PR19 methodology consultations

Response

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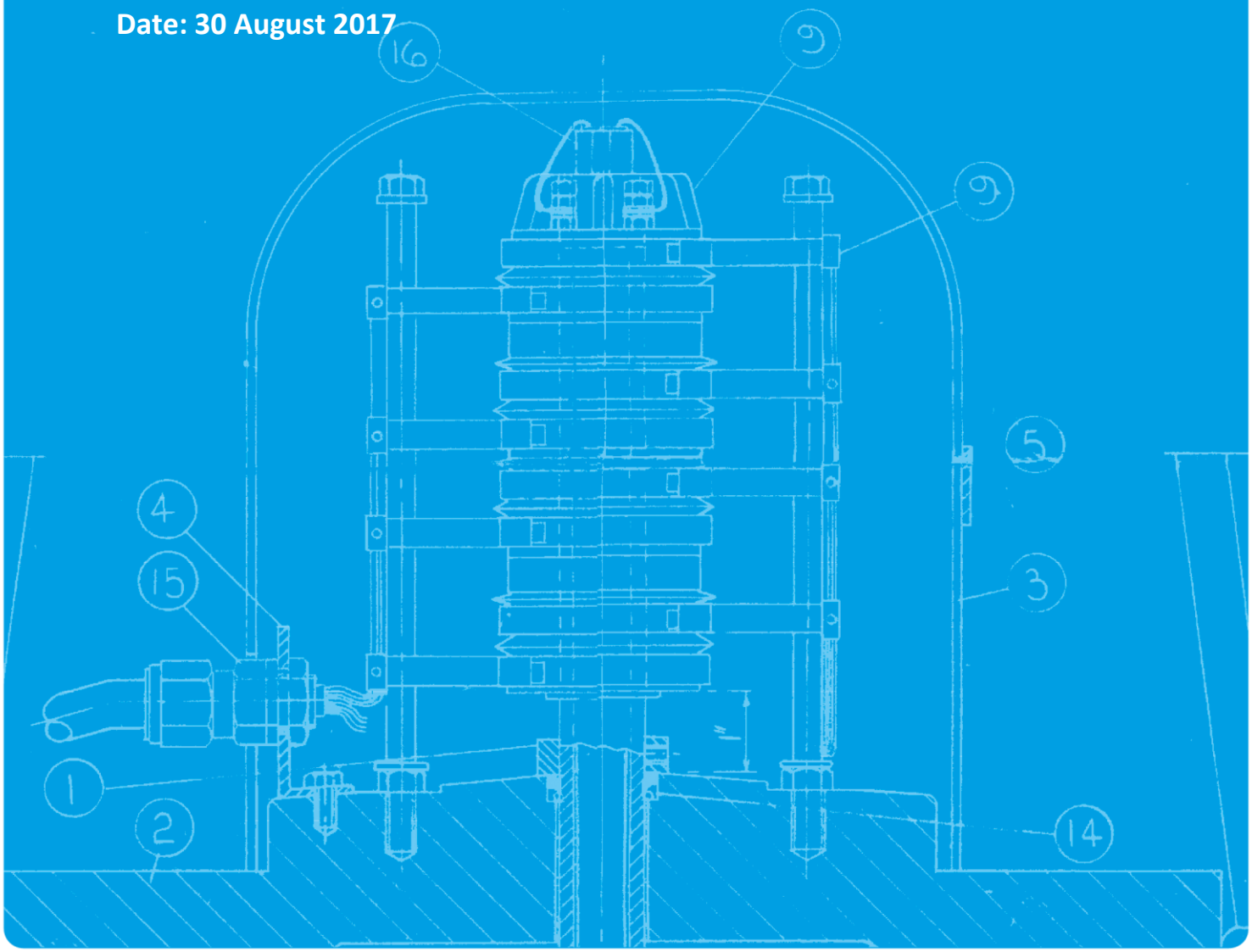


Delivering Water 2020: Consulting on our methodology for the 2019 price review

Executive Summary

The proposed 2019 Price Review (PR19) methodology builds on the last review, with a further shift towards stronger incentives for cost and service performance. This direction of travel is very positive because the incentives introduced, such as totex and ODIs, are already delivering significant benefits for customers. We therefore support the PR19 proposals that enhance these incentives to drive more efficiencies and innovation across the sector.

We are particularly supportive of:

- the design of outcome delivery incentives – with much greater emphasis on in-period revenue incentives which provide more immediate impact on management teams when they deliver for customers, whilst still managing bill volatility;
- strengthening cost and service incentives by removing the totex and ODI caps; and
- applying a proportionate approach to regulation of the non-household retail sector.

These are developments which we have supported in our Charting a Sustainable Course publication.

The consultation also builds on PR14 in respect of customer engagement. We are particularly supportive of the strong emphasis in the PR19 consultation that customers should be active participants in the sector, helping to develop and deliver solutions to some of the big challenges that we face.

We believe that there are areas where the methodology could be improved to deliver better outcomes for customers. In particular, there are opportunities to further incentivise innovation; and apply a more proportionate approach to regulation, which would promote greater focus on delivering value to customers as opposed to meeting the requirements of the regulator. We expand on these points below and then set out some specific areas for improvement before responding to the consultation questions.

1. Incentivising further innovation

The consultation on the PR19 methodology identifies that more innovation is critical to the future of the sector. We support this emphasis and consider that through innovation the sector can deliver more for less - better resilience, greater customer service and more affordable bills.

There are many features of the proposed regulatory framework that we think will help to incentivise innovation. This includes greater emphasis on customer engagement (in particular customer co-creation and co-delivery), the introduction of "supercharged" ODIs, the retention of totex and allowing companies to develop their own bespoke performance commitments (PCs) and outcome delivery incentives (ODIs).

However, we think Ofwat could go further to incentivise innovation and frontier shifting performance by considering the overall risk-return package.

Overall package

Historically the water regulatory framework has been criticised for providing weak incentives for innovation. The 2011 Gray review considered this issue and identified ways in which the regulatory framework was engendering a lack of ambition. It noted that the balance of risk and reward had been tilted too far towards uncertain and potentially large penalties for failure, with relatively limited rewards for outperformance or innovation.

We think the current proposals place too much emphasis on penalties with less scope for rewards. Although the methodology proposes symmetrical incentives, they appear to be too heavily weighted towards penalties due to the current calibration. For example:

- the wholesale cost benchmarks appear to be based on the frontier companies and include a further dynamic efficiency challenge;
- the retail cost benchmark will be set on a similar basis, with additional challenges through the benchmarking of bad debt costs against other sectors; and no automatic adjustment for inflation;
- comparative PCs are set on the basis of 2024/25 UQ with no glide-path;
- non-comparative PCs are set on the basis of a range of stretching metrics; and
- a UQ adjustment to embedded debt was flagged as being under consideration at the PR19 webinars.

This is not to say that the targets should be easy. We support stretching targets as it ensures customers can have trust and confidence in the services they receive. However, incentives are ultimately a means to an end - which is to deliver more for customers - and if they are going to work, a balance between stretch and deliverability needs to be maintained.

While each of the individual PR19 proposals in insolation might be considered appropriate and improve short term outcomes, the package in the round shows a greater emphasis on penalising companies. The consequence is that this might hinder radical innovation and instead promote incrementalism – see for example *Carrots or Sticks? The Effect of Incentive Framing on Radical and Incremental Innovation* which concluded that there is a positive

association between penalty framing and incremental innovation, whilst radical innovation is correlated to incentive framing.[1] This is also consistent with the recommendations of the Gray Review which identified that incentives too heavily focused on penalties could restrict innovation.

When looking at the Annual Performance Reports published in July 2017, it is apparent that performance this AMP has been mixed suggesting that the package in the round is reasonably balanced. While there have been some examples of strong performance with some customers getting much higher levels of service, only half of the companies have earned the base return when we examine the cumulative 2016/17 RoRE. Given that a significant part of the returns reflects financial outperformance from new debt, if the PR14 methodology was applied at PR19 with new debt indexation, it's likely that the proportion earning the base return would be even lower.

For the PR19 methodology we think Ofwat should consider three mechanisms to deliver a more appropriate balance of risk and reward to incentivise innovation and ultimately better outcomes for customers:

- using a cost benchmark based on the top four or five companies for the wholesale and retail controls, with the added dynamic adjustment in wholesale to address the CMA's suggestions and an adjustment to reflect the smaller number of waste companies;
- incorporating a short glide-path for the projected UQ ODI targets – this ensures an outcome that is no worse off for customers and more a realistic journey, which in turn would encourage companies to be more ambitious in setting targets for 2024/25; and
- applying a cost of debt adjustment that allows customers to share in the benefits of outperformance but which doesn't penalise companies for the timing and tenor of existing debt issuance.

We have also identified some specific issues with elements of the cost of equity proposition and discuss these separately.

2. Proportionate regulation

The PR19 methodology is being designed against the backdrop of six principles: (i) targeted price controls; (ii) proportionate price setting; (iii) effective incentives; (iv) ownership, accountability and innovation; (v) flexibility and responsiveness; (vi) transparency and predictability.

[1] Chen, C. X., Lill, J.B, & Lucienetti, L. (2015), Carrots or Sticks? The Effect of Incentive Framing on Radical and Incremental Innovation.

We think there are opportunities for Ofwat to further embed two of these principles – proportionate price setting and ownership. This is important because, as the Gray Review noted, regulation that is too invasive hinders innovation and leads to a sector in which companies are too heavily focused on Ofwat as opposed to customers.

In this context we have identified a small number of areas in which the information requirements do not appear to be critical to the act of setting price limits and could actually undermine innovation. This relates to the design of super charged ODIs, the bio-resource control and the Initial Assessment of Business Plans (IABP). We think reducing the information requirements in these areas would promote better outcomes for customers.

Super-charged ODIs

We support the rationale for introducing supercharged ODIs to incentivise innovation. The principle that those who successfully innovate – delivering benefits to customers that would not otherwise be achieved – are rewarded for taking on risk is consistent with what we would expect to see in a market.

However, the current proposal requires that companies submit plans for how they will share innovations if they want to access higher rewards. This proposal seems inconsistent with how markets operate in practice with innovators being rewarded for the risk they take by retaining the competitive advantage for a period of time rather than being forced to share intellectual property prematurely.

This is important because delivering innovation involves risk – notably R&D failures. For example, we have experienced failures relating to our attempt to utilise Aquifer Storage and Reuse and sludge drying technologies. The current proposal would cap the benefits of innovation at between 1-5 years, which substantially changes the balance between risk and return and undermines Ofwat's intent for introducing supercharged ODIs.

The proposal to share innovation also ignores the fact that there are other avenues for information to be revealed and deliver broader societal benefits. For example, (i) targeted recruitment (ii) utilising different suppliers; and (iii) trading ideas as most companies generally have an area in which they are comparatively high performers and hence there are mutually beneficial opportunities. If management teams are not making the most of these opportunities, then capital market competition should lead to management teams being replaced with more progressive teams.

Bio-resource

The current proposals provide companies with strong incentives to trade – both importers and exporters will gain from any transaction and customers will benefit from the claw back at 2025. It therefore seems unnecessary to require that companies should also submit sludge trading strategies. Furthermore, it is not apparent how this information will be used for the purpose of setting price controls.

If Ofwat is not satisfied with how market develops then it might consider how it can use its regulatory tools, including new information requirements. However, we think this should occur after the market has been established rather than in advance.

The initial assessment of business plans

We are very supportive of the IABP and the majority of tests. We are particularly supportive of having specific tests on affordability and vulnerability – we consider this will help incentivise companies to do more to support customers in vulnerable circumstances and ensure that services are accessible.

In relation to innovation, we think the desired outcomes can be more effectively achieved through incentives, as opposed to specific innovation tests. As we noted earlier, promoting radical innovation requires that the incentives are calibrated in a way to create meaningful opportunities for outperformance. We don't think having information requirements to specify the people and processes involved in innovation will promote innovation. Instead we think it will encourage companies to describe lots of things as being innovative without delivering benefits to customers.

Innovation should be a means to an end – the extent to which companies innovate should be evident in the service levels and the consequential bills impacts. We think this test could be abolished without impacting customer outcomes and ultimately create a sector less focused on what the regulator wants and more focused on what its customers want.

3. Specific areas for improvement

In the sections below we have responded to the consultation questions presented by Ofwat. However, we think it is important to emphasise three areas where we think the current approach could be improved to deliver better outcomes for customers. These relate to:

- direct procurement;
- the cost of equity; and
- C-MeX.

In relation to direct procurement, we support the principle of the policy that markets can reveal better information and ultimately deliver better outcomes for customers. However, we do not think that the current design of the DPC proposal will deliver this outcome.

The ban on companies competing to deliver projects in-area undermines the competitive process by excluding from bidding a party arguably best suited to deliver the work. We understand Ofwat's concern that bidders might perceive that they may not be treated fairly – however this could be addressed in the same manner as the bid assessment framework – by using independent procurement teams. We also think there is an opportunity to incorporate a reference price in the process so proposals can be assessed against a counterfactual to ensure they deliver benefits for customers.

In relation to the cost of equity, we accept that returns in the near future are likely to be different from the long-term historical averages that regulators have relied upon in previous determinations. However, any forecast of the likely cost of equity is bound to rely upon some historic information; the question is what period is selected and whether this has been applied consistently for all variables within the calculation. If the cost of equity for PR19 assumes that total market returns will not revert to the long-term historic mean, **recent evidence for other parameters should also be considered**. We therefore think that the assessment of the cost of equity needs to take into account:

- the upward movement in estimates of beta since PR14;
- the significant distortion of prevailing negative yields from quantitative easing and the rationing of supply; and
- the allowed cost of equity in the context of the overall package. While it has often been argued that the incentives within the regulatory regime are not a systematic risk that is captured within the CAPM model, the output of CAPM should represent the central investor expectation of the cost of equity. If other incentives are intentionally skewed to the downside, this will no longer be the case.

In relation to C-MeX, we support the objectives of the incentive but consider the current design would result in a comparative incentive being applied in an inconsistent manner. This is due to the small sample size and the risk that companies will be assessed over different time intervals thereby creating some averaging effect for certain companies but not others. These concerns could be addressed by:

- increasing the sample size for the surveys to improve the statistical robustness of the analysis (companies could fund the additional size); and
- applying the same time interval to the data.

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?

We support the proposal to use the five listed principles to assess the affordability of business plans.

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?

We believe that option 3, using the principles-based approach with metrics, is the right option to be taken forward as it allows the principles to be applied in a more objective manner. This approach gives greater transparency around what is expected and will ensure companies understand the benchmark they are expected to meet.

However, there could still be an element of subjectivity in the interpretation of the measure definitions. Therefore, only limited cross comparisons should be applied and Ofwat should place more weight on the CCG challenge (or conversely if Ofwat wants more cross comparisons then greater clarity of the definitions is needed as is occurring for the comparative performance commitments).

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

We welcome the flexibility of proposing our own bespoke performance commitments to address vulnerability in our business plan. This is important because there can be diverse and changing reasons why customers are vulnerable – bespoke performance commitments give companies the opportunity to better reflect this diversity.

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 agree with the proposal to use qualitative information to assess:

- how well companies use good-quality available data to understand their customers and identify those in circumstances that make them vulnerable;
- how well companies engage with other utilities and third-party organisations to identify vulnerability and best support those who are in vulnerable circumstances; and
- how targeted, efficient and effective companies' measures to address vulnerability are.

Q5) What do you think about our proposed options for requiring companies to propose bespoke performance commitments for addressing vulnerability?

We believe that the proposed option 2 is the most appropriate option. It provides the companies with the flexibility to decide how they should best address vulnerability whilst enabling Ofwat to more easily collect sector wide data.

Outcomes

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

We are supportive of the proposals set out in Option 4. We agree that this option allows both:

- comparability across a small set of common measures to more effectively enable stakeholders to challenge the ambition of proposed performance commitment levels; and
- scope for companies to set their own bespoke performance commitments which reflect their own customers' preferences and innovate in the design of their performance commitments.

We also agree that the set of 14 proposed PCs are broadly sensible in terms of coverage (further details in our response to Question 1a), and that it is appropriate to set comparative performance commitment levels on three of the four PCs (water supply interruptions, internal sewer flooding and pollution incidents). However the fourth PC, water quality compliance, is a relatively new measure with a limited historical dataset; as such, we think it is too early to set performance levels on a comparative basis.

This issue of comparability is important. The work on agreeing common definitions for leakage, supply interruptions and sewer flooding, carried out by UKWIR and companies, supported by Ofwat and co-ordinated by Water UK has been rightly cited in the PR19 consultation. This work serves to highlight the importance of good quality and consistent definitions. We would support this work being extended to the other measures, and for the Annual Performance Reports to be used as a vehicle for shadow reporting the new common measures. This transparency will provide information on trends and appropriate stretch for AMP7, and highlight where further work may be required to ensure definitions are being consistently applied.

Finally, Ofwat also propose that companies will need to justify if they do not intend to continue with any of their existing PCs into PR19. While we agree that the onus should be on companies to provide strong evidence and reasoning for changes, we believe there may be a stronger case where genuinely innovative PCs were proposed and challenging targets set despite relatively little experience of the measure. It is important that such PCs are able to be refined otherwise companies could be disincentivised from innovating and taking appropriate risks to deliver the outcomes customers value most.

Q1a) Do you agree with the common PCs (1 - 14)?

As stated above, we agree that the set of 14 proposed PCs are broadly sensible in terms of coverage. We believe that a common PC should meet four criteria:

1. Does the PC reflect an area of service that is important to customers;

2. is the PC an appropriate measure for that area of service;
3. are we confident that the PC can be consistently reported; and
4. is the PC mature with robust reporting over time?

We have assessed and ranked the 14 proposed PCs against these criteria in the table below. Our rationale is then explained, setting out where ore work is required before the proposed measure is appropriate (if applicable):

PC	Criteria				Comment
	Customers	Appropriate measure	Consistent reporting	Maturity	
Wastewater pollution incidents	High	High	High	High	
Customer water supply interruptions	High	High	High	Medium	Limited historical data aligned to consistency guidelines
Customer property sewer flooding (internal)	High	High	High	Medium	
Leakage	High	High	High	Medium	
Mains bursts	High	High	Medium	High	June Return guidance available but consistency project has shown variance in how companies have used this guidance on other measures
Sewer collapses	High	High	Medium	High	
Per Capita Consumption	High	High	Medium	High	Need to ensure that all companies are aligned on methodology. Recommend PCC should be an average measure similar to leakage to allow for annual variations
Wastewater assets - pollution incidents	High	High	Medium	Medium	Further consistency and guidance needed on reporting Category 4 incidents
Water quality compliance (CRI)	High	High	Medium	Low	Relatively low maturity creates risk around setting future UQ targets. Could benefit from horizontal assurance to ensure consistent application
Water resilience (drought risk)	High	High	Low	Low	Further work needed to define calculation of 1in 200year RP. Varying methods used currently. Historical context not available.
Unplanned outage	Medium	Medium	Low	Low	Customers are unlikely to experience an interruption to supply. No standard reporting within the industry
Wastewater - flooding risk	High	Low	Low	Low	Further work is needed to define the measure

Our comments on the 14 PCs based on our assessment is set out below:

- On the top four PCs (customer property sewer flooding (internal), customer water supply interruptions, wastewater pollution incidents and leakage), we support the use of common consistent definitions developed by the industry. We would advocate that this dialogue on improving reporting and ensuring consistency is continued through AMP7. **Clarification on the starting position for the 3-year leakage average measure (assumed to be 2020) and inclusion of severe weather to access enhanced rewards on sewer flooding (assumed to be the case) would be helpful.** On stretching commitment levels to UQ2024/25 we have outlined our response in Q2.

- On mains bursts and sewer collapses, companies have historically collated data and formally reported performance as part of the serviceability measures. Whilst this provides a strong foundation, the learning experience from the convergence project is that companies may have interpreted the standard guidance in different ways. **We would therefore support undertaking a**

similar project covering common measures, including mains bursts and sewer collapses. We would be happy to lead on the development of these guidelines.

- On per capita consumption (PCC), **we welcome the inclusion of additional measures to leakage which focus on wider demand management**. This aligns with our thinking that given the uncertainties around absolute leakage measurement, and the variety of factors that can impact leakage, it should not be assessed in isolation. Additionally, we would propose that PCC is considered as an average measure to accommodate annual variations due to weather, similar to leakage.
- On pollution incidents caused by wastewater assets, our experience of having a PC covering Category 4 pollution incidents is that further work is required with the Environment Agency on how to standardise the assessment and reporting process. Currently, if a category 4 incident is reported to the Environment Agency it remains in the category irrespective of any challenge.
- On the water quality compliance new DWI measure Compliance Risk Assessment (CRI) PC, we welcome alignment of measures between regulators. It is a significant improvement on the Mean Zonal Compliance measure and we recognise that the new PC will incentivise companies to reduce compliance failures and focus on improving response and management of failures. However, in terms of its use as a common measure with commitment levels to UQ 2024/25 (with no glide path), we have some reservations:
  - being a new measure, there will be limited historical data to set robust baseline or comparative commitment levels;
  - the measure may fluctuate and both individual company and national scores may be affected by a relatively small number of events;
  - the measure itself may be difficult to explain to customers; and
  - calibration of robust penalty rates will be challenging.

  There are parallels with the pollutions PC where the Environment Agency undertakes assessment on the incidents. In this area, extensive work has been undertaken with the industry to outline guidelines and ensure consistency. A similar approach with regards the new CRI measure would benefit all companies.

  Overall, we welcome this new PC but strongly believe that, as with resilience, companies should be able to set appropriate PC levels for PR19. This would allow the measure to mature such that comparative PC levels could be set for PR24.

- On both the water and waste resilience PCs, we welcome the caution on not requiring companies to have a financial measure whilst still allowing for freedom to do so should customers support financial ODIs to deal with challenges in these areas.
  - On the water resilience measure, our technical experts believe guidance is required to develop a nationally consistent methodology to enable consistent reporting.
  - On the waste resilience PC, we recognise the need to have key common resilience measures and would advocate further work is undertaken by the industry to develop and define a waste resilience measure.

- On unplanned outages, we support the principle (incentivising companies to be more proactive with maintaining assets in a way which reduces unplanned outages), the **PC scope and definition needs further work**.

  The current proposal is to base an outage against maximum production capacity rather than Deployable Output (DO). For many sites the operational regime may choose to work lower than maximum production capacity in periods of low demand raising it at peak periods. The assumption that outage measured in terms of lost DO for the annual Water Resource Management Plan (WRMP) review will be the same or very close to that of production capacity is incorrect and is the reason why DO exists. A number of valid constrains may lead to a site operation where DO is lower than maximum production capacity and companies should not be inappropriately penalised for this. Additional, companies are likely to have variable ways of defining maximum production capacity whereas DO absolute.

Note: C-Mex and D-Mex we outline our views in our response on Q4 and Q5.

Q1b) Do you agree with our approach to asset health outcomes?

We are supportive of the partial standardisation approach on asset health proposed and have outlined our views on the 4 common asset health measures proposed in Q1a.

We agree with the need to explain our approach and proposals on asset health performance to customers and CCG's using past performance and future challenges but **expressing asset health penalties as a percentage of RORE will not be easy for customers to understand**. A view on comparative performance with associated rewards across the industry could be used as an alternative.

We welcome the proposal to enable rewards in this area should customers support the improvements and would like to see options to enable enhanced performance should customers strongly support the need.

Q1c) Do you agree with our approach to bespoke PCs including areas that bespoke PCs should cover?

We are supportive of the approach where common areas have been outlined to ensure that all companies develop measures on vulnerability, environment, resilience and Abstraction Incentive Mechanism (AIM).

We welcome the removal of AIM from the proposed common performance commitments and a move to include it as a bespoke measure. This is important because there are already other programmes that address the problems AIM covers, specifically Restoring Sustainable Abstractions (RSA), the Water Framework Directive (WFD) and improvement solutions will be endorsed in the WINEP. **To ensure that the regulatory framework is proportionate and targeted, companies need flexibility as in some cases the scope of what we could propose under AIM will be limited**.

For this reason, it is important to retain flexibility in the bespoke measures companies propose to protect raw water sources with associated flexibility in the type of incentive.

We welcome the encouragement to consider cross company PC's. Our experience on working with Risk Management Authorities on flooding via our partnership working ODI and working with farmers to deliver catchment management has indicated that joint objectives and goals can be a powerful incentive to drive additional focus on delivery of outcomes which benefit the wider community and environment.

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

We broadly agree with the proposals on setting performance commitment levels with the exception of one area – the absence of a glide-path for the four comparative measures. In order to incentivise companies to innovate, it is important that the package in the round is coherent and not weighted too heavily to penalties. We believe the use of a 3-year glide-path would help address some of our concern whilst ensuring that the same outcome and outputs are delivered. We discuss this more in our response to Q2b. Ofwat could also use differential incentive rates to address concerns about easy rewards.

We also think additional clarifications would be helpful in relation to:

- long-term projections – how these forecasts will be used given that long term cost projections will not be set; and
- clarification on how step changes in performance (particularly where stretching UQ 2024/25 targets are being set) is to be linked to costs.

Q2a) Do you agree with our proposals to setting bespoke performance commitment levels?

We agree with Ofwat's position that companies should set performance levels using a range of data. This flexibility is important because performance levels should reflect customer needs – mandating a particular approach undermines the need for companies to understand the specific requirements of their customers. For this reason we do not think that the starting presumption should be 2024/25 UQ, or greatest historical performance for example – instead the starting presumption should be the performance target is set to a level that reflects the views of customers. We recognise that companies should provide customers with information so that they can make informed choices however we do not think it is appropriate to take the decision away from customers.

We have also identified some specific views on two of the proposals:

- UQ: The convergence project has revealed that companies record the measures in different ways and unless a similar convergence project is applied a comparative UQ target could have unintended consequences. Therefore, whilst we support the ability not to apply UQ targets, we think the "opt out approach" should be removed and this just be listed as an option. Companies could be incentivised to deliver the UQ or higher through the application of enhanced rewards;

- Historical information: Although we agree that this information should be used to inform targets, it is not appropriate to assume that the highest growth rates can be maintained. To generate a step change in performance the regulatory framework needs to provide strong incentives for innovation – which means realistic scope for rewards. Setting performance targets (as opposed to ODIs) on the basis of the best ever performance would not offer meaningful opportunities for rewards. Instead we think this would lead to a culture of incrementalism.

Our preferred approach to setting performance levels is based on the views of customers. This ensures that customers receive value for money and underpins the overarching affordability challenge. If there is a desire to set performance levels away from those levels, then the onus should be on companies to provide a strong justification for why that is appropriate.

We support Ofwat's view that companies should look to draw on other data when undertaking cost-benefit analysis. However, in drawing upon other data such as customer contacts, the resulting service level will inevitably involve more subjectivity than occurred using stated preference WTP. Therefore, it is critical that the IABP assessment affords companies the flexibility to try different approaches.

Q2b) Do you agree with our proposals to setting common performance commitment levels?

We agree with the proposal to set targets for the 4 comparative measures using a UQ benchmark (with the other common measures set using the approaches outlined in table 4.4). However, if the benchmark is 2024/25 UQ then we consider that a short glide path is essential. This is important because what matters to customers is the improvement to their service, and not necessarily the industry UQ. By applying a glide path of 3 years the same outcome can be delivered but in a more realistic manner.

However, we also recognise Ofwat's desire to ensure that rewards are earned when compares stretch themselves. Therefore, one option would be to combine a glide path with different ODI incentive rates whereby until a company delivers UQ performance the incentive rates are reduced. This would address Ofwat's concerns whilst also ensuring that the package is not too heavily weighted to penalties.

For the reasons provided in question 2a, we think the service levels for the remaining common performance commitments should be set based on the views of customers.

Q2c) Do you agree with our proposals to setting leakage performance commitment levels?

We broadly agree with Ofwat's recommendations on leakage and the need for leakage to be a priority measure.

We are supportive of the inclusion of other metrics such as PCC in the basket of measures. The uncertainties around absolute leakage measurement, and the variety of factors that can impact on it, mean that total leakage should not be taken as a performance measure in isolation and should be part of a suite of indicators showing demand management and / or infrastructure resilience.

We support the proposal to stretch leakage performance to UQ but this believe this should be supported by customers and allow for cost effective innovative solutions**. We see this as a multi-AMP strategy with longer term UQ projections for leakage with enhanced rewards spread over two AMP. We would welcome an approach which supports this.**

We welcome the commitment by the industry and the continued support by Ofwat to improve the definition and calculation of leakage so as to reduce variability between companies' approaches. We would recommend that data improvements and real losses are valid improvement areas but methodology changes should be restricted to ensure the focus is on improving true leakage performance.

While we agree that leakage performance should be presented in the context of the SELL assessment for the current AMP and the long term WRMP, it is important to recognise that Defra's WRMP Guiding Principles for leakage will inevitably push companies beyond the SELL. The expectation that leakage can never be allowed to rise means that we will be committing to ever tighter targets that drive leakage down incrementally, even when new resource capacity could reduce the short and medium run marginal costs of water supply. A true SELL would allow leakage to fluctuate if new or surplus capacity comes on line.

Leakage performance should be compared at a company level and not at a water resource zone level. Different water companies will have different numbers of water resource zones, depending on the configuration of the supply networks. Because of the variable number of water resource zones, reporting at a zonal level will not be an effective inter-company comparison. Furthermore, from a customer engagement point of view it would be preferable to report leakage at a company level as water resource zones are a planning tool only and do not correspond to administrative boundaries that customers would recognise.

We would also welcome clarification on how the 3-year average will be applied. Our current view is that this will apply from 2020 onwards. Given the introduction of the new consistency measure, the significant stretch challenge and the complexity of the leakage measure, this would seem a reasonable approach.

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

We strongly agree with the proposals to strengthen ODIs. Our experience is that ODIs drive service improvements where customers value it most because the interests of customers and investors are aligned. Further, company employees can play a pivotal role in terms of driving innovation and improved performance as employee rewards can be aligned to company performance, which in turn, is aligned to customer priorities.

We welcome proposals on:

- strengthening reputational ODIs;
- making greater use of in-period ODIs which create a much stronger and more transparent link between performance and remuneration. Additionally, the annual scrutiny serves to strengthen the impact of our reputational ODIs too by drawing further public attention to our performance in the round;

- enhanced rewards for step change in performance (although we think the specific proposal could be improved as we explain below); and
- asset health rewards and penalties linked to customer engagement.

We have identified two areas where further consideration would be helpful:

- enhanced rewards and penalties – we very much support the concept however the proposal that companies must share their innovative ideas to access higher rewards is counterintuitive because it penalises the first mover and rewards the second mover (this is because the first mover absorbs R&D failures) – see our response to Q3b.
- RoRE cap – we are very supportive of giving ODIs greater prominence. However we think consideration should be given to the overall balance of risk and reward, particularly given the proposed treatment of extreme weather events. This could be achieved by individual caps and collars to help manage risk or by widening the cap, for example to 3-4% RoRE.

Q3a) 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?

We agree that revenue has a more direct impact and will serve to further strengthen incentives. However, there will be **circumstances in which the benefit accrued from outperformance will be realised by customers over the longer term** (eg % of customers with dual supplies). In these instances, it might be more appropriate to retain an adjustment to the RCV.

Q3b) Do you agree with our proposals on enhanced rewards and penalties?

We welcome the concept of enhanced rewards to incentivise the industry to innovate and take calculated risks. The threshold for enhanced rewards at leading company or higher levels is an appropriate threshold. We note that the proposal states that enhanced rewards and penalties are only applicable to common performance commitments with established metrics.

We would like to see the proposal for enhanced rewards extended beyond common performance commitments. We agree that this will pose a challenge with regards comparative assessment check against frontier performance. However, on measures which are part of the long list on asset health and bespoke measures, there will be historical context to define stretching performance.

We do not agree that sharing innovative ideas will promote innovation. The current proposal would undermine the incentive properties of the enhanced reward by only allowing the company to retain the benefit for a short period. This runs counter to competitive markets whereby companies do not share their innovations with competitors. Instead the higher return they earn from more sales/margin is the reward for taking the risks to innovate and compensates for failed R&D projects. For example:

- in AMP5, we trialled aquifer storage and reuse but ultimately discontinued the projects due to the complexity and risk of flooding to local borehole users which substantially increased the cost; and
- in AMP4, we trialled sludge driers to increase the range and quality of the product, but they did not demonstrate demonstrated optimum efficiency and throughput.

Under an enhanced ODI regime the incentive to trial technologies like these would be diminished as the gains would be effectively shared/clawed back at subsequent review periods, limiting the gain to less than 5 years.

We would also advocate that in areas where companies propose enhanced rewards, reasonable exemptions or use of caps and collars or dead-bands should be allowed to enable companies to take calculated risks. This will encourage companies to stretch their performance to enhanced levels.

Q3c) Do you agree with our proposal to remove the RoRE cap?

The use of ODIs (or performance payments) has the potential to deliver significant benefits to customers through higher service levels. It follows that more powerful ODIs can help to deliver even greater benefits. We therefore support extending the indicative RoRE range. This will:

- encourage more companies to embrace ODIs and so deliver benefits to customers;
- promote more targeted challenge from the Water Forum; and
- support alternative methods to setting rewards and penalties (see below).

In terms of the overall cap – we support the removal provided there are other tools that can be used to manage the overall balance of risk and reward, particularly given the proposed treatment of extreme weather events. This could be achieved by individual caps and collars to help manage risk or by widening the cap, for example to 3-4% RoRE.

Q4) Do you agree with our proposed Customer Measure of Experience (C-MeX)? Q4a) Do you agree with our proposed methodology for the C-Mex surveys, as set out in table 4.2 of Appendix 2? Q4b) Do you agree with the C-Mex contact survey focusing on customer satisfaction with both contact handling and resolution?

We are supportive of many of the principles behind C-MeX, particularly assessing customer experience for both those customers who have contacted their water company and those who have not. Although good customer service will be reflected through a number of measures, we think it is appropriate that only one measure, C-MeX, is mandated thereby giving companies flebility about which other measures could be used to complement C-MeX.

In terms of the design of C-MeX, we think it could be improved through a small number of changes.

- increasing the sample size for the surveys to improve the statistical robustness of the analysis, particularly since this has financial implications (companies could fund the additional size);
- applying the same time period to the data – all companies should be assessed on contacts over a consistent time period to ensure that the same “averaging” occurs. In the absence of this consistency companies are not being assessed on a like for like basis; and
- creating a simpler method for accessing the higher quartile or rewards as we do not think it will be possible to robustly translate UKCSI into CMEX.

We would be very happy to work with Ofwat over the next 12 months to develop the C-MEX incentive.

1. Customer Experience Incentive (C-MeX)

Our preference would be to take forwards either option 1 (customer surveys only) or option 2 (customer surveys and complaints).

If option 1 was taken forwards then we believe this could be improved by also including a requirement to have at least four contact channels for customers, of which two are digital. This would help ensure a basic level of service is obtained.

Within option 2 we would like to explore further whether there is value in differentiating escalated complaints and Consumer Council for Water Investigations. This would ensure a quality resolution is incentivised when handling complaints. For the options including complaints as a reputational incentive this would be simple to achieve. Where it forms part of the financial incentive weighting then further investigation is required through the proposed pilot.

Views on channel for undertaking the survey

We support the move to complete surveys across a wider set of channels because customers will have different preferences. By excluding certain channels we could potentially be excluding the views of certain groups of customers.

For an ideal experience the survey channel would be aligned to a customer's preferred channel of choice. In order to provide a personalised service companies should be capturing customer contact preferences by 2020 as this is a trend already being seen across some retail markets. If this data is not available, then an alternative approach could be to contact a customer via the channel that they contacted their water company with as this is likely to be aligned to their preference. The contact channel method is already captured in the data files submitted.

Whichever channel is used, the actual survey experience needs to be easy and valuable for customers. Through our work with Rant and Rave and Qualtrics we see best practice SMS surveys have limited numbers of questions, ideally two questions and no more than four, including the question seeking verbatim feedback. If the proposed customer service (contact) survey includes five questions, then an SMS survey is not the most practical channel to use to ensure a great survey experience and will result in lower response rates. Online surveys can include up to five questions whilst still delivering a good survey experience.

Views on how to implement the score adjustment for non-adherence to the guidance on customer channels

We support the insight shared in the methodology around how customers now use different channels in different ways to engage with companies. If a score adjustment was to be made for option 2 where surveys are weighted 40% each and complaints 20% then a quarter of the complaints element could be removed for each channel not offered. For example, if only 3 contact channels are offered then the company may only score a maximum of 15% against the complaints element, losing

5% overall automatically. Alternatively, it could be reflected in the customer service (contact) survey with a similar proportion (for example a quarter would mean a loss of 10% of the overall score).

Views on methodology definitions

We welcome the inclusion of clearer definitions. The definition of 'customers who have not contacted their company' will be require further clarity to ensure consistency, for example i) if a customer last contacted their water company 12 months ago should they be included in the survey; ii) if a customer made a payment via an online portal does this count as a contact.

For the survey relating to contacts, the customer surveyed should be the one who made contact with the company, as per the current SIM approach, so that the end to end experience is assessed. For the customer experience (non-contact) survey it should be the named account holder who should be surveyed as they are likely to be the customer who reviews and pays the bill. Some customers have multiple names on the account and can be co-primaries. We propose that for the customer experience (non-contact) survey that any of these customers could be surveyed.

Under the current framework there is an element of subjectivity around the interpretation of the definition of a complaint, specifically around the phrase 'an expression of dissatisfaction'. This formed part of the discussion at the recent CCW complaint workshop held in July 2017. We would like to see further clarification of what this means to ensure consistency, particularly given the greater number of channels and different ways customers express themselves.

Samples representing actual performance

As noted in the methodology consultation, there is a risk that only seeking input from 200 customers per survey is not statistically representative of actual performance. With the inclusion of more cost effective survey channels we would like to understand further whether a larger number of surveys could be undertaken for both surveys to ensure they are statistically robust.

With the proposal to undertake surveys quarterly and for some water companies to only submit one-week worth of data and others submit four weeks' worth of data, there is a risk that those submitting just a week worth of data could be affected by within week events and so the survey may not be representative of real performance. We would therefore like to explore whether all companies could submit the same number of weeks' worth of data, whilst considering the point above where we need to ensure the customer can remember the detail of that contact.

We recognise that we need to not over survey customers and there is a risk of this where water companies are conducting their own voice of the customer programme. However, we believe that all customers, whether surveyed by their water company or not, should be included to ensure a representative sample. Some companies survey within journey and others at the end and invest in service recovery which receives positive feedback from customers. Removing these customers from the data file will not incentivise companies to undertake surveys for larger volumes of customers and therefore service recover in a timely manner.

Q5) Do you agree with our proposed Developer Measure of Experience (D-MeX)? Q5a) 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 support option 1 as being the most customer centric option and has the potential to drive the largest step change in customer service. We think this could be implemented through a D-MeX Task and Finish Group made up of developers and water companies. We would be very happy to support this process.

Resilience

Q1) Do you agree with our resilience planning principles?

We are very supportive of the proposed resilience planning principles as they broadly reflect our own approach to resilience planning.

We believe the principles and consideration of 'resilience in the round' will encourage service providers to focus on, and manage, identified resilience risks that matter to customers. They should also encourage the development of efficient solutions across the four strategic components of resilience (Resistance / Reliability / Redundancy / Response & Recovery) and not simply capex driven operational redundancy solutions.

Identifying efficient solutions needs to be based on a thorough understanding of the 'end to end' system resilience of services to customers, not simply the failure of assets. This will need to consider the assets we use, their context in the wider environment and the systems, processes and governance needed to optimise them. These complex resilience issues then need to be articulated to customers in a concise manner to allow them to reach conclusions on the trade-offs between varying degrees of service resilience and the impact on bills.

There will also be a need to understand and articulate to customers, the impact of changes faced by companies in terms of environmental issues (WFD/RSA/ climate change) and demand growth, along with the underlying rate of deterioration of an aging asset base, particularly for low probability / high consequence type assets.

We stress the need for the effective measurement of resilience outcomes. Therefore, we welcome the progress that has been made to develop comparable resilience performance commitments - as discussed in chapter 4. However, as has been acknowledged, we are mindful that the proposed comparative resilience performance commitments consider only specific resistance and redundancy aspects and therefore should not be considered in isolation to measure the operational resilience of companies.

We have also been considering how best to develop bespoke resilience performance commitments. The principles align well with our thinking on how to develop on our existing water service resilience performance commitment (percentage of customers with more than one source of supply), which focuses primarily on the redundancy component. Our emerging thinking is to assess our end to end system resilience capability to identify those customers at risk of a long duration (>24hrs) supply

interruption, which our research highlights as our customers' main concern in terms of supply interruptions.

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

The assessment and prioritisation of risks to our system resilience capability (encompassing 'resilience in the round') is fundamental to the successful management of those risks, and our ability to articulate the level of risk to our customers and stakeholders in our consultation and engagement processes. We are actively seeking to improve our understanding of risk across all assets, systems and processes.

As indicated above, we believe efficient solutions, taking account of our customer's priorities, are best developed by considering the four strategic components of resilience. This allows service providers to demonstrate varying levels of risk reduction (or increase) against a range of solutions, and clear articulation of any residual risk associated with each solution.

We think these tests demonstrate clear alignment with the resilience planning principles, and as such we are very supportive of the approach.

The design of the 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'?

We agree with the proposed approach and in particular (i) the application of a revenue control; (ii) retaining WRFIM but under a different label (ii) and adjusting developer services to reflect change in volumes.

However, we think Ofwat can make greater use of its regulatory toolkit by removing developer services from the price controls and relying instead on charging rules and casework. In Appendix 7 table 1 it is noted that customers would not be protected under an option utilising casework. Used in the right way we think casework can afford customers a high level of protection, and at a very low cost. We therefore support a greater role for casework in relation to developer services and a reduced role for prescriptive regulation.

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'?

We believe that a market in water resources will enable a more efficient set of water resource investments and that the bidding market will do most to help achieve this.

We agree that the bi-lateral will be small, nascent and emerge late in the period if at all. As such it is important that complexity is minimised and the extent of information requirements proportionate.

Our experience from our Water Resource Management Plan pre-consultation process is that tradeable sources of water within the public water supply and other sectors, are scarce as all sectors are under environmental and climate change pressures. Given this fact we believe a post 2025 implementation for the bi-lateral market may be appropriate. A later implementation would also allow testing of the capacity measure on large complex water resource zones, for Abstraction Reform to be implemented, and the Water Framework Directive impacts on capacity to be absorbed.

Response on Appendix 5

Calculation of water resource charges.
We agree with the proposal and will develop a single charge our English licenced area of appointment.

Links to access pricing.
We agree with the proposed link to access pricing and await the autumn 2017 consultation to comment further

Capacity measure.
We agree that yield is the most suitable measure of capacity. However, we do not agree this is a sub component of deployable output for anything other than the simplest water resource zones. Working out the yield for our strategic grid water resources zone, that covers 70% of our company area, will require significant additional modelling. Our initial assessment is that the process will involve;

- software configuration changes to our Aquator model;
- calibration and benchmarking of our methodology with that adopted by other companies;
- sensitivity testing of the yields against scenarios such as climate change, extreme droughts and sustainability reductions; and
- appropriate assurance of the processes and outputs.

In conclusion, this is a substantial new task that is not covered by our current WRMP and drought plan processes. We are open to work with Ofwat and others in developing the detail of the capacity measure so that it is practical and consistent across companies.

We believe that “outturn demand” is a poor measure to determine the extent to which new incremental capacity is used. New capacity to address climate change, replace licence lost for environmental purposes and improve drought resilience is not correlated to short term variations in demand.

It is unclear from Annex 1 whether investment to replace licence lost for environmental purposes will be treated as post 2020 RCV.

Post 2020 investment regulatory approach
We believe it is appropriate to have a building blocks basis with post 2020 RCV plus an adjustment mechanism for bi-lateral market entry. Given the likely pace and scale of bi-lateral market development we think shadow unit cost allowance development or reporting is unnecessary.

In period adjustment for bi-lateral utilisation risk
We believe this should only apply to the proportion of capacity related to non-household customers until domestic competition is implemented. The adjustment should only apply where the entrant has

signed up a business customer ie not a notional capacity that could be made available. The adjustment should also reflect our obligations under section 63AC which came into force in April 2017 to act as a supplier of last resort.

Market wide utilisation risk

We agree with the proposal for an incumbent devised risk sharing approach. Our design of the arrangement will consider that;

- the majority of new capacity is built to replace lost or reduced capacity due to environmental and climate change reasons, which are driven by legislation and regulatory methodologies
- growth in demand will be met by reductions in leakage and water efficiency measures
- resilience capacity is used infrequently – some of our drought sources haven't been used since 1996
- we are required to act as the supplier of last resort should an entrant go out of business or their source fail in drought or due to contamination and we have no provision to access the entrants resource to deliver our duty.

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 support efficient entry into the upstream market. Given that bilateral entry is already possible through the upstream provisions of the Water Supply Licensing regime – which has not been withdrawn – it is important to find a workable approach to access pricing that is compatible with competition law.

Using the Average Incremental Costs that companies put forward in Water Resource Management Plans as the price to compete against is a reasonable approach. We also think that an indirect link between access pricing and the control is pragmatic given that the detailed design of the approach has yet to be developed.

While the exact mechanics of the equalisation payment are outside the scope of the consultation, there are some potential risks with bilateral entry which could mean that it is in conflict with the bidding market (rather than complementary) and put effective water resource planning at risk. These need to be taken into consideration in the final design.

- Firstly, we think that equalisation payments should come out of a fixed pot. When a resource deficit has been filled through prior entry, or the original WRMP options (including bidding entry), no further equalisation payments should be available.
- Secondly, equalisation payments should be provided on a "first come first served" basis. Water resources are a long-term investment and this type of approach would better support any investment necessary to make new resources available. Diminishing payments, divided between multiple entrants, would not support stable supplies.
- Finally, we think care needs to be taken to ensure that there are no adverse implications for long term planning. It is sensible for the calculation to take account of the cost of resources that will deliver in future periods – if it did not, such schemes could never be displaced.

However, we think it is likely that bilateral entry will not deliver sufficient volume to displace large schemes. Once an incumbent (or an entrant through the bidding market) has begun the construction of such schemes, we think there could be a case for this to be removed from the pot available for equalisation payments. If this is not done, small-scale entry that is not capable of delivering the full requirement could represent an additional tax on such schemes. This would potentially increase overall risk, and lead to higher costs.

There are many additional details on the mechanics of bilateral entry that will need to be worked through in the future publication. While the form of the control is based on capacity, it is important to remember the link to retailers. The incumbent will charge an access price to the entrant for carrying its water the retailer's customers; this will be based on the volume that the retailer actually sells – not on the volume that the entrant could provide. In practical terms, it must be possible for the supply to reach the retailer's customer(s) on the network or displace supply downstream of those customers.

Ofwat must also consider what happens if the entrant's supply fails, or is withdrawn (for example, because of a dispute between the retailer and the supplier). Our view, based on the legislation, is that the incumbent is not obliged to provide duplicate capacity as a back-up for bilateral entry; this would duplicate cost and would not be in customers' interests. The incumbent is not bound to provide a supply to the retailer if this would put its other supply obligations (such as domestic properties) at risk – nor to purchase the resource from the entrant.

We do not support charging water resources to retailers. We understand Ofwat's desire for increased transparency in charging, but we do not think that resource charges based on regional average pricing will provide any additional benefits in this regard. Bilateral entrants do need to contract with a retailer, but the average price will not help them do this: it will only inform the "equalisation payment" that needs to be paid by the wholesaler in the event of bilateral entry, not the cost that a competitor needs to beat in order to offer a deal to the retailer.

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

We agree that a transparent bid assessment framework is necessary to ensure fairness and confidence in the process.

The one area in which we think the proposals could be reduced is regarding the ban on an incumbent's affiliate or subsidiary participating in the bidding process. This proposal seems redundant as companies can consider in-house solutions so that they can identify the optimal solution – as the consultation notes. Hence this rule would simply deter companies from setting up subsidiaries such as "water efficiency businesses" and providing those services under the group. Ultimately we think proportionality is required and this specific proposal runs counter to that principle as it doesn't deliver any obvious value and simply creates extra rules that companies must comply with.

Q5) Do you agree with our proposals for the form of control for bio-resources as set out in the 'Wholesale controls' chapter and appendix 6, 'Bio-resources control'?

We remain strongly supportive of Ofwat's plan to set a separate bio-resource control and Ofwat's encouragement of trading with other Water Companies and new entrants. We support the vast majority of the proposals however we have identified three areas which we think require some further consideration:

1. Forecasting accuracy

The area that raises the most concern for us is the tightness of the dead-band for sludge volume forecasts. Whilst we agree the company should hold the volume risk, a move to 3% accuracy within such a tight timeframe seems unnecessary. We note that there is a potential two-year window of opportunity to request a reset of forecast, however for this to be an effective risk mitigant it is important that the specific steps/asks are detailed.

In addition, we think the adjustment needs to differentiate between fixed and variable costs. For example, if companies forecast high production, but in practice produce smaller amount of sludge it would mean they are not recovering fixed costs (albeit they are also avoiding variable costs).

2. Market risk

We note that "PwC found no material increases in beta associated with reform of the bio resources market". Although companies will be swapping regulated risk for market risk, which may be considered broadly similar, the retention of regulatory controls on revenue (the 3% forecasting penalty and +7% volume recovery cap) means companies will be under both market and regulatory risk. We would be interested in understanding if PWC had considered these aspects at the time they drew their conclusion.

3. Bioresource trading strategy

The effectiveness of the bioresource market will depend on the underlying incentives to trade. We think the proposal provides importers and exporters with a strong incentive to trade. Therefore we are unclear why it would be necessary to provide significant level of detail about sludge trading strategy within the business plan. Consistent with our covering note, it is important that the regulatory framework is proportionate and targeted. Given that the form of control incentivises companies to trade it is not clear what this policy is trying to achieve over and above the incentives.

DPC

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 are supportive of new commercial models that deliver benefits for customers and we already have adopted multiple models and risk sharing arrangements in our existing supply chain arrangements. Based on the external work we have commissioned; we see potential for Direct Procurement Contracts (DPC) to deliver benefits under certain circumstances. However, there are

two parts of Ofwat's proposal where further refinement of the framework could ensure certainty that customers will benefit.

1. **Preventing an undertaker from bidding for DP contracts in their own area of appointment:**

   We strongly disagree with the proposal that companies cannot bid for work in their own area of appointment. We consider that done in the right way, competition can deliver the best results for customers. However, this proposal undermines the competitive process by preventing the party most suited to the work from bidding. Although we understand Ofwat's concern that bidders might perceive they may not be treated fairly, this can be addressed in the same manner as the bid assessment framework (ie, independent procurement teams).

   There are already variations of Design, Build, Finance and Operate (DBFO) contracts in place across the water sector which the proposals on Direct Procurement without a licence deliver. Companies today can **voluntarily** choose to enter into these arrangements whilst retaining the overall licenced responsibility as an undertaker. However, Ofwat's proposed framework explicitly **prevents** an undertaker from bidding for direct procurement contracts that in effect forces an undertaker to outsource part of their core functions within its area of appointment.

2. **No baseline price:**

   Under the proposed arrangements, there is no baseline price (ie the price and risk sharing arrangements an undertaker would have done absent DPC) combined with a requirement to appoint the DPC through a competitive process. This means that an undertaker would be forced to select the best value DPC contract being offered, even if the undertaker could do the activity itself and share the risk with customers more efficiently. This does not seem like a good outcome for customers and could be resolved by finding a better method for independently validating DPC contracts against the undertakers own proposals. Regardless of the legal point above, we believe it is in customers' interests regardless to have the undertaker bid on these projects as that will create a ceiling price against which to assess other proposals. To maintain long term customer legitimacy and value for money, we need to be able to demonstrate that DPC will deliver more than our current procurement process, which has brought significant value in AMP6.

The project selection criteria set out in table 7.2 are reasonable. We have applied these at a high level to our emerging needs and solution options to identify indicative projects for PR19. There are other projects we have screened out the process that are not included here.

Potential project	Cost	Discreetness	Innovation	DPC
Sludge lagoons; removal of structures and contents at multiple sites to release	Pass	Pass Discontinued assets recently included in Reservoirs Act	Yes Opportunities to gain value from lagoon content and remediated land	Yes
Water trading to Thames or Anglian; treatment and transfer of effluent from Birmingham to river Nene or river Avon	Pass	Pass Little interaction with our waste water treatment process	Yes Could be dual use for Anglian and Thames	Yes

Please note we have not completed our assessment of these projects so there is considerable uncertainty on whether they will progress.

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?

The type of tender model will vary depending on the type of project and capability of companies' existing procurement processes. A late model will provide more certainty on scope but may reduce innovation. For example, on our indicative schemes;

- Sludge lagoons may suit an early or split tender to allow for innovation to get value out of lagoon content and land
- The Anglian or Thames trading would suit a late tender to gain certainty over planning, river regulation, utilisation, integrating the asset into existing networks and designing to meet long term future needs.

We agree that the tender model should be able to flex depending on the maturity of the scheme, innovation opportunities and risk. Companies are best placed to make this choice.

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'?

The contracting risks can be defined at the time of the contract. However, the big unknown is the degree of regulatory risk exposure from these contracts. There is a substantive difference between DPC contracts under the SIP regime versus those proposed in the framework.

The first SIP, the TTT contract, was able to shift risk onto other parties, namely government and customers, which allowed it to deliver a bid WACC of 2.497% until 2030. At the time this WACC was lower than the core PR14 wholesale WACC of 3.6%. Based on the market's current interpretation of Ofwat's guidance, this bid WACC is not far off where Ofwat might set the overall average PR19 WACC and the marginal PR19 WACC (new debt plus cost of equity) could possibly be even lower than the TTT bid WACC. Hence a SIP project facing the marginal WACC with similar risk transfer could possibly deliver an even lower WACC than TTT did, putting into question the value for money of the TTT WACC.

However, the TTT licence prevents Ofwat from reopening the WACC until 2030 (unless construction completes earlier) and hence investors have certainty over the regulatory risk they face. However, there is no corresponding commitment on reopening DPC contracts over their lifetime. The contractual arrangements remain with the undertaker and Ofwat could at any point over the life reduce the revenue allowances earmarked for the DPC provider over the life of the contract. Hence there is regulatory risk over the life of the contract where Ofwat may choose to reduce cost allowances for DPC contracts should market conditions change and value for money is assessed ex-post.

Absent the commitment behind a SIP licence with a regulated price control determination, a potential solution to this would be to shift this risk onto the DPC provider but that will likely result in a risk premium being required over the life of the contract to the detriment of customers. The PR19 framework would benefit from Ofwat providing long term regulatory certainty over these arrangements that could reduce the regulatory risk and deliver a better outcome for customers. A specific commitment in the undertaker's FD that they would not reassess value for money of the arrangements ex-post over the life of the contract would deliver this.

If this is not possible, it would be helpful to specify more detail around how DPC contracts will be treated in future price reviews in order to factor this into the commercial arrangements and risk exposure proposed for the contract. This would include:

- whether the WACC at future reviews would affect DPC revenue streams;
- the impact DPC contracts could have on totex cost allowances; and
- the degree of pass through of matters that may affect the DPC revenue stream.

The design of the 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?

We agree with the proposal for PR19 which is effectively in line with the PR14 methodology.

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

We agree with the proposal to retain price controls for customers in Wales who use less that 50ML of water a year. We support the use of an average revenue control for these customers.

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

We agree with the proposal that English companies that exit the retail market are not subject to price controls. This should apply to companies that have not exited the market or have not submitted an application to exit.

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

Business retail customers using more than 50 ML of water a year have access to the advantages provided by competition in order to obtain the best deal for their water retail services. As such, we feel that price controls for these customers would not be necessary and therefore shouldn't be put in place for PR19.

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

We are strongly opposed to a 3-year retail price control for household retail activities as we consider it will deliver poorer outcomes for customers. This is because a 3-year control reduces the incentive for companies to deliver efficiencies as they are clawed back much quicker. In contrast a longer price control creates strong incentives for innovation and outperformance, which are still passed back to customers after 5 years.

We understand that a 3-year control has been proposed to allow for the impact of non-household competition to be translated to the household retail market. However, it is not apparent what information is being collected from the non-household market and how it will be used to set the efficiency challenge for households. In light of this, and given the efficiencies delivered by the ACTS at PR14, it is difficult to contend that a 3-year control will deliver more savings to customers than the current 5-year control.

We also recognise that there is the potential for a future Government to introduce household retail competition. We would therefore suggest that instead of setting the control to 3 years in the event there is competition, the control should be set to 5 years with an explicit clause that would allow

Ofwat to consult on shortening the control period to 3 years if Government decided retail competition was appropriate.

Econometric Modelling

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

We agree that it is essential for companies to continue delivering outcomes for customers and the environment as efficiently as possible. We also agree that, where appropriate, efficiency should be assessed using benchmarks across other sectors. However, we recognise the difficulty in accurately modelling complex systems. Therefore, whilst we agree with the overall approach to cost assessment, the process needs to reflect this complexity and produce an appropriate outcome that is proportionate and ensures that the package in the round delivers the right outcome for the sector.

Our key area of concern is how the efficiency benchmark is set. As we explained in our cover note, we think an efficiency benchmark based on 4th/5th best company (for water) is most appropriate, particularly when combined with a dynamic efficiency adjustment on costs, the stretching performance levels companies need to deliver and the greater challenge on financing. This package would challenge all companies to catch up to the best performers thereby protecting customers whilst ensuring that the incentives are coherent and incentivises innovation rather than incrementalism.

We have welcomed Ofwat's willingness to engage with the industry through the Cost Assessment Working Group (CAWG) in order to improve the performance of its cost models. Given the pivotal role of cost efficiency in the PR19 process, we believe it is essential to continue this conversation and consider formalising the dialogue. The particular aspects of the costs assessment proposals that need to be considered in more detail include:

- the need for a consistent approach whereby the results of new models and approaches can be reconciled to previous efficiency assessments and cost performance;
- making sure that that Ofwat's cost thresholds accurately account for current outcome performance and future customer supported targets;
- ensuring that the efficiency benchmark is as stringent as the upper quartile challenge, given the limited accuracy of any model that is developed;
- appropriately making adjustments to ensure like-for-like cross sector benchmarks are applied (e.g. inability to disconnect and/or place customers on pre-pay meters); and
- assessing how best to use the benefits of disaggregated cost models in setting an overall efficiency challenge at a price control level.

On the latter point, we agree that using cost models at different levels of disaggregation (Totex, Botex, Network plus, Business unit and potentially sub-business unit e.g. abstraction charges) is beneficial in that it allows specific variables to be identified which closer reflect material drivers of cost. Triangulation of a range of models will help to reflect specific costs at the same time as considering efficiencies and trade-offs inherent in more aggregated models. However, we do not think that it is appropriate to develop efficiency challenges at a disaggregated level. This would reduce the scope for companies to balance their business operations by trading off relative

efficiency in one area with inefficiency in another - effectively delivering efficient outcomes in the round. Consequently, we suggest that efficiency challenges should continue to be assessed at a price control level.

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

The cost sharing incentives should be designed to incentivise companies to:

- deliver efficiencies thereby delivering long term benefits to customers; and
- reveal the truth about a company's costs.

We agree with the replacement of the totex menu with cost sharing incentives but strongly disagree with the current design. Under the current proposal a company will be incentivised to submit a plan that is lower than Ofwat's cost model – even if in practice it expects costs to be higher. This wouldn't incentivise efficiency which is what is important, but rather inaccurate business plans. **We do not think these properties, are appropriate or would engender trust across the sector.**

An alternative would be to build on PR14 but apply the asymmetry either side of central position. This would incentivise efficient expenditure, whilst also incentivising truth telling. The difference with the current proposal is that for a given level of expenditure the sharing rates would be symmetric. For example:

Business plan totex	80	90	100	110	120
Baseline	100	100	100	100	100
Outperform	60%	55%	50%	45%	40%
Underperform	60%	55%	50%	45%	40%
Actual expenditure					
80	12	11	10	9	8
90	6	6	5	5	4
100	0	0	0	0	0
110	-6	-6	-5	-5	-4
120	-12	-11	-10	-9	-8

Under this approach a company would be incentivised to drive efficiencies and also submit a plan that reflects its genuine expectations of costs. Given the greater weighting for outperformance, this model would also better protect customers by ensuring they do not share the risk for underperformance whilst creating strong incentives for long term efficiencies.

When considering how to calibrate the strength of the cost sharing incentive, consideration must be given to unintended consequences at the extremes of the range. If the sharing rates are too punitive for a company with a high ratio, this is likely to encourage risk averse behaviour and reliance on non-innovative tried and tested solutions because the incentive is significantly greater to avoid underperformance rather than seek outperformance.

We note the discussion about how the incentive will be implemented within the AMP7 and how this would affect short term cash flows. Of the two options discussed, we agree with Ofwat that for the purposes of the FD, it is preferable to apply the cost sharing incentive as per the anticipated outturn with a subsequent adjustment once actual outturn costs are known. This will moderate the short term reliance on Ofwat's modelled cost baseline but retain the cost efficiency incentives.

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?

Managing uncertainty has been an issue in previous price reviews and there is a risk that further divergence of regulatory timelines could exacerbate this. However, we believe companies should be incentivised to develop innovative solutions to manage potential changes and ensure customers are protected. We therefore believe the current proposal could be improved by:

- differentiating between projects that have a high degree of uncertainty versus those that remain uncertain;
- allowing companies to use existing mechanisms; and
- only using transition mechanisms for AMP8 as a last resort.

Our approach to managing uncertainty in PR14 was based on undertaking early feasibility to better understand the need, constructive dialogue with the Environment Agency (EA) and developing a unique and innovative Water Framework Directive ODI which enabled flexibility whilst securing customer protection. We strongly believe this approach can work again.

Looking ahead to PR19, we anticipate a reasonable level of certainty in March 2018 with the publication of the WINEP which will deliver a clear view of schemes required by in AMP7 and a traffic light uncertainty description. **We would advocate that the quality enhancement cost baselines reflect this scope of activity for green and amber projects.**

Although there is a risk that the subsequent river basin management planning will modify the scope of activity (schemes moving into or out of green/amber status) there are existing mechanisms to manage such changes with the EA. For example, swapping with alternative schemes of equivalent cost or environmental benefit. Where there are significant changes to the quality programme that appear after the 2018 WINEP but are required to satisfy WFD obligation, it would be sensible for these to be eligible for a transition mechanism for early inclusion in AMP8 price limits or be accounted for at PR24

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

We believe that the cost assessment process needs to reflect the complexity of the systems we operate and produce an appropriate outcome that is consistent, proportionate and sustainable. An essential part of this approach is a clear and transparent process where anticipated efficient costs

that are not fully or partially reflected in models can be included in (or removed from) Ofwat's baseline of efficient expenditure.

Considering Ofwat's approach for adjustments that was used at PR14, the basis for the partial coverage of adjustment claims (assessment of implicit allowance) is particularly challenging for companies to account for. It would be helpful to set out a set of definitive principles so that appropriately sized adjustments can be presented after appropriate consideration of implicit allowance.

The proposal that cost adjustments should only be made where there is a systemic case for an adjustment rather than considering specific historic costs in isolation is clear. However, in practice this is very difficult to objectively define or quantify. We understand Ofwat's desire for companies to focus on delivering high quality, efficient business plans rather than focusing on out performing Ofwat's modelling assumptions. **However, building the case to robust and adjustments is particularly challenging when cost models or assessment criteria for adjustments are not visible to companies**. We believe that Ofwat will be able to reveal more information about the types of models and cost drivers it is minded to use; and how it will test for systemic bias in relation to proposed adjustments. We consider that clarity in this area will help to improve the quality and reduce the number of poorly considered adjustment claims.

We accept the theoretical case for negative adjustments where there is a systemic modelling bias in the favour of particular companies. Where such cases can be revealed, either through analysis of other positive adjustment claims or model performance, Ofwat should be transparent about the basis for the adjustment. It would be appropriate for such negative adjustments to satisfy the criteria for positive adjustments including passing a materiality threshold. We would also like to have more clarity on the timescales for revealing potential negative adjustments so that companies have an opportunity to review and challenge the proposed adjustments as part of the price review process.

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

We understand the attraction of assessing efficient totex of the household retail price limits using an independent economic modelling approach. However, our analysis suggests that it will be challenging to make stable models that can robustly predict expenditure. We welcome the opportunity to continue to engage with the CAWG in this area but consider that it is sensible to consider alternatives including retaining the current approach but varying the efficiency challenge – this is simple and well understood across the sector.

It is appropriate to consider retail costs at different levels of disaggregation; this will help to expose generic costs from those specific to the industry. However, as stated in our response to Question 1, it is essential that benchmarks are compared on a like-for-like basis (e.g. obligations for vulnerable customers, the inability to disconnect, required technical expertise to address operational incidents and the technical differences of meter reading across sectors).

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?

We agree that water companies will have greater control over input price pressure in retail compared to wholesale price limits. However, whilst companies are able to negotiate contracts for resource, third party services and IT infrastructure, there remains a significant element in each case that will be controlled by macro-economic circumstance rather than management control. We also note that, whilst the retail control was not indexed during PR14 (real price effects effectively being funded by efficiency outperformance), this coincided with a period of initially low inflation rates.

The PR19 consultation states that companies can make the case for adjustments for real price effects in the retail price control. Where real price effects are likely to affect all companies (e.g. ongoing wage inflation or energy prices), we believe a more efficient and transparent outcome could be achieved through setting central adjustments for all companies. This could be an area for the CAWG to consider further.

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

We agree that the move to outcome based regulation should largely mitigate the need for a transitional programme but recognise that there are special circumstances where they may still be required.

We believe therefore that transitional programme should be retained with the onus on companies to explain why it is efficient to bring investment forward and to ensure that performance against the funding is clearly set out in future Annual Performance Reports.

Risk and return (WACC)

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?

It is reasonable to take a forward-looking view of the cost of equity that is required for the next control period, but in doing so it is important that Ofwat takes a consistent approach. While we note that Ofwat's statement that it is too early to take a definitive view at present, we strongly disagree with some of the indicative numbers set forward, in particular for the risk free rate.

We accept that returns in the near future are likely to be different from the long-term historical averages that regulators have relied upon in previous determinations. However, any forecast of the likely cost of equity is bound to rely upon some historic information; the question is what period is selected and whether this has been applied consistently for all variables within the calculation.

The view that total market returns will remain lower for longer places greater weight on more recent history – since the financial crisis of 2007. If rolling averages are used, any lengthening of the period

to include earlier years will tend to increase the average; a shortening of the average to exclude immediate aftermath of the crash would also increase the average.

If the cost of equity for PR19 assumes that total market returns will not revert to the long-term historic mean, recent evidence for other parameters should also be considered. For example, the consultation notes some upward movement in estimates of beta since PR14.

Risk Free Rate

A forward-looking view can also look at evidence about investor expectations for the future. Forward yield curves for gilts indicate that the current levels, where investors are prepared to accept after-inflation yields of less than 0% for holding gilts, do not represent their expectations for the period of the price control. In a forward-looking approach, more weight should be placed on expectations of the Risk Free Rate for AMP7 which are rising above 2%.

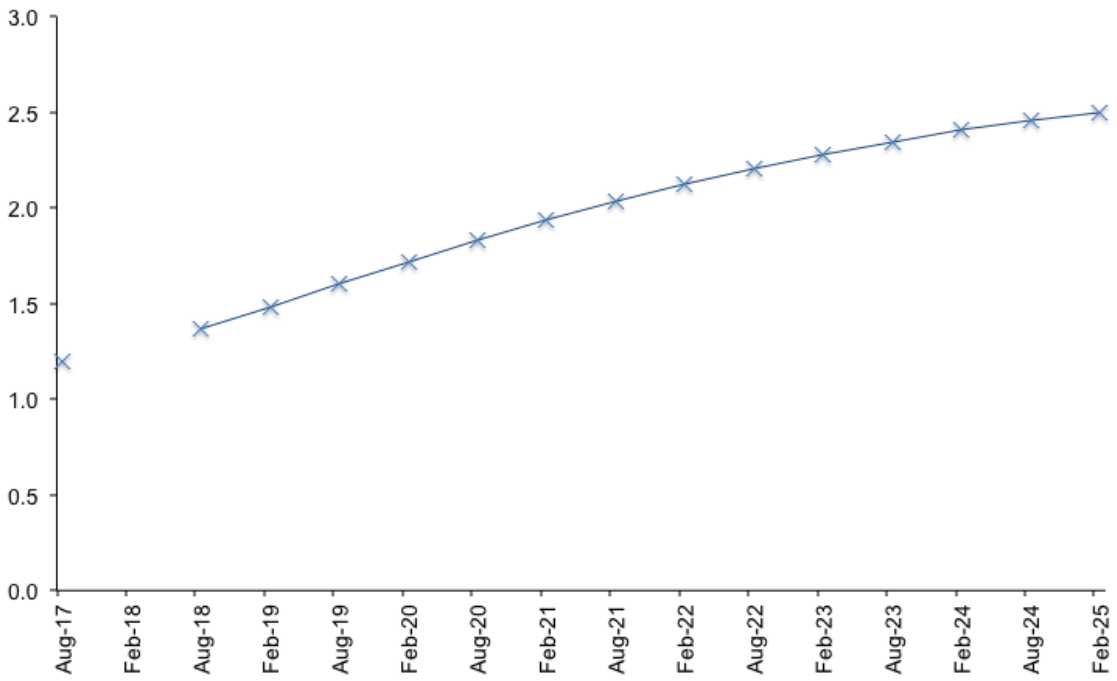
The prevailing negative yields on gilts are distorted by external influences, such that they do not give an accurate indication of the returns that a typical equity investor expects in exchange for holding a riskless asset:

- quantitative easing – the Bank of England started has been deliberately driving down interest rates and now has £435 billion worth of assets on its books. The central banks in the US and the Eurozone have also pursued similar programmes; and
- pension fund demand – the rationing of supply has coincided with a period of unprecedented demand from pension funds, who now own the vast majority of issued gilts[2], potentially squeezing out other investors.

Allowing for these distortions, we think a plausible range for the risk-free rate now could be anywhere between 2-2.5% and perhaps, 3-4% by the end of AMP7. At the very least, we think that Ofwat should adjust for the 100bps that the Bank of England attributes to its quantitative easing.

Forward market rates for 10-year gilts

[2] Schroders (2016), Pension funds and index-linked gilts: a supply/demand mismatch made in hell.



Source: Bank of England

In their report for Ofwat, PwC provide some analysis to show that the Equity Return Premium does not always wholly compensate for changes in the Risk Free Rate and that Total Market Return does not remain constant when there are changes in the RFR.

This could be used to support a view that equity returns have fallen in response to the reduction in gilt yields over recent years. In an environment where the risk free rate is expected to rise in future, it would suggest that TMR should rise, at least to some extent. This line of argument should not be used selectively.

Incentive package and investment risk

We also think that it is important to consider the allowed cost of equity in the context of the overall package. While it has often been argued that the incentives within the regulatory regime are not a systematic risk that is captured within the CAPM model, the output of CAPM should represent the central investor expectation of the cost of equity. If other incentives are intentionally skewed to the downside, this will no longer be the case.

In the new regulatory framework, capital invested within the Resources and Bio-resources control will not have the same level of protection as investment within Network Plus. However, Ofwat is not minded to adjust returns to take this into account arguing that this should not impact on the cost of capital for the reasons set out above.

Separately, Ofwat has stated that where Direct Procurement is used to provide investment, any utilisation risk should be borne by the incumbent (as the incumbent has identified the need for that capacity). Whether this sits with the DPC provider or not, external companies are being asked to bid

financing costs for discrete schemes with the expectation that the bidding process will provide evidence about real financing costs. If DPC providers are asked to bid with and without utilisation risk, we think this could provide good evidence about its impact on the cost of capital.

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

We think Ofwat's proposals to index the cost of new borrowing is appropriate to address the criticisms of the CMA. Adjusting to remove the forecasting error on new debt is targeted and proportionate.

We also think that the use of assumed rather than outturn inflation to adjust nominal interest rates is a pragmatic approach. We think that the volatility of spot rates of inflation and distortions to the index-linked gilt market make these unsuitable for adjusting nominal interest rates. Such adjustments make historic decisions about borrowing seem either efficient or inefficient when movements in inflation could not have been foreseen.

We note Ofwat's argument for making this an end of period adjustment, but our general preference would be for an in-period correction. While in-period changes can lead to greater bill volatility, it would have some key advantages:

(i) In-period adjustments would provide a more obvious hedge against changes in rates; and
(ii) Ofwat would not be required to make a five year forecast of the cost of debt, relying on the outturn index value to determine allowed interest.

In line with ODIs, in-period corrections for interest rates also match management decisions more closely to their effect which creates sharper incentives.

In terms of the specific approach to developing the index – the proportion of "new debt" based on year 1 data would appear to increase each year, as illustrated in the table below. It would be helpful to understand if this is something that would be repeated each AMP or whether this would just be an initial phenomenon.

	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**
New debt	5%	15%	25%	35%	45%
Index	100% year 1	50% year 1 & 50% year 2	33% year 1…	25% year 1…	20% year 1…
Amount reflecting year 1 index	100% * 5% = 5%	50% * 15% = 7.5%	33% * 25% = 8.33%	25% * 35% = 8.75%	20% * 45% = 8.75%

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

We support the move to CPIH-indexed price controls. There are only small differences between CPI and CPIH, but the ONS believe that the latter is a better measure of inflation for the overall economy. We expect that its designation as a national statistic is only a matter of time.

Ofwat has explained that a portion of the RCV will be indexed by RPI as a transitional arrangement, providing some support to existing index-linked debt. By setting a nominal cost of capital, Ofwat has also taken explicit measures to demonstrate that the CPIH-stripped cost of capital will be no different than it would have set under an RPI-based framework. It would be helpful if Ofwat could take similar explicit steps to set out how it will adjust other aspects of its framework to take account of the difference in the inflation measure – in particular around costs and efficiency.

We think the greatest challenge will be around messaging, comparing price changes in AMP7 against earlier periods or other sectors where "real" changes in prices and rates of efficiency have been measured relative to the RPI.

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

In summary, we agree with the approach to setting tax allowances at PR19 including the proposal for a true-up mechanism. However, **we think the true-up should also include other forms of tax, notably cumulo rates**, which is now our largest tax. We discuss the detailed proposals below.

<u>The true-up mechanism</u>
We agree that "option 2" is attractive as it retains an incentive for companies to manage their tax affairs efficiently in the best interests of customers whilst avoiding a significant increase in the regulatory burden that a full true-up mechanism under "Option 3" would necessitate.

However, it is still a concern that tax matters outside of a company's control (i.e. as yet unknown changes to the tax landscape) could give rise to windfall gains or significant additional tax costs that would not automatically be included within any end of AMP true-up.

To address this, we would recommend an extension to Option 2 to include the impact of other significant tax changes. This could be defined to include only individual significant items, for example, a +/- 0.3% impact on total allowed revenue in any one year.

As the tax true-up will be run at the end of the price control rather than in year, the additional regulatory burden should not be significant especially given there would be scope for in period notifications were a company to become aware of a potentially significant matter.

Such an approach would borrow what the NAO might consider to be a sensible component of the OFGEM framework (particularly in view of the potential accounting changes to IFRS 15 and IFRS 16) whilst retaining the elements of simplicity and transparency that make Option 2 attractive.

Finally, the trigger as drafted is limited to corporate taxes. It has been HM Treasury's deliberate policy in recent years to shift the burden of taxation away from profit based taxes (e.g. corporate tax) towards non-profit based taxes including specifically business rates. Business rates (including Cumulo rates) is now our largest tax cost and there will likely be a further rates review in the middle of AMP7. An adverse or beneficial rates review has the potential to be equally as impactful as an amendment to tax or capital allowance rates and, as such, would warrant its own true-up.

Other Comments

To further enhance transparency and modelling consistency, we note the following observations:

- Approach to Capital Allowances – We agree with the proposal to revert back to an approach based on separate capital allowance pools in line with those defined by HMRC. Further, the proposal to apportion brought forward balances across wholesale price controls on the basis of the RCV split makes a lot of sense.

  The apportionment of new capital expenditure between capital allowance pools is inherently subjective as we are being asked to consider the correct tax categorisation of expenditure before it has been incurred. OFWAT may want to consider an approach whereby new capital expenditure is allocated to pools based on, for example, the average capital allowance pool split per a company's last 3 submitted tax returns (i.e. a trend based allocation). Such an approach would provide a standard methodology for allocating new expenditure between pools with a clear audit trail back to previously submitted HMRC returns. It would also provide a transparent basis for identifying non-qualifying and deferred revenue expenditure (see further below).

  For significant projects that would be expected to have a capital allowance profile which differs from the trend based approach (e.g. a new impounding reservoir construction which would be large non-qualifying), the trend based approach could be set aside in favour of a project specific analysis.

- Deferred Revenue Expenditure ("DRE") – Appendix 29 does not appear to contain an input line for DRE. This is expenditure which although capitalised for accounting purposes, is revenue for tax purposes giving rise to a deductible amount of 'eligible depreciation.' STW's brought forward DRE pool balance is c.£300m which gives to a typical per annum deduction of between £15m and £20m.

  We would recommend that additional input lines are added to Appendix 29 (i) to identify brought forward DRE pools and (ii) to capture the proportion of new capital expenditure which would be expected to be revenue for tax purposes (e.g. based on the above trend analysis).

  A blended rate of depreciation would then need to be calculated to convert the DRE inputs into a tax deduction. Again, this can be drawn from allocation schedules included in our HMRC tax returns.

- Interest deductibility – Deloitte note in their review that where it appears in principle that water companies could qualify for the Public Benefit Infrastructure Exemption ("PBIE"), it may be that a certain amount of restructuring will be required in order to satisfy the conditions for the PBIE. In effect, a conclusion that a standalone water company should not be impacted by the revised rules on interest deductibility is reasonable albeit not certain.

  On that basis, and given the introduction of what in effect will be a tax effected interest true-up on new debt at the end of the price control period, we would suggest that OFWAT calculates the tax allowance for companies with an actual gearing of less than the assumed notional gearing level on the basis of actual gearing. With the comfort of the end of period true-up for new debt, this should better align the treatment of interest in the calculation of the tax allowance with the statutory tax environment whilst protecting customers in the event that actual interest costs exceed that assumed in the business plan (i.e. via the cost of new debt true-up).

  It would also remove a reconciliation difference between the tax allowance and the subsequent actual tax charge as well as mirroring the approach we understand OFGEM take.

- Bad debts and retail controls – The aligning risk and return chapter notes that the retail control will receive a margin on profits to include an allowance for corporation tax. We have traditionally treated our annual bad debt provision as being part specific and part general for tax purposes. Although we anticipate revisiting this treatment with HMRC prior to the completion of the business planning process, to the extent that HMRC require us to continue treating part of the bad debt provision as general, this could be material in the context of the tax allowance for household retail control and, hence, may require a computational adjustment.

- Tax Reconciliation Report – Deloitte's report notes the need to ensure that the approach to tax is clear and transparent. As any reconciliation will require a comparison back to the calculation of the tax allowance in the business plan, it would help if the tax reconciliation report for each price control resembled a tax computation. This would enable us to more easily identify how the Appendix 29 inputs have translated into amounts actually taken into account in calculating the tax allowance for each price control. At an aggregate level, this would make it easier to prepare those tax reconciliations required in the APR as well as to more readily respond to NAO/ other targeted reviews.

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?

We support the use of a limited range of prescribed scenarios. We think it is reasonable for companies to set out the evidence or assumptions that lie behind their P10 / P90 ranges for each ODI. When looking at the RORE range that results from this exercise it is important to note that the upper and lower bounds rely upon all factors moving in the same direction when some may counteract each other - for example, improving performance on ODIs may have an implication for costs.

In this context, we note that Ofwat's proposal to move towards asymmetric cost sharing ratios has implications for the trade-off between improving service and saving cost (unless the ratios are also applied to ODI calibration). An asymmetric sharing rate could encourage companies to save cost at the expense of ODI improvement as cost savings could be more valuable than an ODI. Even if the latter also had an asymmetric upside, this would be difficult to calibrate.

With company-defined scenarios, we would expect these to reflect management actions as a matter of course. For example, in a scenario driven by extreme weather additional costs would arise *because* of management action. We are happy to prescribe our own economic parameters as we think we are more likely to focus on changes which would create genuine issues for the financeability of the business.

Financeability

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

We support a financeability test based on an appointee with a notional financial structure. The notional company should be able support itself at the chosen level of gearing; if this is not the case then it is important that Ofwat's modelling should reflect the way in which a solution assumed to be applied. In other words, if lower gearing is actually required this should be reflected consistently through the cost of capital and all modelling.

It is reasonable for companies to provide assurance that they are financeable on their actual structures. In our case, our capital structure has been close to Ofwat's assumptions at successive reviews so we do not expect that providing this assurance will present any significant overhead.

While the financeability for sub-controls is of some interest, we think action Ofwat is right to *consider* whether any adjustment for financeability at this level rather than to require this. The sub-controls would only need to raise their own finance and pay their own dividends if they were separate companies; if they were, they would have a wholly separate determination.

It is possible to engage with customers to a limited degree on financial issues, and we were able to do so at PR14. However, we do wonder about the value of customer involvement in this process. Ofwat has a duty to ensure that companies are able to finance their functions, acting in the long term interest of customers.

We do not agree that the financeability assessment should be carried out before the application of incentive adjustments. The consultation argues that this avoids customers paying more to address financeability constraints arising from poor performance. This is not the case.

- Firstly, the solution to financeability problems would not be an overall increase in allowed revenues. If PAYG rates are increased this is affects the timing of cash flows – companies receive more revenue now at the expense of a lower RCV and lower revenue in future. Any regulatory penalty is not reversed or avoided – an RCV penalty is still a reduction in shareholder value.

- Secondly, the consultation talks of "financeability constraints arising from poor performance". But in AMP7 negative revenue adjustments will arise from totex sharing; **the best performing companies will see reductions in cash flow.**

Considering the scale of these adjustments in AMP7, we think that Ofwat needs to reconsider this policy. At the very least, it should consider whether all of the "penalties" that are being excluded from the assessment can actually be described as such.

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?

We support providing companies with flexibility to include the definitions that their agencies use.

Q3) 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 agree that it makes sense to use data up to 2018-19 to set the SIM rewards and penalties given the final year's data will not be known, and it would seem disproportionate to carry forward a true up in relation to SIM given the introduction of the C-Mex.

In relation to the reputation incentives for 2019-20, it would seem sensible to use the draft run of the C-Mex in 2019-20 as the reputational incentive for the final year of AMP6. We do not have strong views on either of the proposed approaches.

It would be helpful if Ofwat could set out the specific detail of the reward/penalty calculations for SIM and take into account views from companies on any potential proposals in this consultation. This is particularly pertinent for this question, given the requirement for companies to true up and forecast these incentives in their business plans. Ofwat requires companies to have discussed these with customers and obtain board assurance on its forecasts, yet it is unclear how companies can achieve this when the mechanism is still so uncertain.

In this instance, it may therefore be appropriate to remove the financial element of SIM from the PR14 true up tests applied at the Initial Assessment of Plans, given companies will not know the proposed mechanism to be applied and will be unable to reliably forecast the financial impact.

Q4) 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.

In the main, we consider the proposals as set out are sensible and we particularly welcome the inclusion of past performance in the initial assessment of plans for the future. Further, the approach

to allocation of incentives to the new price controls seems proportionate and straight forward. However, we have highlighted some key issues with Ofwat's proposals as follows.

Whilst we agree that companies should be transparent about performance, we do not consider it appropriate to publish forecast performance. The reason for this is twofold. Firstly, our targets were clearly set out in the PR14 final determinations. We are happy to (and do) make clear in our annual reporting how our actual performance compares to this target level and what we are planning to do to address any areas of concern and mitigate any risk of failing to meet the required performance. However, we do not think providing forecasts in the models (particularly the ODI model) would be helpful particularly given the complexity and that they are unlikely to be accessible to any but the most technical stakeholders - namely Ofwat.

Secondly, as we are a listed company there are certain restrictions on forecast data we are allowed to publish. ODI, totex and other outperformance incentives are by nature an adjustment to company returns. Due to these restrictions we would strongly resist any publication of such information either with our APR data or as part of the business planning process.

Whilst we appreciate Ofwat would like to get a 'head start' on review of plans, given the timescales in relation to the APR process running alongside the PR19 submission process and the risk analysis requirements on company boards set out in the proposals it will be incredibly difficult for companies to meet the timelines Ofwat has set out and we believe that providing the additional forecast data for 2018-19 and 2019-20 with the APR could reduce companies' ability to provide robust data in both the APR and the forecast data, due to the fact that resources (both internal and external assurance providers) are stretched at this critical pinch point in the process.

In relation to the requirement to consult with customers, we support this in relation to gathering customer views on our actual performance to date and how we have communicated in order to assess the robustness of our future plans and engagement. **We do not consider it appropriate that customers should be engaged on the application of historic incentives already agreed and set out as part of existing Price Controls, and which have already been endorsed by our customers. This would undermine trust and confidence in the stability of the regulatory framework.**

Assurance

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

We have examined the business plan and data requirements. This has identified a number of issues which we explain below. However, until we populate the data tables and run the financial model it will not be possible to fully comment on the data requirements. The shortened consultation period does not provide sufficient time to undertake this task. We expect to be in a position to deliver this prior to the publication of the final methodology. Our request is that Ofwat remains open to discussion of the specific data requirements at least until publication of its final methodology in December

Having noted the above, we would like to raise a few key issues we have picked up to date, and draw your attention to the detailed points in the remaining worksheets of this response.

1. Price base. The use of price base appears inconsistent across data tables (for example, whilst most AMP6 data is required at outturn, some tables include 2019/20 data at 17/18 CPIH adjusted values) - in particular the indexation appears to have been applied inconsistently between the water and the wastewater tables. Given the complexities of moving from RPI to CPIH, we believe additional review of price bases should be included both by companies and Ofwat to ensure a repeat of indexation errors such as the CIS mechanism are not repeated. We welcome the additional RCV and Revenue models issued which seek to address some of this indexation complexity and help ensure adjustments are transparent.
2. Naming convention. The same data table has different numbering in different controls which makes the data tables generally more confusing, perhaps a minor issue, but equally easily changed and something which would help companies when compiling the data.
3. Links - we welcome Ofwat's approach to greater links within the data to ensure the same data only requires one input. We note that in some cases however we believe Ofwat may have linked inappropriately. For example, the 'developer services' revenue in the financial model picks up ALL grants and contributions from App28 table when only some of these revenue elements are related to developer services (and the table name of 'developer services' is also misleading as it includes other revenues such as diversions income and EU grants which are not related to developer services). In other instances, data could be linked - for example inputs and outputs of the financial model to data tables, links between PR14 true up models and the data tables. We recognise that this may be resolved by Ofwat's new system

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

Yes – please refer to the “financial model”, “Appointee”, “Water”, “Wastewater” and “Retail” tabs in this response spreadsheet for more detailed comments on specific elements relating to this question.

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

Business Retail - one key element of data not included is the retail element of developer services for companies which have exited NHH retail. This activity remains part of the appointed business, and Ofwat confirm it should be recorded as business retail activity in the methodology but do not include this input in any of the data tables as there is no Business retail table for exited companies. For ease of submissions, perhaps this line could be moved to the developer services appointee table as a separate block and removed from the retail section of the data tables (including those who are based in Wales and remain as NHH retailers) to avoid confusion between the business retail market and the different, Ofwat definition of business retail.

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

We are supportive of the need to have consistent, accurate and assured set of information across companies and that a common set of data tables will provide consistency. We agree that not prescribing the assurance approach is the right one to enable companies to utilise existing processes, where relevant, and to ensure that the approach is proportionate to the company, its customers and stakeholder needs. This would also align with and support the taking into account of the 2018 company monitoring framework assessment. We also agree that assurance should be provided that the plan complies with statutory obligations.

We will provide our detailed response on the data tables in the relevant section of our consultation response. With regards to the assurance of the data tables we agree that there should be adequate assurance to ensure the data is high quality and consistent with models. Assurance on this scale will be performed over a period of time; to provide robustly assured, consistent and accurate data final models, data tables and guidance will be needed to be included in the PR19 Final Methodology. Any changes in guidance, tables and line definitions after this time increases the risk of having insufficient time to deliver the assurance required.

We agree that having an assurance statement from the Board will help provide the trust and confidence in the quality of the plan and the evidence to support it. We agree that the Board should provide evidence of governance and challenge, rather than guidance and ownership, over the plan as a whole, however, we need to ensure that any statements that the Board is asked to make do not remove the collective responsibility of the Board nor are they asked to undertake a role that is beyond the responsibility of a Board. For example, where the Board is asked to make a statement "in their own words" this should reflect the Board as a whole rather than individually.

We also support Ofwat's views that companies should make their plans accessible to customers and stakeholders whilst ensuring commercial confidentiality. To help balance the confidentiality in publishing the plan with the opportunity to submit plans early it would be helpful to have the publication date separated from the submission date i.e. a plan may be submitted to Ofwat in August and published in September when all plans will have been submitted.

The initial assessment of business plans (IABP)

Q1) Do you agree with our proposed approach to the initial assessment of business plans?
Q1a) In terms of the nine test areas?
Q1b) In terms of the business plan characteristics we want to see? (high quality, ambition and innovation)

We agree with the principle of the IABP and a number of design features. We are particularly supportive of the specific tests on affordability and vulnerability. This clarity helps to set

expectations about what is required and should promote a more effective assessment process and ultimately deliver better results for customers.

Our one area of disagreement is that innovation will be promoted by having specific tests on innovation and assessing "innovation" characteristics.

Ultimately innovation is important for the outcomes that it promotes as opposed to the narrative and descriptions that are likely to be generated from this proposal. As we explained in our covering response we think innovation is best promoted when the overall package of incentives works in a coherent manner and is not heavily weighted to the negative. If this doesn't hold then the regulatory framework is likely to create a culture of incrementalism.

We think Ofwat should seek to promote innovation by ensuring that the incentives work in a coherent manner. This would involve setting efficiency benchmarks at 4th/5th place and using short glide-paths for the 2024/25 UQ ODIs. The current approach runs the risk of inviting companies to describe a lot of things as being innovative without necessarily delivering the outcomes that matter to customers.

So whilst we agree with the outcomes that Ofwat wants to deliver we disagree with the approach.

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

We agree with the approach.

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

We agree with the need for financial, procedural and reputational incentives. However, we think there are opportunities to improve the arrangements by including a "do no harm rule" as per PR14. This would enhance the procedural benefits by ensuring that the Draft Determination is as close as possible to the Final Determination.

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 very much support the PR19 objective to promote innovation because it allows companies to deliver more for less where customers and society value it most.

We think the most important means to delivering this objective is ensuring that the incentives work coherently as a package. There should be stretch but it's also important that incentives are not too heavily weighted to penalties otherwise it will lead to a culture of incrementalism without step changes in performance.

In this context we consider that focusing on a companies' capacity and process to innovate is the wrong approach. If the incentives don't work, then companies will not innovate – even if they have great processes. This is because the downside from taking a risk is too great compared to the potential reward.

We also think asking companies to set out these processes is inconsistent with an incentive based approach to regulation. Although we understand the rationale for asking for this information – we think it runs the risk of creating a culture of "regulator focus" sector. Instead Ofwat should be focused on incentivising the outcome.

Q3) Do you agree with the key questions under each of the test areas?

We largely agree with the key questions under each of the test areas. The exception is the test areas relating to "targeted controls, markets and innovations". These tests appear to duplicate the outcomes that the incentives and markets are being used to deliver. This runs counter to the concept of targeted and proportionate regulation.

For example the bio-resource price control has been designed to incentivise both imports and exports as all parties benefit. It is therefore not apparent what additional use bio-resource trading strategies would provide when setting cost allowances.

The two exceptions are the tests relating to RCV allocation. We appreciate that companies many not have the right incentives to do these activities in the manner desired by Ofwat and hence this additional requirement will help guide the right behaviour.

Q4) Do you agree with what we will look for in terms of high quality, ambition and innovation under each of the test areas?

Below we discuss each specific area – our headline position is that there needs to be greater use of objective measures. At present a number of the "things" that will be looked for are very subjective given the adjectives used – for example one test notes the need for companies to use "sophisticated and global best practice". We have set out our specific comments on a "by exception" basis.

<u>Delivering outcomes for customers</u>

In relation to ambitious and innovative plan – for the most part we agree with the proposal however it would be better to define sector leading as at the time of the submission and so multiple companies could propose something that is sector leading.

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

See earlier comments.

<u>Securing cost efficiency</u>

For an innovative and ambitious plan – we think "sector leading cost efficiency" is likely to be observed from the cost modelling so it is not apparent what additional insight Ofwat is seeking.

<u>Accounting for past delivery</u>

We strongly disagree with the statements of a high quality plan and in particular the presentation of evidence that mechanistic adjustments agreed with customers at PR14 require another round of engagement to be implemented.

The incentives which form part of the PR14 determination price control were already endorsed by our customers through the PR14 business planning process. We do not consider it appropriate that customers should be engaged on the application of historic incentives already agreed and set out as part of existing Price Controls as this would undermine trust and confidence in the PR and FD process.

Q5) 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 high level approach however we think that the process needs to include a final check to ensure that the assessment is appropriate in the round and that undue wait is not placed on certain tests.

For example, it would seem odd if a company is delivering very stretching levels of performance in the areas where customers value it most, at very efficient levels of cost and yet was marked as "slow track" simply because it did a poor job or explaining its processes relating to innovation.

Q6) Do you agree with our proposed schedule for the initial assessment of business plans?

We agree with the initial schedule but consider that greater specification is required on the exact dates. This will support more effective planning and scheduling of CCG and Board meetings.