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30 August 2017

David Black
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By Email Only

Dear David

PR19 methodology consultation

Your PR19 methodology consultation confirms very clearly that you are keeping us well ahead of where we were at the equivalent stage at PR14. The policy decisions published in May 2016 have now been translated into a detailed methodology that enables companies to progress their PR19 business plans ahead of your confirmation of the methodology in December. This is a significant achievement, for which you and your team should be congratulated.

We also strongly support the key features of your approach – in particular the centrality of customer participation in developing company plans, the focus on long-term outcomes, the importance of innovation and affordability, and the consideration of resilience 'in the round'. These features provide a robust, balanced approach appropriate to an essential service that needs to continue planning for the long term, and mirror the themes identified by our own Board for our own circumstances.

Inevitably, responses to a methodology consultation will tend to focus on areas where alternative approaches might be more effective or efficient and will tend to say much less about areas of agreement. This response is no different – but that should not detract from the very large measure of support we have for the principles and approach embedded in your proposed methodology. All our subsequent comments and suggestions should be taken against this overall context.

We appreciated the opportunity to discuss with you in person the key areas of our response. These are summarised here and further detail is included in Appendix 1 as a response to the questions in your consultation.

One size does not fit all

The water sector is unique amongst regulated utilities in the fact that companies are so mixed in size. This diversity has served customers well for nearly thirty years, as different approaches have driven the service and cost frontier for the benefit of all customers. There is no doubt, however, that operating under an increasingly complex regulatory regime is more challenging for the smaller companies. It would be inefficient of us to devote the same amount of resource to regulatory matters as a company with even double our customer numbers.

We appreciate that the challenges, in general, need to be met with more agile working practices and different ways of doing things. There is plenty of evidence that smaller companies have stretched frontiers on cost and performance. However, there is a broad range of evidence that debt financing is one area where we cannot compete on the same terms as larger companies. We have also evidenced that the additional financing costs that we face are more than offset by the support we have from customers for continuing to be served by a small local company.

In July we shared further evidence with you on the efficiency of our main debt instrument. You have since clarified that you intend to apply a cost and benefit test to any requests to reflect company-specific financing costs and that the benefits test will assess the benefits to customers as well as their support for an adjustment. We see no reason why efficiently incurred financing costs, related to our specific circumstances, should be treated any differently to claims for company-specific operating or capital expenditure. Regulatory transparency requires that the tests you intend to apply are published in advance: the confirmation of your methodology in December provides the final opportunity to do this and should provide a similar level of detail as the requirements for adjustments to take account of company-specific operating or capital expenditure. Your intended approach will also need to address the concerns the Competition and Markets Authority raised with the approach taken at PR14 in its 2015 determination on Bristol Water. We look forward to the methodology decision articulating how the proposed tests will help you meet your statutory duties and what, if any, further evidence you will want to see in our business plan to justify our position.

Risk and reward package

Setting tough challenges in the interests of customers is an appropriate role for a regulator, and the sorts of challenges you have laid down in your methodology consultation are all appropriate in their own right. Companies should aspire to levels of service that stand comparison with other sectors; efficiencies need to be found as they would be in a competitive market; innovation should be expected; bills need to be affordable for all – and measures developed to help those customers in vulnerable circumstances; and company boards do have obligations to ensure that companies will be able to respond appropriately to changes in circumstances on different fronts. Individually, such challenges are entirely reasonable.

However, the potential combination of individually reasonable challenges may result in an unsustainable overall outcome. It cannot be right that a methodology deliberately aims at ensuring that “an average company with average performance would expect to incur penalties on its ODI package”, when only by avoiding such penalties would companies be expected to earn a return equivalent to the allowed cost of capital. This is entirely a question of how risk and rewards are calibrated as part of an overall package – and needs careful consideration in the round to avoid individually reasonable challenges resulting in an unsustainable outcome.

Interactions between totex allowances and outcome delivery

The regulatory approach, in particular the outcomes framework, incentivises individual companies to deliver the levels of service that their own customers support. We are very supportive of this framework but it does create complications when it comes to comparative cost assessment – an approach to setting allowances more suited to delivery of homogenous products and service levels. This is not a new issue but at each consecutive price control it becomes more pronounced as the regulatory approach encourages companies to differentiate themselves. This interaction should be recognised, in part, through reconsidering the proposed move to a more stringent efficiency frontier than was applied at PR14. Not recognising this interaction risks providing totex allowances that are too tight to deliver stretching performance commitments for the benefit of all customers and it risks companies focusing on less risky, and therefore less innovative, approaches to delivery.

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Retail control

A proposed three year retail control was one of the few surprises in your consultation. We consider this an unnecessary complication. There is clearly on-going uncertainty on the expansion of retail competition that must be addressed. We consider that the uncertainty can be better managed through the current Relevant Change of Circumstance mechanism in companies' Instruments of Appointment.

Data requirements

Having the data tables required for business plan submissions in draft form at such an early stage in the process is helpful and allows for proper planning of data collection, review and assurance requirements. It also provides an opportunity to identify potential data requirements of questionable value. In particular, we consider that projecting some data beyond 2025 has limited value in relation to the wider exogenous variables – and merits some reconsideration.

Alongside this letter you will find the completed response proforma. If you have any questions related to our response please contact Joanna Campbell, Economic Regulation Manager (Joanna.campbell@seswater.co.uk, 01737 785 692).

Yours sincerely

John Chadwick
Finance and Regulation Director

Responses to questions raised in the consultation

Affordability

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?

We support use of the five principles but note that none of the three initial assessment tests for affordability (page 44) specifically reference the principles. It would be helpful if they did as the tests would then act as a clear reference point for what Ofwat will consider in its assessment.

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?

We recognise that determining the measures to assess how company plans perform against the five principles is not straightforward. We suggest that the onus should be on us to provide evidence to support our plan which may include quantitative evidence.

We do not believe the chosen metrics will add any benefit to the assessment process and will require resources to be devoted to generating data but will not improve the service we deliver to our customers. In particular:

- None of the measures allow for fair comparison across companies and are poor barometers of the quality of the service we offer. For example, it is unfair to compare the number of customers engaged with across companies that vary in size of population served from 265 thousand to 9.9 million people. Equally the average bill reduction of financial assistance schemes and number of customers supported will be impacted by both the level of need in the community served and customers' willingness to support financial assistance schemes – both of which are outside of companies' control.
- For a number of years we have asked our customers about satisfaction with value for money and affordability. However, we do not currently ask about 'acceptability' and therefore it is not possible to provide a robust figure. It is likely that every company has a different approach to their on-going measurement of affordability.
- Any metric related to costs and benefits needs a detailed definition to avoid companies including/excluding different elements. For example, would the costs and benefits of affordability measure capture customer benefits/costs as well as costs/benefits to the company?

Vulnerability

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

In our response to the outcomes consultation published last November we stated our preference for the development of bespoke performance commitments to be left as a choice for companies, based on discussion with customers and other stakeholders. We still believe that this would provide an outcomes framework that better reflects our customers' views but note that addressing vulnerability would likely appear in all companies' frameworks anyway.

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

As with the affordability assessment, we believe the onus should be on the company to provide evidence of how vulnerability is being addressed in their plan. The proposed quantitative metrics in data table 'App4' are merely one way of doing this, but more work would be needed to convert them into reliable measures. For example:

- Vulnerability assistance options needs to be clearly defined.
- Eligibility for assistance is transient and likely to be very difficult to estimate robustly for the purposes of completing this table, especially if 'vulnerability assistance options' is wider than financial assistance.
- Clarity is needed on what would be measured by 'customers contacted by the company about eligibility for vulnerability assistance options'. It's unclear whether it would cover pro-active contact we make with customers or just count contacts we receive. We are concerned that both may be poor barometers of the level of service we provide as they reflect only the quantity of the contacts made and not the quality or outcomes driven by those contacts.
- We measure overall satisfaction and a proportion of those surveyed will be receiving support, but the sample size will be very small. To set up a survey specifically to achieve a robust sample size would require significant expenditure and we do not believe this would drive a better service for our customers.

Delivering outcomes

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

We support the targeted introduction of common performance commitments and welcome having sight of what these commitments will cover at this stage in the process. Our preference would be for fewer common performance commitments to allow scope for developing our own commitments without creating an excessively long list. However, we appreciate that the outcomes framework must strike a balance between a proper fulfilment of the regulator's duties and the scope for innovation and diversity driven by the priorities of the particular customers we serve and are therefore comfortable with the balance that has been reached.

Do you agree with the common PCs? Do you agree with our approach to asset health outcomes?

The seven common performance commitments (excluding WaterworCX) proposed for water cover the areas likely to be important to all customers.

We remain unconvinced that asset health metrics represent outcomes and our preference is to exclude them from the outcomes framework (so no rewards or penalties would be on offer) but keep them in the annual reporting requirements. This would provide Ofwat and other stakeholders with information to allow monitoring of our commitment to maintain serviceable assets but prevent double counting the end impact to customers or, at worst, lead to an incentive to focus on the wrong areas. For example, a burst main may cause a visible leak and interrupt customers' supply but the outcomes framework already incentivises us to manage the potential customer impact. It's unclear why the outcomes framework needs to incentivise us additionally to deal with one of the potential causes – when in fact a burst main, if well managed, may have no detrimental impact on supply. Equally an unplanned outage may have no impact on the service received because water can be transferred from another treatment works.

The aim of the drought risk measure is unclear. We have not previously invested to meet a 1 in 200 year drought, but will be assessing scenarios based on this for the next Water Resources Management Plan (WRMP). We support encouraging reductions in the level of risk from drought but to meet the requirements of a 1 in 200 year drought may require some companies to invest significantly. It is unclear if a significantly higher level of investment is the outcome Ofwat is trying to incentivise or whether the measure is designed simply to provide information and a means of monitoring risks.

The current definition may also disadvantage smaller companies as there is less likely to be a differentiation in drought risk. Our next WRMP will treat our area as one Water Resource Zone (WRZ) due to the improved connectivity of our network allowing water to be flexibly used across the supply area. The population at risk from a drought is therefore everyone or no one. We are concerned that improving the connectivity of our network and therefore its resilience further disadvantages us under this measure of performance.

There is some ambiguity in the definition for per capita consumption which should be removed to better ensure consistent reporting. References to 'customer' should be avoided and instead the definition should refer to 'population' or 'person'. Population is calculated by companies based on property numbers and an assumed occupancy rate (which you would expect to vary by region). Providing guidance on the way to count properties would improve consistency in measurement across companies. For example, a block of managed flats could be counted as one property (as one bill is generated) or several properties. Unmeasured household consumption is not directly measured and the definition is currently ambiguous – should the consumption figure we use be pre or post any MLE adjustment?

Do you agree with our approach to bespoke PCs including areas that bespoke PCs should cover?

Our preference would be for a set of targeted common performance commitments and for all other commitments to be for us to design in consultation with our customers and other stakeholders. Stating what must be covered by bespoke commitments reduces the scope to address the areas that matter most without creating an excessively long list of commitments.

We support the objective of the Abstraction Incentive Mechanism (AIM) but have been unable, based on its current form, to apply it. The detailed guidance on what the AIM performance commitment should look like in PR19, outlined in Appendix 2 of the consultation and brought to life in the data table requirements, leaves little room for companies to develop a bespoke commitment that works for their particular circumstances. We consider that a better outcome will be achieved for the environment and our customers if there is more flexibility for us to design a mechanism that works in our area. Ofwat could assess the mechanism based on how well it meets the objective of the AIM (to reduce the environmental impact of abstracting water at environmentally-sensitive sites during defined periods of low surface water flows).

The restriction created by dictating bespoke commitments is compounded by the proposal that all current performance commitments should continue. As flagged in our outcomes consultation response, our Customer Scrutiny Panel has already warned against excessive numbers of performance commitments. Our early research with customers for PR19 also demonstrated that customers have limited interest in seeing a large range of commitments and want a few clear and transparent targets on which to evaluate our performance.

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

The flexibility at PR14 to set performance targets and incentive rates that reflected what mattered most to our customers had many benefits, but also created some perverse outcomes. Figure 1 shows that we are the best performer in terms of water quality contacts but narrowly missed a penalty. Figure 2 demonstrates that the better performers on leakage are not necessarily the companies receiving rewards. United Utilities reward for being the second poorest performer in the industry was larger than the penalty paid by Thames.

Figure 1: Water quality contacts in 2016/17

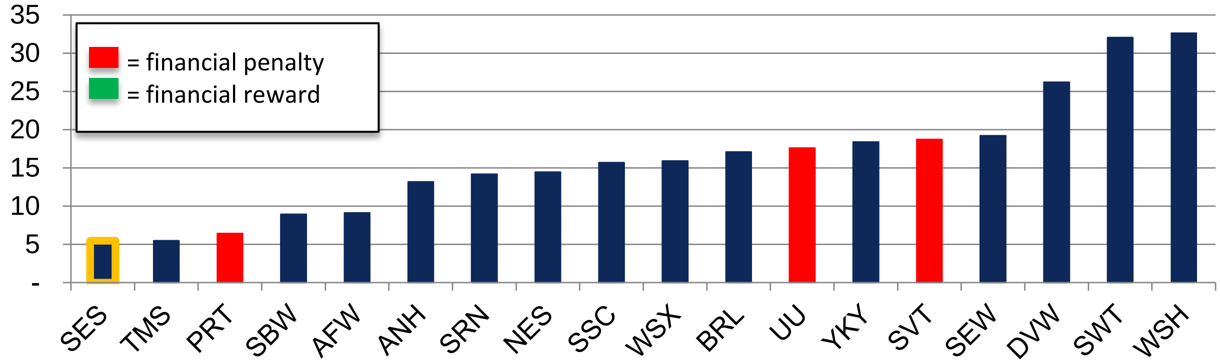
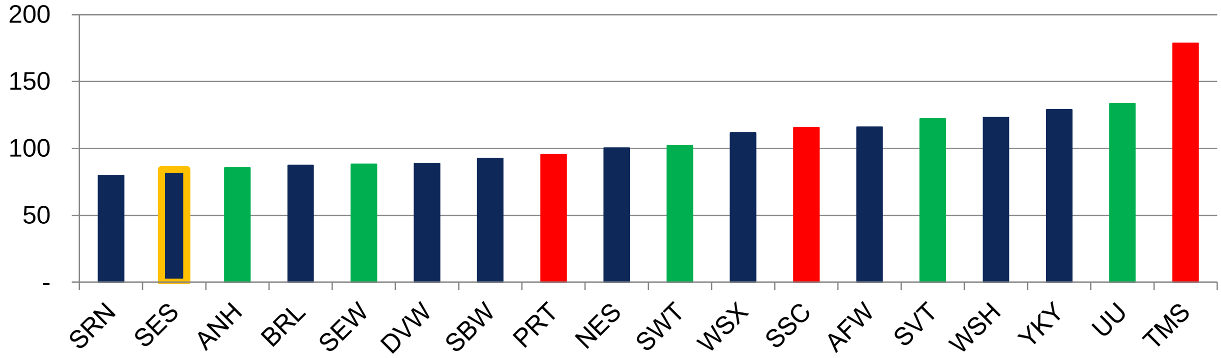


Figure 2: Leakage (in litres) per property per day in 2016/17



Ofwat's renewed focus on reporting and publishing performance information will help us put forward robust options to our customers and help them make more informed choices on the level of service they want us to deliver. We support the emphasis placed on setting stretching performance commitments and the focus Ofwat is aiming to place on comparative assessment of commitments.

We agree that single-year commitments are generally more appropriate than multi-year commitments. We welcome Ofwat's acknowledgement that there are uncontrollable impacts on performance, particularly those driven by the weather. We think these are better addressed through the use of well-calibrated deadbands rather than multi-year commitments. We suggest that, rather than excluding the use of deadbands, the onus is placed on companies to demonstrate that their use is appropriate to deal with uncontrollable impacts.

We are unclear what Ofwat's view is on a plan that demonstrates continuous improvement through increasingly stretching performance commitment levels. We are concerned that the draft methodology's position on glide-paths is incompatible with a plan that commits to continuous improvement. It is natural that improvements in service may take some time to deliver as investment or changes in systems or processes may be needed. The efficient level of service is therefore likely to change over time. We disagree with the statement that glide-paths mean that "customers have to wait for the levels of services they have funded companies to deliver" as frontier levels of service are not necessarily funded from year one due to the approach to cost assessment and the setting of totex allowances. Confirmation that sensible phased improvements in service do not amount to an unacceptable 'glide-path' would be welcomed.

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

The draft methodology appears to take a different approach from the options consulted on in the November outcomes consultation. The methodology proposes that industry leading performance is expected from all and that this should be the new norm and be funded through base revenue rather than rewards. This means that "an average company with average performance would expect to incur penalties on its ODI package". It cannot be right that a methodology deliberately aims for this outcome, when only by avoiding such penalties would companies be expected to earn a return equivalent to the allowed cost of capital. The approach to risk and return from the ODI package needs to be considered alongside other elements of the overall package.

The consultation, and in particular the initial assessment tests, leaves the onus on companies to get agreement from their customers for industry leading performance commitments and therefore leaves no option for lower levels of service and consequentially lower bills. We feel there should be scope in the initial assessment tests to provide evidence in support of such a scenario rather than ruling it out completely.

The interactions between the outcomes framework and cost assessment approach are not adequately acknowledged in the draft methodology and we think this is an oversight that should be addressed in the methodology decision. We fully support the outcomes framework and the incentive it creates to deliver the services that matter most to our customers and we think that the cost assessment approach needs to better reflect this variation in the level of service delivered across the country. We discuss the options for doing so in response to your question on the cost assessment approach.

Do you agree with our proposals to increase the strength of ODIs by increasing the impact ODIs have on reputation, the greater use of in-period ODIs, linking ODIs to revenue rather than RCV and having a greater onus on financial ODIs?

There is a strong reputational incentive to set stretching performance commitments and to meet the targets we developed with our customers. This has been recently enhanced with the increased focus on comparing across the industry, including through the Discover Water website. We remain unconvinced that putting greater weight on the magnitude of financial incentives will drive better outcomes for customers and could create increased variability and less predictability in charges.

Customer engagement has highlighted the importance our customers place on us being a local, trusted business that cares about its social responsibilities. These are important features that we may want to include in the outcomes framework but, in many cases, it would be unsuitable to ask our customers to pay more for exceptional performance. We would expect Ofwat to consider the merits of non-financial ODIs as well as financial ones in the initial assessment of plans.

In-period ODIs have their merits and we understand why Ofwat are keen to see them used more. We remain concerned that the proposed annual assessment process is overly complex and will diminish the benefits. We suggest that the process can be simplified and rely on companies' assurance and Board sign-off processes to ensure the accuracy of in-period adjustments. A full review in the course of the subsequent price review could be used to address any anomalies identified with the annual Board certification processes.

Do you agree with our proposals on enhanced rewards and penalties?

This proposal is inconsistent with the general message adopted in the methodology that, rightly, significant weight will be placed on assessing that customer acceptability was sought for all aspects of our business plan. There is a risk that this approach will result in significant differences across the country between what customers pay for a given level of service – partly because the level of service that would be deemed 'exceptional' will be forecast separately by each company. Ofwat should set out in the final methodology whether they will step in to ensure consistency.

Do you agree with our proposal to remove the RoRE cap?

The onus should be on us to develop a business plan that balances risk and reward in a way that allows us to meet the needs of all stakeholders including customers and investors. We therefore support the removal of caps so we can consider ODI rewards and penalties as one element of the overall risk and reward package.

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

We support the general move to improve the current Service Incentive Mechanism but raise some points on its practical application in response to the next question. The C-MeX incentivises better business practices and approaches that aim to improve the wider customer experience. Our preference would be to continue to include complaints as part of the overall scoring system, i.e. we would choose option 2. Including a specific measure of complaints ensures that the views of these customers are heard as the likelihood of picking up these customers in the survey is low simply due to them being a small proportion of the customer base.

The methodology proposes that C-MeX rewards and penalties are limited based on a percentage of residential retail revenue. The C-MeX will be measuring service across both retail and wholesale functions and therefore penalties and rewards should be calibrated based on appointee revenue and the resulting reward or penalty for each company should be split across price controls.

Further clarity on who will receive rewards and who will receive penalties is needed. Incentives work best if you know what the potential rewards and penalties are in advance. The consultation states that the top three performers would receive rewards. Does that mean that the fourth highest performer receives no reward? How many companies would receive penalties? These questions need to be answered in the final methodology.

Do you agree with our proposed methodology for the C-Mex surveys, as set out in table 4.2 of Appendix 2?

We support testing the use of text as well as online surveys. One concern with moving to a different survey method is that the response rate may be lower, particularly from those that choose to contact us over the phone. Response rates may be better if the survey method mirrors the contact method. This will be a useful area to test in the trial and if response rates are found to be low then the survey approach could be modified. We support submitting data weekly even though the survey is only conducted four times a year. To further promote a proactive and quality end-to-end service we think that companies should not be informed of when the surveys will be conducted, or they could be conducted continuously.

We think consideration should be given to using an external source of data for the survey of customers who have had no contact with water companies. This eliminates the potential bias in our own data where we are more likely to have up to date contact information for customers who have contacted us in the recent past.

C-MeX is incorrectly described as a “symmetrical” incentive. The potential maximum reward and penalty may be the same but the goal posts change as there is an extra test to achieve the maximum reward and therefore it is not symmetrical. Your own analysis shows that no company would currently receive the top reward available. This asymmetry should be reflected in the plausible range of company returns illustrated in the RoRE range.

Do you agree with the C-Mex contact survey focusing on customer satisfaction with both contact handling and resolution?

Yes we agree that both are important aspects of a customer's experience and should be included.

Do you agree with our proposed Developer Measure of Experience (D-MeX)? Do you agree with our proposed approach to implementing D-MeX, in particular by conducting a satisfaction survey amongst past developer services customer contacts?

We believe that a better approach would be to allow companies to address service improvements through bespoke measures that are targeted at the areas their own customers identify as needing improved. If the proposal is to continue in its current form it will be very important to trial this survey as we have concerns that it may not produce robust results. Our preference would be for early trials and to apply it as a reputational rather than financial incentive for the first few years of the next period.

Our main concerns are:

- Sample size: the number of developers that we have contact with is obviously significantly below water customer numbers. Getting a robust sample size is particularly an issue for smaller water companies. When response rate is taken into account this could leave a rather small number of customers to base a financial incentive on.
- Potential for a skewed response: the proposal suggests that our competitors – self-lay organisations, new appointments – would be surveyed. These competitors have an incentive to score us low as they have nothing to gain from giving us a high score.

We have a good working relationship with developers in our area and would prefer to devote resources to further service enhancements rather than operating this mechanism given the potential issues it has.

Resilience

Do you agree with our resilience planning principles?

Yes we agree.

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

The two test questions proposed are appropriate.

Wholesale controls

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'?

We agree with the form of control and the continuation of the existing revenue forecasting incentive mechanism and water trading incentive.

The proposed approach to developer services is better than the current approach. The main drawback of the proposed approach is that is requires a robust average revenue figure to be calculated. The cost, and therefore revenue, on connections related jobs is variable. An alternative would be to base the true-up on actual revenue, which reflects outturn costs as well as volumes. Given all the other protections in place to charge a fair price – charging scheme rules, competition law – there is very little risk of companies using this alternative approach to alter prices in a way that is not in line with cost changes.

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'?

We welcome the detail now provided on the decisions already made through the Water 2020 programme.

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 do not agree that access pricing should form part of the business plan submission. It can be more efficiently managed through an alternative process that allows for a later submission. The risks of delaying the submission appear very low because access pricing will only be needed once Defra puts the necessary legislation in place, and we will have sufficient lead time to develop prices when a date is known.

We welcome Ofwat's intention to publish further guidance this autumn and hope that the point we make above will be taken into account.

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

The proposed framework looks to be built around a standard approach to procurement and for that reason we support it. We would welcome clarification on what is meant by "an incumbent's subsidiary or affiliate should not participate in the bidding process". Is this statement intended to exclude affiliates from bidding to provide services to us? If so we are unclear why this would be the case. We would expect them to be able to bid on the same basis as any other company and to be assessed against in-house solutions on the same basis.

Direct procurement

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 agree that this approach should focus on large schemes where customer value will be generated, given there is a sunk cost to operating such a framework.

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?

No comment.

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'?

No comment.

Residential retail controls

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?

We support continuing to set the allowances using a weighted average revenue control.

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

We do not support a three year control. We think that a five year control, with an appropriate mechanism for managing the uncertainty around expansion of retail competition, is a more measured approach. We believe that the current licence provision for a Relevant Change of Circumstance would provide such a mechanism. But if this was considered unsuitable we would support a tightly defined licence amendment to address the potential need to re-open the price control to address residential retail competition.

We think that the proposed revenue setting process for retail, which will capture industry cost drivers and benchmark across other sectors, means that there will be limited value added from applying evidence from business retail market two years earlier than under a five year control. Our main concern with a three year control is that it creates an unwelcome distraction from delivering a continuous high-quality service to our customers. As we still need to provide a full five years of data and information for the PR19 review an additional price control review creates additional resourcing requirements. It may also negatively impact investment decisions as the uncertainty, of committing to investments when funding is uncertain, is greater under a three year control.

Securing cost efficiencies

Do you agree with our overall approach to cost assessment?

We welcome the collaborative approach taken to date in developing data requirements and in considering different approaches to cost assessment modelling. While this work did not quite deliver its intended output we feel Ofwat and the industry are in a much better place than at this stage in PR14. In particular, we know what the data requirements are and, we hope, we can continue to work together to ensure consistency in the interpretation of definitions.

The consultation leaves the choice of final modelling approach very open with options including; use of historical vs forecast; looking outside the sector for benchmarks; aggregate vs disaggregate; and unit cost vs econometric. This is not unexpected, given the stage Ofwat are at in the process, but it makes it difficult for us to agree or disagree but we do support the direction of travel. We would welcome continued dialogue on the approach to cost modelling and sight of the models prior to submission of special cost factor claims next May. Further sight of the modelling approach will reduce the number of special cost factor claims. We discuss this further in response to the relevant question.

The regulatory approach, in particular the outcomes framework, incentivises individual companies to deliver the levels of service that their own customers support. We are very supportive of this framework but unfortunately it creates complications when it comes to comparative cost assessment. It is reasonable to expect companies delivering different levels of service to have different levels of costs. But, comparative cost assessment assumes delivery of homogenous products and service unless differing levels of service are included as cost drivers. The proposed approach to cost assessment will not use service metrics as cost drivers – and we understand the difficulty in doing so. However, we feel that the cost assessment approach needs to recognise this interaction and address it pragmatically. Options for managing this interaction include:

- Not applying the more stretching frontier proposed in the methodology, and setting totex allowances based on a combination of the company's view and Ofwat's modelled view of efficient costs.
- Incorporating a sense-check to confirm if the more efficient companies are targeting lower levels of service than others and making adjustments to the model inputs or modelling results if this is the case.
- Allowing companies to recalibrate their performance commitment levels once totex allowances and other companies' performance commitment levels are known.

On the basis that Ofwat recognises that some costs or levels of activity, e.g. taxes and developer services, are outside of our control and therefore more difficult to forecast there should be further scope to include some form of true-up mechanism for other such costs. In our view these costs include business rates, environmental taxes, the Ofwat licence fee and Market Operator Services Limited fees.

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

We are pleased to see that the menu approach used at PR14 has been replaced.

The consultation refers to setting different cost sharing rates across controls. We think that one sharing rate for wholesale water totex is more appropriate. The proposed approach to cost assessment could result in the totex allowance for water resources being set based on a wholesale totex model with apportionment of allowances based on a percentage split. The recorded over- or under-spend would therefore represent not only true cost out or under performance but also any misallocation of allowances at the time the price control was set. We don't believe that this is the intention and the way to prevent this is to have one totex sharing incentive.

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 this is more of an issue for wastewater providers and have no comment.

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

We agree that there should be a process for allowing cost adjustments to address differences in costs between companies that cannot be robustly modelled, either because there is no reasonable cost driver available or because the imperfect nature of modelling means the impacts are not adequately picked up. The requirement that these claims be well-evidenced is reasonable and we welcome your acknowledgment that different levels of evidence may be needed for different claims.

It would be helpful to have sight on the cost assessment models prior to the deadline for making cost adjustment claims. For example, pumping head is, in part, driven by regional operating circumstances. You would expect it to be a cost driver and be included in the cost assessment models but at PR14 it was not. If we have not had sight of the models then we may be inclined to submit a cost adjustment claim in case the final models do not take it into account.

We think it would be more appropriate to apply the same materiality to wholesale and retail claims. The retail business unit is treated as a standalone business for the purposes of regulatory reporting and it therefore does not seem right to that it has a higher materiality threshold.

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

We support the move to setting allowances based on econometric models on the basis that robust cost drivers can be found and that the models themselves are robust. We support assessing abstraction charges outside of the model as there is no suitable cost driver that can explain the regional differences.

We do not agree that the impact of regional labour can be substantially mitigated. Ofwat acknowledge that regional labour costs are a relevant driver of costs and therefore we find it odd that it should not be as, if not more, relevant for retail as it is for the wholesale business. We appreciate that there is some element of choice on where your customer service centre is located, but our customers value the fact that they speak to someone local with local knowledge when they call us. It's important to note that retail costs also cover a proportion of general and support staff costs which are even less easy to locate outside of the area.

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?

We do not agree with setting a retail control that takes no account of the input price pressure that we are likely to face as these cost pressures are outside of our control. We would welcome clarity from Ofwat on what "if appropriate" means and therefore what will and will not be considered a reasonable claim for input price pressure in the retail control.

The statement that "We consider that inflation risk to retailers is limited within the price control period" seems to be based on the premise that retail costs "predominantly consists of labour costs" and are therefore controllable. We agree that labour costs are controllable but they do need to reflect market conditions. Not reflecting market conditions creates additional costs including increased rates of staff turnover. We would like confirmation from Ofwat on whether well-evidenced claims of input price pressure, coupled with efficiency improvements, will be appropriately considered.

Allowances for non-labour costs should move in line with those costs in the wholesale price control. There is no logical reason for treating them differently as proposed by Ofwat.

Do you agree with our proposals for the transition programme?

No comment.

Risk and return

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?

There is significant uncertainty in relation to changes in the macroeconomic climate that cannot be ignored. In particular how the government, Bank of England, financial institutions and investors will respond to Brexit.[1] This uncertainty means that a balance must be struck between using the past as a predictor of the future and using forecasts. We conclude that the PwC approach places too much emphasis on forecasts in a time of heightened uncertainty.

[1] Recent comment from the deputy governor of the Bank of England notes the potential for interest rate rises greater than the market expects, www.bbc.co.uk/news/business-40823237, 4 August 2017.

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

On the basis that the decision is to press ahead with debt indexation we support the conclusion that an end of period true-up (for differences between forecast and outturn indexation) is more appropriate than annual true-ups. We also think it is right to apply the simplest and most transparent approach to accounting for inflation and therefore support using the Bank of England inflation target.

Decisions on debt financing must take account of the broad range of evidence that this is one area where smaller companies have not been able to compete on the same terms as larger companies. The additional costs of financing smaller water companies was recognised in the CEPA report published last autumn[2] and rating agencies recognise different operational gearing for smaller water companies in their rating parameters as evidenced in our response to the cost of debt consultation.[3]

We understand that Ofwat will want to see evidence of the efficiency of costs, the customer benefits received and customer support for any adjustment to reflect a company's particular circumstances on debt financing.

In July we shared further evidence with you on the efficiency of our main debt instrument. You have since clarified that you intend to apply a cost and benefit test to any requests to reflect company-specific financing costs and that the benefits test will assess the benefits to customers and their support for an adjustment. We see no reason why efficiently incurred financing costs, related to our specific circumstances, should be treated any differently to claims for company-specific operating or capital expenditure. Regulatory transparency requires that the tests you intend to apply are published in advance: the confirmation of your methodology in December provides the final opportunity to do this and should provide a similar level of detail as the requirements for adjustments to take account of company-specific operating or capital expenditure. Your intended approach will also need to address the concerns the Competition and Markets Authority raised with the approach taken at PR14 in its 2015 determination on Bristol Water. We look forward to the methodology decision articulating how the proposed tests will help you meet your statutory duties and what, if any, further evidence you will want to see in our business plan to justify our position.

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)?

We have no further comments on the intended indexation approach.

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

We support the targeted introduction of an uncertainty mechanism related to changes in liabilities that our outside of our control.

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?

We prefer mechanisms that are transparent and kept as simple as possible. We therefore prefer the true-up mechanism to be limited to changes in corporation tax rates and capital allowances.

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2 Alternative approaches to setting the cost of debt for PR19 and H7, September 2016
3 Sutton and East Surrey Water – response to Water 2020 cost of debt consultation, October 2016

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 set of scenarios are sensible. We welcome publication of the financial model at this stage in the price control review.

We agree that it is not necessary for Ofwat to publish economic information on which to base our scenarios. The assumptions used should be part of the evidence included in our plan.

Financeability

Do you agree with our overall approach to assessing financeability?

We support the inclusion of metrics within the financial model. We would expect Ofwat to consider the evidence, and any proposed solutions, around financeability included in each company's plans.

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?

The calculations appear to be correct in the methodology and financial model.

Accounting for past delivery

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.

We welcome the flexibility provided by allowing revenue adjustments to be applied in the first year or spread across the next period. We assume that, as the RCV adjustment will be made prior to its allocation between water resources and network plus, the intention is for all RCV adjustments to be made as midnight adjustments. Please could this be confirmed.

More detail would be welcomed in the final methodology on the approach that will be applied to calculating rewards and penalties on the SIM. The only information shared so far is the maximum and minimum rewards and not how these will be calculated for an individual company based on its relative performance. Without this information there will be a significant degree of guess work required to complete the reconciliation submission.

Our preference would be to submit the PR14 reconciliation rulebook at a later date than the Annual Performance Report (APR). There is already a significant volume of work to complete between the end of the financial year and the 15 July APR submission deadline, particularly now all non-financial information has been incorporated into the APR. A later date would allow for a more efficient allocation of resource – even two additional weeks would be beneficial.

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.

Yes we agree that past performance should be one of the factors considered in the initial assessment of plans. If a company presents credible evidence on why it can achieve a step change in performance in the next period then this needs to be considered as part of this assessment.

Securing confidence and assurance

Are the business plan and data requirements clear and sufficiently specified? Are there any areas we need to look at again? Is there any data missing, or included but not required?

The business plan requirements are mostly clear. There are some data requirements that are not clearly defined and we believe there is some scope to rationalise the requirements. There is a significant amount of duplication which involves copying and pasting data from one set of tables to another. Rationalising the requirements will reduce the burden on companies and minimise the risk of errors being introduced. For example, App25 data is all available elsewhere so the table could either be deleted are it could remain and the equivalent water and retail tables could be deleted.

We have included specific comments in the proforma as requested. The final data table specifications also need to reflect feedback supplied to the recent consultation on the Regulatory Accounting Guidelines and feedback through the query and response process on the 2016-17 cost assessment data submissions as a number of the data items are the same.

We consider that projecting some data beyond 2025 has limited value in relation to the wider exogenous variables – and merits some reconsideration.

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

We agree with the requirements on assurance and Board ownership of the plan.

Initial assessment of business plans

Do you agree with our proposed approach to the initial assessment of business plans? In terms of the:

- **nine test areas?**
- **business plan characteristics we want to see? (high quality, ambition and innovation)**
- **business plan categories we propose to assign companies to? (significant scrutiny, slow track, fast track, exceptional)**
- **financial, procedural and reputational incentives we propose to put in place?**

We appreciate the clarity provided in the consultation on what is expected from us and it provides us with a good basis on which to structure our business plan.

The procedural and reputational differences between the four business plan categories are clear as is the financial implications of being under significant scrutiny. We would argue that the financial incentive attached to an exceptional plan is weak. If Ofwat are looking for companies to truly stretch the boundaries then a greater financial reward should be on offer. A reward that is of a similar magnitude to the penalty that will apply to a company in the significant scrutiny would provide a far greater incentive.

If our understanding is correct then the incentive to produce a plan that is exceptional or fast-tracked is diminished by the removal of the 'do no harm' rule. This rule should apply to ensure that any material changes, e.g. changes in the macro-economic climate which result in a more favourable determination for slow-tracked companies, are also applied to exceptional and fast-tracked companies.

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

The proposed approach correctly places the onus on us to demonstrate through our plan that we embrace innovation for the benefit of our customers and the environment.

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

The questions are key reference points for companies and in most areas they provide a good summary of the approach Ofwat will take in assessing our plan. There are a few areas where the assessment will include a review on whether our plan meets stated principles, e.g. affordability and resilience, but these principles are not referenced in the questions. It would be helpful if they were.

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

Yes we support the proposed approach.

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

We agree with the categorisation of plans into four categories.

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

The schedule looks sensible. It would be helpful if the methodology decision confirms when in January 2019 the initial assessment will be published.