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Dear Cathryn

WATER 2020: REGULATORY FRAMEWORK FOR WHOLESALE MARKETS AND THE 2019 PRICE REVIEW

South West Water (SWW) welcomes the opportunity to comment on the Ofwat Water 2020 consultation outlining the high level proposals for wholesale markets and the 2019 Price Review (PR19).

Our summary comments are provided below with responses to each of the questions provided in the appendix.

Overall, we support many of the proposals set out in the consultation. We welcome that Ofwat plans to build on the successful 2014 Price Review (PR14) approach which focused on customer engagement enabling company specific outcomes to be developed. We support this approach and firmly believe any proposals for the future should be based on what is in the long term interests of customers, society, the environment and investors. We have undertaken customer research and investor engagement to help inform our response to this consultation.

The Water 2020 proposals are both more detailed and earlier in the cycle than the equivalent stage at PR14. We believe the early engagement and inclusion of companies, including SWW, in the development of many of the proposals through contributions to the 'market place of ideas' has resulted in a detailed and informed consultation.

The involvement and engagement has been invaluable and will continue to be so, as there are far more proposals than at PR14, with many having more far reaching financial, reputational and operational consequences.

We particularly support Ofwat's ambition for the further development of markets and are pleased to consider the next areas of reform (water resources and sludge) planned for the industry. Whilst these areas of the value chain are relatively small (c. 10%) we feel it is critical to ensure the market is effective and operates as intended. It is imperative that the approach and principles used to develop and implement these markets do not deliver unintended outcomes, avoids the potential

stranding of assets and avoids setting a precedent for decisions in the future with more material financial consequences.

Another potential material impact within the consultation is the proposed change of approach to using CPI rather than RPI for inflation in cost recovery. We acknowledge there is growing pressure for change, with the Office for National Statistics (ONS) suggesting RPI is statistically flawed, and in the interests of legitimacy, CPI should be the main measure of inflation used to index prices.

We agree that a transition to CPI over time will be required to address concerns over RPI. In making this transition it is essential that the timing and pace of this transition, is in the best interests of customers. Customer legitimacy will only be achieved if the transition results in the right outcome for customers.

Our own financial analysis suggests that the transition proposals at PR19 would result in an increase in the cost of debt and equity and increase our customer bills by c. 3%. Unless regulatory mechanisms (PAYG / RCV run-off rates) are used to defer revenues, customer bills will increase at PR19 as a result of the proposals.

There may be better ways to manage the transition rather than relying on relatively new regulatory tools such as PAYG and RCV run-off rates. An example could be to phase the move to CPI more gradually (e.g. 75% RPI / 25% CPI in PR19, 50% RPI / 50% CPI in PR24, 25% RPI / 75% CPI in PR29 and 0% RPI/100% CPI in PR34). Ofwat could also consider giving a commitment to when it expects to fully transition to CPI and committing to a pathway (the example above would provide such clarity).

Inevitably, the utilisation of any regulatory mechanism has consequences and impacts upon companies' financeability and its ability to raise debt finance for future investment. This impact needs careful consideration and in particular the potentially higher incentives that will be required for equity investment to close any gap should it be necessary.

In addition, while there is not a fully functioning market for CPI debt, the financing costs to customer and companies of CPI-based financing are uncertain. We believe that any transition to CPI needs to recognise this and be phased to coincide with CPI debt market developments. This will help ensure that financing costs to customers do not rise unnecessarily.

This is supported by independent economic analysis undertaken by NERA (report enclosed) for members of Water UK.

SWW has also undertaken independent customer research to test customer responses to different bill impacts (available on request) resulting from the Water 2020 CPI proposals. The results of this customer research suggest that customers would prefer bill profiles more consistent with the existing RPI methodology.

We believe stability is vital in the water sector to ensure investor confidence and the access to resultant long term low cost finance this provides for the benefit and protection of customers.

We hope you find these comments useful and look forward to continuing the positive engagement and discussing our response in detail with you.

Yours sincerely



Iain Vosper
Regulatory Director

APPENDIX – CONSULTATION QUESTIONS

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

Agree

Sludge and Water Resources offer the greatest opportunities for promoting markets compared to other elements of the value chain. We agree with the principles of the proposals, however it is difficult to understand the total impacts of the reforms for South West Water and Bournemouth Water at the current stage of the proposal development.

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

The overall balance of risk and reward of the package clearly needs to be considered as a whole. We agree with the principles set out for the future regulation of the sector, and support the focus on the long term and putting customers at heart of decision making. However, we recognise that many of these issues are multifaceted and in some circumstances may be contradictory. While we are supportive overall of the direction of travel for the industry and the future form of regulation proposed by Ofwat, the variety of complexity of reforms being proposed may present challenges in understanding the totality of the proposals and ultimate outcome for customers and we are supportive of on-going work to establish a better insight.

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

Agree

We are very supportive of the ongoing approach to engaging customers in the development and delivery of the sectors business plans, and ensuring that stakeholders have trust and confidence in the performance of the industry. We agree that a prescriptive approach to customer engagement is counterproductive, and will we continue to involve customers in our business in the best way possible. We are also very supportive of the proposals surrounding the future involvement of CCGs. We await the further development of Ofwat's proposals on outcomes, indicated later this year, and welcome the opportunity to engage on the more detailed proposals when possible.

Question SQ4: Do you agree with our proposals to extend protection of the RCV to 2020?

Agree

Yes, we welcome Ofwat's commitment to extend protection of the total RCV to March 2020 as it will provide investors and wider stakeholders in the business with much needed certainty that efficient expenditure incurred made prior to the proposed Water 2020 reforms will earn an appropriate return. This certainty will be particularly important in the face of the level of change the sector will undergo and the uncertainty that it will bring. Protecting the RCV sends a clear signal

that Ofwat intends to honour previous promises and will help to increase the legitimacy of regulation in the sector and wider UK industry.

SLUDGE TREATMENT, TRANSPORT AND DISPOSAL MARKET DESIGN

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

Agree

While we are supportive of the proposal, we note that it is not necessary to have a separate binding control in order to achieve the objectives set out by Ofwat for promoting greater use of markets. However, a separate price control would clarify issues around cost allocation and focus management control to help to deliver efficient investment in the business unit. We note that the definition of the activities within the separate binding control will need to be very carefully considered, as the inclusion of sludge transportation is likely to have large effects on the functioning of the market. The potentially large distances that sludge could be tankered, depending on the geographic locations of existing sludge treatment works, will have a material consequence for the level of gate fees in the market.

Question 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?

Agree

Yes, a range of information will need to be accessible for all parties considering involvement in sludge treatment, disposal and transportation activity. However we are concerned that if this is restricted only to regulated waste water companies, it may create a disproportionate burden on regulated companies while not revealing the full market information. We would welcome wider consideration of what additional information above that provided by the regulated industries may help to facilitate a market place. South West Water is currently preparing discussions with other water and sewerage companies to understand the potential opportunities for sludge trades. The proposals for publishing cost, capacity and location information would certainly help in the early identification of opportunities, and help to reduce the administrative and organisational complexities currently involved in initiating these types of discussions.

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

Agree

Yes, we agree that this would be the ideal information to publish, however there will need to be recognition that some of the data may be newly created (in line with any new allocation guidelines) and so may not be as robust during the early phases of implementation.

It is important that the market is effective so as to deliver the benefits assumed from the approach. We think there is therefore merit considering whether data is needed for all sites, or for a subset of sites, based on size, for example.

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

Agree

Question 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?

Agree

We support the need for further engagement with Ofwat and the industry on the level and type of data that would be appropriate to collect. As with all form of regulatory information, it will be important to ensure that there are clear and detailed definitions for data collection to ensure consistency across the industry.

Question 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?

Disagree

We consider that it will be important to be clear where additional regulation is required, and where existing legislation and regulation cover the proposals. The Competition Act may be sufficient to ensure a level playing field, alongside existing OJEU procurement standards. We would encourage Ofwat to consider further extending the risk based approach, to target where information of 'bids' are required, rather than adopting a blanket approach to information provision. While we consider it to be a small risk, there is potential that discussions between participants in the market may be hampered by stringent rules on publishing bid details, and would welcome an approach that allows the market to develop before extensive reporting requirements are implemented.

Question 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?

Agree

In principle, we agree that the data should be available centrally, although it will be important to ensure that the benefits from implementing an information platform are not outweighed by any potential system costs. We see no case for going further than the current platform for publication of information by Ofwat.

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

Agree

We agree that it is not necessary for a System Operator in the current design of the sludge market.

Question 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 do not think it is appropriate to introduce financial incentives for sludge trading whilst also implementing the proposals for promoting a greater role for markets, as this risks introducing an additional layer of complexity. Through the Outcome Delivery Incentive framework, companies are likely to already be incentivised where it is in the customer interests (for example Renewable Energy incentives).

Additionally, we consider it essential that the Biosolids Assurance Scheme currently in place for recycling to land (for all WASC's) is applied to all applicants in the market, in order to protect the sustainability of biosolids to land. Any benefits gained by the proposed approach to sludge treatment, transportation and disposal would be lost if the agricultural route was not available.

WATER RESOURCES MARKET DESIGN

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

Agree

A separate binding control is only necessary for implementing access prices and making use of bilateral markets. However, as with sludge markets, we consider there are benefits to a separate control, in line with those being realised in the retail controls at PR14.

Question 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?

In principle we support the introduction of an offset mechanism to ensure that entrants can recover the cost of new resources appropriately. However, we consider that further work is needed to assess the detailed implications and mechanics of how this mechanism would work in practice, ensuring cost transparency and fair treatment of all parties. There should also be a level playing field as between the incumbent wholesaler and a non-household retailer when it comes to a new resource entrant assessing its contracting options. The new resource entrant should face the same incentive to contract with the retailer as to enter into a third party supply agreement with the wholesale incumbent. This would ensure a fair competitive process.

Question 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 agree in principle, although note that the current timetable for WRMP and Ofwat Price Review is yet to be aligned, and such an approach would necessitate a combined approach.

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

Agree

While there are benefits to a third party managing the information, it will be important to bring learning across from the retail market opening in terms of the scale and cost of implementing third party systems and resources. It will be important to ensure that any additional cost and data borne by such an approach is proportionate to both the potential benefits delivered and those likely to receive them.

Question 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?

Agree

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

Disagree

Although the RCV allocation for these parts of the value chain is not significant, it potentially sets an uncertain precedent for future treatment of the RCV. In terms of the 'focused' and 'unfocused' approach between water resources and sludge, it may be the most appropriate form of allocation but more work needs to be done in this area to more fully understand the impact.

Indeed, through the market place of ideas, we submitted a report (copy available on request) on RCV allocation which was presented to David Black and the Ofwat team in advance of this consultation. We continue to believe that the principles presented in this report still have merit and should be considered further as proposals in this area are finalised.

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

See response to question 12.

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

See response to question 12.

Question 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?

We welcome this extended commitment. In order to be effective it will be important for Ofwat to clarify aspects of implementation. For instance, it will need to confirm that it would determine 'efficient investment' on the basis of an assessment of efficiency at the time the investment was made, not a retrospective judgement. In addition, it will need to clarify how it would distinguish between pre and post 2020 assets when considering any possible stranding of the post 2020 RCV (as the pre 2020 RCV will be a number that is not directly related to particular assets).

Question 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?

The proposals in the consultation document appear to be designed to avoid stranded assets in the 2020-25 period. However, there is insufficient clarity about how stranding would be approached in practice to enable us to determine whether Ofwat's assessment is reasonable.

Question 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?

The proposal is set out at high level and there is considerable further work needed to determine whether this mechanism would provide appropriate protection in practice.

Question 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?

In principle, and depending on appropriate implementation, we agree that this approach will deliver appropriate incentives (see also response to question 8 and 20).

Question 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?

Agree

Previously, companies have reported data on Long Run Marginal Costs for the water services elements of the value chain. This showed very large variations in approach to costing. Similar issues have arisen in the past with AIC calculations.

Consequently we think it would be prudent to spend time on ensuring the methodology adopted by companies is consistent if the market is to work.

Furthermore, historically water resource planning has looked to minimise total cost (private and environmental and social). It is not clear how the environmental and social costs would be considered in the proposals in order to prevent, for example, high environmental impact schemes being selected over other alternatives.

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

Agree

We agree that it is the company's responsibility to know the cost of running its assets and what prices will be needed to be charged in order to cover these costs and make an efficient return.

Question 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?

See response to question 8.

In principle we agree that an approach based on LRIC may have merits, and that the AIC method may be the easiest method to proxy it.. However, this will need to be given careful scrutiny as

there are a number of potential issues in practice with using AIC that will need to be addressed for the approach to be effective. These include (though not exhaustive):

- How environmental and social costs are treated in the LRIC calculation;
- How the cost of headroom and outages are treated in the access price;
- Whether it is appropriate to include non-network schemes for instance demand management in LRIC calculations;
- The time horizon for reviewing the LRIC calculations, taking consideration of the need to provide certainty to entrants;
- How network investment would interact with water resource zone LRIC, i.e. if an incumbent invests in connecting two zones together, whether access prices would be revised.

In addition, for SWW in particular, we have not needed to develop significant new water resources since 2000, we do not have a robust set of AIC for our existing assets. The WRMP only requires AIC to be developed for options on new water resources, so it will be a significant exercise to identify these costs at the level Ofwat appears to propose.

We are particularly concerned that this approach may lead to the possibility of being required to provide a service at an AIC, when the actual costs are higher than this. We are not clear how the AIC mechanism ensures that the service provider will be fully reimbursed for its cost. We would need clarity on this point in order to properly assess the acceptability of this proposal.

Question 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 agree that that this is the best way to encourage economically efficient new entrants into the water resources market.

Question 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

Yes, we agree that this approach represents the closest approximation for how a fully competitive market would function.

Question 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?

Agree

As the market for sludge treatment develops, it would be helpful to have high level guidelines for companies, however ultimately it should be a commercial arrangement, and we would not expect to see these guidelines in operations once the market is functioning.

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

SWW is open to consideration of all options for our investment and operations to be conducted as efficiently as possible, and this may include direct procurement. However, the transaction costs associated with direct procurement options – as evidenced in the Thames Tideway project – suggest that, in practice especially for smaller projects, it will be hard to generate meaningful efficiencies by this approach.

Question 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?

Disagree

We are unclear of the precedent this may set for the future and would like to see further justification and assurance for the £100m threshold. It maybe that this figure is not suitable for all companies and such a proposal may introduce additional costs.

Question 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

Question 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?

Agree

Question 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 are undertaking further analysis in this area to fully understand the impact of exposing sludge treatment, transport and disposal to volume risk.

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

We are undertaking further analysis to consider the most appropriate method for remunerating new investment in sludge and water resources from 2020.

Question 30: How can we best ensure that long-term contracting arrangements are not disincentivised – and that any continued application of a return on RCV approach for incumbents is on a level playing field with third party providers?

We are undertaking further analysis in this area to answer this question.

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

Agree

We believe the RBR worked well in PR14.

Question 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

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

Agree

Yes, we agree although note that this was already and explicit part of the PR14 RBR approach, and which South West Water and Bournemouth Water strongly adopted in the approach to business planning.

However, as has been noted in the development of PR14 methodology, there may be difficulties associated with holding companies to account over long term commitments as a result of the higher degree of uncertainty over longer time periods, and the number of factors outside of management control which affect delivery of long term targets. While it is vital for the industry to plan on a long term basis, and we welcome the proposals set out in the recent 'Resilience' paper by Ofwat, we consider further engagement with the industry on the practicalities of implementing long term targets is needed.

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

We welcome the initiation by Ofwat of a joint working group between companies, Water UK and Ofwat to develop the modelling process for PR19. We are keen to see totex models for each price control, and clearly linked to performance.

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

Agree

In order to set binding price controls, clear guidance on cost allocation will be necessary and should be developed in conjunction with the industry. Lessons for cost allocation between

household, non household retail and wholesale should be incorporated, and guidance produced in adequate time for companies to undertake the work and provide adequate assurance.

Question 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

In line with the industry approach through Water UK, we would seek a solution to the misalignment of WRMP and the Price Controls. We consider that it is in the best interests of customers and the industry to bring WRMP and the Price Review into alignment to avoid duplication of engagement activity to ensure the highest level of certainty in the planning process. Recognising that it will be a significant challenge to amend either one of the current timetables, a compromise could be to converge the timetables in October 2018, allowing companies time to submit business plans for the price review whilst still recognising that Ofwat require additional time to the PR14 timetable to complete the RBR. We welcome further engagement and discussion on this issue.

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

See response to question 36.

Question 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

Yes, but it should always be within the control of companies to determine the extent of revenue fluctuations as extensive customer research across the industry demonstrates that customers consistently prefer smooth bill profiles over time.

Question 39: Do you agree with our proposal to move to CPI (subject to the UKSA's final recommendations)?

We agree that a transition to CPI over time will be required to address concerns over RPI. In making this transition it is essential that the timing and pace of this transition, is in the best interests of customers. Customer legitimacy will only be achieved if the transition results in the right outcome for customers.

It is important to draw a distinction between the price series that is used to index regulated revenues and prices and the price series for indexation of the RCV.

Any benefits that may arise from a switch from RPI to CPI, for example in terms of less volatility of price movements for customers, will arise solely from the indexation applied to regulatory prices. These benefits do not require any change to the indexation of the RCV (see response to Q40 and

Q41). Indeed the recommendation of the Johnson Review was that “*Taxes, benefits and regulated prices should not be linked to the RPI.*” This recommendation can be satisfied through just changing the indexation of prices and not the RCV.

Question 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?

See covering letter.

Stability is vital in the water sector to ensure investor confidence and the resultant long term low cost finance this provides for the benefit and protection of customers. Investor engagement suggests Ofwat proposal risks damaging the confidence of investors.

In addition as part of its independent work for Water UK, NERA interviewed a range of equity and debt investors, as well as analysts.

The interviews highlighted that investors were concerned that:

- Ofwat cannot credibly commit to the value neutrality of the change;
- CPI risks cannot be hedged perfectly and this will increase financing costs;
- CPI corporate debt instruments require CPI linked government bonds; and
- There is a concern from investors that Ofwat’s move was premature and not properly motivated, investors are not clear why Ofwat are moving in advance of the development of a CPI linked debt market.

Overall investors consider that the proposal will increase financing costs and reduce confidence in the sector.

In addition, the proposal will require an immediate increase in the cost of capital (measured relative to CPI) and this will push up customer bills in 2020/21, unless there is some offsetting adjustment to PAYG or run-off rates. This is not in customer interests. Indeed SWW independent customer research we have undertaken to test customer bill impacts (available on request) resulting from the CPI proposal suggests that customers would prefer retention of the RPI methodology.

Overall, there is a great deal of uncertainty around the proposed changes to RCV indexation.

Question 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?

See covering letter.

We consider that Ofwat does not need to make any change to RCV indexation at PR19 and review the situation at future price reviews in the light of emerging developments in the CPI linked debt markets, including any government decision to replace RPI linked with CPI linked government bonds.

Should Ofwat decide that some transition to CPI indexation of the RCV is required then there are different options to consider other than the current 50 / 50 proposal. Examples of these were provided in the covering letter. Another approach would be to apply CPI indexation to 'new RCV' post 2020. In this approach where the existing RCV retains RPI indexation is important as it recognises the reasonable expectations of investors at the time that they invested in these long-lived assets, i.e. that the investment would be added to the RCV and indexed by the RPI. The transparent and predictable treatment of the RCV is the cornerstone of the low risk regulatory model, that brings significant benefits to customers through low cost financing of investment. Any step that undermines investor confidence in the RCV needs to be considered very carefully.

Question 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?

As above.

Should Ofwat proceed with a change to RCV indexation then it is essential that Ofwat is able to credibly commit to a method that is understood to be value neutral. Otherwise there will be a loss in investor confidence and an increasing in financing costs.

It is also clear from the NERA analysis for Water UK that, at present, the commitment to value neutrality is not seen as credible by investors. Therefore, there would be considerable work for Ofwat to do to address this.

Question 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?

See response to questions 40-42.

Question 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?

The Ofwat paper provides an analysis of how risks vary across parts of the value chain, (section 6.3 of the consultation paper). We consider that this analysis is very high level and although it does not raise any specific concerns it can only represent an initial view on the issue.

The key omission is that the analysis does not take account of the fundamental point that the regulatory methodology and the form of control is likely to be one of the most important risk factors each part of the value chain. As such any differences in business risks and operational gearing are generally less important than the regulatory incentives and risk mechanisms and the investor perception of RCV risk in each part of the value chain.

As a result we consider that Ofwat should evaluate the impact on the cost of capital of its proposals as it develops them and that the assessment of different costs of capital in each value reflects both the underlying characteristics and the regulatory model.

Question 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?

It is extremely difficult at this stage to assess the impact of the proposed market and incentive reforms on the balance of risks and opportunities. As a minimum we consider that the proposals will result in an increase in the range of performance of companies in the industry, which in the short-term will result in an overall increase in risk.

Question 46a: What does good customer engagement look like?

Agree

Good customer engagement involves ongoing dialogue with customers through a wide range of methods – be it ongoing qualitative and quantitative techniques, or through the day to day interactions with customers. Ultimately it is not the methods and techniques that determine what good customer engagement is, but the how successfully companies use the information to develop and deliver water and sewage services.

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

Agree

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

Agree

A Water UK network could be convened to share customer engagement learning and experience and look at learning opportunities from outside the sector.

Equally, there is a potential for each company to identify the most suitable methods from other sectors to develop a high quality business plan rather than an industry-wide view on what should be done.

Question 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?

Agree

We agree that there is a great potential for companies to further develop and explore the information customers provide in day to day interaction. To date, the development of revealed preference techniques in the sector have been relatively limited, and driven by external consultants and research companies capabilities.

We note that the development costs designing and commissioning specific research techniques such as revealed preference and stated preference are high, and will take time to develop to ensure that any results are robust. While the industry has begun to explore these options, as with the collaborative avertive behaviour study at PR14, it must be recognised that these techniques will take time to deliver.

Furthermore, revealed preference techniques are likely to work for some service aspects but not all so a mix of methods would have to be applied in the end. Some measures may have 3 different valuation points (WTP, RP and trials/experiments) whereas others may have to rely on WTP.

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

Agree

The consultation proposals echo our own response to the July consultation and we pleased to see the industry views being developed in Ofwat's proposals. CCGs played an invaluable part at PR14 and we support their continuation. We are also very supportive of their roles being clarified and information provided to them earlier in the process to enable them to fulfil their roles more effectively.

Question 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?

Agree

Yes. However in our view it would be helpful for Ofwat to give CCGs some form of guidance to enable CCGs to provide the information Ofwat requires to conduct its RBR. For example; what would be Ofwat's expectation around the use of the terminology 'where appropriate', and will there be expectations in relation to the evidence portfolio CCGs submit with their report.

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

Agree

We broadly agree with the proposals, but consider that CCGs should be at liberty to comment whether they endorse a company's overall plan, as this can add an additional level of assurance to a company's submission. For example, the CCG may (or may not) be satisfied with a company's customer engagement, but may want to comment on the plan as an overall package.

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

Agree

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

Agree

We consider that early publication of key price review information such as the WACC and RoRE ranges will help enrich the dialogue that companies have with customers throughout the development of the business plan by allowing more accurate representations of investment plans and bill levels to be tested.

We are interested to note that Ofwat do not appear to be considering using customer views and valuations to inform the appropriate RoRE ranges for outcomes.

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

Ultimately, the best incentive for companies to engage with customers in the development of business plans and delivery of day to day activities is to see what customers have said is important to them reflected back in the determination process.

Question 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?

In principle, a long term approach to asset health indicators would be welcomed, provided those indicators represent an accurate measure of future asset performance (i.e. not backward looking service indicators as in serviceability). We would need to understand the totex and bill impacts arising from such an approach.

Ofwat could consider weighing up certainty versus flexibility so it may be possible to trial this approach for 1-2 measures but not apply long-term targets to all measures.

Question 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)?

Agree

We agree that the proposed contents of the November consultation are a fair representation of the issues identified at PR14 as requiring further consideration in the Outcomes approach. However, we are keen to understand how comparative measures and targets are going to be reflected in the totex modelling approach, and so do not think these two areas should be considered in isolation. As some of these decisions feed into the customer research, it is important for Ofwat to provide timeline guidance on these issues. For example, if companies need to reflect comparative information in customer research, this would be good to identify early.

Question 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?

Agree

We agree that this will be appropriate for outcomes and performance commitments which will have not changed significantly from PR14. However, there may be new commitments and outcomes which will be in considered in development with customers and CCGs, and may not be feasible to provide ahead of business plan submissions in 2018.

It is important for Ofwat to allow for this flexibility to encourage innovation in measures of success.

Question 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?

Agree

South West Water is one of a few companies already with in-period adjustments for ODI performance and are therefore supportive of the approach for the rest of the industry.

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

We are supportive of the licence changes in principle and will continue to engage with Ofwat throughout the licence change process.

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

We agree with the next steps outlined in section 9.2. As with all new data requirements, continued engagement with companies is essential to understand if there are likely to be any constraints.

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

Disagree

See response to question 36.