10 February 2016

Dear Sir/Madam

**Consultation on Water 2020**

Thank you for the opportunity to respond to Ofwat's consultation on Water 2020.

We strongly welcome the focus on putting customers at the centre of the next price review, and Ofwat's clear intention to engage with stakeholders in the development of its proposals. Such a collaborative approach gives us the best chance of successful implementation, and therefore the best chance that customer benefits are fully realised.

We have submitted detailed responses to each of the consultation questions in Appendix 1, and in the spreadsheet format provided by Ofwat.¹

The main messages from our response are summarised below:

1. **We strongly support the continued emphasis on customer engagement.** We also support many of the proposals relating to customer engagement including the augmentation of stated preference research with other approaches, greater collaboration between companies' Customer Challenge Groups ('CCGs') and the use of longer-term outcomes where appropriate.

In relation to customer engagement, we strongly support Ofwat's focus on encouraging and enabling companies to provide the services that their customers want both now and in the future. For this reason, we welcome Ofwat's proposal to retain many of the innovations that Ofwat introduced at PR14, e.g. company ownership of plans, the CCGs etc. It is also why on a forward-looking basis, we would strongly encourage Ofwat to do all it can to give companies confidence that the outcome of that customer engagement – if properly conducted and reflected in company plans – will be endorsed in final determinations. Specifically, it would also be helpful if Ofwat could be transparent as possible around its approach to comparative assessment of outcomes, so that this can be an input to companies’ customer research and not cut across the findings at a later stage.

¹ It should be noted that we have provided our response to each question in the context of our understanding of the proposed regulatory framework overall. To the extent that Ofwat’s proposals for the overall framework change, then our view on the matters raised in the individual questions may also change.
Whilst stated preference surveys will continue to have an important role in valuing customer preferences, we recognise the need to ‘triangulate’ the results using other forms of valuation to provide assurance on their validity. We are pursuing a range of options in this area, and will keep Ofwat updated on progress.

In our view, Ofwat should enable, but not mandate, the use of longer-term outcomes. This would encourage companies to take ownership of their business plans, look for innovative approaches in consultation with their customers and CCGs and consider how to address implementation issues in designing longer-term outcomes.

2. **We recognise that there may be significant potential for innovation in sludge treatment, transportation and disposal.** It follows that we support Ofwat in exploring how creating markets for sludge treatment, transportation and disposal could provide both benefits to customers, and opportunity for economic and efficient sludge operators.

 Whilst we support exploring the introduction of markets for sludge treatment, transportation and disposal, whether these reforms can be expected to benefit customers will depend on how the proposals are implemented. For example, the design and duration of the price control that will apply to incumbent sludge operators – and the way it interacts with the price control that applies to waste network plus operators – will have a significant bearing on investment incentives.

It will also be important to be realistic about the amount of resources required to establish sludge operations as separate business units for the purposes of economic regulation. For example, to ensure a level playing field for effective competition between incumbents and third parties, there will need to be a clearly defined boundary between effluent and sludge, taking account of the different configurations and processes between companies. Costs will need to be allocated on a consistent basis, particularly for sites where sewage treatment and sludge treatment are co-located and there are joint costs. Indeed, a revaluation of Modern Equivalent Asset Valuations may be required to ensure that the appropriate level of MEAV (and therefore RCV) is allocated to the price control. This will be a significant undertaking for companies. We would welcome confirmation that Ofwat would envisage that the efficient set up and ongoing costs of establishing the market arrangements would be recoverable via the relevant network plus control.
3. We support Ofwat's proposals to encourage markets in new water resources, including the introduction of a separate price control and the proposals for unfocused RCV allocation and access pricing. Just as for sludge, there are however important considerations in designing the separate control and market.

Whilst we support the principle of introducing markets for procuring water resources — just as in the case of sludge — there are some important considerations in designing this price control. For example, costs will need to be allocated on a clear and consistent basis, and the proposals will need to accommodate that the incremental costs of water resources will vary significantly by a number of non-price terms of trade (including location, supply duration, firmness of supply, water quality etc.). We look forward to working with Ofwat to develop these details.

The development of a market for water resources is also likely to require companies to devote significant resource to identify, collect and allocate cost data. As with the sludge market developments it would be helpful if Ofwat could confirm that the efficient set-up and ongoing costs of creating the market are recoverable via the relevant network plus control.

We note that Ofwat's analysis of the potential for water trading in our area is based upon dry year annual average conditions, whereas water resource planning in the Thames Valley area is actually undertaken on dry year critical period conditions. It follows that Ofwat's approach may overstate the potential for new trading in our area. We have written to Ofwat separately on this matter and would be happy to provide further explanation — perhaps in the form of a workshop on the practicalities of water resources planning — if that would be helpful.

4. We support direct procurement for very large, discrete projects. It will be important that only wholly discrete projects are considered for direct procurement to avoid the risk that the requirement would undermine the efficient procurement of an integrated capital programme.

Whilst there can be material overheads associated with direct procurement, as we have seen with the example of the Thames Tideway Tunnel procurement, direct procurement can be a very effective way of delivering service improvements to customers at the best value. However, there are risks and costs associated with mandating direct procurement, particularly where the projects are relatively small or are not discrete. In these circumstances, it is unlikely that any benefits would outweigh the loss in economies of scale and scope that companies would otherwise receive from developing integrated capital programmes. To mitigate this risk, we suggest
that Ofwat gives companies the option to consider direct procurement for large, wholly discrete projects, but does not mandate the requirement.

5. We recognise that, on the grounds of customer legitimacy, there is a case for indexing prices in future to CPI (or CPIH), rather than RPI. However, we question whether customers would benefit from moving from RPI to CPI (or CPIH) for the purposes of RCV indexation, taking into account the apparent degree of investor unease that the proposal has created. If Ofwat chooses to proceed, we would encourage Ofwat to take a number of steps to underpin its commitment to value neutrality, including reflecting this commitment in any associated licence modification.

We understand the reasons why Ofwat – in the light of the recommendation from the Johnson review on indexation – want to move from RPI to CPI (or CPIH) indexation, and we agree that Ofwat should consider the option of CPI indexation for prices (rather than RCV). If Ofwat does, however, decide to proceed with CPI-indexation of the RCV, it will be important for investor confidence for Ofwat to provide a robust and lasting commitment to value neutrality.

We consider that the following measures could support this commitment to value neutrality:

- transparency over calculation of CPI-based and RPI-based WACCs over the longer-term;
- commitment to long-term transition arrangements. We agree with Ofwat that transition arrangements are particularly important, as they allow a track-record to be established demonstrating that companies can earn their nominal cost of capital in a CPI-linked environment in the same way that they do in an RPI-linked environment;
- publication of RPI-based and CPI-based WACCs, and allowing companies to choose how much of their existing RCV is linked to RPI through a menu-based incentive;
- commitment to allowing companies to use totex PAYG/depreciation levers to mitigate the impact of the increased CPI based cost of capital on customers; and
- use of true-up mechanisms for differences between actual and forecast RPI and CPI.
We would also encourage Ofwat to consider building this commitment into any licence modification it brings forward to enable Water 2020.

6. **We support better alignment of timetables between the PR19 Business Plans and Water Resources Management Plan (“WRMP”). We suggest this could be achieved by setting October 2018 as the submission date for both plans.**

As we explained at the Water UK/Ofwat Water 2020 seminar on 2 February 2016, we consider that an alignment of the timetables for these plans would favour the customer by reducing the number of consultations required, better framing of the WRMP outcomes in the context of other wholesale service attributes, and making it easier to develop joint solutions across investment areas, e.g. measures to slow water down in catchments to alleviate flooding, improve water quality and benefit the environment.

A single submission date in October 2018 would mean delaying the business plan submission from August 2018 and bringing forward the WRMP from December 2018. This involves additional timetabling challenges for companies, Ofwat and the Environment Agency, but seems the best solution given the benefits to customers of an aligned approach.

We do hope these responses are helpful. If you would like to discuss them further, please do not hesitate to get in touch.

Yours faithfully

Nick Fincham  
Director of Strategy & Regulation