

Wessex Water's Response to Water 202: Regulatory Framework for Wholesale Markets and the 2019 Price Review

10 February 2016

SQ1	Do you agree with our proposals for making a greater use of markets in relation to sludge and water resources?
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We support your proposals to make greater use of markets for sludge and water resources but, in response to your proposals for separate price controls, we note that:

- We do not think it necessary to allocate the protected RCV.
- The transport of sludge away from the sewage treatment works should remain outside of the new price control for compliance and performance reasons.
- The case not been made for a for a separate binding water resources price control.

SQ2	Do you agree with our proposals in relation to the future form of regulation for the sector?
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Regulation in the water sector is already highly complex which can in itself be a challenge to investor and customer confidence in the sector, and the Water 2020 proposals suggest a further step-change in complexity, so throughout our response we have considered whether there could be more simple regulatory approaches that achieve the same goals.

For instance, we support a separate price control for sludge but market approaches need not always require regulatory separation and complexity. We are working in this AMP to develop market based approaches within our vertically integrated business to better allocate revenues and to incentivise behaviour change.

SQ3	Do you agree with our proposals in relation to customer engagement and outcomes?
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The initiatives at PR14 to make greater use of customers' views and CCGs in the business planning process were welcome and we continue to believe that there are clear benefits in giving customers a greater say in the services they receive and in ensuring that there is direct customer challenge of the methodology itself. Overall we are disappointed that the scope of customer panels has been reduced although greater clarity on the scope itself is helpful.

SQ4	Do you agree with our proposal to extend protection of the RCV to 2020?
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We welcome the statement that you are protecting the RCV at 31st March 2020. We would welcome more clarity on how this will be implemented in a way that ensures asset stranding

does not result in reduced cash flows. We give some potential scenarios in our question responses in relation to the sludge price control and look forward to Ofwat providing further clarity in the May 2016 design document.

1	Do you agree with our proposal to have one separate binding price control for sludge treatment, transport and disposal?
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We are supportive of change that will encourage a competitive sludge market.

While competition is a desirable outcome, it is important to remember that, from the perspective of a Sewage Treatment Works (STW), sludge is an unwanted by-product (negative externality) that, if not disposed of, could mean it cannot treat more sewage because of capacity constraints and environmental compliance requirements. STWs thus represent the demand-side of the market, being potential customers for the treatment and disposal of sludge, with entry and expansion driven by operational decisions and population growth. Sludge Treatment Centres (STCs) represent the supply-side of the market, with potential for entry and expansion on the supply side from Other Organic Waste providers (OOWPs) particularly if sludge treatment provides a means of generating net income.

Competitive and dynamic markets require that barriers to entry and exit are low. Ofwat has identified information asymmetry as an impediment to efficient entry which requires that suppliers have a good understanding of their actual and potential customers and access to STW data that makes clear how much sludge is produced (minimum/ maximum over the year), its type (primary, secondary etc.) and the location of the STW. Such data will help identify potential trading opportunities as will STC and OOWP data and improved transparency will foster competitive and liquid markets.

Wessex Water agrees with your proposal to separate sludge treatment and disposal from the existing wastewater price control but we do not believe that the boundary of this separation should include sludge transport, which we believe should be included within the (sewerage) network plus price control for a number of reasons:

- (a) Sludge is a by-product of sewage treatment processes, with STW operators responsible for the safe disposal of sludge.
- (b) Sludge is heavy and STW operators are able to reduce the water content and their transport costs, a cost efficiency opportunity only available to the STW operator.
- (c) STWs have limited capacity to store sludge and will be operationally motivated to move sludge on to the STCs so that they can focus on their core activities of treating sewage (rather than be capacity constrained by sludge stocks).
- (d) Sludge transport is already a contestable activity, often outsourced to third party hauliers, with little scope for future innovation or reductions in costs.
- (e) Sludge is not homogenous in quality and sludge operators need to ensure that sludge imports have the appropriate qualities to optimise anaerobic digestion processes.

We hope these factors help clarify why we believe that the boundary for the sludge price control should begin at the entry point for the STC.

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?
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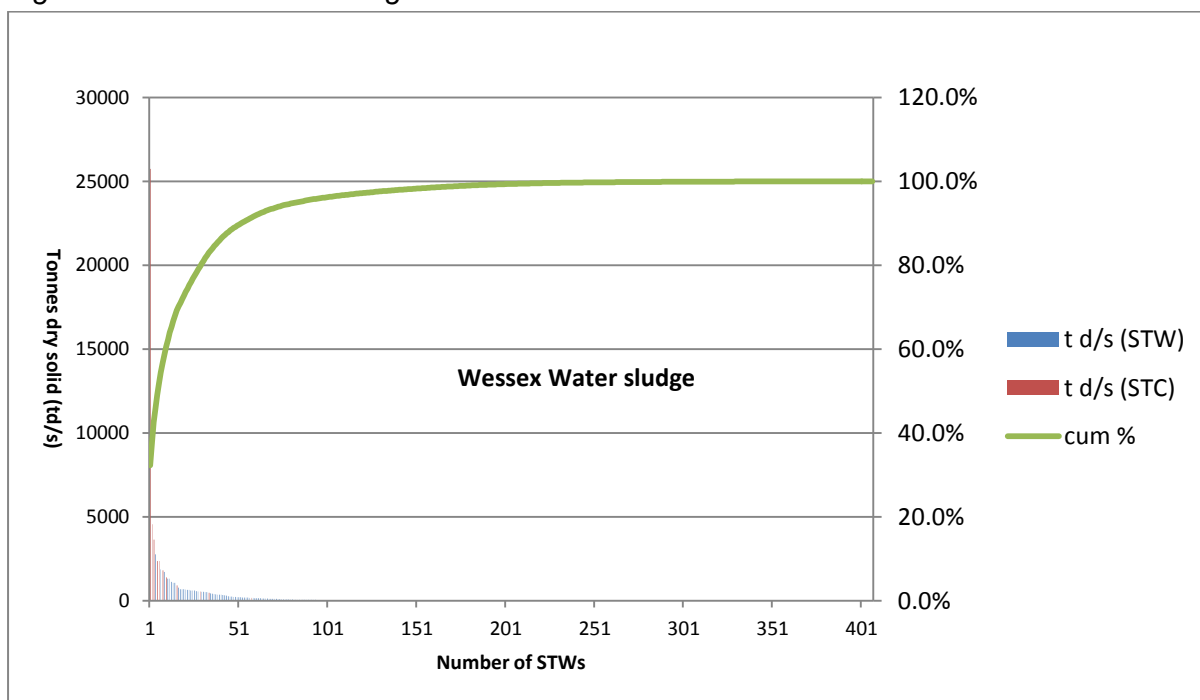
Ofwat's proposal will reveal information about the demand-side (STW) and supply-side (STC) of the sludge market and will increase transparency to market participants. If trade is the primary objective of increased data requirements, providing this data on the demand-side (at STW level) may be sufficient to generate market interest, with data requirements on STWs potentially limited to information on location, volumes and type (primary and secondary) of sludge produced and data requirements on STCs limited to summary data on sludge capacity and treatment and disposal costs. Minimising the data requirements would be less onerous although there may be benefits in providing the full range of data proposed.

Further discussion of the data requirements could be undertaken by the Sludge Working Group to ensure the data requirements are meaningful at an operational level. For example, the STC data table stipulates that information is required for 'primary sludge as a proportion of input sludge (%)' which does not recognise that sludge imports may be primary, activated or a mixture of primary and activated sludge, and that while the STC operator may know the approximation composition of sludge imported from its own STWs, it will be reliant on third parties to provide this information on their sludge imports.

2b	Do you agree that the data should be published on a STC and STW site level?
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Location and volume are crucial in understanding potential trading opportunities, although it is worth noting that we have rationalised our estate to benefit from economies of scale with our co-located STW/ STCs responsible for producing more than half our sludge. Many of our c.400 STWs are very small and unlikely to provide much of a trading opportunity, as is demonstrated in the following graph which shows (in red) the STW output where there is a co-located STCs and (in blue) the tonnes of dry solids produced by our other (c.400) STWs.

Figure 1: Wessex Water sludge



An alternative method of considering the trading potential of these largest sites is to assess what percentage of all sludge is produced by each site and to calculate concentration ratios (number of sites: percentage volume of sludge produced) for our STWs. This is shown above (in green) and shows a highly concentrated market, with the largest 30 STWs producing 80% of our sludge. 99% of all our sludge is produced at the largest 180 STWs, with the remaining 220 STWs producing 1%, which might be good grounds for a *de minimis* data requirement on the smallest STWs.

2c	Do you agree that the data should be published annually?
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Publication of data should be aligned with companies' annual reporting requirements, although it should be open to companies to update this more frequently.

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?
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A well-developed sludge market will allow market participants to agree on contracts to process sludge that makes best use of the available capacity, both at STCs and OOWPs. To this end, we welcome increased transparency in the provision of data on both the demand and supply side of the market.

As noted above, there may be merit in the Sludge Working Group considering in more detail the exact data specification (and definitions) further. The most liquid trading markets are

those where the contracts traded are standardised and the product is homogeneous and it would therefore be appropriate to ensure that all data requirements are clearly specified and contract terms well defined, although the market may ensure this outcome. For example, clarification is required on whether 'total treatment capacity (tds/ month)' refers to design limits on each site and/ or environmental and/ or operational limits and whether or not it is worthwhile distinguishing between each of these different capacity constraints.

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?
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Information uploaded onto the database could provide the starting point for commercial negotiation although participants are already able to invite expressions of interest for sludge disposal and treatment services. It is unclear what is gained by publicising bids on the database (particularly if the market is 'thin' and company positions can be identified from these bids) although there may be merit in publishing agreed contracts. We would therefore recommend Ofwat gives weight to the views of OOWPs on this point.

Guidelines for the assessment of bids may be helpful for the development of the market, particularly if they include expectations of how bids will be assessed but they may be superfluous in locally defined markets for sludge where incumbents are likely to be dominant and therefore subject to the Chapter II prohibition of the Competition Act 1998.

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?
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Ofwat envisages that information will be publicised by means of a centralised information platform, available to all market participants and potential entrants, although it does not specify who will bear the cost of this platform or how data uploaded onto the platform will be safeguarded. To gain company confidence in this process, it would be helpful if, in line with the approach taken at PR14, Ofwat confirms that specific cost allowances are made for the set-up cost of new markets and that this would not be considered 'at risk' investment.

Having said this, a simple platform with minimal functionality may be all that is required in the first instance; should an active market develop for sludge, a more sophisticated platform could be independently developed by a third party provider at its own cost. Where there is any risk that the data collected may differ by company interpretations, it would be helpful for Ofwat to provide clear definitions to ensure that the data is wholly comparable.

5	Do you agree with our proposals not to make any changes to the status quo in relation to system operation activities?
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Wessex is interested in ideas that extend system operation to the catchment areas but, within the context of PR19 methodology, does not consider that a change the system operator function within water companies is necessary.

6	Do you agree with our proposals not to have any specific financial incentives to support trading in relation to sludge at this time?
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If the market develops in line with Ofwat's expectations, trading incentives will not be required. Companies will trade sludge if there is a cost differential (including transport differentials) that creates a margin and most importantly if companies are confident that the gains from trade will accrue to companies and their investors, rather than be captured by the regulator in a short time frame.

7	Do you agree with our proposal to have a separate binding price control for water resources?
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Wessex Water sees no need for a separate binding price control as the proposals make use of information and processes that are already in place – namely companies' average water resources costs, their AICs and treatment/ network access price. These values are very different to the average accounting costs within water resources that will be generated through accounting separation and the separate price control so it is not clear to us what additional benefits will be gained to outweigh the increase in regulatory complexity. Competition is driven by neighbouring companies and others offering additional water resources capacity at a lower price than that provided by the incumbent; effectively this is just an open procurement exercise as is done for other wholesale services.¹

We also note that, for many companies the distinction between water resources and water treatment is somewhat theoretical. For most water sources the raw and the associated treatment plant come as a package of infrastructure with no choice as to the raw water which feeds the treatment plant.

Further the consultation refers at times to competition in raw water resources and at other times to competition in treated water so therefore it is not clear why the boundary of a separate price control is set at water resources per se. Demand management in particular is a treated water option. In most circumstances the choice that a company will be making is how it can best meet the demand for treated water. In some circumstances this may be

¹ Companies use average incremental social cost (AISC) or strategic environmental assessment (SEA) to select options in their WRMPs and this provides them with an understanding of whether or not there is a good social or environmental reason for not following the least cost approach. Calculations for payments could include only those factors used in determining AICs.

driven by obtaining more raw water to put through an existing treatment plant – but that is probably the exception.

We do not believe that a separate binding price control is required for water resources and consider that it will add to the existing complexity without realising any benefits.

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?
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This principle makes sense in achieving the objectives stated of supply demand options being provided by the lowest bidder without undermining the incumbent's historic costs.

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?
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This proposal is a development of what happened in the last WRMP process when water companies were required to publish on their websites a statement of their draft supply demand balance position. This process resulted in Wessex Water having substantive discussions with Bristol Water and Thames Water over changes to bulk supply arrangements.

In the proposed market information database it will be necessary for a company to make clear whether they are looking for additional raw water resources (presumably to supply a particular, and therefore specified, treatment works with spare capacity) or treated water delivered to a suitable point within the water resource zone in (projected) deficit.

Key criteria that would need to be provided either on the database are:

- Raw or treated water availability or need
- Average capacity (in a dry year/ drought)
- Peak capacity (in a dry year/ drought)
- Reliability – i.e. the circumstances, if any, when the volume of the supply would be restricted or curtailed
- Location of any surplus resource or deficit

A mandatory real-time information database could be a costly and bureaucratic burden on companies, realising few benefits, even when accompanied by a trading incentive that means incumbents are effectively sponsoring new investment (and entry). In our view, the same objectives could be achieved more easily and cheaply if companies were required to publish more information on their surplus/ deficit position in their WRMPs and, if they were unable to agree trades with a specified counterparty were able to rely on third party intervention and resolution.

10	Do you agree that a third party organisation may be best placed to manage the information database?
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In a market situation the database, or potentially competing databases, should represent a potential commercial opportunity. As with the proposed sludge database, there may be a clear benefit in focusing on what data will facilitate trading (rather than requiring *all* possible data to be uploaded) and in considering whether companies could use a bulletin board to publicise this information.

The database could combine potential resource needs and availability across a number of areas including:

- Abstraction licences – linked to abstraction reform
- Raw water / storage
- Treated water
- Demand management

Ofwat may need to have a role if the database or exchange is not developed commercially or if a company cannot develop sufficient income stream from introducing buyers to sellers in these markets: while licence holders will be required to put their information onto this database, it would be helpful for Ofwat to consider what incentives would encourage non-regulated companies to contribute their information.

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?
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Along with price, security of supply is usually a contentious point when agreeing a supply demand balance option with a third party, such as on bulk supply. Early clarity on proposed measures to ensure this will aid the development of trading.

Ofwat needs to be clear that water trading occurs for two different reasons: (i) to overcome a supply-demand deficit and (ii) in bilateral arrangements (where there is no deficit). Ofwat also needs to clarify whether its proposals apply to raw supplies and/ or treated supplies (bulk supplies).

12	Do you agree with our rationale for allocating the RCV?
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No, although Wessex Water welcomes Ofwat's proposals to protect the RCV at 2020. Given that this decision has already been made, there is little value in allocating 2020 RCV across

the value chain, particularly if the allocation reduces investor confidence in the RCV protection.

13	Do you agree with our proposed approach for allocating the RCV for sludge?
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We welcome the statements around protection of the RCV at 31st March 2020.

We would welcome more clarity on how this will be implemented in a way that ensures asset stranding does not result in reduced cash flows.

Given that this decision has already been made, there is little value in allocating 2020 RCV across the value chain, particularly if the allocation reduces investor confidence in the RCV protection. We agree however that the assessment of costs within the sludge treatment price control should take into account MEAVs to allow for efficient entry but may be complicated by the fact that some assets at co-located STW/ STC sites are owned and operated by both the STW and STC. We see merit in a focused approach which will promote a level playing field (on capital costs) for incumbents and potential entrants.

14	Do you agree with our proposed approach for allocating the RCV for water resources?
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We see no need for a separate price control and by extension a separate allocation of RCV for water resources, although we support proposals to revisit MEAVs to ensure a clear understanding of the replacement value and condition of the current asset stock.

Wessex Water sees no need for a separate binding price control as the proposals make use of information and processes that are already in place – namely companies’ average water resources costs, their AICs and treatment/ network access price. These values are very different to the average accounting costs within water resources that will be generated through accounting separation and the separate price control so it is not clear to us what additional benefits will be gained to outweigh the increase in regulatory complexity.

In the event that Ofwat decides that it will allocate RCV to water resources in a separate price control, we agree that it would be preferable to allocate this on an unfocused basis.

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?
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Investors in regulated markets should be protected from stranded asset risks particularly if it is the regulation that changes the market. This is because companies will undertake investment appraisals on the basis of known facts and a number of assumptions and – as

the proposal to separate price controls for sludge shows – a change in the regulatory regime could mean that, in hindsight, the decision to invest no longer looks efficient. In our response to question 16 we put forward some potential scenarios for consideration on which we would welcome Ofwat’s views.

Ofwat’s protection of efficient investment will need to ensure that there is no retrospective reassessment of efficiency after the event. We would therefore welcome confirmation from Ofwat that the PR14 totex and ODI reward/ penalty sharing frameworks would apply in full, as defined in the PR14 rulebook, after which the adjusted RCV would be deemed efficient.

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?
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Agreeing with this absolute assessment requires greater on clarity around what constitutes efficient investment.

Economic loss from asset stranding could occur through other regulatory mechanisms not directly linked to the RCV, as the following scenarios illustrate.

1. Company A’s digester capacity at 2020 becomes under-utilised as a result of market entry – as a result of this the ongoing running costs of the plant become comparatively ‘inefficient’ because the fixed costs are higher per unit. The company then receives a lower settlement at a future price control because Ofwat judges it to be less efficient than its comparators and does not allow it to recover its full costs.

We do not read your consultation to give companies protection from economic loss in this example – therefore we consider asset stranding will be possible under your proposals.

2. Population growth in Acity leads Company B to invest in increased capacity at the local STW and STC in 2018. One year after the augmentation of existing assets have been completed, changes to local environmental regulations mean that the STC has to close down.

We read your consultation to suggest that this would be considered efficient investment, but would welcome clarity from Ofwat on this point.

3. The Environment Agency determines that co-digestion is allowed and the safe sludge matrix is amended so that sludge can be processed alongside OOW (and vice versa). Company A’s Atown site is upgraded in 2019 to allow co-digestion but instead an OOWP located in Atown wins the bid to process sludge from local STWs.

We read your consultation to suggest that this would be considered efficient investment, but would welcome clarity from Ofwat on this point.

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?
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Wessex Water supports the principle of an income guarantee against the risk of assets becoming stranded but is unclear on how this would be achieved. Experience in AMP5 and AMP6 with the RCM and WRFIM suggest that there is a balance to be struck between simplicity and the robustness of the income guarantee afforded. In either case, a transparent ex ante approach would be of benefit and would instil confidence for investors and certainty of prices for customers.

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?
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We support the application of network plus approach for bilateral trades. However account will need to be taken of how much of the 'network plus' is used – but on a regionally averaged basis. For instance if a bilateral trade is based on the input of treated water then the access price should only reflect network costs, rather than treatment and network costs.

Access prices based on water resource zones seems reasonable but locally, within a resource zone, there may be additional reinforcement costs (which might require a separate connection cost to be imposed) if a lumpy additional resource is added to the zone.

Guidance from Ofwat will be required to ensure that the process of accounting separation is undertaken consistently across all companies so that the resulting exercise of estimating average costs is consistent. Guidance on methodology for estimating average costs is also required so that companies can be sure that their calculations are sound even if there is a significant change in the denominator (volumes distributed and treated).

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?
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We believe that companies are best placed to calculate their own access prices.

19b	Do you agree they should be published by water resource zone, with network distribution and treatment costs separately identified?
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Network distribution and treatment costs should be identified separately as bilateral trades may be for either treated or raw water.

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?
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We agree with the approach of using AIC although the payment should be made on the basis of capacity provision and commodity rather than an all-in unit rate because of the uncertainty in utilisation. The capacity provision payment also helps ensure that the party inputting water will continue to ensure that that the capacity is provided reliably.

The following table shows our understanding of your proposals and their likely impact.

	Incumbent pays new entrant	New entrant pays incumbent	Comment
New treated water supply to meet treated water deficit	Incumbent's AIC (treated water) <i>less</i> Average WR cost	Connection cost for reinforcements if required	Further reduction to provide incentive for incumbent to take trading option – subject to maintaining a margin for new entrant. Bulk supply is one example here. How does this link to existing trading incentives?
New raw water supply to meet treated water deficit	Incumbent's AIC (treated water) <i>less</i> Average WR cost (reflecting fact that the incumbent is not providing treatment)	Connection cost for reinforcements if required	Further reduction to provide incentive for incumbent to take trading option – subject to maintaining a margin for new entrant. How does this link to existing trading incentives?
Raw water input for bilateral trade (no deficit for incumbent)		Network plus access charge for treatment and distribution	Customer pays new entrant
Treated water input for bilateral trade (no deficit for incumbent)		Network only access charge as water is treated.	Customer pays new entrant

We think there would benefit in Ofwat providing companies with guidance to ensure consistency in the methodologies used to calculate AICs (as used in companies' WRMPs) and/ or LRICs.

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?
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It makes sense to use the incumbent's AIC for the basis of the payment to the new entrant as this is the price that competition should be beating but the full benefits arising from this methodology accrue to the new entrant (or trading party).

While this might be considered appropriate as a stimulus to market activity and better long-run investment decisions, it is not immediately clear how customers will benefit from this arrangement where there is no bilateral arrangement with retailers. Given that it is unlikely that in the long-run the full appropriation of the value created by new appointees would be considered legitimate, this uncertainty may impede market entry on what are long-run investments. It may therefore be helpful to directly address this question now.

One means of resolving this would be for the incumbent to pay a proportion of its AIC to the new entrant – subject to this not reducing the payment below the new entrant's costs – with the remainder being passed back to customers as lower incumbent bills.

Demand-management provides an alternative means of addressing a demand-supply imbalance with companies, even where there is no imbalance, obliged to promote efficient use. In the event that the new entrant's water resource option (costing £19 million) is cheaper than the incumbent's proposed demand-management solution to use less water (costing £25 million), the new entrant's option would be selected as the least cost option. This approach may serve to crowd out demand management options which have wider societal benefits. Our view is that it is likely that companies may need to assess bids including some form of environmental and societal assessment – but that payments made to successful entrants should relate only to AICs.

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?
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The information database will provide a starting point for commercial negotiation and agreement and, for this reason we consider that it should focus on providing information that allows market participants to understand trading opportunities. While cost data may well stimulate market interest we note that it might be misleading, particularly as final agreed contract prices could vary significantly from average cost data, as:

- STW operators are legally required to dispose of sludge safely and this requirement and the potential for the STW to become capacity constrained if sludge is not removed may mean that, at times, STW operators will be willing to pay high prices (reflecting their inelastic demand), and

- STCs and OOWPs offering to provide sludge treatment and disposal services may need to use less economic assets or make changes to their own treatment schedules such that they face higher costs (i.e. their supply curve is inelastic).

Well-defined homogenous products and standardised contracts both facilitate liquidity in trading, although there may be good reason for bespoke contracts that include a range of non-price terms. Long term contracts may well be appropriate for STCs and OOWPs that agree to undertake additional investment in treatment and disposal capacity.

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?
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Our response to question 1 makes clear our view that sludge transport should not be included in the sludge price control. As in our response to question 3, we think there is benefit in Ofwat publishing its expectations of how offers should be evaluated but that, ultimately, companies will need to comply with the Competition Act 1998.

24	Do you agree with our proposals relating to the use of direct procurement on behalf of customers?
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We do not agree that there should be an undefined requirement to consider the use of direct procurement for schemes below £100 million without further work to understand the likely costs and benefits of such approaches. Direct procurement is to be welcomed where it delivers clear benefits to customers but it less than clear why these benefits of competition *for the market* would not also result from a company-led procurement process. Financing costs of individual schemes might also be expected to be higher where companies are not able to diversify their risk across a portfolio of schemes.

Direct procurement could have a greater role to play in the water industry particularly if it can improve the legitimacy of large-scale investments and can give customers greater confidence that best-value has been achieved but this must be balanced against an evidence based understanding of the likely costs and benefits of such an approach.

We would caution against a view that considers recent examples of direct procurement to be more efficient without taking full account any differences in approach. Our understanding is that the cost of financing the Thames Tideway Tunnel resulted in a low cost of capital in part because many of the risks of this project were allocated elsewhere. In addition project finance was able to take into account current market rates which, when compared with a mix of embedded and new debt in a price control WACC calculation, suggests further savings were achieved but this saving may be illusory (because there should be an offsetting adjustment to the mix of embedded and new debt costs for comparison).

More evidence on the benefits of direct procurement should be adduced before companies are mandated to use direct procurement. Without clear and compelling evidence that direct procurement benefits customers, it would seem inappropriate and disproportionate to penalise companies in the RBR for not making use of it.

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?
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The set-up costs of direct procurement may mean it is most appropriate only for the largest projects. We would therefore welcome more work from the industry to understand better the costs and benefits of alternative procurement processes and the point (in terms of contract values) at which direct procurement becomes most appropriate.

We would recommend that Ofwat considers whether there should be a lower boundary, below which direct procurement is not required as a means of delivery. This would give greater clarity to companies as to which of their (thousands of) investment projects should be let through direct procurement.

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?
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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?
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Wessex Water supports total revenue controls as:

- This is more in line with our duty to promote efficient water use and
- Short run marginal costs are far lower than LRMCs and the average accounting costs on which charges are based.

Ofwat should consider again whether contributions from developers should be part of the total revenue controls as the relationship between income and cost is far more direct in this instance. This could lead companies to reduce or slow new development activity to reduce both costs and incomes within the period.

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?
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The volume risk adjustment is intended to expose companies to gains and/ or losses in market share resulting from innovative and dynamic competition. Defining markets and calculating market shares is a non-trivial exercise and, as CA98 case law shows, is always the subject to considerable debate so that determining whether changes in capacity utilisation (volume change) are the result of changes in competition is likely to be a significant exercise. It would therefore be helpful for Ofwat to give *ex ante* guidance through examples and case studies to illustrate how companies would undertake this assessment.

We believe that the interaction between protection of the 2020 RCV and the exposure to volume risk needs to be clear and transparent in advance of the separate price controls. In particular, more clarity is required to understand how future investments will be recompensed and whether capex will be added to the RCV and rewarded through WACC or whether companies will need to specify capex by site and get *ex ante* 'approval' for efficiently incurred investment from Ofwat.

29	In your view, how should new investments be remunerated in the sludge and water resources controls from 2020?
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New investments made after April 2020 could be added to the RCV.

While Ofwat wants to ensure that investment made after this time is undertaken at the risk of investors, it is worth remembering that investment will not be undertaken if investors are unable to assess the risks of investment or if there is an unfavourable risk: reward ratio. The RCV model helps ensure that investment is properly remunerated and investment risks protected, with depreciation offset by maintenance funding. While investments made after April 2020 are made at the investor's risk, remuneration for maintenance costs is still appropriate and should occur either through the price settlement or the RCV.

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?
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This is a difficult area but removing RCV protection on future investment will help as will the revaluation of assets at their current costs.

31	Do you agree with our proposal to retain our RBR approach for PR19?
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The RBR approach incentivises companies to ensure their Business Plans set out their stalls since it effectively sets up a competition between companies to gain Enhanced Status. To guard against subjectivity, Ofwat should make clearer the assessment it will undertake and how it will use input from CCGs. The competition should include an assessment of how companies have performed comparatively in service and operational delivery as well as how they have delivered against their previous Business Plan commitments.

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?)
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The competition should include an assessment of how companies have performed comparatively in service and operational delivery as well as how they have delivered against their previous Business Plan commitments. We also consider that operational performance levels should be a factor in the assessment of efficient expenditure as per our response to question 34. Performance can be assessed both against service metrics and operational service delivery which will include compliance with statutory requirements (e.g. the number of prosecutions for non-compliance on water supply) and best practice metrics (e.g. number of odour complaints).

33	Do you agree that the RBR assessment should consider the extent to which the business plans are part of a longer term plan?
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Yes. Our PR14 plan was clearly a step towards our longer term vision in our strategic direction statement, tested with customers and their representatives and we set a series of 25 year targets for our nine outcomes which demonstrate our commitment to long term planning. Wessex also has a history of undertaking projects that span price controls periods (such as the Grid project and North Bristol sewerage) and we should consider how Ofwat can continue to give company boards comfort that these longer-term investments will be funded.

Whilst no company Board or Regulator can fetter the discretion of their successors, a mature relationship should enable each to offer the other suitable statements of intent that allow longer term planning approaches.

34	Do you agree that the consideration of disaggregated cost models is appropriate given the price control structure proposed?
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Yes, but we are concerned that the scope of Ofwat's proposals are limited to integrated network+ models. We would advocate techniques alongside this that break the value chain

into its further constituent parts and ones that consider different types of expenditure separately.

We believe in more disaggregation of cost modelling to improve cost transparency. The CMA's reviews of Ofwat's PR14 cost models reveal clear benefit in using a range of models, techniques and approaches (aggregated, disaggregated, top-down, bottom-up) to assess efficient wholesale costs. We welcome Ofwat's initiative in working with the industry to develop its thoughts on wholesale cost modelling and the recent industry initiative to understand what information might be included on an industry datashare to help Ofwat.

Econometric models are not appropriate for large parts of the enhancement programme where requirements are driven by UK and European regulations and each company may be at a different position in terms of its investment requirements. Each company will have had to develop prices for these programmes of work and more appropriate methods of assessment would include market testing, cost-base and use of third party cost consultants to compare on an outturn basis.

It is particularly important in our view that Ofwat considers how to take into account differences in operational service delivery when assessing efficient costs. This year we will be investigating ways in which this could be achieved and will share the results with you.

35	Do you agree that the development of detailed cost allocation guidelines is appropriate?
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Yes. Detailed cost allocation guidelines will help in making difficult judgments on boundaries of different activities for accounting separation and in ensuring that companies are consistent in their approach. Wessex Water is already working with Ofwat on these because we recognise the importance of this issue.

36	Do you agree with our proposal to retain the current timings of our price controls, i.e. 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?
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We agree that it is appropriate **not** to stagger the wholesale water and wastewater price controls for PR19 but we do think that the timetable could be better aligned with other regulatory planning processes (with a suggested approach to be found in answer to question 55.)

In the medium term, it is worth keeping under review the impact of disaggregating the different activities of the value chain into separate price controls to ensure that:

- There is some smoothing of the regulatory burden and workloads

- Customers are able to contribute to discussion and debate
- A sustainable long term approach is developed
- Ensure that management can focus on innovation, risk management and most importantly improving services to their customers

In our view this is likely to require:

- Simplification of regulatory processes
- A greater say for customers within broad boundaries set by the regulator, and
- Some staggering of price controls

It would be preferable for there to be greater coordination between price review time tables and other regulatory processes. The PR19, River Basin Management Plans (RBMP) and National Environmental Programme (NEP) programmes are less aligned than they were in PR14, which creates risk and uncertainty. We therefore need to clarify the extent to which companies are expected to bear the risk of changes to statutory obligations within a five year period, since in the current framework it is not clear the extent to which ODIs are designed to allocate this risk or whether they are designed to penalise and reward company performance.

Allowing companies until the autumn of 2018 to submit plans would enable them to take account of other regulatory requirements and plans will be better as a result. Plan submission in autumn 2018 would still give Ofwat more time to consider plans than it had at PR14.

37	Are there any other measures, not considered above that could help to encourage a longer term approach?
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Yes. Our PR14 plan was clearly a step towards our longer term vision in our strategic direction statement, tested with customers and their representatives and we set a series of 25 year targets for our nine Outcomes which demonstrate our commitment to long term planning. Wessex also has a history of undertaking projects that span price controls periods (such as the Grid project and North Bristol sewerage) and we should consider how Ofwat can continue to give company boards comfort that these longer-term investments will be funded.

We have successfully implemented overlap programmes (spanning more than one price control) to help manage investment programmes for the long-term. We have recognised and accepted the risks but overall the benefits have been significant for customers with improved resilience, and service levels being delivered through more holistic programmes of work than would have been achieved through a series of individual within-AMP projects. This approach has also reaped benefits in terms of smoothing the investment cycle between AMPs and retaining internal and external skills in our market.

We therefore believe that a greater use of overlap programmes should be applied across the sector supported by selective use of ODI's to protect customers' interests. While no company Board or Regulator can fetter the discretion of their successors, a mature relationship should enable each to offer the other suitable statements of intent that allow longer term planning approaches.

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?
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Overall we support the principle of greater in-period adjustment, but companies must retain the ability to keep customer bill profiles stable. Water is different to other regulated sectors in that the regulated element is a far greater proportion of the end-customer bill, so whereas for instance in energy networks in-period adjustments are likely to be outweighed by the impact of changes in the wholesale market prices, in water there will be proportionately a far greater impact of any bill change.

ODIs

We understand the desire for there to be a more immediate link between performance and returns, but we need to balance this against the need to keep customers' bills stable. We need also to acknowledge that companies' engagement with customers in the lead-up to PR14 suggested that they did not necessarily readily understand the concept of company rewards.

To generate greater confidence in these kind of arrangements we think a review of ODIs in advance of PR19 should acknowledge that not all ODIs are the same:

- Some are about risk allocation (for instance when environmental requirements are uncertain)
- Some are about amending financial incentives to adjust for externalities (for instance our financial incentive around AIM at Mere)

In these circumstances, the terminology of "rewards" and "penalties" is unhelpful as it is not an accurate description of the purpose of the adjustment, and could lead to the undermining of customer confidence where penalties become "fines from the regulator" and rewards are considered unjustified profiteering. We think different terminology could help in this regard.

Our view is that in period adjustments are most likely to retain public confidence where they are demonstrably based on comparisons with the industry, for instance SIM has retained customer confidence because it can be shown that companies who benefit are delivering comparatively the best service performance. In contrast a company may be due a reward because it did not have a hosepipe ban in a year where no other company had a hosepipe ban - the application of an in-period reward in this instance might be expected to reduce confidence.

Revenues

We agree that in-period adjustments for wholesale revenues would be appropriate but any licence mechanism should allow companies to make due adjustment to ensure bill stability can be maintained. It would be perverse for instance for companies to increase bills to customers in Year 3 of a price control because poor weather in year 1 reduced demand, when the company also knows that year 2 was comparatively dry and demand had increased.

Cost-sharing

We do not think in-period adjustments for cost-sharing would be appropriate as greater immediacy may make companies more risk averse and less innovative in their investment approach if the savings were captured by the regulator in advance of the success of the new approach becoming apparent.

We consider that a five-year “true-up” of cost sharing remains an appropriate balance that gives investors confidence that efficiencies made will be retained for a suitable period, before being passed back to customers in the form of lower bills.

39	Do you agree with our proposal to move to CPI (subject to the UKSA’s final recommendations)?
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We accept that, since 2013, the RPI has not been an official government statistic and its methodology has been largely discredited. Despite this, because much of the UK’s government/ corporate bonds and pensions are indexed by RPI it seems likely that the RPI will be published for a considerable time to come. While regulators in other sectors have been moving away from using RPI, with many indexing allowed revenues within a price control period by CPI, no regulator has so far proposed change in indexation of regulated companies’ RCVs.

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?
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We agree that the key objective for both customers and investors should be increased customer legitimacy of price controls rather than a windfall gain or extraction of value from either party. Given that the RPI is increasingly falling out of everyday use we see merit in indexing allowed revenues by CPI through the period as the most simple and effective way of achieving this objective. CPI is a widely used measure of inflation, well understood by most customers.

We welcome Ofwat’s commitment to ensuring any change to CPI indexation is value neutral to investors but consider the work undertaken by NERA for Water UK shows that investors are concerned that this will not be achieved in practice:

- It may increase the nominal cost of raising capital, given the limited appetite for CPI linked bonds.
- It will be costly for companies to reinstate the hedges they have taken out with RPI index linked debt.
- Complex transition arrangements that could span a number of decades are unlikely to be considered immutable by Ofwat or investors.

While there is value to customers in indexing revenues to CPI there is no obvious value to them in indexing RCV. The concerns identified above all have the potential to increase the cost of finance which will be to the detriment of customers in the long-run and it is therefore difficult to see what gain will accrue to customers in return for this risk and the additional regulatory complexity that this will entail. Given that the benefits to customers are unclear, we think that the move to CPI indexation of RCV should only be implemented if Ofwat has clear evidence that this will be beneficial to customers.

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?
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The move to CPI will be appropriate in time, when markets in CPI ILD gilts are more developed and liquid (which, research undertaken by NERA for Water UK suggests, might take 20 years) but Ofwat has not made a good case for it to be introduced in PR19.

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?
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The research undertaken by NERA for Water UK indicates that Ofwat’s proposal will be bill/revenue neutral but not value neutral.

The same research puts forward a number of options that would increase transparency on the approach taken by Ofwat and give increased confidence in the credibility of Ofwat’s commitment, including:

- Detailed calculations on how revenue/ value neutrality would be maintained, e.g. using PR14 outcomes as an example;
- Publication of both RPI and CPI WACC estimates at the next price review and detailed reconciliations of how these estimates have been derived and how they compare across other regulated sectors;

- Publication and commitment to a PR19 allowed rate of return well in advance of the 2019 price review;
- Detailed calculations on how hedging costs and additional costs of CPI debt will be taken into account;
- Greater transparency about what will happen after 2025 on the transition profile to CPI indexation.

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?
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We do not support the use of CPI for the RCV.

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?
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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?
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46a	What does good customer engagement look like?
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In competitive markets, customers are free to vote with their feet but this choice is not open to them in monopoly markets. Incumbent water suppliers should therefore endeavour to understand their customers through continuous engagement that is then used in business planning and business decision making to ensure that customers are given a level of service that they value most.

Good consumer engagement should:

- Be innovative
- Use easy to understand techniques and ensure that customers know what they are being asked so that they can drive business decisions.
- Be multi-channel to offer customers a choice of how they take part
- Be inclusive to make sure we capture views of hard to reach and vulnerable, and consult out in the community
- Engage with younger or prospective customers as water companies are long term businesses so their views are important

- Be two-way and drive change.

46b	What are your views on the principles outlined above?
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We support the principles of good customer engagement and engage with our customers and out new Wessex Water Partnership to understand better our customers' needs and remain top of the SIM score rankings. We are disappointed that Ofwat is reducing the role for its own customer scrutiny panel and reducing the role of companies' CCGs.

46c	How could companies draw on good practice from within and outside the sector?
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Comparative regulation ensures that water companies are in competition with each other despite being regional monopolies. Disclosure of best practice by the regulator stimulates innovation between companies and allows companies to learn from each other and adopt approaches that are liked by customers.

Wessex Water is pioneering the use of Net Promoter Scores (NPS) which allows us to compare ourselves with other companies outside the water industry and is looking at information on customer effort. We have joined the Institute of Customer Service and are considering how best we can understand better what other companies are doing so that we learn from them.

CCG representatives will be able to draw on their own experience of customer engagement and this could result in more innovation as companies learn from best practice in different markets and sectors.

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?
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Ofwat has itself noted the difficulties of revealed preference surveys² which may explain why most companies have opted for stated preference surveys in understanding customer preferences. Wessex Water is exploring alternatives to the WTP approach it took in PR14, including the use of meta-analysis to reveal customer preferences. We already use information from day-to-day interactions with customers to understand their preferences and levels of satisfaction and the success of this approach is demonstrated by our high levels of performance in the SIM rankings.

² Cascade/ EFTEC, *The use of revealed customer behaviour in future price limits*, final report, 08 April 2011

We are also looking to ensure that our day-to-day feedback (from around 60,000 customers) is used more systematically to make changes to processes, communication, training, systems and policies/ offering. We are now asking more questions (such as on NPS and effort) and moving that data into a more real time environment so we can act on it more quickly, as well as using sentiment analysis and tools to identify trends and common issues to drive improvements valued by customers.

47a	What are your views in relation to our proposals on future CCG remit; scope; timetable; governance arrangements; and membership?
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Greater clarity of CCG's remits is welcomed as is clarity on the scope and appropriate focus of CCGs. It seems sensible for CCGs to submit their reports to Ofwat at the same time as companies submit their business plans so that Ofwat can use the report to undertake its risk-based review.

While greater liaison between CCG Chairs and Ofwat will improve the performance and independence of CCGs, it can create tension if a company's innovative ideas are shared amongst its competitors and it is not then given credit for its original ideas in the RBR.

We have continued to engage with our customers to understand what is important to them. Our new Wessex Water Partnership has an independent Chair and diverse membership, which will ensure appropriate challenge and assurance on the quality of our customer engagement and the use of this engagement in our decision making.

We are disappointed that Ofwat appears to be reducing the direct customer challenge of the methodology itself, by reducing the role of its own customer advisory panel while defining company's CCG's role more narrowly. We think it would be helpful for the sector if new approaches to regulation are tested with customer groups to ensure that they can be understood to be acting in the interests of those we are ultimately here to serve.

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?
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Yes.

47c	What are your views on the division of responsibilities between CCGs and Ofwat?
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In the market place for ideas, Wessex Water proposed that customers should have a greater say in the services they receive, such as making direct choices for some aspects of the Business Plan, and we are disappointed that Ofwat was not more ambitious in its proposals. It remains our view that there are clear advantages in giving stakeholders a stronger role in

making decisions – not least because this could foster a simpler approach to price setting that better retains customer legitimacy.

48a	What are your views on our proposal to facilitate more collaboration between CCGs?
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In PR14, there was close collaboration between our CCG and Bristol Water's CCG, which was particularly important to Wessex because of our joint billing activities.

The sharing of ideas will benefit customers but Ofwat needs to consider how CCG Chairs can contribute fully and equally and this may require an understanding of any commercial confidentiality clauses agreed as part of the contract with CCG Chairs. Without this, there is a danger that RBR assessments will be skewed.

48b	What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early?
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Wessex Water welcomes early publication of WACC and RoRE ranges and believes that these will be welcomed by CCGs.

48c	Without inserting ourselves between companies and their customers, what else could we do to incentivise and encourage good quality customer engagement?
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Ofwat should limit itself to setting out principles around engagement and ensuring CCGs are clear about their roles and responsibilities.

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?
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We agree that outcomes should focus on long term objectives that are important to customers. Our nine outcomes were determined during the development of our Strategic Direction Statement (SDS), which looked forward 25 years, and includes asset health related performance commitments. The SDS is based on customer consultation and prepared in advance of each business plan but there needs to be a 'line of sight' between the SDS and the business plan, with the investment plan and performance commitments set within the context of the long term outcomes.

The SDS is reviewed every 5 years and this includes any adjustment to the future glide-path of outcomes. We do not agree that any particular outcome needs to be mandated; encouragement can be provided by making this issue one of the assessment criteria in the RBR.

We are committed to long term planning as is shown by our current business plan to 2020. Our Grid Project has delivered multiple outcomes spanning more than one price control and shows that companies can commit to invest across price control periods if they are confident that their investment is financeable.

While no company Board or Regulator can fetter the discretion of their successors, a mature relationship should enable each to offer the other suitable statements of intent that allow longer term planning approaches.

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)?
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We consider that outcomes should cover a company's long term aspirations and be developed in their long term plans. While we support the proposed consultation in November 2016, we believe that with the UKWIR RG07 report being finalised in February 2016, this date will be too late for our customer consultation regarding the WMRP and the expected publication of our updated SDS in December 2016.

The benefit of outcomes and ODIs is that they reflect the priorities of each company's customers. Each company starts from a different position in terms of its service levels and investment and, if companies are to achieve significant improvements to service, this must be relative to their customers' priorities and the levels of service currently provided. While we recognise that some ODIs can be comparable, we consider that the majority should be bespoke and reflect local requirements and priorities.

We think the ODI consultation in advance of PR19 should acknowledge that not all ODIs are the same:

- Some are about risk allocation (for instance when environmental requirements are uncertain)
- Some are about amending financial incentives to adjust for externalities (for instance our financial incentive around AIM at Mere)

In these circumstances, the terminology of "rewards" and "penalties" is unhelpful as it is not an accurate description of the purpose of the adjustment, and could lead to the undermining of customer confidence where penalties become "fines from the regulator" and rewards are considered unjustified profiteering. The ODI consultation could consider whether different terminology is appropriate in some circumstances.

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
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	early 2018 before they submit their business plans?
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We think that it is a good idea to submit the proposed performance commitment measures and their definition early, before submission of the plans. This would provide more certainty and reduce the possibility of late changes in metrics. We agree that the actual targets and incentive mechanisms should not be submitted early and should part of the business plans.

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?
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We understand the desire for there to be a more immediate link between performance and returns, but we need to balance this against the need to keep customers' bills stable. We need also to acknowledge that companies' engagement with customers in the lead-up to PR14 suggested that they did not necessarily readily understand the concept of company rewards.

To generate greater confidence in these kind of arrangements we think a review of ODIs in advance of PR19 should acknowledge that not all ODIs are the same:

- Some are about risk allocation (for instance when environmental requirements are uncertain)
- Some are about amending financial incentives to adjust for externalities (for instance our financial incentive around AIM at Mere)

53	Do you agree with our summary of potential licence changes and the process for achieving these outlined in section 9.1 above?
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We understand the need to amend licences for PR19 but the important point for us is that these potential licence changes to be developed with the industry alongside the PR19 methodology. We are pleased that this document marks the start of this process.

54	Do you agree with the next steps for establishing the necessary data for the 2019 price review outlined in section 9.2?
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Separate price controls for sludge and water resources will require further changes to the accounting separation information that is collected from companies and a possible need to revalue relevant assets. We support Ofwat's approach to this which will mean a targeted review in the first quarter of 2016 and revisions in the 2016-17 RAGs, with guidance on

MEAV valuations issued by Ofwat later this year, and companies submitting valuations in 2017 that can be used by companies in their 2018 Business Plans.

55	Do you agree with our indicative timetable for the Water 2020 programme?
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We welcome the fact that Ofwat has set out its proposals for PR19 early and it is already clear that at the time companies submit plans Ofwat's own detailed methodology will be far more developed than was the case at PR14. It is therefore unlikely in our view that Ofwat will need 18 months to consider company plans when at PR14 it reached determination in 12 months.

We note that at this stage Ofwat has more time to review company plans than it has given companies and their Customer Panels time to respond to finalised proposals and that the proposed timetable does not accommodate other regulatory timeframes such as the WRMP and the NEP.

In our view allowing companies until the autumn of 2018 to submit plans would enable them to take greater account of these other regulatory requirements and plans will be better as a result. Notably, plan submission in autumn 2018 would still give Ofwat more time to consider plans than it had at PR14 (as well as allowing some contingency time).

IA1	Do you agree with the benefit and cost impact categories we have identified?
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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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IA3	What are your views on the indicative scale of the impacts we have identified?
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IA4	Are you able to provide any evidence on any of the impacts in relation to our proposals?
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The data changes proposed for sludge will require us to undertake additional monitoring that will require new and additional meters at our STWs and STCs. Our initial assessment is that this may cost c.£1 million (although the process of assessing actual requirements and costs is ongoing).