Draft Methodology for 2019 price review

Consultation response from Anglian Water – August 2017

Contents

Contents ....
Main consultation response ....
Executive Summary – headlines 3
Annex – Response to individual consultation questions ....
Affordability and vulnerability 11
Outcomes 12
Resilience 27
Wholesale controls 28
Direct procurement 35
Retail controls 40
Cost assessment 41
Risk and return 46
Financeability 49
2015-20 performance 54
Securing confidence and assurance 55
The initial assessment of business plans: securing high quality, ambition and innovation 56

Main consultation response

Executive Summary

Introduction

We are pleased to submit this response to Ofwat's consultation on its methodology for the 2019 Price Review (PR19).

Our overarching aim for PR19 is to ensure we continue to understand the changing priorities of our customers and to deliver excellent service and great value whilst enhancing the environment and improving resilience.

Addressing resilience is a long-term challenge. But the pressures are growing. In the East of England, we see rapid growth and changing weather patterns increasing the likelihood of drought and flood in the future. Our strategy goes well beyond the five years covered by PR19, but it is clear that taking action on resilience during the next AMP is essential if we are to meet the needs of future customers, support economic and housing growth ambitions in our region and provide the necessary underpinning for the Government's industrial strategy priorities.

We therefore approach PR19, and this response, in the context of our draft refreshed Strategic Direction Statement[1], which sets out a 25 year view of the actions we will need to take to meet the needs of customers, the environment, the economy and society more broadly. We have also reflected upon the Government's draft Strategic Priorities for Ofwat, and our ongoing engagement with the National Infrastructure Commission as we have framed this response.

Taking all of this into account, whilst we support many elements of Ofwat's approach, there are important areas where we suggest changes may be needed if these critical long term outcomes are to be secured, and to deliver long term value for money for current and future customers.

Key areas where we are supportive of Ofwat's proposed approach

Resilience

We welcome the stronger focus on resilience in the draft methodology. We also agree with the proposal to reflect resilience measures in the common performance commitments framework, alongside an opportunity to propose a bespoke financial incentive as part of our business plan.

We also welcome the commitment to allow for efficient investment in resilience through the cost assessment process, and the proposed resilience measure for water based on the risk of severe restrictions in a 1 in 200 year drought. This reflects the research carried out as part of Water UK's Long Term Water Resource Planning Framework, and subsequent discussions with the industry, Government and Ofwat.

However, our support for Ofwat's generally positive approach to resilience is tempered by concerns that the potential for natural capital to play an increasing role may be under-realised, and that the

1 http://www.anglianwater.co.uk/_assets/media/55189_AW_Long_Term_Strategy_linked_-_Main_document.pdf

collective impact of the methodology proposals may chill the future investment climate and challenge the deliverability of much-needed resilience investment.

Stronger incentives

We agree with the general principle of making Outcome Delivery Incentives (ODIs) more powerful. This will mean that companies who deliver excellent outcomes for customers, and drive innovation can earn greater rewards, and those that perform poorly face larger penalties. However, we have some reservations about the detail of the approach which Ofwat proposes, which we set out in our response to the specific consultation questions on ODIs. In particular we would suggest that, if customers are supportive, higher reward rates for significant outperformance could be more widely available, not just for common performance commitments.

Cost of debt

We support the proposed approach to the cost of debt. This position emerged from constructive workshops that Ofwat held on the topic. We are pleased to see some of our proposed approaches to the choice of index and inflation adjustment reflected in the draft methodology.

Botex emphasis on cost modelling

In relation to the approach to cost modelling, we are pleased to note that Ofwat is indicating that it may not be appropriate to use a totex approach in its models. As we have previously argued, a more appropriate approach is to model base operating and maintenance expenditure ("botex") separately from any enhancement costs. We would hope that this approach would now be adopted across all of Ofwat's future cost models.

C-Mex and D-Mex

We support the direction of travel proposed for both the C-Mex and D-Mex measures of experience; noting that further development of both measures is required, specifically the non-contact survey for C-Mex. We will work with Ofwat through both task and finish groups to support the effective design and piloting of these measures.

Key areas where we propose change

Overall Approach

This response has been informed by our analysis of whether the methodology as a whole supports the overarching objective we set out above[2]. Ofwat has not provided evidence that it has assessed whether it is striking an appropriate balance between costs, risk and tougher service performance incentives. We would ask that Ofwat undertake such analysis and give further consideration to the interplay between the various elements in its proposed methodology and assess whether, taken as whole, the methodology creates a regulatory framework which supports the long term investment in the sector which is needed to deliver resilience, environmental and wider economic and societal objectives.

2 i.e. our aim to ensure that we continue to deliver excellent service and great value for our customers whilst enhancing the environment and improving resilience

Ofwat is proposing for PR19 that there should be a series of step changes, all of which increase the overall risk position: cost allocations for companies are proposed to be much lower; service levels companies need to achieve - not just to gain rewards but also to avoid penalty - are much more stringent; average performance will attract a penalty.

For any price review, we believe that the regulator will wish to:

- create an environment which incentivises efficient investment;
- create an environment which delivers acceptable levels of service to customers;
- avoid creating an environment which could deter investment; and
- minimise the risk that, with hindsight, the price review may appear to be unduly lenient i.e. overly generous to companies at the cost of customers.

Our assessment of the likely effect of the PR19 methodology is that it materially increases risks around cost assessment, service provision and likely returns on investment. In addition, the systemic risk for UK investment is affected by uncertainties related to Brexit, which will likely continue throughout the PR19 process.

Our conversations with investors and lenders suggest a broad consensus of increased risk to future revenues and profitability for the water sector. We consider that this could result in significant harm for both current and future customers if the funding required for vital investment is deferred or rejected.

Without prejudice to the points that we make above, we also note that the PR19 methodology also proposes a series of significant changes that impose additional burdens on companies without appearing to offer any glidepaths from current to new approaches. Regulatory precedent would suggest that it would be appropriate for glidepaths to be provided in such circumstances, rather than cliff-edge shifts. We would also urge Ofwat to clarify this point, and to ensure glidepaths are in place to mitigate negative impacts.

Cost of Equity

We are surprised by the cost of equity range quoted in the methodology. Total Market Returns for regulatory price settings are generic and therefore regulatory precedent is relevant here, and the approach suggested seems to set aside recent precedent. Given the importance of this topic, we have worked with others to engage KPMG to review the underlying assumptions made by PWC.

We see merits in a framework that encourages long term investment for long term outcomes. Such investment will enable companies to meet the wider needs of society, the economy and the environment in the context of rapidly changing exogenous economic and climate change factors.

But to attract such investment, there must be a good prospect of fair returns for global investors who could choose to put their money into a number of other sectors and countries. The cost of equity proposals would create the lowest allowed cost of equity of any UK regulator and do not favour the stable long term investment we believe is needed.

We believe the cost of equity approach also fails to take into account the more negative investment climate that would be created by the rest of the PR19 proposals.

More specifically, we question the approach to the assessment of total market returns. To base a long term position on cost of equity on the assessment of an atypical period for low interest rates is to assume that a structural (rather than an unusual cyclical) shift has occurred. If this assumption is proved to be incorrect, the chilling effect on investment could be significant. The proposals also seem inconsistent with established CAPM approaches.

KPMG has published a report which reviews Ofwat's proposed approach. It sets out a range of issues relating to cost of equity which we believe warrant further consideration.[3]

Direct Procurement

We believe that the approach currently proposed could deny customers the option of an incumbent firm delivering major infrastructure, which could represent the best value for money option.

We would propose an amendment to the proposed DPC policy, aimed at maximising the range of available options, so that customers can benefit from the best value proposition. Our suggestion is an independent third party could run the procurement process. This would ensure a level playing field and enable all potential bidders, including in-area incumbent firms, to put forward proposals.

We considered whether such an outcome could be achieved with the incumbent running the procurement process. However, we conclude that the additional costs and complexity of operating "Chinese walls" and the perception of unfairness if an incumbent (or related party) were awarded the DPC contract make this an unattractive option.

We have also given thought to how DPC arrangements could work on an ongoing basis during delivery of the project, and ongoing operation. Part of the argument in favour of the incumbent running the procurement is that it would then take on a role beyond this point in holding the DPC partner to account. However, this issue only arises as a consequence of Ofwat choosing not to pursue the option of requiring a licence for the DPC entity, as we have previously argued would be preferable.

Notwithstanding this point, if a non-appointed business within the incumbent's group were successful in a procurement exercise, we believe this entity can still be held to account during the delivery of the project. This is partly because the appointed business would in any case be incentivised to ensure that the project was being delivered on time and to budget, and then operated efficiently, to meet the needs of its customers. In addition, it can be assured through the existing transfer pricing rules, and through Ofwat's regular engagement with the appointed entity. We also consider that the whole approach could be strengthened if the DPC project were subject to a separate price control, which could bring significant benefits through the inclusion of mechanisms to check that customers' interests are safeguarded. Finally, the option of more formal regulatory enforcement action would still be available to Ofwat as a backstop should concerns arise.

Under any procurement structure, we would suggest that bidders should be assessed against a simple "best bid for project" template. If incumbents are not allowed to bid, it will be difficult to assess whether bids received are better than the incumbent's offer. We would want to work further with Ofwat to ensure that customers are not disbenefited by the approach to DPC procurement.

3 http://www.anglianwater.co.uk/about-us/statutory-reports/ KPMG: A review of Ofwat's proposed approach to total market returns

We would also propose that, recognising that DPC is a new approach being trialled in PR19, the threshold at which DPC is expected to be considered could be more simply defined. We think a £100m capex threshold is preferable to a whole life totex threshold (which could draw in smaller schemes where the benefit of a DPC approach is not clear). We would also stress the importance of assessing schemes against the discrete criteria, as it is in the case of large-scale discrete schemes where the potential benefits of DPC, and attractiveness to potential investors, are most apparent.

Cost assessment

We consider that the timetable proposed for companies to submit special factor claims is inconsistent with the primary purpose of special factors, namely to reflect appropriately those factors which are not adequately captured in the cost assessment modelling framework.

Requiring such claims to be submitted ahead of sharing the cost models undermines this objective and potentially creates a significant amount of abortive work for companies. The importance of special factors is further reflected by the role they play in the initial assessment of companies' business plans.

In our previous W2020 response we advocated an alternative timetable which proposed that Ofwat published their cost assessment models simultaneously with the submission by companies of their business plans. The case for this simultaneous "reveal" of cost assessments is strengthened should Ofwat proceed with its proposed cost sharing mechanism, where companies' cost sharing rates are determined by the ratio of companies' and Ofwat's assessments. We still believe such an approach has much merit. It would allow companies to develop special cost factors to reflect elements not adequately captured in the models. It would also allow special cost factors to be submitted ahead of Ofwat's initial assessment of business plans.

In addition to the cost assessment modeling framework, there is a need for a robust approach to determine efficient enhancement expenditure, which is fundamental to the delivery of long term customer priorities. This expenditure, by its nature, will not be modelled in <u>base</u> operating and maintenance expenditure ("botex") cost assessment models. Enhancement expenditure may be operational as well as capital expenditure. An example would be the potential enhancement expenditure on water efficiency, which is of particular importance in the East of England. We suggest Ofwat should consider how such enhancement opex should be captured in the data tables.

ODIs

As mentioned above, we support the general position to strengthen incentives on ODIs but would argue that higher reward rates should also be available for significant outperformance more broadly rather than just for common performance commitments.

More broadly, the calibration of ODIs as proposed seems to create a level of asymmetry as between penalty and reward. If "an average company with average performance would expect to incur penalties on its ODI package rather than rewards", this could result in a situation whereby a company could deliver good improvements against its base position but still be penalised. A tough but fair regime would, we believe, see such companies at least in a neutral position.

Whilst we aim for and expect to be a high performing company, the ODI framework should reflect that no company is likely to be able to deliver upper quartile performance across the board.

Therefore the overall balance of rewards and penalties should be calibrated recognising there will naturally be some variations in performance levels achievable across the suite of ODIs.

Consistent with our response to the November Outcomes consultation, we remain very concerned by the proposed definition of the water mains Asset Health measure. As currently defined, the headline measure proposes to include all bursts. It also ignores the leading practice of accounting for seasonal and severe weather. We have significant reservations on an "all bursts" approach. As we strive for lower leakage levels (as an important element of our wider demand management strategy) we and other companies will detect significantly more hidden burst mains. We believe this should be encouraged. However, if proactive mains bursts detection leads to a potential penalty for companies, this creates a perverse incentive against such activity. We would ask that Ofwat reconsider this approach to avoid such an outcome.

Leakage

We agree with Ofwat that reducing leakage should be an imperative for PR19 given the scale of water resources challenges facing the sector. We also agree that companies should be set ambitious targets, although note that achieving upper quartile, based on 2016-17 reported performance of leakage per km and per property, requires the bottom three companies to reduce their leakage by 30% to 50%.

Our concern is that Ofwat's proposed approach may not recognise outstanding performance at the frontier, especially where performance is already significantly ahead of upper quartile. We have delivered frontier performance on leakage so far during AMP6 and are committed to going further – our SELL in 2015 was 211 Ml/d and we are committed to reducing this to 172 Ml/d by 2020, a reduction of 19%. Our journey of delivering this step change in leakage started in AMP5, and has required very significant expenditure, significant management time and, in large part, has been done at our own risk, under the existing ODI framework (with remuneration dependent on delivery of stretching performance targets.)

We do not believe that targeting a further 15% reduction in Committed Performance Levels for leakage is appropriate for companies already at the frontier of performance. We recommend that the approach, which we developed at PR14, of funding and rewarding performance that shifts the frontier through an ODI mechanism should be retained for PR19.

We would also propose that the starting totex position for leakage for AMP7 should reflect the full expenditure associated with achieving stretching AMP6 performance commitments such as ours, and that the cost models should fully reflect this.

The mechanism could also be adapted and improved through Ofwat's proposed use of enhanced rewards. Enhanced rewards would also recognise that it is significantly more challenging for companies at the frontier of performance to improve compared to those who are further behind.

2015-20 performance

One area not currently captured under the tests for the initial assessment of business plans is the level of ambition shown in companies' current business plans. This needs to be taken into account and should allow companies which are currently meeting challenging performance commitments to be considered more favourably than companies with less stretching performance targets.

Transition Programme

We believe the transition programme was a positive addition to the PR14 price control methodology and should be retained for PR19. The benefits in attenuating the regularly observed dips in expenditure (and associated inefficiency) in the first and last years of a price control were recognised at that point by Ofwat, IUK and industry specialists. They are also confirmed in the Government's 2013 Strategic Policy Statement[4], and we believe hold good today. Indeed, as we enter a period that is likely to see significant activity across infrastructure sectors, the ability to retain a smooth profile of investment may be even more to the fore. We made good use of this mechanism at PR14, the expenditure positively benefited our customers and was initially funded by our shareholders.

Tax

The draft methodology recommends that companies should use the actual capital allowance balances forecast to be included in their 2020 tax computation, rather than a notional balance. This approach seems to us to be contrary to the advice that Ofwat received from Deloitte, is contrary to Ofwat's usual practice in other areas (where it expects the regulated entity to be treated on a stand-alone basis), and is inconsistent with the approach elsewhere in the methodology, where Ofwat views water companies on a notional rather than an actual basis. We would ask that this point be reconsidered.

Initial Assessment of Business Plans

Relative to PR14, the greater visibility of the Initial Assessment of Business Plans (IABP) framework is a positive step. In terms of the assessment criteria, we believe that Ofwat should be clear how performance on each test contributes to the overall IABP.

We do not agree that Ofwat's starting assumption should be that all plans will require significant scrutiny. We believe that a company's plan should be presumed to follow the "standard" regulatory process, in this case "slow track" (itself perhaps an unfortunate descriptor). It should then be categorised upwards or downwards based on the evidence within the plan. In our view, any other approach is inconsistent with wider regulatory approaches such as the Company Monitoring Framework and the description of significant scrutiny set out in appendix 14.

Conclusion

As we have discussed above, we support the introduction of stronger incentives and are happy to be judged on our performance. We believe we have a good track record in delivering against our current ODIs.

However, we are concerned that the overall effect of the proposed methodology relating to the building blocks for the cost of capital, risk and reward could be negative in relation to future

4 Defra's strategic policy statement to Ofwat, March 2013, para 2.13,: "Government expects Ofwat to take forward the recommendations for changes to its approach to address the impact of investment cycles in the water sector in reducing the productivity of infrastructure delivery."

investment in the sector. This is a particular concern when considering the 2020-2025 period where we expect significant additional investment may be needed to ensure resilience, to maintain and enhance the environment, to support the aims of the Government's emergent industrial strategy, and to underpin the significant housing growth needed in the East of England.

Where exogenous factors (including the uncertain macroeconomic position the UK may be facing as a result of Brexit) are likely to increase systemic risk, we believe there is an argument in favour of the regulatory framework acting as a stabilising counterweight to support resilience investment. We do not believe this is likely to be achieved if the PR19 methodology is implemented in line with the consultation.

Annex – Response to individual consultation questions

Affordability and vulnerability

Q1. Do you agree with our proposal to use the five principles of customer engagement; customer support; effectiveness; efficiency and accessibility to assess how a company is addressing affordability in their business plan?

Yes, the five principles cover the broad nature of affordability. We note that affordability as set out in the consultation relates to three areas: overall affordability, long-term affordability and affordability for those struggling to pay. The methodology sets out the expectation that companies explain both the range of activities they propose and how effective these approaches are. It is important to establish how the assessment of the three affordability aspects will be balanced. Otherwise, too much focus on one aspect (e.g. overall affordability) could have a detrimental impact on the broader objectives of companies' plans (e.g. long-term investment and resilience).

Q2. Do you agree with our proposal to use information and measures, including possible common measures, to assess how a company performs against the five principles in addressing affordability in their business plan?

The consultation is clear that companies are expected to capture the full range of costs and benefits associated with the range of affordability measures it proposes. We believe this runs the risk of oversimplifying the complexities of assessing the range of activities companies undertake as part of managing affordability. We would be concerned if Ofwat proposed only to allow recovery of costs for the activities dependent on full quantification of benefits.

For example, we regularly run randomised control trials (RCTs) relating to our debt management strategies. We consider are approaches for managing affordability as they contribute to reducing bad debt to the benefit of the broader customer base. The discrete benefits associated with these approaches are difficult to capture given the need to control for wider factors which could also be impacting on the effectiveness of such trials (e.g. changes in wider macroeconomic factors affecting customers' ability to pay).

In relation to the sources of information for assessing affordability (table 3.2 of the methodology) we believe some of the quantitative measures need further detailed consideration on their appropriateness. For example, "the number of customers engaged with on affordability in the company business plan" is a relatively crude measure and only captures quantity and does not capture the underlying quality of engagement, which should the primary consideration. As stated above, we also think further development work on costs and benefits is required.

Q3. Do you agree with our proposed option for requiring companies to propose bespoke performance commitments for addressing vulnerability in their business plan?

We agree that vulnerability is an important matter, that affordability and vulnerability are related and that this relationship will be both transient and vary, dependent on the nature of customer and their individual characteristics.

Reflecting the importance of this topic, and drawing from our own research and emphasis on this topic, our Customer Engagement Forum has established a Vulnerability sub-group to explore these issues and how effectively they are reflected in our PR19 business plan.

We do not agree with the assertion in the consultation that understanding and addressing vulnerability will naturally result in lower costs through fewer unpaid bills. Certain supporting activities for vulnerable customers can be hugely beneficial to the benefiting customers but will not have any direct affordability impact. For example, as we increase promotion of our priority service register along with expanding the qualifying criteria to support further vulnerable groups in the event of an interruption to supply, we will incur additional costs which would not see a corresponding increase in revenue or reduction in bad debt.

The proposal for a bespoke commitment for vulnerability seems appropriate given that the potential scale and nature of vulnerability will vary from company to company. The detailed design of such measures, including whether these have associated rewards and penalties, will need to be subject to further consideration and customer engagement and support.

Q4. Do you agree with our proposed option for using measures in our assessment of companies' approaches to addressing vulnerability in their business plan?

We support the principle of building measures and are pleased that Ofwat recognises the need for these to be developed with in collaboration with wider stakeholders. We recommend this includes appropriate third parties such as the Citizens' Advice Bureau and CCWater.

We do not offer specific views on the proposed measures at this stage as it is difficult to do this in absence of robust standard definitions. These will be essential if they are to be used as common measures, and potentially as common performance commitments in future (e.g. from PR24). We look forward to working with Ofwat on this.

Outcomes

Q1. Do you agree with our proposals for common and bespoke performance commitments?

Q2. Do you agree with our proposals on setting performance commitment levels?

We are broadly supportive of Ofwat's approach to common and bespoke performance commitments. The guidance provided on setting performance commitment levels is clear on the process and techniques that should be used.

There are however, several common performance commitments where we think the definitions proposed lack clarity. For measures where Ofwat proposes common industry targets, and where financial incentives may be attached, it is critical that these definitions are robust. They also need to be established in good time so they can effectively form part of our customer engagement programme and so we can set challenging performance commitment levels that are based on genuine reliable benchmarks. Where possible, we would like to engage early with Ofwat to accelerate the conclusion on final definitions.

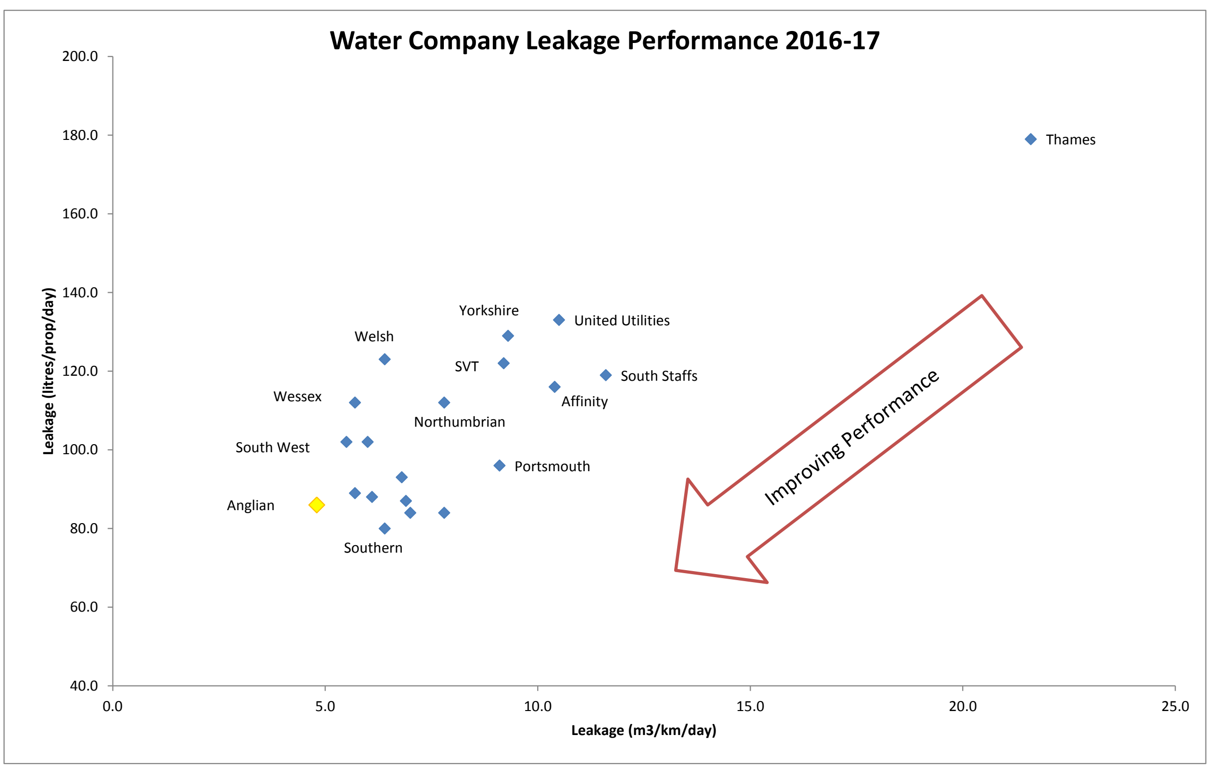
Our most pertinent concerns related to specific performance commitments are:

- Leakage – the general approach to setting performance commitments and whether the incentive framework is suitable for a frontier company.
- Water quality – we have substantive concerns about the application of the new definition to set industry performance commitment levels.
- Asset health – we remain concerned about how robust the definitions are, and whether the proposed metrics will encourage the desired change.

Leakage

We agree with Ofwat that reducing leakage should be an imperative for PR19 given the scale of water resources challenges facing the sector. We also agree that companies should be set ambitious targets, although note that achieving upper quartile, based on 2016-17 reported performance of leakage per km and per property, requires the bottom three companies to reduce their leakage by 30 to 50%.

Our main concern is that Ofwat's proposed approach may not recognise outstanding performance at the frontier, especially where performance is already significantly ahead of upper quartile. We have delivered frontier performance on leakage so far during AMP6 (as illustrated by the chart below). We're also committed to going further – our SELL in 2015 was 211 Ml/d and our target is 172 Ml/d by 2020, an outperformance of 19%.



Our journey of delivering this step change in leakage started in AMP5, and has required very significant expenditure, significant management time, and in large part has been done at our own risk, under the existing ODI framework (with remuneration dependent on delivery of stretching performance targets.)

We do not believe that building further stretching targets of around a 15% reduction in leakage in to Committed Performance Levels is appropriate for companies already at the frontier of performance, and where performance is beyond the upper quartile. We recommend that the approach, which we developed at PR14, of funding and rewarding performance that shifts the frontier through an ODI mechanism, should be retained for PR19. The mechanism could also be adapted and improved through Ofwat's proposed use of enhanced rewards for exceptional performance.

We would also propose that the starting totex position for leakage for AMP7 should reflect the full expenditure associated with achieving stretching AMP6 performance commitments such as ours, and that the cost models should fully reflect this.

Enhanced rewards would also recognise that it is significantly more challenging for companies at the frontier of performance to improve compared to those who are further behind.

Water Quality

We remain supportive of including water quality as a common performance commitment. Water quality remains customers' highest priority and customers expect safe and clean drinking water. We have actively engaged with the DWI (and will continue to do so) to support the development of the new Compliance Risk Index (CRI).

However, the new CRI definition is in its infancy and we are not convinced it represents a solid base on which to make comparative assessments with rewards and penalties on water quality across the whole industry. For example:

- We expect the CRI to be highly volatile as individual failures vary year on year. This will make understanding, and then setting, targets under Ofwat's upper quartile approach challenging. In addition, there is currently limited historical data for the CRI across water companies, which will compound this challenge.

- The CRI measure includes Metaldehyde failures. This is a concern for us due to the high levels of Metaldehyde application to agricultural land in our region. We recognise we have a role to play in reducing Metaldehyde use, but failures are largely beyond our direct control. Catchment and abstraction management do not guarantee compliance and discussions with Defra are ongoing regarding a targeted ban which would provide a better solution than can be achieved by existing methods. We think the inclusion of Metaldehyde in any performance setting, when compared to other companies, provides an imperfect reflection of our performance on water quality in our region. Without a targeted ban we do not expect to be able to reduce our CRI and inclusion will therefore contribute to substantial volatility in the CRI score each year.

- As the measure is a sum of the issues identified by each water company, the CRI could be seen to unfairly penalise the larger WASCs who take more samples compared to WOCs.

Therefore it may be appropriate to consider whether there should be a separate measure for each.

As an industry we need to think further about how to set challenging, yet credible, targets in this area that do not place undue risk on customers or companies, or damage public confidence in this new measure. We think that the final decision on company performance measures can only follow once the measure is better understood and after further discussions take place with Defra, DWI and the Environment Agency about Metaldehyde. Until then, it is difficult to realistically set performance measures for companies – particularly where Metaldehyde affects their scores. We think Ofwat engagement in further discussions on the metric is vital, to ensure changes can be reflected as part of its decision in December.

Asset health measures

We think that fundamental issues remain with regard to the asset health measures as currently proposed. We believe changes should be made prior to their implementation as robust common measures for PR19. Confidence in the common measures is vital, specifically to ensure a level playing field on reporting and data definitions. This is particularly important where performance commitment levels and financial incentives are influenced by companies' relative performance. We currently do not have sufficient confidence that any of the common measures proposed are on a similar basis across all companies, so we are unable to endorse them as part of the PR19 package.

In particular, we are concerned:

- that Ofwat has not given due consideration to the concerns raised during the November 2016 outcomes consultation;
- that in some cases, the proposed measures are not joined up with the wider package of performance commitments and could incentivise the wrong behaviours; and
- that transparency and legitimacy for customers will not be achieved if what is being reported is not a robust and valued measure of performance.

Ofwat needs to act quickly on these proposed measures in order to assure themselves, the industry, and customers, that prior to adoption as common measures:

- they do not have any perverse incentives; and
- there is confidence in the standardised reporting by all companies.

This looks challenging by the December publication of the final methodology, but we feel it is essential for us to engage effectively with our customers as part of our business plan.

A framework for assessing whether a common performance commitment is suitable

In our response to Ofwat's November 2016 outcomes consultation, we provided detailed comments on what is needed for the appropriate application of common performance commitments, including:

- That great care should be taken in setting targets until consistent definitions have been agreed.
- That all companies should be reporting against consistent definitions with confidence that those definitions are being applied in the same way by all companies.

- The need for Ofwat to ensure that it has systems in place to ensure companies act in compliance with consistent definitions.
- That for any robust comparative assessment to be made, an historical dataset collected on a consistent basis for a number of years should be available.

We also highlighted specific challenges with respect to the two asset health measures that were proposed at this time – mains bursts and sewer collapses. The draft methodology does not respond to these specific challenges.

As a relative reference, there is value in considering the process to establish confidence in the metrics that were part of the Consistency Report (leakage, sewer flooding and supply interruptions). This work programme spent around 18 months building up industry definitions, and is now implementing a period of shadow reporting. In their first shadow reports, companies will report their data for 2016-17 but also describe the extent of their compliance with the reporting requirements. This latter part is essential for knowing how far we can rely on the industry dataset for identifying reliable benchmarks and proposing challenging PC levels.

Mains bursts

Ofwat has set out clear expectations in the methodology consultation that reducing leakage over AMP7 is extremely important. This aligns with our continued focus and customer priorities. For example, Ofwat stated that *"Reducing leakage continues to remain a top priority for customers and the UK and Welsh governments"*[5] and the incentive will be subject to stretching leakage targets.

We think the mains bursts measure, capturing all mains bursts, works in direct opposition to the aim of leakage reduction and creates perverse incentives for companies. This is because, under this measure, positive actions a company takes to proactively search for and repair burst mains to reduce leakage will result in penalties. We made this point in response to Ofwat's November 2016 outcomes consultation. In light of Ofwat's clear expectation for leakage reduction, we think this point remains pertinent, as we would expect to see a substantial increase in mains bursts numbers across the industry during AMP7 if companies respond to the leakage challenge. There is therefore a lack of joined-up thinking within the methodology between the focus on reducing leakage and the proposal for a common ODI which has the effect of penalising the activity companies need to undertake to achieve that reduction.

Our second major concern is that the proposed measure makes no allowance for the fact that mains bursts numbers are highly dependent on exogenous variables, in particular weather patterns affecting soil moisture deficit and temperature. Without any recognition of this, companies could attract penalties (or potentially rewards) due to factors largely outside their control.

At PR14 we proposed a mains bursts ODI which tackled both of these problems[6]. Firstly, it would take account of reactive bursts only – that is, bursts which are found and reported by customers. Proactive bursts (those found by the company, whose numbers will rise and fall according to leakage detection effort) are not included. Secondly, we would not benchmark our burst numbers against a static target, but against a modelled estimate of the number of bursts we would expect to

[5] Taken from Appendix 2, Page 50, of the PR19 methodology consultation
[6] This was based on our Wispa modelling

see given the prevailing environmental factors. This approach seeks to eliminate the weather factor, revealing the true underlying performance.

We understand Ofwat's desire to limit exclusions within metrics. However, we firmly believe the measure proposed represents a backward step relative to the metric we use now. Ofwat accepted our case at PR14 that exogenous variables should be controlled for. We do not understand why this has changed. We would be happy to discuss this important point further, and we strongly commend that this, or a variant, should replace the proposed mains bursts measure in PR19.

Unplanned Outages

The types of outage reported under this measure are at the site level (linked to maximum output and not actual customer demand). This can affect companies in different ways, depending on how well they have managed their water supply network and how resilient they are. For an integrated and resilient network to only consider the impact of an unplanned outage at site level, rather than network level, does not reflect effective asset management planning.

Planned refurbishment carried out at low demand periods can take advantage of redundant spare capacity in the system. This lower demand can allow for unplanned outages to occur without customer detriment. This approach to planning is good practice and protects customers as the work is at periods of maximum spare capacity. However under the proposed measure, companies could be penalised for unplanned outages where there is no elevated risk to customers. The example below illustrates this:

Example of proposed outages metric penalising effective asset management

Assume:
- Site maximum output of 250 Ml/d
- 6 pumps @ 50 ml/d each. 5 on duty; 1 standby
- Usual high season demand 220 Ml/d
- Usual low season demand 150 Ml/d

Scenario where company follows an optimal asset management approach of maintenance in the low season:

High season:
1 unplanned outage would mean:
- no loss of maximum output (as the standby pump is deployed); and
- no actual customer impact, but no spare capacity left in system.

Low season:
1 pump out for planned maintenance and 1 unplanned outage would mean:
- loss of maximum output 50 Ml/d (to 200 Ml/d); but
- still 50 Ml/d spare capacity left in system (as lower demand) and no elevated risk to customers.

Conclusion:
Unplanned outages introduced as a performance commitment could unfairly penalise a company optimally managing its assets, where there is no elevated risk to customers.

We consider it reasonable for Ofwat to allow companies more time to understand how the measure works, as it may create perverse incentives, such as a reluctance to remove assets for planned refurbishment as illustrated in the above example.

Sewer collapses

Under the proposed measure companies will be judged on the total number of sewer collapses. This could reduce the incentive for companies to put in place proactive monitoring systems to detect sewer collapses. Over AMP6 we have seen considerable success from our CCTV programme. This has provided us with valuable intelligence about our wastewater network and, through proactive actions to reduce sewer collapses, helped to drive improvements in other performance commitments related to pollution and flooding.

As an industry, there has been little work to understand how and whether companies would report under the proposed definition in a consistent way. This is vital before a robust common measure can be put in place. One clear change to consider is for the measure to make a distinction between proactive and reactive actions to address sewer collapses.

Pollution incidents caused by non-infrastructure

We are concerned that the introduction of this measure would create a double jeopardy situation, where companies could be penalised twice for incidents that appear here and in the category 3 pollutions common measure. In addition, we do not support the inclusion of category 4 incidents. These are incidents with relatively little or no impact on the environment; their inclusion may drive the wrong behaviours in companies as they seek to reduce these, rather than incidents that could have a more material environmental impact.

We think further thought should be given as to whether the established 'Treatment Works Compliance' measure would be a more appropriate metric to understand how well treatment works are operating. This is a measure that is consistently reported by the industry and has historical data on which to base a performance commitment level. We acknowledge that this does not cover the full range of non-infrastructure assets, but would argue that treatment works are the most substantive group of assets within the class.

Bespoke asset health measures

We support Ofwat's long list of other asset health measures that companies may select from as part of any bespoke performance commitments. We also welcome the flexibility to allow companies to develop their own measures.

Other points on the proposed performance commitments

Resilience

It is vital that the industry prepares for future resilience challenges deriving from growth and climate change, so that services for future customers and the environment can be safeguarded. We welcome the proposal to reflect resilience measures in the common performance commitments framework, along with the opportunity to propose a bespoke financial incentive as part of our business plan.

Water resilience

We support the proposed definition for risk of severe restrictions in drought. The proposed metric is a simplification of the approach proposed by the Water Resources Long-term Planning Framework group and the definition that arose from the UKWIR (UK Water Industry Research) and WWRAG (Water and Wastewater Resilience Action Group) work. We believe that simplification is appropriate given the WRMP planning guidance requires plans to be prepared on the basis of a reference level for drought risk of 1 in 200 years.

We agree with Ofwat that a financial incentive should not be mandatory at this stage.

The WWRAG also proposed three other measures of water supply resilience:

- Interruptions to supply
- Water assets at risk of flooding
- Percentage of customers reliant on a single source of supply.

The interruptions to supply measure is already included in Ofwat's proposed common metrics; the other two metrics were included in a number of companies' ODIs at PR14 and it seems sensible that these be considered as bespoke metrics for PR19, rather than in Ofwat's common metrics.

Wastewater resilience

We agree with Ofwat on the challenge of developing a common performance commitment measure for wastewater. We have, and will continue, to be engaged and play an active part within the various industry groups looking at the potential metrics.

While we consider substantial progress has been made, it will be challenging to finalise a common performance commitment for PR19 that can readily be adopted as a robust comparator of performance across companies. As such, we welcome the flexibility to consider bespoke commitments in this area, whilst remaining committed to finding a common metric that all can agree on.

Currently we do not have a clear preference in terms of the metrics options put forward in the consultation. We support the work recently commissioned through to develop further the potential wastewater resilience metrics. From the list of options two appears the most readily implementable. Our comments in the table below highlight some of the key areas that will need to be considered before it is possible to give a firm view on the best measure. Confidence in the metric being used to measure performance is crucial if it is to be adopted and we agree with Ofwat that a financial incentive should not be mandatory on companies at this stage.

Metric Option	**Comments**
1a and 1b	a) Under this proposal a level of risk (from 1 to 5) will be assigned to each catchment. Many of the characteristics are not in our control, in particular, the low lying region in which AW operates means that most of our catchments will be in the highest risk categories. It will be vital that Ofwat recognises this in any cross company comparisons. b) The 1 in 50 year return period to apply to the drainage capacity model is not a return period we recognise for planning/sewer flooding comparisons. We would like to understand the rationale for selecting a particular return period associated with a catchment. Were a 1 in 50 year period seen as the industry expectation of resilience, this could have a substantial impact on the level of investment required to be resilient to this extreme event. c) It is worth exploring whether the workstream 2 model cited under step 3 could be used to measure the risk grade of all the catchments (replacing the need for steps 1 and 2). This model was developed by the industry

	over several years and may be superior to the use of the consequence table set out in the consultation – it would certainly provide an established and consistent approach to identifying catchment risk. d) Under option 1b - the return period used increases with the risk grade. It might be better to consider whether the return period should be reversed i.e. for risk grade 5 use a lower return period such as 1 in 10. The logic being that for a high risk area you should be concerned if it couldn't withstand a relatively small amount of rainfall. e) The process looks very manual and time consuming and is very narrowly focused on flooding from our assets but not other's drainage assets.
2	As a potential performance commitment measure this option may have some merit and should be explored further. Two key challenges are: a) Combined Sewer Overflows (CSO) event monitoring is at an early stage of development and therefore it may be difficult to adopt as a robust industry wide measure. b) It's arguably not a broad measure of wastewater flood resilience and might sit better as an environmental outcome.
3	We think this option would be difficult to apply as a common measure because of the varying opportunities to remove surface water from large area across the country. It might be more relevant for high growth urban environments. As such, we think the measure may be better as a potential bespoke performance commitment, as per Thames Water's SB5 performance commitment in PR14. This is something we will look to explore as part of our customer engagement alongside our plans for surface water management.

Internal sewer flooding

We remain committed to a comparable and consistent approach to reporting and measuring flooding incidents. That said, the new definition is in its infancy which raises questions about using it to set a stretching, but credible, common industry performance target under the upper quartile approach set out by Ofwat. Indeed, in appendix 3 of the consultation, the challenge of using the definition to make historical performance comparisons at both a company level, and between companies, is acknowledged. While we think in the future this will improve, we need to be able to make a robust assessment of what we think is achievable at an individual, and industry level, next year in our business plan.

Some other specific comments include:

- The proposed measure for the performance commitment, and associated ODI, is the number of incidents. However, this will need to be normalised (e.g. by number of properties or length of asset). Setting an industry target based on the upper quartile with no normalisation will unfairly affect larger companies.
- The proposed metric will create two datasets for internal sewer flooding, one including severe weather and one excluding it. We believe both measures should be reported. It is currently unclear which one will be used to set the performance commitment level.

However, the challenges noted on cross-sector comparisons are further compounded with the inclusion of weather related incidents.

We think further discussions are required with Ofwat on the practicalities of using this measure to set performance commitment levels.

Wastewater pollution incidents (category 3)

We agree with the inclusion of pollution incidents as a common performance measure as it covers a key stakeholder priority that has historically also shown strong customer support. However, as noted under the asset health measure, we are concerned that the introduction of Non-Infrastructure Pollution Incidents will create a double jeopardy situation, where companies could be penalised twice for incidents that appear in both categories. It is also important to note that any cross sector comparison of performance under this measure is a reflection of both company performance and factors inherent to the region that the company operates within.

Per capita consumption (PCC)

We are content with the inclusion of a standard consumption metric into the common performance commitment framework. It is however vital for Ofwat when making, and communicating, any cross sector comparisons to be clear on the reasons why the PCC may vary between regions and companies. Together with a number of other companies, we have recently commissioned a report by Artesia[7], the draft of which highlights a number of the drivers of consumption, including weather, socio-economic factors, housing type and demographics. The report also highlights the particular difficulties in reporting PCC and suggests that Per Household Consumption (PHC) is a more reliable metric.

We would suggest discussing the findings of this report with Ofwat and other stakeholders to ensure that meaningful comparisons can be made.

We think the definition proposed could be improved by:

- Making clear its interaction with the new leakage guidelines as set out in Appendix 3.
- Setting out the timing of the measure that will be used for any performance commitment measurement. Given its linkage to leakage we think it should be on a consistent basis, i.e. 3 year rolling average, to smooth out the impact of weather events. It should also be noted that the introduction of a consistent approach to reporting leakage may result in changes to previously reported PCC as unmeasured consumption is re-estimated as the water balance is rebalanced.

Process for arriving at final definitions for performance commitments

We would welcome further guidance on the request for companies to submit performance commitment definitions to Ofwat on 3 May 2018. Having clarity on the definitions is vital when engaging with customers. Given this importance, we think engagement with Ofwat on the

[7] Artesia - Planning for the future: a review of our understanding of household consumption in the UK – a Joint project with Thames, Affinity and South East Water. The final version of this report will be shared with Ofwat upon completion.

definitions could start as early as January – this is also consistent with when Ofwat expects to discuss with company's their broader customer engagement plans.

We would also welcome clarity on the following areas related to the May definition submission:

- Will Ofwat provide feedback on the submissions?
- Will company submissions, and any Ofwat response, be public or private?
- Could Ofwat, following its review of companies' bespoke measures, look to introduce so of them as common measures? This was the case for PR14 and would be concerning if repeated, particularly for our customer engagement process.
- How will Ofwat review definitions for the common performance commitments in May? It is our understanding that the Final Methodology document in December will confirm these definitions. Is Ofwat's intention that, in May, companies can propose further changes to the common definitions in exceptional cases? While this may be necessary in some areas, Ofwat must be mindful that late changes to common measures may be especially challenging for companies to manage late in the business plan development process and could undermine their customer engagement.

Q3. Do you agree with our proposals for strengthening outcome delivery incentives?

Consistent with our response to the previous November 2016 Outcomes consultation, we agree in principle that ODIs should be made more powerful as reflected by the removal of the cap on ODI rewards and also the change for the indicative RoRE range for ±1% to ±3% of RoRE.

The consultation and subsequent conversations confirm Ofwat's preference for most of the weight of potential rewards and penalties to be borne through the common performance measures, including enhanced rewards and penalties for companies proposing to shift the frontier of performance for the sector.

This reinforces the position we set out in our previous consultation response and repeated above, that practical considerations in terms of standardisation of definitions must be resolved prior to Final Determinations to ensure that stakeholders have confidence that rewards and penalties are driven by genuine performance rather than reporting differences.

In general, we are supportive of the proposal for enhanced rewards which push forward the frontier performance for a specific performance measure. We would argue that such rewards should also be potentially available for bespoke ODIs as well.

We note Ofwat's preference for financial and in-period ODIs. In our previous response to the outcomes consultation we advised against over-prescription on this issue. Noting Ofwat's preference, we remain of the view that the type, scale and timing of ODI rewards and penalties remains a matter for companies, their customers and CCGs to determine. Companies should therefore not be penalised if the final proposals for ODIs, backed by customer support, do not fully align with Ofwat's default position.

Q4. Do you agree with our proposed Customer Measure of Experience (C-MeX)?

Having reviewed the three potential options for the operational of the future C-Mex measure set out in the consultation, our views align with Ofwat's preference for option one i.e. a 50:50

weighting between the customer service and customer experience study. This is associated with a move to companies' performance on the volume of complaints being a reputational only measure.

The majority of our comments relate to the detailed design and implementation of both survey elements and the classification of complaints. We consider the non-contact component of the proposed C-Mex is the area which requires most targeted focus and development. With respect to benchmarking to the UKCSI all-sector measure, we are concerned that the sample size used in the measure means that a company's performance can be benchmarked based upon a very low sample size which may not be representative.

Previous experience of the development and refinement of SIM demonstrate there is significant effort required to ensure measures are implemented and interpreted in a consistent matter. We propose the following questions require clarification:

<u>Definition of "contact"</u>: Whether a customer has contacted the company is the central differentiator between the two survey components of C-Mex. It is therefore important to clarify upfront what types of interactions with customers are included in the respective surveys. Clarity on what is included in each of the surveys is needed – non contact versus contact. E.g. if a customer uses a web form is this considered a contact? Or in another example, if we proactively send the customer a message, is this considered a contact?

<u>Customer Service survey</u>: We support the use of "resolved" matters or complaints for this survey. The definition of what constitutes "resolved" will need to be developed to ensure confidence and consistent application across companies. We also note the proposal that the customer service survey could be conducted either online or potentially via text. We are concerned that conducting the survey only online (and/or text) will exclude certain cohorts of our customer base especially groups which may have characteristics which may them vulnerable. Finally, our experience of surveying suggests that these two options are not perfectly substitutable – e.g. a text based survey is likely to have a significantly higher response rate however this format generally restricts the number of questions that can be asked. In our experience more than three questions on a text based survey increases the drop out rate significantly.

<u>Non-contact survey</u>: We have a general concern that, unless carefully constructed, the non-contact element of the C-Mex measure could become an indication of the relative success of a company's marketing and brand recognition rather than offering genuine insight into the experience of customers who have not contacted their company during the survey quarter. The significant of this becomes increasingly important given the proposed benchmarking to the UKCSI all sector threshold.

There are also further considerations for the non-contact survey element which need to be explored, including how customers will be included in the survey and how the customers served by different companies for their water and water recycling services will be included. For example, some customers will receive their wastewater service from a company who does not bill them, making it difficult for these customers to routinely differentiate between the companies. One solution to this issue would be that it should be either the water or water and sewerage provider for the company included in their sample quota.

Survey quotas and in-period financial incentives: We note the proposal to move from an end of AMP period financial reward to an annually reconciled reward and penalty based on performance on the new measure. On this basis, and as part of the Task and Finish group, we recommend confirming the quotas and frequency of survey are appropriate given the proposed timing of incentives.

Complaint definition: Complaints performance is now proposed to be based on a reputational incentive and extended to include those received via social media. We believe this will have an unintended consequence of changing the incentives for companies to provide the broadest multi-channel approach to engaging with customers. A proposed alternative approach would be to base a measure on both positive and negative interactions as this will provide a better incentive for companies to increase their overall level of engagement with customers.

This increases the challenge around consistency of reporting of complaints and will be heightened by any differences in digital channels offered by companies.

Implementation timetable: We consider that the implementation timelines need revising. Publishing the final guidance in March 2020 is too late for companies to be able to make any final amendments and technical changes that may be required. We believe it would be essential to have clarity by December 2019 to allow for final changes to gain confidence that all companies will be able to supply the necessary data from the start of April 2020.

We anticipate these questions will be explored at the proposed C-Mex Task and Finish Group, of which we will be an active participant.

Q5: Do you agree with our proposed Developer Measure of Experience (D-MeX) ?

Overall

We fully support the proposal for a specific developer measure of experience (D-Mex). We believe Ofwat's preferred approach is proportionate and strikes the right balance for the reasons outlined below.

- The existing Water UK measures are process focused and we agree that a higher level, overall measure of service supporting the existing measures is appropriate.
- We agree that including developer services customers within the broader customer measure of experience (C-Mex) may dilute the incentive for companies to provide developers with an appropriate customer experience; and
- We agree that a common measure is appropriate. The reputational element of the incentive will be an important part of driving company behaviours. More bespoke arrangements (e.g. Ofgem's Incentive on Connections Engagement) could entail higher admin burden for companies, customers and Ofwat.

Segmentation of developer services customers, and how we receive, log and manage their contacts from developer services customers

Currently, we do not rigidly categorise our customers – we aim to provide an equivalent service to all customer types. Our customers can be broadly grouped as:

- Developers (repeat customers),
- Builders (generally one off customers),
- Self-lay organisations (SLO), and
- New appointment and variation (NAV) companies.

We receive contacts from customers via various communication channels. This includes via email, telephone and through our live chat facility.

Customers are often given a single point of contact in order to manage any ongoing communication once an application progresses. This is dependent on the nature of the customer requirements e.g. the type of infrastructure in question.

Dedicated resource will be assigned to jobs where appropriate. For example, for complex requisition schemes, a Growth Liaison Manager will coordinate the scheme from pre-planning through to connection.

Understanding the satisfaction of our developer services customers

We currently send customer satisfaction surveys upon completion of a job or activity. The surveys are either sent to our customers via email/post, or conducted over the telephone. Annually, we receive upwards of 1,200 survey responses from our customers.

The surveys are tailored to whether the job is water or drainage related, to ensure we receive the most relevant information back from our customers.

We capture our performance from the surveys, against the following key metrics:

- proportion of customers that are very satisfied
- net promoter score.

Performance against these metrics is reported internally on a monthly basis.

In addition to customer surveys, we actively monitor levels of service through the Water UK LOS metrics. Our performance is reported monthly to Water UK and published externally through the Water UK website on a quarterly basis.

Detailed considerations

Consistent with the development of the revised C-Mex incentive, there are a number of detailed design elements to be considered for the revised D-Mex measure. Some of the areas we have identified and given some initial though to are outlined below:

<u>Basis for inclusion in the survey</u> – Consistent with our comments on C-Mex, consideration is needed on when customers and jobs are eligible for inclusion in the survey. This could be on the basis of completed or ‘resolved’ contacts. However some large developments can take place over a number of years and capturing ongoing satisfaction, not just at completion, should be part of the measure.

<u>Segmentation and weighting</u> - Segmentation and the weighting of customer groups will be an important consideration and a vital part of the development of the detailed arrangements. Our initial view is that a key focus should be ensuring appropriate representation from large developers

in the surveys. These repeat customers represent a significant proportion of the overall value of transactions and play a key role in sustainable economic development of the nation.

NAVs and SLOs - We are keen to ensure that NAVs and SLOs are appropriately represented. There may be limited activity from these types of customers in certain regions and this may be, in part, the result of levels of service they receive. If the surveys are conducted only on the basis of completed jobs they may miss a portion of these customers. The basis on which surveys are undertaken (e.g. completed or resolved jobs), especially when some developments are multiyear, will be an important consideration for the Task and Finish Group.

Interactions with wider markets – Early proposals for the non-household retail market included developer contacts being primarily handled by retailers. This market structure could have a material impact on the D-Mex measure. The interaction with wider markets and likely market developments should be explored by the task and finish group.

Implementation timetable - We consider that the implementation timelines need revising. Publishing the final guidance in March 2020 is too late. We believe it would be necessary to have the final guidance earlier and believe the pilot should be held earlier. This will ensure that companies are able to comply with the final guidance well in advance of April 2020 when the incentive comes into effect.

We anticipate these questions will be explored at the proposed D-Mex Task and Finish Group. We will use our experience in this area to support the development of D-Mex through this group.

Resilience

Q1. Do you agree with our resilience planning principles?

Yes, we agree with the principles. We have, and continue to be, an advocate for putting long-term resilience at the heart of our approach to investment, operations, financing and governance. For example:

- Our Strategic Direction Statement, published in 2008, was structured around the need to be resilient to long-term challenges and our refreshed SDS, out for consultation at the time of writing, proposes resilience as one of our four long term ambitions;
- Long term resilience was at the heart of our PR09 and PR14 Business Plans;
- Jean Spencer was a member of the Ofwat Resilience Task and Finish Group and now sits on the Water and Wastewater Resilience Action Group.
- In 2015 we, together with Yorkshire Water and United Utilities, published "Long term challenges and uncertainties for the water sector of the future[8]"; and
- In 2016 Jean Spencer chaired Water UK's study of Long Term Water Resources Planning Framework.

The future challenges paper that we published, with Yorkshire Water and United Utilities, set the context for what the sector and wider stakeholders needs to address over the long-term to enable the ongoing delivery of secure reliable services for customers, the environment, and the economy and society more widely.

[8] http://www.anglianwater.co.uk/_assets/media/Water_2020_LT_Challenges_-_Final.pdf

The principles set out in the PR19 methodology capture those challenges, as well as the need to work with customers and others to deliver best value resilient services for customers.

We are particularly pleased that Principle 2 recognises the importance of naturally resilient ecosystems and biodiversity to delivering the services we provide.

Effective customer engagement and an understanding of customers' appetite for risk is critical to developing our long-term plans, as set out in Principle 3. Companies will need to balance their customers' appetite for risk with the direct impact on others should risks materialize. For example, drought restrictions impact other water abstractors, especially agriculture, and the environment.

We are concerned, however, as stated earlier in this response, as to whether other changes proposed in the methodology will hinder rather than help the delivery of necessary investment to address the growing risks to resilience. We also note Ofwat's intention to publish a further document in September 2017 which will contain further detail on Ofwat's expectations for resilience.

Q2. Do you agree with our approach to assessing resilience in the initial assessment of plans?

The assessment criteria set out in the consultation are sensible.

We are pleased that Ofwat recognises that companies should have regard to the wider costs and benefits to the economy, society and the environment. We believe this should include the sustainable use of natural capital. This is consistent with the approaches we are proposing in developing our PR19 plans.

On a point of detail, the Ofwat proposals on corporate resilience state that confidence on Board assurances will, in part, depend on the quality of past assurances and processes. This seems reasonable but only if those assessments are evidence based and proportionate. We do not consider that this was the case in Ofwat's Company Monitoring Framework assessment in 2016 where minor concerns were flagged relating to an immaterial cost allocation error (£21k) between retail and developer services and an item of casework in which Ofwat requested data going back to 2003 and suggested incorrectly that we had lost data. We infer these findings directly contributed to Anglian being classified in the "targeted" assurance category.

Wholesale controls

Q1. Do you agree with our proposals for the form of control for network plus water and network plus wastewater set out in the 'Wholesale controls' chapter and appendix 7, 'Wholesale revenue incentives'?

The proposed approach in relation to Network Plus controls appears reasonable and appropriate.

Developer services

We understand the retention of developer services charges within the control on a "single till approach", and on this basis welcome the proposal for a period-end adjustment to revenues based on a symmetric volume correction mechanism, to allow for changes in demand. This recognszes the disincentives that were structured in to the wholesale control at PR14. However, the mechanism for the average cost and contribution value of this adjustment will need further clarification. Specifically, we would ask whether this proposed average cost is to be a company-specific average cost or an industry-wide one?

Equally, we would appreciate clarification as to whether this is average revenue at the PR19 price base uplifted by the relevant inflation index, or (as with retail cost to serve) it is a value to be set out in the Final Determination and therefore not subject to indexation. There is a strong case that these revenues should be indexed as this would be consistent with indexation of associated developer services costs in the price controls.

We would also appreciate clarification as to how the developer services period-end volume correction for average revenue works alongside the in-period revenue adjustment for the broader Network Plus total revenue control. Our experience shows that the proportional variability in these developer services is sensitive to macroeconomic drivers to a greater degree than variability in main charges revenues. Such macroeconomic drivers and wider exogenous factors (e.g. impact of weather on demand and metering uptake) are outside of a company's control when forecasting main charges.

We recognise that any forecast submitted as part of companies' business plans (i.e. in 2018) will be a forward forecast covering a 7 year period. Companies' ability to accurately forecast this activity will be significantly impacted by a range of wider factors, (e.g. the UK's referendum vote to leave the European Union, the uncertainty of the political implementation of this vote, the accuracy of Local Plans and wider macroeconomic considerations) all of which could result in significant volatility in the housing market.

Against this backdrop, we would value the opportunity to contribute to further discussions with Ofwat to establish the "deadband" for the incentive mechanism in relation to developer charges forecasts.

Revenue forecasting incentive

We support the preferred option for in-period adjustments for under or over recovered revenue and the associated change to licences that will be required. We agree that the strength of the existing incentive mechanism in use for AMP6 is effective in promoting forecasting accuracy and thereby appropriate action by companies.

Water trading

The preferred option to maintain the existing incentives for new water trades appears reasonable and appropriate, allowing those existing incentives time to be tested through the current round of WRMPs.

In that context, we would note that the on-going water resources planning round and the outputs of initiatives such as Water Resources East and Water Resources South East are likely to identify some trading opportunities to help manage the balance between supplies and demand. The trading assessment opportunity described in the consultation document was carried out ahead of detailed water resources planning and should be updated in early 2018.

However, what we expect to see overall is further pressure on the availability of qualifying trades/volumes due to amongst other things the impact of climate change and growth; water companies' plans to increase levels of resilience; changes to abstraction licences required to achieve sustainable levels of abstraction, and the requirement to develop additional storage and other assets to buffer the impacts of severe droughts.

Q2. Do you agree with our proposals for the form of control for water resources as set out in the 'Wholesale controls' chapter and appendix 5, 'Water resources control'?

Broadly, we support Ofwat's proposals on water resources and the moves towards a multi-company and multi-sector approach. This echoes the work we are taking forward with others as part of the Water Resources East project and on multi-sector financing.

We welcome moves to open up markets in water resources where these are genuinely contestable and can deliver benefits to consumers.

Form of control

We support the proposed form of control and building block approach. We recognise that this remains close to the traditional building blocks while enabling Ofwat's decisions regarding the treatment of investment post 2020. We also believe the proposed market entry adjustment mechanism is a logical approach to enabling policy decisions already made by Ofwat. But we have reservations about the resulting exposure of post 2020 investment to utilisation risk and believe further detail is required on how this will work in practice.

We agree with Ofwat that moving to a unit cost approach would be premature at this point in time. Using unit costs would be a fundamental change, with cost implications for companies. As water resources markets develop a unit cost approach may be appropriate, but any decision would need to include a clear understanding of the expected benefits. Any information requests issued by Ofwat on this topic should be proportionate to the expected scale and timing of the new markets.

Risk, resilience and the bilateral market

We note that the detailed arrangements for the bilateral market are yet to be finalised and we are keen to contribute positively to the design of the market.

Our region is one of the driest in the UK. Climate change, economic growth and changes to our abstraction licences make the challenge of securing future water supplies particularly acute for us. We are taking this challenge seriously through our work in WRE and in the development of our WRMP. Working with neighbouring companies, customers and stakeholders, we will be taking innovative yet efficient measures to ensure we can deliver security of supply for our customers. This is likely to involve investment in schemes to ensure resilience of our business and our ability to supply clean, safe water to customers.

The final methodology needs to include clear guidance on how risk sharing will apply to resilience and demand management expenditure and investment.

We are concerned about the interaction between the investment in schemes for resilience, the bilateral market and the sustainability of new entrant schemes. For some resilience schemes, the hope will be that we would need to use them only infrequently, if at all. However, if they are included in the measure of total cumulative capacity, then funding for this investment could be at risk from the bilateral market entry adjustment. We are concerned that this may undermine water company willingness to invest in schemes that are primarily intended to ensure resilient supplies, rather than increase capacity.

We are also concerned about how the new arrangements will interact with demand management, water efficiency and leakage schemes. On a purely economic basis, such schemes may not trigger "least-cost" criteria. However, we agree with Ofwat and the Government that demand management, including water efficiency, should be a priority for water companies for the wider benefits it delivers. Our WRMP is likely to include an ambitious demand management strategy. Companies that undertake such activities to secure wider benefits with the support of customers may be exposed to efficient but less sustainable bilateral market entry, undermining the focus on delivering water efficiency. It is not clear how companies should allow for this interaction within their business and water resources planning.

Similarly, we would suggest that any market entrant should have to demonstrate the same level of demand management efficiency as an incumbent. This is particularly important to ensure efficient entry is encouraged, as the costs of demand management would normally be much higher than supply side solutions.

We have identified two specific areas relating to sustainability that need to be addressed in the arrangements for the market:

- **Customer sustainability** – new entrants may not be able to guarantee the same security of supply as incumbents. Would incumbents be expected to act as supplier of last resort? If so, how should this be funded and included in company planning to ensure resilience in their supplies.
- **Environmental sustainability** – we would also expect any new entrants to be subject to the same sustainability obligations (e.g. abstraction management, catchment risk assessments) as incumbents to safeguard the environment and ensure a level playing field.

In addition, we believe the exposure of the post 2020 investment should be time limited. Our infrastructure and interventions tend to have long asset lives. Accurately forecasting market entry over the lifetime of our supply interventions is impossible considering the rapid pace of change in the sector. It is unfair for companies who have made an efficient investment to avoid a supply demand deficit and ensure supply to their customers, then to be unable to recover the costs of that investment due to unforeseeable market entry several years later. This issue should be considered in the development of the market architecture.

Market wide demand risk

The methodology sets out that the development of proposals to share market wide demand risk is likely to be challenging. Where the new water resources in question are focused on resilience this is likely to be even greater, as utilization and requirement will only be tested over the long term. It suggests a stability and accuracy in long term forecasting which will be difficult to achieve given the uncertainty in variables as noted, and the potential for significant macro-economic disruption in the medium term. It may also reduce company willingness to devote resources to demand management and water efficiency activities, as these could reduce overall consumption. The detail required from company business plans in relation to risk-sharing mechanisms should reflect the extent to which schemes vary between resilience and deficit reduction over the short term.

Capacity measure

We are familiar with the proposed metric: water resources yield. We already use this as part of our water resources planning. We agree with Ofwat that as it aligns most closely with the proposed boundary of the price control, it appears to be a logical capacity measure to use.

Charging of water resources

We understand the rationale for the proposed approach to charging. We agree with the approach but note that, in addition to the implementation risks and associated burden set out in the consultation, it could create additional complexity for retailers around settlement in the non-household market.

Q3: Do you agree with our proposals for access pricing for English water companies set out in the 'Wholesale controls' chapter and appendix 5, 'Water resources control'?

We understand the important role that access prices play in encouraging and facilitating competitive markets. In 2015 we completed a significant piece of analysis and consideration[9] of some of the issues related to developing effective access prices, and recognise that access pricing regimes have complex relationships with other parts of the regulatory framework.

We are keen to understand the detail of the adjustment mechanism and equalisation payments to avoid double counting. We assume that this reconciliation is one of the topics that will be covered in the detailed paper due in the autumn.

We support the principle of transparency and, of the options presented, believe Ofwat's preferred option is the most appropriate. However, we believe the implementation of this proposal needs to be proportionate to the expected timing and scale of the market. There are specific considerations to be made for water access pricing, particularly water quality and treatment requirements.

For water, unlike other utilities such as electricity, the product is not homogenous and there are additional difficulties relating to its location and quality. Not all water treatment works are able to provide the same treatment services e.g. not all works can provide metaldehyde treatment. In practice this means it will be very challenging for companies to generate access prices that are more than indicative and we note Ofwat's proposal that access charges include average costs for existing capacity.

A large part of the access prices for new entrants will relate to network plus charges, which will be available to retailers under Ofwat's proposals. New entrants will be able to understand from the WRMP and market information published by companies where it may be economic to enter the market. Using this information, along with its own cost to supply, entrants could calculate the

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[9] http://www.anglianwater.co.uk/_assets/media/Access_Pricing_-_Issues_paper_-_Main_report_-_FINAL.PDF

resulting equalisation payments. On this basis, a proportionate approach to the likely timing and scale of the new bilateral market could be that access prices are determined on application rather than published by water resource zone alongside business plans.

We believe the principle of proportionality should also be applied to other proposals for water resources, such as the bid-assessment framework.

Competition law and other obligations would ensure that companies develop access prices that link to their business plans and relevant costs, as proposed under Ofwat's proposed option.

As we have described in this response, there are many detailed points to be considered when developing an access pricing framework. We look forward to working with Ofwat to develop the detailed design of access prices and the water resources market more generally over the coming months.

Q4. Do you agree with the proposals for company bid assessment frameworks set out in appendix 9, 'Company bid assessment frameworks: the principles'?

We have been considering how companies could participate in a competition while also running it, for both direct procurement and more generally.[10] We think it is possible for companies to simultaneously run and bid into competitive processes. But rigorous controls are needed to ensure equivalent, impartial treatment and to minimise perceptions of conflict of interest.

As we have noted during previous engagement on this topic, we believe that existing procurement rules, competition law, efficiency incentives and regulatory requirements (including for the WRMP) will ensure that companies will assess bids fairly and choose the most economically efficient option, to the benefit of customers.

However, we recognise that the existence of bidding assessment frameworks will increase the confidence of would-be participants who might be aware of those other controls or the incentives they apply to incumbents. We believe the strongest justification for the requirement to develop a bid assessment framework is that it will help reduce perceptions of conflicts associated with companies running and bidding into a process.

Notwithstanding the points above, we are concerned about the proportionality of the proposed regulatory approach. It is clear that Ofwat envisages the bidding assessment framework to be a substantial document. It is clear to us that creating a framework will accordingly require significant resourcing. Our concern is whether the associated cost is justified by the associated bidding activity.

We therefore propose that the scope of the bidding framework remains more limited until the degree of activity and interest in the market becomes clear. The framework should not attempt to foresee and account for all possible eventualities but should provide an outline of the approach that would be followed to assess generic bids. For example, evaluation criteria may need to be specific to the 'problem' that bids are trying to address.

[10] We have taken external advice from KPMG on this topic.

In making our plea for proportionality, wherein the level of detail required of a bidding framework depends on the level of activity in local markets, we recall the effort companies have made since 2005 in drafting and updating access codes which have never been used.

We accept that a proportional approach could mean that the specification of bid assessment frameworks differs between companies. Another outcome might be harmonisation of frameworks between companies serving neighbouring regions on the basis that bidders may operate across incumbent boundaries.

We also have some comments on the details of the proposals.

Topic	Comments
Separation of procurement teams	We agree that an independent team should be responsible for the assessment of bids, as separation is a key part of managing real and perceived conflicts of interest. However it is important that the procurement team understands the specific challenge that bids are seeking to address, otherwise a sub-optimal solution may be selected. This knowledge could be provided through the involvement of experts from the relevant part of the business who were not directly involved in the development of the incumbent's solution.
Bidding windows	We do not agree that there should be no time limited bidding windows. There must be a cut-off point at which a solution is selected with development and implementation being progressed in earnest. It would be inefficient for companies to be receiving and assessing bids for schemes already well developed. We believe there should be scheme/problem specific windows for bids, taking place at an appropriate time before a final investment decision is made.

Q5. Do you agree with our proposals for the form of control for bioresources as set out in the 'Wholesale controls' chapter and appendix 6, 'Bioresources control'?

The proposals are broadly in line with those which have been developed through the sludge working group since the start of 2017.

A new proposal is the bioresources accuracy forecast incentive (BFAI), which will penalise companies if their actual sludge production differs by more than 3% from their forecast volumes. We understand and accept the objective behind the introduction of this incentive but have concerns about its operation. The new definition for sludge reporting, which was confirmed in IN17/04 in April, requires a change for us from the way we have measured sludge hitherto and we reported against it for the first time in July's Information Request. Naturally we are still to assess the likely annual variance we might expect to see as a consequence of this change. We can see that the impact on revenues from substantial variances would be material.

We are well aware of the potential margin for error in the readings from the numerous flow and dry solids meters on which our volume measurements depend. Our response to the introduction of a forecast incentive would be to increase substantially the resources we apply to meter maintenance and calibration, and the cost of this would be reflected in our PR19 bioresources plan.

Given the potential impact on costs and revenues from a BFAI, it is clear that its design and calibration needs to be proportionate. We think it be would be helpful for the industry to have an opportunity to debate the incentive as proposed, so that its development could benefit from the input of companies. This process has worked well for developing the other proposals for the bioresources control. We therefore suggest it be would be helpful to explore this proposal through the sludge working group before the methodology is confirmed in December.

Direct procurement

We support the development of competition in the water sector, where it is introduced in a fair and even way and brings long-term benefit to customers. For high-value projects, we have historically used competitive tendering to achieve the best possible value for customers. We believe that projects delivered via DPC need to be evaluated on a case-by-case basis to ensure that the best procurement route for customers is chosen.

To ensure that we can deliver the best outcomes for our customers, we have constructively engaged in the development of DPC. This includes commissioning two independent reports on the subject. The first '*Direct procurement of water industry projects*' was produced by First Economics for Severn Trent, Tideway and us in February 2017. The second '*Setting direct procurement up for success at AWS*' was produced by KPMG in August 2017.

Q1. Do you agree with our draft guidance that appointees should focus on projects likely to deliver the greatest customer value for DPC at PR19? (We ask that appointees provide a list and description of which projects, based on our guidance, they consider would be in scope at PR19.

We agree that only projects that will deliver the greatest value to customers should be progressed through DPC. We believe that projects with a high proportion of capex relative to opex are likely to deliver the greatest benefit to customers. Projects will likely need a sufficiently high proportion of capex to stimulate interest in the market and justify the associated administrative costs of procuring and managing a DPC project.

We believe that a threshold of £100m capex (rather than the proposed threshold based on whole life totex) is more appropriate for DPC projects. We believe this is the point at which cost saving has the best chance of outweighing administrative costs while securing market interest. This is informed by:

- KPMG's advice to us in August 2017, that this threshold is more likely to secure market interest than projects with a high proportion of opex within the £100m totex.
- Our analysis of existing and currently under development PPP and PFI projects in the UK. The average capex value of these projects is over £100m in current prices.[11]
- Ofgem's threshold for competitively appointed transmission operators, which was chosen as a starting point to balance costs, benefits and market interest.

[11] Based on UK Treasury data.

We consider one appropriate rule of thumb for considering which projects to progress under DPC is a capex/opex split of totex of at least 90/10. We understand that water sector schemes most likely to benefit from being procured through DPC, such as Thames Tideway or a reservoir, have a capex/opex split of 99/1. Due to interoperability and separation concerns, we believe higher portions of opex would reduce benefits to customers and potentially limit investor interest. Our proposed split aligns with infrastructure PPP schemes, such as roads. Higher proportions of opex are associated with social infrastructure, such as education or healthcare facilities.

To secure maximum benefit for customers, it is important that companies are using a consistent approach to identify projects suitable for DPC.

In that regard, we would also wish to underline the importance of ensuring that schemes subject to DPC should be discrete schemes (as Ofwat proposes), and that this is an important principle for companies to take forward as plans are developed.

We also feel that appropriate consideration should be given to how changes in accounting standards may affect the treatment of DPC projects, and that that may impact on net debt and financeability should be kept in mind as the work on DPC continues.

We welcome further guidance from Ofwat on these points, and on the model and parameters that Ofwat will use to assess qualifying DPC projects.

Table 1 contains our potential projects that may be appropriate for DPC. Significant work is ongoing as part of our business plan development and Water Resource Management Plan and as such this is list is subject to change as the most appropriate solutions are identified over time.

Water Resources transfer scheme – River Trent to Rutland Water or equivalent
Water Resource development – South Lincs Reservoir and associated interconnectivity
Water Recycling Non-Infra – Potential rebuild of Flag Fen Water Recycling Centre
Water Treatment – Portfolio of schemes to Metaldehyde treatment at WTWs[12]

Table 1: *potential projects that may be appropriate for DPC*

DPC is a significant change for the industry. We believe ongoing dialogue between companies, Ofwat and other stakeholders will help ensure the best possible outcome. We are keen to engage in ongoing dialogue on this topic through the PR19 process. During AMP7 we believe companies should share best practice and lessons learnt from delivering DPC schemes, within the bounds of competition law and other obligations.

Q2. What are your views on the type of tender model (ie an early or late tender model) appointees should use? Do you have any views on whether or not we need to specify a tender model companies should use?

[12] In the case of the potential metaldehyde investment; this will be informed by future policy discussions which will impact on the need and scale of required investment.

We recognise there are specific benefits to each tender model. Different tender models may be better suited to different asset types or specific projects. We agree with Ofwat that allowing flexibility at this stage in the development of DPC is appropriate.

The early tender model introduces increased scope for innovation but it also brings additional risks as it increases the uncertainty around project feasibility. There are examples of PPP projects failing to get planning permission, at significant cost to the procuring client. Investors are likely to 'price in' these additional risks and uncertainty within their bids, potentially increasing costs for customers.

We believe the late tender model is likely to provide the best value for customers, especially for the first DPC projects. We believe it allocates project risks to the parties best placed to manage them, while retaining the potential for cost savings on construction and operation - a key potential benefit of the DPC model. Under the late model we would undertake the enabling works, which have a similar risk profile to our existing business and which we are familiar with delivering. We would take on risk associated with design, planning, consent and initial site investigations, leaving construction and operational risk for the CAP. This optimisation of risk sharing should enable the most competitive bids to be submitted by CAPs.

We believe there is merit in the industry developing a suite of 'standard' DPC documentation. Model documentation is a common feature of all three PPP models in the UK, including the Welsh Government's recently launched Mutual Investment Model (MIM). The benefits of this approach are minimised procurement costs for the procuring client, minimised bid costs for bidders and allowing potential market participants to familiarise themselves with terms and make informed decisions about whether to engage in the market. We are keen to work with Ofwat and the industry to develop common terms and potentially draft contract documents for DPC.

Q3. What are your views on the overall commercial and regulatory model, including our draft procurement and contract principles set out in appendix 10, 'Direct procurement for customers'?

We have carefully reflected on the commercial and regulatory model. In particular, we have been considering, with support from KPMG, how incumbents could manage conflicts of interest associated with bidding in their own areas if they are running the procurement process. We believe that it would be possible but very difficult and costly to put in place measures to appropriately manage these risks.

We strongly believe that Ofwat or an independent third party should run the procurement process. This would allow incumbents the opportunity to bid to offer the best outcome for customers.

We are concerned that excluding incumbents from bidding in area would undermine the model's ability to meet the Government's direction in the draft SPS "*to secure assurance that undertakers' duties will be met to an equivalent or better standard and ensure that the consumer interest is protected and value for money is delivered*".

We believe it is in the best interests of customers that the fullest range of options be considered when taking forward large projects. Considering the widest range of options is the only way to ensure that the consumer interest is protected and value for money is delivered. Incumbents delivering DPC projects within their regions is an option that may deliver the greatest benefit to customers. There are significant practical challenges associated with companies running and bidding into the same competitive process. Ofwat or an independent third party running the procurement process will allow incumbents to participate in region so the fullest range of options are considered. This could also help ensure that the most efficient financing costs are realised.

Ofwat has an expectation that the DPC will reveal lower financing costs than would otherwise be the case. Customers may be worse off if incumbents are not able to competitively bid and provide a benchmark for other bidders.

If the incumbent is not allowed to bid then there should be a straightforward and fair test to ensure customers do not pay more than they would otherwise.

Whilst we believe a licence based approach would be the best way forward when considering DPC and customer value, we recognise that Ofwat has looked to address two significant points that were highlighted in the report from First Economics namely, the levels of counterparty and incumbent risk.

We agree that the initial price control for pre-construction (that includes tendering and procurement costs) should form part of totex allowances for PR19. This makes sense as some of our project development costs will be similar whether a scheme is developed using DPC or a more conventional route. However, procurement of PPP type schemes is a specialised and intensive process. A likely procurement process of 18 months will include intensive negotiations and multiple meetings with each bidder (there are usually at least three bidders in PPP procurement) on most topics. There is then a further period of effort to get projects to financial close. The contracts and allocation of risk over the life of an asset are also entirely new and different to the award of a conventional procurement contract.

Water companies have no experience of delivering schemes using this type of procurement model. They will need specialist financial, legal, technical and commercial advice. Public sector bodies with experience of procuring PPP schemes still need financial, legal and technical advisors for each project. We believe that procurement costs for a DPC scheme will be of a magnitude different to our current procurement costs and are likely to be millions of pounds per project. According to the NAO, advisory fees for public sector procurement of PFI schemes are on average 4% of the capital value. The likely scale of these costs needs to be recognised and assurances provided that efficient procurement costs can be recovered.

We believe the impact of residual and new risk exposure to the incumbents with the proposed new model has not been fully reflected in the draft methodology. We believe that although the proposed licence conditions are helpful in enabling the model to work effectively, consideration as to the impact of these licence changes in terms of risk allocation between the incumbent, the CAP and customers needs to be clearly understood. KPMG has further backed this thinking and stated in their report '*that a robust risk assessment and allocation methodology will be critical to inform the contractual and regulatory framework that underpins the DPC model*".

KMPG also highlighted that there will be different perspectives on where risks should sit under the DPC model. Incumbents would not want to be left with a high level of residual risk through adopting the DPC model. The CAP will require a return which reflects the risk profile of the project, i.e. the more risks are born by the DPC provider the higher return will be required by potential investors. Also, a key consideration for the CAP is the level of control they have regarding future performance and potential for upside in returns. Finally and importantly, our customers will expect the DPC model to result in no additional risks borne by customers just for the purpose of attracting investors and lenders. All risks will need to be considered on a case by case basis in order to ensure they sit with the most appropriate party and the right level of mitigation is in place.

Large DPC projects are likely to represent significant investments in Totex terms and carry risks beyond the normal course of business. While some of these risks might be systematic, they are particularly likely to feature project-specific downside risks (such as construction, delivery, or counterparty risks) with an asymmetric profile typical of major, stand-alone projects and assets.

Whether these project-specific risks are allocated to the DPC provider and priced in the bid price, or remain with the licensed undertaker (who will no longer earn a return on the corresponding assets), they would not be reflected in the CAPM-based industry WACC, which assumes a symmetric risk profile and does not capture required returns for such one-side exposures.

Compensation for these risks beyond CAPM-derived returns would be consistent with the economic theory, precedents for the treatment of major projects in regulated industries, and with the market approach to pricing project-specific risks in the infrastructure sector more broadly

We believe that the regulatory model should allow sufficient flexibility to allow elements of the scheme to be tendered separately. This could be separate tendering for financing and construction. This could improve transparency in the procurement process and give greater confidence that the process is delivering best value for customers. Separating construction and operation could be appropriate for assets where operational activities are discrete. These approaches would need to be considered on a case-by-case basis and the expected benefits would need to justify any additional procurement costs.

We believe there is a gap in the proposed regulatory and commercial model. The new model alters the regulatory framework, with limited scope for incumbent companies to innovate, outperform and earn a return for new major schemes while simultaneously increasing the risk that companies bear from failed procurement and delivery. As proposed, companies will have limited financial incentives to ensure the lowest cost to customers through the procurement. Neither will they be incentivised to engage actively with projects during their lifecycle. Furthermore, the proposed model provides the incumbent company with no return to compensate for the remaining risk associated with the assets and services being provided through the DPC contract. Experience from PPP and PFI projects shows that the client often needs to be actively engaged in monitoring a project’s performance to ensure the best outcome.

One approach to aligning the interests of incumbent companies, customers and the successful bidder is for the incumbent to take a small equity stake in the successful consortium following procurement. This is supported by common PPP practice in the UK; a fundamental change associated with the UK Government’s new PF2 model for PPPs is that the public sector should act as an equity partner. This is also a feature of the Welsh Government’s MIM approach. The benefits of this are that it gives the procuring client a financial incentive to ensure the project is a success; it gives the client greater visibility of performance of the operator of the scheme (so prompt corrective action can be taken) and it allows greater influence from the client in the activities of the operator.

As noted in our response to question two, we believe there is merit in the industry developing a suite of 'standard' DPC documentation. The use of standard documentation could reduce procurement and bid costs. We would expect project agreements/contracts to include standard provisions from PPP type contracts, such as the expected availability payment, performance specifications and associated deductions, gain sharing from refinancing and hand back requirements.

Appendix 10 states "*For CAP delivery costs, we would need to be satisfied with the outcome of the tender in order to allow companies to recover the CAP's revenue stream from their customers*.". It is not clear what the process would be if Ofwat is not satisfied with the proposed CAP delivery costs and what the appeal mechanism would be for the CAP if Ofwat does not approve their costs? We would be extremely concerned if there is any possibility of the incumbent bearing the risk of being liable for any difference between the CAP's costs and the revenue stream that can be recovered from customers. One approach to allow for an appeal mechanism would be for the CAP revenue stream to be subject to a separate price control with the ability to appeal determinations to the CMA.

Finally, we believe it is essential that Ofwat sets out in advance its model for assessing whether the outcome of the tender provides best value for customers. Incumbents and bidders that enter the DPC process in good faith will want to be confident that they understand the criteria that will be used by Ofwat to ultimately sanction the recovery of the DPC revenue stream and procurement costs.

Retail controls

Q1. Do you agree with using a weighted average revenue control, where appropriate taking account of different costs by customer type for the residential retail price controls for English and Welsh water companies?

The proposed approach to the Retail revenue control seems reasonable and is consistent with the approach to PR14; noting the difference in approach to cost assessment.

Q2. Do you agree with using an average revenue control for business retail price controls for Welsh companies not subject to competition?

We do not have any strong views on the proposed approach relating to companies operating in Wales.

Q3. Do you support price controls for business retail activities for English water companies that have not exited the business retail market?

The approach for dealing with non-exited non-household retail activities seems sensible.

Q4. Do you support price controls for water service customers of Welsh companies using more than 50 megalitres a year?

We do not have any strong views on the proposed approach relating to companies operating in Wales.

Q5. Do you support a three year price control for residential retail activities and business retail activities?

The rationale for the 3-year as opposed to 5-year price control for retail activities is driven by potential new information revealed by the new business retail market which opened on 1 April 2017. This also aligns with Ofwat's preference for reviewing the potential for a future retail market for household customers.

We note that the information Ofwat cites as being generated by the business retail market will in the majority of instances reside in separate, exited business retail businesses so we are not clear how Ofwat will either access this information nor be able to apply it to households in a transparent way given that business customers will have different characteristics to households. We further note the ability to disconnect non-domestic supplies for non-payment which will also impact on the costs associated with serving business customers relative to households.

We have two further questions on the mechanism for the retail price control which we request clarification on. The first is how Ofwat would reconcile the 3-year retail control with the 5-year wholesale controls. The second is whether companies will be able to separately appeal their retail household control from the wholesale controls.

We propose that Ofwat should detail in the final methodology a clear approach to how companies should expect to recover any costs associated with the development of a future potential household retail market, noting that the majority of these costs are borne by the wholesale business which is still be subject to a 5-year price control period.

Cost assessment

Q1. Do you agree with our overall approach to cost assessment?

We support the overall approach to cost assessment, although we do have some comments on the detail.

We support the proposed approach to benchmarking. We agree that the use of econometric models, including for retail costs, is appropriate. However, we recognise that finding robust models is not easy and the quality of a model should always be taken into account before deciding how much reliance to place on its results.

We have undertaken cost modelling across all services, at varying levels of disaggregation, using the data from the August and October submissions from 2016. Our work is far from finished – for example, we intend to re-run all our models with the 2017 Information Request data – but we intend to conclude this work in the autumn as part of our contribution to the modelling challenge.

We agree with the proposal to exclude rates and pension deficit repair charges from the benchmarking. On abstraction charges, we support the case made by Northumbrian Water for their exclusion from modelled costs in the paper to the January 2017 Cost Assessment Working Group (CAWG). Furthermore, we think the chart on page 10 of appendix 12 of the consultation supports the view that distribution input is not a good predictor of abstraction charges. In our own modelling work we will test further the impact of including and excluding abstraction charges.

Since 2014 we have strongly argued that totex modelling is not feasible and that separate approaches are necessary to assessing enhancement costs. We set this out in our July 2015 Market Place for Ideas paper[13]. Our own modelling has been of botex only.

Exclusion of enhancement costs from cost models demands that a separate approach is taken for enhancement expenditure. We are disappointed that little progress has been made on developing these approaches by the industry since 2014. In our 2015 paper we suggested that a range of approaches for assessment of enhancement expenditure (which may be a mix of enhancement opex and enhancement capex) might be necessary. We proposed that a substantial proportion of enhancement expenditure could be assessed by expert 'deep dive' and that resources should be mobilised in preparation for this. We further suggested in a presentation to the January 2017 CAWG that certain programmes (for example, sewer flooding reduction and first-time sewerage schemes) could be benchmarked in a unit cost approach. We remain ready to work with others between now and December to develop acceptable approaches in this area.

We strongly support the discontinuation of menus. Another of our 2015 Market Place for Ideas paper[14] set out our views on this.

We have reservations regarding some of the details of the approach – particularly the early decisions on frontier benchmarking, discontinuation of catch-ups and the abandonment of the cap. The appropriateness of these decisions will be largely determined by the quality of the models. We believe it is premature to 'lock-in' these decisions in advance of developing the models. We consider Ofwat should reserve its judgements in these areas to make a final decision once the quality of the models is clear to ensure the most appropriate application of their findings.

We would welcome additional information regarding the use of forecast data, especially given its potential interaction with the cost sharing incentive. We believe the use of evidence from the wider economy could be informative but note that caution is required to ensure that any evidence used is relevant, robust and comparable.

Q2. Do you agree with our proposed cost sharing incentive? We welcome thoughts on the calibration of the incentive

We understand the rationale behind the cost sharing incentive. However we note that it is an additional piece of regulatory complexity in addition to the already complex process of setting a price control. Ofwat needs to be satisfied that this additional mechanism will deliver proportionate benefits.

We are concerned that the mechanism, as proposed, may create perverse incentives. Gaming companies could 'bid' as low as theoretically plausible to secure the best sharing rate, while still receiving the Ofwat allowance. We do not see any disincentive for this behaviour. These low bids could then be used by Ofwat to challenge the industry, which is of concern if they are artificially low and not reflective of the bidders' true positions. The consequent benefit to all customers would come at a cost to the customers of the gaming companies, who would pay an unrealistic sharing rate. We are not clear whether, as proposed, the incentive would influence the spending proposals of a conscientious company. We remain to be convinced about this regulatory innovation and would welcome further discussion with Ofwat on its application.

[13] http://www.anglianwater.co.uk/_assets/media/Totex_cost_assessment_at_PR19_-_Final.pdf

[14] http://www.anglianwater.co.uk/_assets/media/Future_use_of_menus_as_part_of_price_setting_methodology_-_Final.pdf

We note also the potential for double jeopardy, given the proposal for a 'Securing cost efficiency' test in the Interim Assessment of Business Plans. That is, a company with a very low bid:baseline ratio will be rewarded with both a favourable cost sharing rate and a favourable IABP assessment.

Q3. Do you agree with our proposals to funding unconfirmed environmental requirements? Which of the two options do you consider is more appropriate, and why?

We believe option two is preferable. Under the current price control, option two has been applied to us for 97 schemes with a combined value of £60m. The operation of two ODIs provides strong protection to customers against non-delivery of these schemes. This protection is asymmetric – we will not have be protected if the final programme exceeds the funding.

If option one is pursued, we would prefer the variant that includes a transition programme so that we could commence work sooner than April 2025.

We believe the examples used in the consultation are not applicable to all companies. Our final NEP closely matched the scale, if not in every detail, of our programmes funded in Ofwat's final determination.

Q4. Do you agree with our approach to cost adjustment and our proposed approach to make the process more symmetric?

We agree that provision for adjustments should remain part of the process.

We strongly disagree with the proposed timetable for special factors, wherein outline cases are submitted to Ofwat in May 2018 before companies know the specification of Ofwat's models. At this time companies may be able to accurately propose adjustments for exceptional schemes but this will not be possible for regional operating circumstances. Companies cannot propose accurate and relevant adjustments to models without knowing what is included in those models. The example from PR14, where Thames Water submitted a regional wage adjustment which was later found to be unnecessary, is relevant to consideration of this issue. We believe the prospect of aborted work on this scale is a grossly disproportionate regulatory burden.

We recognise Ofwat's desire to smooth its work over a longer period and support this ambition. As noted in the executive summary to this response, we have previously suggested a "simultaneous reveal" approach be adopted to achieve this and are disappointed that this has not been progressed. We still propose that Ofwat publishes its models on the same day that companies submit their business plans. This would allow work on special factor claims to begin immediately and be submitted in time for inclusion in the initial assessment of business plans.

We attach again, as an appendix to this letter, our 'simultaneous reveal' timetable.

We believe the symmetrical application of adjustments is acceptable in principle. However we believe affected companies should be given an opportunity to make representations and provide evidence, if relevant, before downward cost adjustments are made.

Q5. Do you agree with our proposed approach for assessing retail (residential and business) costs at PR19?

We support the proposed use of econometric benchmarking. We believe this is a more robust alternative for cost assessment to the use of average cost to serve metrics. We have undertaken modelling work in this area and believe the results to date are promising.

We cautiously support the use of benchmarking with retailers from other sectors. However, we note that care must be taken to ensure comparisons are relevant and reliable. The comparison of the bad debt performance of water and energy in the consultation is an excellent example of the dangers of indiscriminate benchmarking as it fails to make allowances for critical differences between the sectors. It is disingenuous not to recognise the role of both installation of pre-pay meters and threat of disconnection which are present in the energy sector, but illegal in water.

Q6. Do you agree with our preferred approach not to index the retail controls to a measure of general inflation, and, if appropriate, deal with input price pressure as part of our totex allowance?

The failure to acknowledge the existence of input price changes in retail was a major flaw in the PR14 methodology and constituted a significant unsubstantiated efficiency challenge. We are pleased that Ofwat appears to have changed its philosophy on this subject and recognises that reasonable input price changes should be reflected in revenues. We do not have a strong view on whether this is done via a general inflation allowance or an alternative approach.

We do not accept the contention in the consultation document that retail inflation risk is controllable by companies. We note the comparison in the consultation to other competitive markets, but also observe that retailers in competitive markets raise prices once options for absorbing input price pressures are exhausted – this option is not available to us in a price controlled regime.

For this approach to be effective it is critical that the relevant cost allowances appropriately capture input price inflation. We would welcome further reassurance from Ofwat in this area and expect regard to be made for legitimate input price pressures.

Q7. Do you agree with our proposals for the transition programme?

No. We believe the transition programme was a positive addition to the PR14 price control methodology and should be repeated. The transition period is particularly helpful for attenuating the regularly observed dips in expenditure (and associated inefficiency) in the first and last years of a price control. We believe this may be even more important as we move into AMP7, given the demands on resources for infrastructure projects are expected to be increasing, and labour market flexibility may be negatively affected by Brexit.

We sought to maximise our use of this mechanism at PR14. In 2014-15 our transition expenditure was £57m, representing over a quarter of the industry's total. This expenditure positively benefited our customers and was initially funded by our shareholders. We believe other companies and their customers could have benefitted from maximising their use of the transition programme.

We would not support an outcomes framework as an alternative to the transition programme. Minimising the cyclicality is a key element of driving efficiency, as detailed in the Infrastructure UK report on Smoothing Investment Cycles in the Water Industry.[15]

In this AMP we have not been able to fully minimise the amplitude due to the early delivery of the No Deterioration programme, which is significant in cost and resources. This programme consisted of 20 projects with an estimated cost of £120m, all to be completed by 31 March 2018 so phasing the delivery was essential. With a similar early delivery environmental programme anticipated for AMP7, similar transition arrangements would be appropriate.

The transition programme enabled companies to smooth investment between periods and to retain key staff. In our case, our transition plan was based on the skills and resource capacity from our delivery alliances. We are again forecasting spare capacity in our design resource at the end of AMP6. The learning from these teams allows us to 'bake in' the delivery efficiency in our cost models. These efficient costs will be reflected in our PR19 Totex Expenditure Plans and allows us to plan the effective and efficient delivery of the early environmental obligations and projects that benefits customers.

We will retain our alliances for a further two AMPs. It is therefore essential that we maintain the key skills and resources as we move from AMP6 to AMP7. By the end of AMP8 we will have our next generation of alliances in place. At this stage we do not know what they look like or the transition arrangements, but it is clear some form of transition expenditure will be required. Not to allow this could risk the delivery of some of the benefits for customers that result from our alliance approach.

As part of our Water Resources Management Plan, we are considering an ambitious demand management strategy. We believe this will benefit our customers, society and the environment. Once our planning is concluded, it is likely to be in everyone's best interests if we can begin rolling out our initiatives immediately. We believe the transition arrangements would support us being able to begin rolling out our ambitious strategy in the most effective and efficient way.

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[15] Page 13 shows the comparative efficiency from those companies who have historically reduced the amplitude *https://www.gov.uk/government/publications/smoothing-investment-cycles-in-the-water-sector*

Risk and return

Q1. Do you agree with our proposed approach to setting the cost of equity, based on the best estimate of expected returns in the 2020-25 period?

We agree that recently markets have appeared to show lower total market returns (TMRs). There is less evidence, however, that this change is permanent. Over the last decade, financial markets have made significant errors in judging the future interest rates. It seems less clear to us that much weight can be put on short-term TMRs so as to make a reliable judgement on returns that will apply until 2024.

To help us form a view, we have engaged KPMG to advise us on some of these issues and they have highlighted shortfalls in PWC's judgement on TMRs. Some of the points KPMG make are listed below:

- Short-term estimates of TMR are volatile and have less predictive power for 5 to 10 years
- PWC's own evidence, and a wealth of academic evidence, supports a negative correlation between Equity Risk Premium and Risk Free Rate.
- There are no regulatory precedents that have focussed on short-term TMRs.

This report is available to Ofwat.

Q2. Do you agree with our approach to indexing the cost of new debt?

We broadly agree with the approach to link cost of new debt to an index, and the chosen index.

We welcome Ofwat's proposal to assume the Bank of England's long term rate to convert nominal rates to real, and therefore remove the complexity of an inflation adjustment.

Q3. Do you agree with our proposal to index price controls to CPIH (subject to its redesignation as a national statistic before we publish our final methodology)?

CPIH has now been redesignated as a national statistic. However, this remains a new index with no real track record. CPIH previously achieved national statistic status only to have that revoked by the UKSA. With this decision, the water industry will be the first regulated industry to link revenues and RCV to this index.

Given the way water companies are funded (real terms, inflation comes through RCV), it is important for companies to be able to hedge their asset base in a way which moves in line with inflation. CPIH is a new statistic, and for that reason there is no existing demand for CPIH linked debt to form the basis of any hedging instruments or debt. We note it may take a number of years before a market for CPIH debt will emerge. If companies continue to raise RPI-linked debt, it introduces a basis risk which ultimately will need to be borne by the sector, its customers and investors. As set out in our responses to the financeability questions, when Ofwat indicated a movement away from RPI companies have sought to reduce their exposure to RPI linked debt.

Q4. Do you agree with our approach to setting tax allowances at PR19, including the proposed true up mechanism?

In general, we agree with the majority of the proposed approach but have a number of specific comments which we set out below. References to section headings relate to appendix 13 of the methodology.

Basis of tax calculations (s6.1)

The draft methodology proposes that companies calculate a separate tax allowance for each of the four wholesale controls and then limit the total allowance to the total of the four controls combined.

This approach is not consistent with tax computations for submission to HMRC which are prepared on a "whole company" basis and we see little benefit in requiring four separate computations of tax allowance considering both the likely level of tax allowance arising for companies and the level of estimation that will be required to calculate these separate allowances by price controls.

For example, to calculate separate allowances requires opening capital allowance pools, capital additions in the year and other items to be split between the four controls. The opening pool balances and some other computational adjustments will most likely be split using RCV and the capital additions will be allocated on an estimation of the assets likely to be built in the period.

We consider a better alternative would be to calculate the total tax allowance for the four wholesale controls combined and then allocate this between the individual controls on an appropriate basis (probably RCV). This approach is both proportionate and would also make it easier to provide the reconciliation required annually between the tax figures in the annual regulated accounts and those in the company's final determination.

Treatment of interest (s6.2)

We agree with continuation of the policy adopted in previous determinations that the tax allowance should be calculated on the basis of the company's actual capital structure if gearing is higher than the notional structure. We can also agree that the impact of the new Base Erosion and Profit Shifting (BEPS) legislation should have little impact on the regulated companies either because of the public benefit exemption or the group relief ratio, and so full deduction should be assumed for tax purposes.

Approach to capital allowances (s6.3)

Whilst we are pleased to see that the "simplified" methodology adopted at PR14 has been abandoned, we disagree with the proposed treatment of capital allowances in cases where disclaimers have been made in earlier years to utilise group relief in other group companies. We believe that the requirement for PR19 capital allowances to be calculated using the higher opening pool balances rather than the notional pool balances is fundamentally flawed. This is for the following reasons:

This approach is inconsistent with the proposed tax computation for all four wholesale price controls to be calculated as if they were stand-alone entities. This cannot be achieved if you take any account of tax planning made for group purposes.

The methodology states that "*In our calculation of tax allowances, we will assume that companies make full use of all the capital allowances available to them*". This is contradictory to an approach that does not recognise the impact of previous disclaimers. In PR14 we calculated our tax allowance on the assumption that we claimed all available capital allowances. We have made disclaimers during AMP6 but these are for Group purposes and not for the regulated business. If we now use the higher opening pools that arise from these disclaimers as our opening position for PR19, customers will be benefitting twice from those disclaimed capital allowances. They will have reduced the tax allowance in PR14 and again in PR19. This is inequitable.

The approach that Ofwat proposes is contrary to the independent opinion given by Deloitte that a notional pool approach was the more appropriate methodology.

We would also point out that the notional pool approach was favoured by the Competition Commission in its considerations over Northern Ireland Electricity Transmission and Distribution as discussed in Deloitte's report at section 5.47 to 5.57.

We do not see any difficulties in calculating the "notional" pool as all companies will have copies of their submitted tax computation and it is a simple procedure to calculate the effect of the disclaimers made.

Approach to group relief (s6.4)

We agree that when calculating the tax allowance the assumption should be that regulated companies will pay for group relief surrendered from other group companies based on the headline corporation tax rate for the year in which the surrender is made. This upholds the principle of treating the regulated company on a stand-alone basis and charging the headline rate of tax on all of its taxable profits (i.e. ignoring any group relief).

We also agree that a company should incur a liability to pay for that group relief at the headline rate of tax, noting however there may be valid reasons why the regulated company does not settle those liabilities within the control period. We agree with the principle of recovering a proportion of the tax allowance corresponding to the proportion of group relief not paid for but we believe it is important that this proportion should be based upon the amount for which no liability has been accrued rather than the actual amount paid. The company will then have been funded for its future liability.

Q4a. Should the true up mechanism be limited to change in corporate tax rates and capital tax allowances or should we extend that true-up mechanism so we can also make adjustments for other changes in tax legislation or accounting regulations which have a material impact on the amount of tax companies are liable to pay?

Our main concern is that any true up mechanism should be easy to calculate and should occur at the end of the control period rather than annual true ups during the control period. We therefore prefer option 2 which limits a one-off true up to changes of corporation tax rate and capital allowance rate.

Q5. Do you agree with the set of scenarios for RoRE analysis we have prescribed, the guidance we propose and to use our financial model to provide the suite of prescribed scenarios?

The proposed table setting out the RORE analysis scenarios is consistent with the one proposed at PR14 with the move to a lower number of prescribed scenarios.

We understand the intended purpose of the table but question how Ofwat will be able use this evidence in a meaningful way given the inherent differences companies face in the base case and the plethora of potential interpretations for the scenarios.

Finally, it is important that the RORE table and the financial model align and we believe there is a current misalignment.

Financeability

Q1. Do you agree with our overall approach to assessing financeability?

We recognise that financeability should be tested based on a notional capital structure as well as based on each company's actual capital structure. The approach to financeability should take account of the recent regulatory changes that impact the risk. These changes, highlighted below, will impact both notional and the actual capital structures. For the notional company financeability test, we suggest the following additional considerations:

a) *Cost of debt end of period adjustment and resilience buffer:* We agree that the cost of debt adjustment between Ofwat's ex-ante assumption and the actual Iboxx index should be made at the end of the period. However, it exposes companies to a timing risk if market rates move significantly and overshoot Ofwat's ex-ante assumption. Historically, Ofwat added a contingency to their forward-looking cost of debt for this reason. Given that any gap between ex-ante adjustment and the actual Iboxx index would be returned to customers, we believe it is in the best interest for the industry and customers that Ofwat should continue to allow a resilience buffer in its ex-ante assumption.

   This would be in line with Ofwat's previous determinations. In addition, given the uncertainty of Brexit and with related macroeconomic risks on the horizon, companies may need a higher level of resilience to withstand any interest rate shocks than in the previous price controls.

b) *PAYG adjustment PMICR ratio*: The rating agency Moody's has stated its intention to make an adjustment for fast money brought forward, i.e. where this is above the "natural rate" in their calculation of interest cover ratios.

   The draft methodology states that Ofwat considers this to be a matter for companies to manage "as the issue arises where the proportion of RCV financed by RPI-linked debt is above our notional assumptions". This is not our understanding of the issue. Rather, it relates to companies having insufficient income after deducting their operating expenses and capital charges to cover their cash interest expense. Moody's concern is that a PAYG adjustment is storing up issues for the future.

Moody's first suggested this adjustment in December 2014 in their paper 'Ofwat's final price decision for UK Water Sector challenging but as expected':

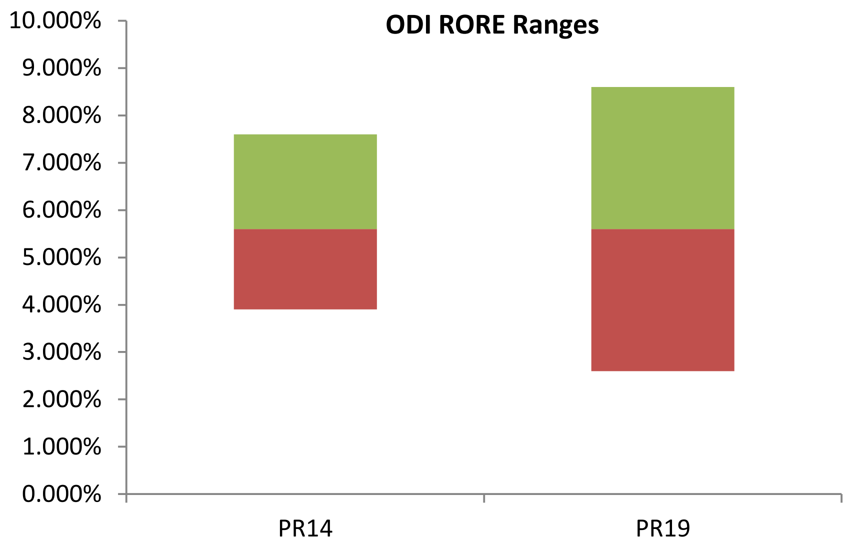
> *"We believe that changes in the speed of money will not in and of itself change a company's credit quality. For Moody's Adjusted Interest Cover Ratio calculation, we reverse out speed of money adjustments by increasing regulatory capital charges by a corresponding amount"*

Ofwat's proposal to transition from RPI was announced in 2016. In our discussions, rating agency Fitch has also shown concern about the PAYG adjustment. We believe this suggests a general direction of travel, rather than a one-off adjustment by Moody's. Moreover, we understand that Moody's apply this adjustment across the industry, regardless of a company's exposure to RPI linked debt, including to our listed peers. Therefore, if a notional company existed, it would almost certainly face similar constraints that Moody's apply to the rest of the industry. For those reasons, we would contend that the notional company should be subject to the same adjustments in Ofwat's test for financeability that the rest of the industry will incur.

c) *RPI linked debt assumption in the notional company financeability calculations:* In the PR14 final determination, Ofwat had assumed that the notional company will continue to raise RPI-linked debt during the AMP6 period including and until 2019 and thereby maintain 33% of its debt portfolio linked to RPI. In 2016, Ofwat decided to transition away from RPI and stated its intention to remove the remaining linkage of RCV to RPI.

   A notional company, if it existed, would be expected to have a prudent treasury team that would consider all opportunities to reduce exposure to RPI-linked debt after the decision in 2016. Many prudent companies are now actively taking steps to reduce exposure to RPI as the inflation metric. Given Ofwat's stated intention with regards to RPI linkage to RCV, and particularly given the pace of transition that Ofwat has implemented, we believe that changes to the assumptions applying to the notional company are necessary. In principle, the notional company should not be assumed to have to raised new RPI-linked debt since Ofwat made the decision in 2016. Therefore, we do not believe that the notional company should be assumed to have maintained similar levels of RPI-linked debt as at PR14.

d) *High powered ODIs:* With increasing rewards and penalties revenue fluctuations are likely to increase, and rating agency Standard and Poor's have raised this as a concern. This theme has been echoed in our conversation with investors and lenders who consider there to be greater risk in revenue and profitability. Increased revenue volatility will mean companies will need to retain increased headroom to key credit ratios to manage financial resilience.

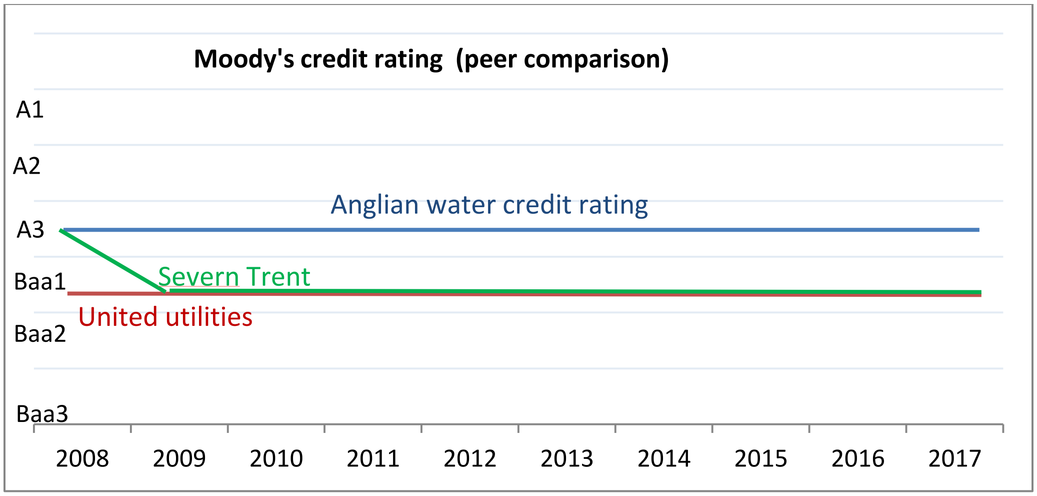


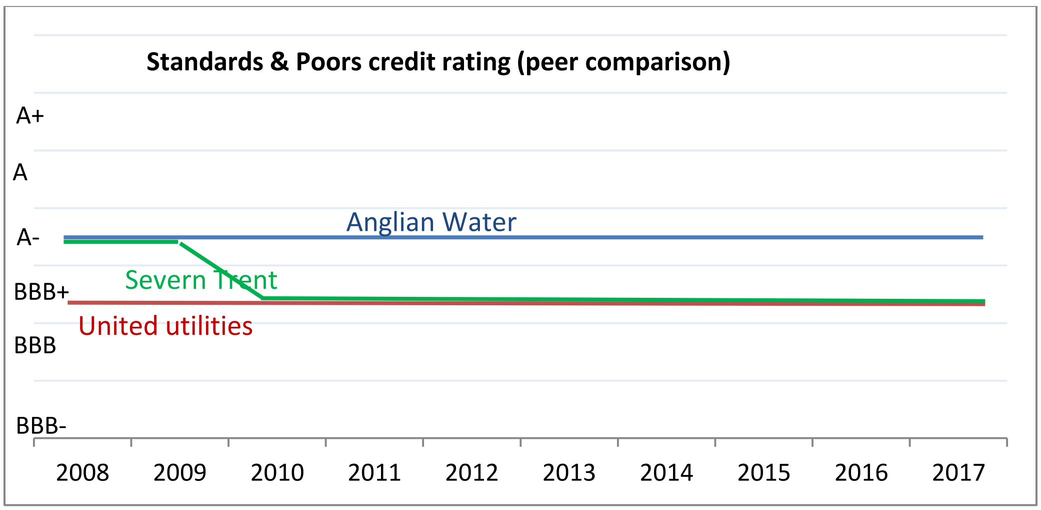
Efficient capital structure

The methodology statement notes that the notional capital structure is efficient and appears to suggest that more highly geared structures may be more risky or less efficient. We would challenge that assumption with the following evidence:

We have carried out a high level analysis of costs and benefits to customers. Here are some of our findings:

a. Anglian Water has raised debt and continues to raise debt at advantageous rates compared to our listed peers.
b. Anglian Water's credit rating has been stronger than our non-securitised peers (see graph below) recognising the strong covenant protection they benefit from.
c. During the global financial crisis in 2008 & 2009, both United Utilities and Severn Trent received a credit rating downgrade (from both rating agencies Moody's & S&P – see graph below). However Anglian Water's secure covenanted structure protected the top quality credit rating.
d. To date, Anglian's credit rating from the three rating agencies – Fitch, Moody's and S&P is one notch higher than our peers that follow a capital structure similar to the notional company.
e. If our gearing had been lower at 62.5%, our customers would have paid higher bills due to higher tax.





The evidence above questions the validity of negative perceptions about more highly geared structures. These views are based on a simple comparison of gearing (60.5% vs 80.0%) but fail to include in their comparison the additional security provided to investors by our highly covenanted structure. Our structure, we argue, has benefitted customers in our region with lower bills, and at the same time has helped to retain a higher level of credit rating.

Confronted with all this evidence and, importantly, our experience over the last 15 years of being one of the biggest issuers in the capital markets, we could argue that Anglian Water's capital structure has indeed been more efficient than that of a conventional notional capital structure.

However, we do not believe these comparisons are necessarily the key issue – rather we see that there is benefit in diversity. These two capital structures are different and they both play an important role in the sector by enabling comparisons to ensure customers can get the benefit of the most efficient source of financing.

Financial markets are efficient at most times, and securitised structures have now been put through the test of time and distress. Even during the most vulnerable time for debt financing, in 2008, Anglian Water continued to raise debt at preferential rates (evidence available).

More recently, however, as global interest rates have fallen and WACC funding has come down – there has been pressure on interest cover ratios (both on notional and actual structures). This implied that gearing above 80% may be less advantageous. We have therefore taken pre-emptive action to de-gear before our credit metrics and ratings were affected, and our shareholders have been supportive of these decisions.

Anglian Water remains committed to strong credit metrics and to retaining its A ratings category for senior debt. This is evidenced through covenants in the financing structure.

Anglian Water issued its first Green Bond in August 2017, demonstrating continued innovation in its use of the debt markets. Strong governance, both in terms of project identification as well as in the deployment of proceeds, is required to demonstrate compliance with the Green Bond requirements and this was aided by the governance involved in our financial structure.

Q2. Do you agree the calculation of the metrics (as set out in Section 11.5 in the Financeability chapter) that we are proposing to use in our assessment?

Test ratios

We broadly agree with the proposed tests and have suggested one additional test - Standard & Poor's FFO ratio (description below). This ratio definition, as used by rating agency Standard and Poor's, is now standard for all companies and should therefore be included in the calculations.

FFO (funds from operations): EBITDA, minus net interest expense minus current tax expense (plus or minus all applicable adjustments).

Test levels

Ofwat first established test levels during the PR04 price control and similar test levels were taken forward and applied during the PR09 Final Determination. Given the changes proposed for PR19, particularly the higher rewards/penalties proposed for ODIs, revenue risk related to the competitive elements, and the change of indexation to CPIH, it is worth reconsidering what the appropriate test levels are for a notional company. We will take advice and, where possible, engage with the rating agencies to help determine appropriate test levels to assume in our business plan.

2015-20 performance

Q1. Do you agree with our proposed approach for dealing with PR14 reconciliations and SIM? If not, please explain your alternative approach and why this would be in customers' interests.

The proposed approach for dealing with PR14 reconciliations and SIM is appropriate.

We are one of the companies with an existing reputational ODI for the qualitative component of SIM. We agree that the contact survey element within the proposed C-Mex measure will provide an adequate reputational substitute for this ODI in 2019-20 and assessment of the ODI can be dropped for the final year of the AMP.

Q2. Do you agree with our proposed approach for reflecting how well the company is delivering for customers over the 2015-20 period in the initial assessment of business plans? If not, please explain your alternative approach and why this would be in customers' interests.

The consultation sets out the two test areas of past performance which will be applied under the initial assessment of business plans (IABP); the first based on evidence for proposed reconciliations and the second in relation to how well the company has delivered its 2015-20 business plan and engaged with its customers on its performance.

We would challenge the need set out in the consultation for companies to evidence customer support for proposed adjustments. Given the difficulty of finding customers who want to be engaged on this very specific subject and are prepared to invest the time necessary to be able to give valid opinions, we expect the CCG to play this role. Also, we know that a lot of customers, including their representatives on CCGs, still do not support the principle behind some of the incentives which were part of the PR14 price control package. We do expect them to recognise the incentives as contractual elements and to reassure themselves that they have been accounted for and applied correctly.

In relation to the second IABP test, as noted by Ofwat, it is important to avoid any double counting between this test area and others relating to, for example, outcomes or cost assessment. The final methodology should provide further clarity on this.

One area not currently captured under the IABP tests which we think should be is the level of ambition in companies' 2015-20 business plans. This needs to be reflected so that a company which meets the very challenging performance commitments it set in conjunction with customers at PR14 is considered in higher order than companies which met less stretching performance targets.

Finally, we recognise the need for a company to demonstrate how well it has engaged with its customers on its performance. In order to ensure our customers are engaged with our performance we have developed our performance portal[16]. We are confident this is the first company-specific performance portal in our industry. The site gives stakeholders clear, easy to access and up-to-date information on our current performance, broken down by Outcome and ODI. The site combines reporting, integrating video and infographic content to inform customers, providing both contextual and data trends on our performance.

[16] Available at http://ourperformance.anglianwater.co.uk/index.html

Securing confidence and assurance

Q1. Are the business plan and data requirements clear and sufficiently specified?

It is clear from the draft methodology that Ofwat is seeking to move away from the freer form of business plan submission we saw at PR14 to a more prescriptive approach for PR19. For example, whilst the requirement for companies to populate a suite of regulatory data tables remains consistent with previous reviews the draft methodology goes further and prescribes a page limit for the companies' main business plan narratives. As expected, the requirement for companies to provide all supporting evidence, analysis and modelling underpinning their business plans remains.

There is also currently a lack of clarity in a number of areas; for example: what Ofwat considers "main" business plan and what is considered "supporting evidence"? Also it is not clear how the data capture system will operate and in what format submissions will be permissible.

Data submission

We set out in our response to the Outcomes questions in the consultation our views on the need for clear ex-ante confidence to be established in relation to the consistency and comparability of data collected and used to assess companies' proposed plans. In a number of areas of the data tables, there is an absence of detailed line descriptions for the required information. These gaps need to be filled urgently to ensure companies are providing information on a consistent basis. Therefore, we conclude further work is required with the sector ahead of the final methodology in December.

A number of data tables (e.g. the tables requesting explanatory information) request historic information which has been provided previously in other regulatory submissions (e.g. previous Annual Performance Reports or the July information requests). To ensure consistency, we request that Ofwat confirms that where this information has been provided previously this will be pre-populated into the final versions of the data tables.

For the purposes of the methodology consultation, the proposed data tables have been presented separately between price controls and the overall appointee level tables. There are many instances in the data tables where tables are linked (i.e. either as a copy of a cell in another sheet or where a cell is an input to a calculation in another sheet). These links are not presently visible and we would expect the final methodology to present the tables in a single file with all of the relevant relationships (i.e. copied and calculated cells ready).

Our comments on the definitions of individual lines are highlighted in the data table comments pro-forma.

Q1a. Are there any areas we need to look at again?

As mentioned in the executive summary, we think there is merit in Ofwat considering the structure of the tables in order to allow for the appropriate capture of enhancement opex. This should allow for such expenditure to be modelled separately from botex, which the draft methodology suggests may be necessary.

We consider there is a general need to provide further information on the data capture system and the potential consequences for companies' submissions of their business plans and the constraints this may have on companies presenting innovative, digitally driven business plans.

Where industry-wide data is being collected (e.g. tables WWS18 and WS18) for broader purposes we would encourage the use of well-defined and truly comparable data. For example, capturing the 'number of customers engaged with' does not reflect the depth or nature of engagement that has occurred.

We therefore argue that such a metric, in the absence of assurance on comparability, would be almost meaningless. We have highlighted other data lines where inconsistency across companies will present an issue in the comments on individual data lines.

As stated above, where we have comments on formatting and wording of individual lines, we have highlighted these in the data table comments pro-forma.

Q1b. Is there any data missing, or included but not required?

We have highlighted in the pro forma template for data table responses where we have comments on specific data requirements. However, we have a general concern that in some instances the rationale for including some data is not clear.

Q2. Do you agree that our approach to assessing assurance can provide us and stakeholders with confidence in the companies' business plans?

Overall the approach seems sensible. We note that Ofwat is proposing to use companies' Company Monitoring Framework (CMF) assessment as part of its IABP process. It is critical that where Ofwat proposes to use this information in the IABP process it does so in a clear, transparent and objective manner. We do not consider that this was the case in Ofwat's Company Monitoring Framework assessment in 2016 where minor concerns were flagged relating to an immaterial cost allocation error (£21k) between retail and developer services and an item of casework which Ofwat requested data going back to 2003 and suggested incorrectly that we had lost data. We infer these findings directly contributed to Anglian Water being classified in the "targeted" assurance category.

The initial assessment of business plans: securing high quality, ambition and innovation

Q1. Do you agree with our proposed approach to the initial assessment of business plans?

In general, relative to PR14, having visibility of the Initial Assessment of Business Plans (IABP) framework is a positive step.

We do not agree with the view that Ofwat's starting assumption should be all plans require significant scrutiny nor the rationale for this to be the case. We believe that a company's plan should be presumed to follow the "standard" regulatory process, in this case "slow track", and be categorised upwards or downwards based on the evidence within their plan. Not to act in this manner would be inconsistent with wider regulatory tools Ofwat uses such as the Company Monitoring Framework and the description of significant scrutiny set out in appendix 14.

We support the principle behind the proposal for a pro-forma signposting within a company's business plan the relevant evidence for each of the tests under IABP however we question whether such an exercise would drive the right behaviours in both the production of, and review of, companies' business plan submissions.

We agree that a high quality business plan should be easy to navigate.

In terms of the assessment criteria, we believe that Ofwat should be clear how performance on each test contributes to the overall IABP.

We would welcome additional clarity as to the level at which the assessment will apply, i.e. at the appointee or price control level.

In this regard we believe that it would be possible for Ofwat to provide potential examples of what it defines as "material interventions" with respect to assessing companies' plans.

• Q1a: In terms of the nine test areas?

Overall, the nine test areas have suitable coverage across the main component areas of companies' business plans. As set out above, in the final methodology we recommend Ofwat confirms whether these tests apply at appointee or price control level. We note that these tests are not mutually exclusive; for example how stretching companies' outcomes are will be in the context of both previous business plans and past performance in the 2015-20 period.

In addition we request in particular detail on how performance in any specific tests potentially may act as "gated tests" against the four overall assessment categories.

For example, if under the Securing Cost Efficiency test, a requirement to achieve fast-track or exceptional is to be assessed as having an efficiency totex baseline relative to Ofwat's assessment, then this should be explicit. We understand this was the case at PR14. We consider this is of significance given Ofwat's proposal to apply categorisations of business plans "in the round". We previously noted the overlap between this particular test and the cost sharing incentive.

• Q1b: In terms of the business plan characteristics we want to see? (high quality, ambition and innovation)

The widest possible range of stakeholders would agree that companies need to submit high quality business plans. High quality covers a range of characteristics, i.e. that plans reflect stakeholder priorities, contribute to the specific long term challenges facing each company and have a clear, well evidenced plan. There is a risk of double counting across Ofwat's three categories insofar that Ofwat could judge a company's business plan of not being of high quality if under qualitative assessment it is not deemed to be sufficiently ambitious or innovative enough.

The ambition of companies' plans should be assessed both in terms of the company's level of ambition in previous business plans and the proposals set out within its PR19 plans. Companies who set themselves ambitious plans at PR14 and do so again at PR19 should be recognised relative to companies who only propose ambitious plans at PR19.

• Q1c: In terms of the business plan categories we propose to assign companies to? (significant scrutiny, slow track, fast track, exceptional)

We have commented on Ofwat's approach to placing all companies in significant scrutiny as a starting point above.

On balance we would question the strength of the incentives set out for the respective fast track and exceptional categories given the subjective nature of the assessment.

Should our comments on the starting point for IABP be taken on board, we would propose the slow track categorisation should be renamed as "standard". This would be consistent with PR14 and provide some consistency across price reviews for stakeholders.

• Q1d: In terms of the financial, procedural and reputational incentives we propose to put in place?

The consultation proposes a range of financial, procedural and reputational incentives across the four categories. We question whether the incentives are sufficient for the higher classification of business plans. For example, given the subjective nature of the IABP assessment whether the 0.2% uplift on RORE incentivises companies to target this categorisation given that innovation by its nature is risky and this is a pre-requisite to an exceptional plan.

Q2. Do you agree with our proposed approach to assessing a company's ability to deliver results for customers and the environment from innovation?

We agree that innovation should be integral to companies' business plans and that companies will need a clear track record of innovation, and future plans to continue to do so should be rewarded. We note that innovation in and of itself is subjective and we think that this is an area where Ofwat's IABP approach could be expanded to provide companies with greater clarity on how Ofwat will assess innovation.

The following consultation questions relate to Appendix 14 on the initial assessment of business plans:

Q1. Do you agree with the key questions under each of the test areas?

Q2. Do you agree with what we will look for in terms of high quality, ambition and innovation under each of the test areas?

The following detailed comments address these two questions on the nine test areas:

Engaging customers

- We agree with the focus and criteria, namely that companies need to demonstrate the influence of a wide-ranging and comprehensive programme of customer engagement in their plans. To this end, we do not consider the inclusion of the "number of customers engaged" [Table App4 – line C1] in the draft business plan tables is required as this measure does not capture the extent to which companies have used this engagement in shaping plans, nor the nature of the on-going engagement beyond business planning.

Addressing affordability and vulnerability

- The emphasis in table 14.2 in the appendix of a cost benefit analysis on companies' social tariffs is too narrow at determining the efficacy of companies' approaches and we favour a broader assessment of companies' approaches to affordability;
- In terms of the data tables (specifically section B of table App4) we are concerned that the data requested on metrics is too prescriptive to capture the breadth of approaches taken by companies; for example working with other third party agencies.

<u>Delivering outcomes for customers</u>

- We presume that in this context "appropriate" is intended to capture how well a company's ODIs capture the specific preferences of each company and how these are reflected in their plans. If this is the case, this should be explicit, noting that Ofwat has to a certain extent set some constraints through the common ODI measures and the preference for the majority of incentives to be delivered through these common measures.
- As set out above, the assessment of how stretching a company's performance commitments and services levels are will need to be assessed in the context of previous plans and delivery so that companies who have previously set and delivered high levels of performance are not penalised in the assessment.

<u>Securing long-term resilience</u>

- We agree with the proposal for companies to engage with their customers on their resilience in the round, but question a company's ability to provide comparative data on the risks faced by other companies.

<u>Targeted controls, markets and innovation</u>

- We consider this test should reflect how well a company uses its supply chain and alliance partners to deliver innovation and cost efficiency to customers.

<u>Securing cost efficiency</u>

- We interpret the requirement for companies to submit an efficient level of totex in all areas to mean that a company is required to be below Ofwat's baseline for each price control to be considered high quality. This is a high bar.
- We have raised separate points relating to special factor claims in our cost assessment chapter response.
- We consider this test should reflect how well a company uses its supply chain and alliance partners to deliver innovation and cost efficiency to customers.
- As stated previously, this test also overlaps with the cost sharing incentive.

<u>Accounting for past delivery</u>

- As started above, the assessment needs to reflect the level of ambition in previous performance.

<u>Securing confidence and assurance</u>

- We note that Ofwat is proposing to use both companies’ 2018 Company Monitoring Framework assessments as well as a broader “assurance in the round” (p254) as part of assessing the assurance and governance supporting their business plans. We are supportive of this approach in general, provided the application is evidence based and proportionate.
- We note that Ofwat is proposing to use companies’ Company Monitoring Framework (CMF) assessment as part of its IABP process. It is critical that where Ofwat proposes to use this information in the IABP process it does so in a clear, transparent and objective manner. Based on our experience of the 2016 CMF, we are concerned with the subjective nature of this assessment and the disproportionate emphasis on very minor points.

Q3. Do you agree with our high-level approach for scoring business plans into the four categories (significant scrutiny, slow-track, fast-track, exceptional)?

Our comments to the sub components of question one in the main consultation documents capture our views on the four assessment categories.

Q4. Do you agree with our proposed schedule for the initial assessment of business plans?

The proposed schedule for IABP seems appropriate.

Appendix 1: Revised timetable for special cost factor submission and cost model publication