service

The current Ofwat proposal only gives minimal assurances on how the transition will be managed beyond 2025 **moving us away from 20 year interest certainty model to a five year model at a time of major sector change**.

Emergence of CPI linked debt market

Compounding this issue is the **lack of an established alternative CPI linked debt market**. We note that all of the 3 issuances are below our minimum size (£500m) and have a much shorter duration relative to our debt profile.

The availability and pricing of derivatives is not clear at this stage while the cost of exiting the current debt is prohibitive (as evidenced by the current fair value premium). The issue of hedging basis risk is inexplicitly linked to financing costs, covered in the next section.

The Water UK report by NERA highlights that *"investors expect cost of finance will increase due to increase exposure to* ***basis risk*** *and the absence of a CPI government gilt market. In the short to medium term investors are concerned about the miss-match between the RPI linked debt on companies' balance sheets and a CPI linked RCV, or basis risk, which may need to be hedged. However, investors considered that instruments to hedge CPI risk are imperfect, and would involve higher financing costs. For example, CPI-linked products generally have a substantively shorter duration than the tenor of RPI debt (e.g. up to 5 years), commonly include break clauses, and are higher cost than RPI-linked products."*

New debt is likely to be more expensive due to the loss of access to cheap RPI-linked debt and an inability to substitute to CPI-linked debt. Again referencing the findings of the NERA paper, "*the Debt Management Office has stated that it sees no pressing case for issuance until there is evidence of substantive demand for CPI related products, resolution of uncertainty over the definition of CPI (notably, the treatment of housing costs), and resolution of risks around market fragmentation. The pension markets remain focussed on hedging its RPI linked exposure.*"

We acknowledge an increase in CPI linked liabilities could increase demand in the future but there is little evidence at present. Ofwat's paper recognised there have only been three issuance to date and these have been below £300m benchmark. The absence of CPI index linked GILTs would seem to undermine the assertion that there is large scale pent up demand for CPI linked debt at present.

Use of regulator levers

If the resultant bill increase from CPI indexation of the RCV is not initially affordable and further use of PAYG is required, this could lead to negative perception on the sector due to the increase in complexity. The regulatory model is becoming increasing complex and further manipulation of PAYG / run off rates hinders transparency of returns. We have a concern that continual manipulation of the PAYG and run off rates is not sustainable in the long term.

Rating agency Moody's did not recognise PAYG adjustments included in the Severn Trent Final Determination in their assessment of credit metrics indicating a lack of trust or full comprehension of the purpose of the tools. In their January 2016 note on transition to CPI in the water and energy sector Moody's do recognise that the higher current returns could be credit positive but this is dependent on the price increases being acceptable to customers and that pressure to offset the bill increase could erode confidence in the regulatory framework.

Moody's state "*Use of regulatory levers to offset bill increases could erode confidence in the regulatory framework. By permanently capitalising a larger share of total expenditure, it is possible to protect customers from bill increases. However, if revenue deferrals are imposed on companies such that the "allowed" return can never be realised, our current view of the regulatory framework could be weakened."*

The RCV was invested for 20-30 years i.e. an investment for the long term. Manipulation of this investment using PAYG reduces transparency of the returns on that investment. If 'allowed' returns can never be realised due to deferrals to address affordability the current view of the sector could be weakened.

Our proposal

We propose that RPI should be retained for indexation of the RCV but if RPI is deemed unsustainable a better transition would be to retain RPI for the pre 2020 RCV.

Customer bills: Our proposal would avoid or mitigate the bill impact to a manageable level without the need to use regulatory levers. If PAYG or run off rate adjustments are used to offset the bill increase it creates more complexity and reduced transparency as in effect it remains a RPI based control.

Transition: Under our proposals the transition would be more gradual than the Ofwat proposal and a better match for the maturity profile of existing RPI linked debt.

Financing costs: In the absence of a liquid market for CPI linked debt and instruments we feel our proposed options are more pragmatic. It will enable retention of long term interest stability for legacy investment. New financing requirements for new growth can be made in the context of amended regulatory framework.

Negative perception / credit risk: Our proposal reduces the risk of requirement of use of PAYG or run off rates and impact of transparency and confidence in the regulatory framework.

NPV neutrality: Our proposal would retain more confidence from the investment community.

Volatility and forecastability: Addition volatility of RPI to CPI will create additional volatility in customer bills. The issue of additional volatility of RPI impact on RCV indexation is not material and can be addressed through the existing midnight adjustment to the RCV.

In conclusion

Ofwat's proposal will not deliver benefits to customers however it gives rise to added risk and uncertainty. We propose that RPI should be retained for indexation of the RCV but if RPI is deemed unsustainable a better transition would be to retain RPI for the pre 2020 RCV. This avoids the issues on cost of debt, maintains investor confidence, creates long term certainty and gives more time for alternative finance markets to establish themselves. We reiterate our earlier point our proposal is cleaner and cheaper for customers and better for investors.