Aileen Armstrong
Ofwat
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Via email to: PR24@ofwat.gov.uk

21 July 2021

Dear Aileen,

Re: PR24 and beyond creating tomorrow together

We welcome the opportunity to respond to Ofwat's PR24 framework and supporting documents and will continue to work constructively with Ofwat as the methodology and approach to PR24 is developed.

We agree that business plans should be set within the long-term strategic context for companies and are pleased to see that Ofwat's PR24 themes align closely with our strategic direction. The themes that Ofwat has set out focus largely on the social and environmental benefits that water companies can deliver or enable. To facilitate the desired outcomes, we think that Ofwat should incorporate a measure of value within the cost assessment process and in relation to ODIs, to enable it to take account of wider and longer-term improvements to social and natural capital. We think these measures should follow a six capitals approach to valuing the benefits that water company investment delivers.

We were surprised to see Ofwat referencing the industry reaching net zero by 2050, when the industry has committed to net zero by 2030 through the Water UK Public Interest Commitment. We would urge Ofwat to explain how it will support the industry in its commitment to meeting the Government's net zero targets at a pace that will allow the UK as a whole to show steady progress towards the Government target, and how it will enable the net zero investments companies put forward.

We welcome Ofwat's proposal to issue initial views of WACC, common performance commitments and the performance levels that correspond to base investment. We strongly urge Ofwat to confirm the detailed form and depth their initial views will take, and to commit to early sharing of those views. In the case of the common performance commitments and levels by December 2021.

While we support the principle of national customer engagement due to the process and cost efficiencies it could bring, we think the willingness to pay (WTP) research needs to be accelerated. The national customer WTP research will provide results too late for the purposes of developing a business plan and performance commitments that can be tested with customers. In order to incorporate the results into our business planning process, we will need to see initial results by December 2021, and a detailed timeline setting out when additional information will be available. This will enable companies to plan accordingly and reduce the risk of duplication due to late or unexpected centrally produced information.

We also recognise the importance of engaging with communities, as well as customers. Communities can have a role to play in delivering key behaviour-led outcomes and facilitating jointly funded initiatives, and we think co-creation of plans with communities should play a more prominent role at PR24 than at previous price reviews. We welcome Ofwat's views on how to encourage this approach at PR24.

We are supportive of the majority of Ofwat's proposals for market development at PR24. We welcome the removal of developer services from the wholesale control, and the use of DPC for large projects, where feasible. We think it is necessary for Ofwat to bring some standardisation to the process companies use to assess whether there is value to customers in pursuing the DPC route. It will also be important to provide appropriate incentives for companies to promote and participate in the DPC route for delivery.

We do not think any of the options for boundary changes in the scope of the water resources control would change incentives in relation to markets, but should Ofwat decide to proceed, this should happen ahead of business plan submission to ensure any cost allocation issues are thoroughly worked through.

We welcome Ofwat's intention to simplify and reduce the number of performance commitments, and we think part of the process of simplification should ensure there is a consistent calculation methodology. We think it is important that the rewards and penalties available to companies should be appropriately balanced, with more opportunities to earn rewards. At PR19, the use of upper quartile targets and ODIs skewed the balance of risk and reward to the downside, while setting stretching targets for companies, unreasonably penalised what would otherwise be regarded as good performance. It will be important at PR24 for the reward available to companies to be achievable, particularly if performance commitments are fewer in number, with stronger incentives.

We think one significant change that can be made to the suite of common performance commitments is to simplify the measures currently in place that are collectively intended to incentivise companies to leave more water in the environment. We propose a single measure combining leakage and PCC, with a financial incentive for non-household demand to be shared with retailers. This incentive could take the form of removing the link between the quantity of water a retailer sells and the amount of return it can earn. This would provide incentives for all parties to abstract, treat and transport less water

Clearly it is important that costs incurred by companies are done so efficiently, and that customers get value for money. How Ofwat measures that efficiency, and sets appropriate targets, is critical to ensuring the right behaviours are incentivised. When considering the appropriate productivity targets, for example, we think Ofwat's current view is too simplistic and does not take account of externalities such as increasing environmental protections. Similarly, when considering benchmarking approaches for large projects, we think Ofwat should use detailed engineering assessment rather than mechanistic benchmarking, which would not take account of bespoke and locational issues.

We welcome in principle Ofwat's proposals for indexing the cost of equity and moving to full CPI-H inflation for RCV. However, we do not agree with Ofwat's proposal to reduce gearing for the notional company, and we think Ofwat needs to set out why this would be in customers' interests or any way helpful in furthering key policy objectives. Ofwat has repeatedly been clear that it is for companies, their management and Boards to decide the most appropriate capital structure, and to provide Board assurance over that structure. At PR19, we undertook extensive stress testing on our actual balance sheet as part of the plan to assure ourselves that our capital structure remained resilient to shocks and stresses. We would expect to do the same at PR24.

Affinity Water has a securitised financing structure which involves protective covenants and a security package with meaningful restrictions which enhance protection against insolvency and disruption to customer services. Furthermore, the CMA found no evidence of a link between company financeability and customer risk. Given that the CMA dismissed the GOSM and other interventionist measures regarding capital structures in its CMA21 redeterminations, we were surprised to see that Ofwat continues to be considering amending both the notional approach and whether additional customer protections are required.

In light of the above, we do not think that further work on 'risky structures' is necessary, and reference to 'risky' structures is not only unhelpful for the sector but to date, remains unsubstantiated. Indeed, in the current global pandemic, the water industry has continued to deliver high quality services, with no change in availability for customers, Affinity Water have made no use of the furlough system on which many other sectors have relied, and the industry has collectively implemented many additional measures designed to help customers as well as providing significant liquidity to non-household retailers which have operated in a liberalised market since 2017. This should be seen as confirmation that the current structures in place work, and work under the most extreme circumstances that could have been envisaged.

For companies, having early sight of methodology is vital to allow the business planning process to be as efficient as possible, and we are pleased to see the draft timetable set out within the framework document. Although we can see pros and cons of removing the IAP stage, on balance we think an IAP offers benefits to both Ofwat and companies in terms of scrutiny of both plans and determinations. We encourage Ofwat to continue to share information on the process and timetable for PR24 in a timely manner.

We have provided further comments and detail in an annex to this letter, structured around the questions set out in Ofwat's document.

I hope you find our comments helpful, and I look forward to continuing our regular discussions as Ofwat's approach to PR24 develops.

Yours sincerely,

[redacted]

Nicky Fomes
Interim Director of Regulation and Strategy, Affinity Water

cc:
David Black, Ofwat

Questions for stakeholders

Chapter 2: Ambitions for PR24

Q2.1: Do you agree that the themes we have suggested for PR24 are appropriate for England and for Wales?

We think the ambitions are appropriate and align closely with our own strategic direction (as set out in our Strategic Direction Statement which we will publish shortly). We have proposed changes to the proposed price control framework where we think these are needed to facilitate realising your ambitions in the remainder of our response.

Q2.2: Do you have comments on the considerations we've identified as relevant to the design of PR24?

We agree that the challenges you identify are the appropriate ones.

We were surprised that, while presenting other Water UK commitments on Figure 2.1, you have not included the Water UK commitment to achieve net zero by 2030, instead including the UK Government commitment of net zero by 2050. Whilst we recognise the longer-term challenge of reaching total Net Zero emissions by 2050, the Water UK Net Zero 2030 routemap[1] sets out recommendations on where we need support from Government. These include: an economy wide transition strategy from Government, Government policy that prioritises carbon; prioritising Net Zero innovation; and enabling more nature-based solutions.

The water sector is exposed to the impacts of climate change, and it is important that Ofwat supports ambitions for Net Zero operational emissions by 2030 and those companies who are pledging to meet total Net Zero emissions before 2050 in the 'race to zero'.

Chapter 3: How we regulate

Q3.1: How can we best regulate the water sector to deliver value for customers, communities, and the environment? Do you agree, or have comments on, our suggestion to maintain our 'building block' approach based on outcomes, costs and risk and return?

Outcomes

We are supportive of the need to simplify the performance commitment framework. We provide further commentary on this in our responses to chapter 9.

We would value as early a view as possible of the performance commitment levels Ofwat intends to include in base service. Ideally, we would want this information now to help shape our initial view of totex and engage with our customers. However, we recognise that a more realistic timeline might be by December 2021. While we can try to rely on assumptions until we have full information, earlier sight of the commitments and levels will help us to develop a more robust plan.

As well as cost adjustment claims, we think that Ofwat should introduce value cases for bespoke investments that are outside of the normal cost base and deliver wider value. We think there is a

[1] https://www.water.org.uk/routemap2030/wp-content/uploads/2021/03/Water-UK-Net-Zero-2030-Routemap-Summary-updated.pdf

gap in the framework, and a risk that the sector will not realise wider benefits if Ofwat retains cost assessment alone with no consideration of interventions that could offer wider value to communities and the environment. For example, investments that help us meet our net zero targets may involve up-front investment that delivers public value but may not generate costs savings within a single AMP.

Over time, we think that moving from a cost assessment to a value assessment approach is a desirable outcome for the industry. However, we recognise that there is a need for maturity and consensus in the industry's approach to benefits assessment before this can be fully embedded. We think that allowing companies to make targeted cases where they may be investing outside of the normal cost base to deliver societal and/or environmental value would offer a positive step towards Ofwat's goal of greater environmental and social value.

We note Ofwat's proposal to provide greater certainty or indications about ODI rates in price controls beyond PR24. In practice, we think there are likely to be changes in rates between price controls and it may therefore be difficult to provide a reliable indication. Customers' wants and needs from their water companies will change and the relative value they place on improvements to different service attributes is also likely to change as water companies improve and as customer preferences evolve. We expect that Ofwat will want to reflect such changes in future price controls.

Cost assessment

We welcome Ofwat's focus on operational resilience, in particular, on asset health, and the use of Ofwat assessments in establishing appropriate baselines at PR24.

We note the consideration of common frameworks and data for assessing risks to resilience. We think that these will need to be put in place sufficiently in advance of the business plan submission to allow companies to develop robust data against any proposed measures or risks.

Allowed returns

We provide commentary in our response to chapter 11.

Markets

We think that there are risks surrounding re-drawing the boundaries for the water resources control and want to see revised reporting through the APR before we submit our business plan so that any regulatory issues around cost allocation and allocation rules are dealt with before the price control. We also think that the boundary for the contestable market needs to be discussed and explored – the risk profile of water resources and water treatment are different and may attract different investors. There is therefore a need for an industrywide debate over who would own and operate assets with flexibility for asset owners to operate either resources or treatment or both, as this would need to be reflected in companies' reporting requirements.

We welcome Ofwat's proposals on developer services and major projects – we provide further comments in our response to chapter 8.

Q3.2 To what extent is greater co-ordination required across the sector? In what ways might we promote better co-ordination across companies and with other sectors, and how might this benefit customers?

System operation

We agree that there is a need for system operation, especially as we move towards strategic regional resources. We think it is for Defra to deliver the policy framework, and to own any codes or guidance required and would favour system operation set up and run by the industry. While we think that RAPID has a role to play in helping to set the governance framework, we do not think Ofwat should be leading on developing the architecture for system operation on its own.

There are currently multiple emerging parties in this space as noted in the framework document – while this is workable for now, we think there may be a need for simplification or agreeing a hierarchy once the policy landscape becomes clearer (e.g. between the SRO owner-operators, regional water resources planning groups, WRMP-DWMP co-ordination, RAPID, catchment system operators and, if different, natural capital system operators). We would want to see clarity over the direction of travel (and preferably a proposed enduring approach) by the time the SROs start to be procured. This is so that the asset owners for these resources can have long run certainty over the degree of control they will have over the operation of their assets. We think procurement of the SROs may be more difficult or less competitive if there is remaining uncertainty over who controls the water flows and how these are controlled.

We think that there is a distinction between large resources that have or may have the potential to provide resilience across multiple companies and smaller interventions that provide local resilience across one (or more) water resources zone(s) within a company. To avoid unnecessary complexity, co-ordination of small-scale work may be better controlled by individual companies with the resilience impact reflected in system operator plans, whereas a regional system operation protocol would have greater influence over the direction and allocation of strategic projects, strategic use of recycled effluent (e.g. to provide resilience to existing sources during a drought or to support river flows), better control of flooding and storage of flood water to improve drought resilience.

We also think that system operation will work better if there is open two-way dialogue between the companies and any future system operator, and a right of reply so that the rules put in place benefit all parties and help them to optimise their resilience.

While a system operator approach for Natural Capital sits outside Ofwat, there will be a need to better consider partnership funding and delivery to improve Natural Capital via mechanisms such as Local Nature Recovery Strategies and the Nature Recovery Network. These are included in the Environment Agency Water Resources Planning Guideline and could be reflected in PR24 also.

Chapter 4: Increasing focus on the long-term

Q4.1: What are your views on the need for greater focus in companies' regulatory business plans on how they will deliver for the long term?

We think that this is very much required, and investment business cases should be articulated within the long-term context and ambitions for the company. Companies will start to deliver Strategic Regional Options from AMP8, which are likely to involve multi-AMP investments both for the resource itself and to put in place resilient infrastructure to transport the water to customers. We see significant benefit in regulatory commitment to longer term programmes – for example progressive adaptation to climate change and resilience programmes.

We want to see an assessment within PR24 of intergenerational bill impacts, and whether the industry is providing a fair allocation between current and future generations.

We welcome any clarity Ofwat can give well ahead of investment plans being prepared, and at the latest within the draft methodology due in Summer 2022.

Q4.5: Would providing our views on comparable aspects of companies' plans in advance of business plan submission streamline the price review process?

We welcome early sight of Ofwat's views on comparable aspects of plans such as base performance, cost allocations and WACC. In order to be useful and allow the most efficient business planning process, it is important that these are issued as early as possible, and at the latest within the draft methodology due in Summer 2022, with the exception of the common performance commitments and levels, where it would be useful to see Ofwat's first view by December 2021. We think if Ofwat were to issue their views at several points in the PR24 process, each with a narrowing range of values, this would greatly aid companies in preparing plans.

We agree that this will allow us to focus more on setting the pace and strategy for long term enhancements assuming there is sufficient lead time after Ofwat gives guidance around its expectations for those areas where we have not provided long term forecasts in recent business plans. We note that, notwithstanding steer from Ofwat, it will be for companies to assess and include in their plans how they will deliver the base service levels that Ofwat intends to set out. This means that the lead time will be important both for us to produce a well thought out, deliverable plan and for us to assess, including through industrywide research as appropriate, whether the overall (base plus enhancement) package is acceptable and affordable for our customers.

It will also allow us to focus on testing and reining our strategy for making our package even more acceptable for customers, including for example the potential to introduce innovative tariffs.

Q4.8: Are there barriers to water companies changing how they deliver their core functions to deliver greater environmental and social value? How can we address any barriers?

The focus on common service performance outcomes that relate solely or mainly to levels of service to customers can represent a barrier to delivering greater environmental and social value. In previous AMPs, companies have used bespoke, and mandatory bespoke PCs to reflect outputs and outcomes that enhance natural capital and some aspects of social capital. If the number of bespoke PCs is reduced, we think Ofwat will need to bridge the gap by setting either additional PCs or price control deliverables that relate to natural and social capital enhancements. Such performance commitments will need to be broad enough to enable companies to innovate in delivery of sustainability. For example, our current river restoration PC delivers projects measured in morphological units but does not incentivise or capture wider natural capital and partnership benefits.

Financial ODIs that reflect the benefit to natural and social capital flows (and/or stocks) would also help generate greater value where policy makers and customers support the benefit and agree that the water sector is best placed to deliver it. Funding or ODI rewards need to reflect the benefits of delivering biodiversity, sustainability and going beyond statutory requirements to deliver public value. The current mechanisms may lead to a focus on funded programmes only where the ODI rates do not fully reflect the value added from an incremental improvement.

We discuss potential barriers relating to the cost assessment framework in our responses to Chapter 10. We also think there may be opportunities to reflect environmental and social value added through the calibration of RoRE.

Chapter 5: Strengthening incentives

Q5.1: Should we undertake an initial assessment of plans at PR24? If so, what areas should we focus on in this assessment?

We think, on balance, that the complexity of RIIO-style price controls in the water sector has led to a need to make significant changes between initial assessment, Draft Determination and Final Determination. This contrasts with earlier price controls where there were no significant changes in regulatory approach between Draft and Final Determination.

By comparison, in RIIO-GD2, Ofgem needed to revise its Final Determination meaning that the final control was not issued until February 2021. Ofgem's approach involved no initial assessment of plans stage, with Draft Determination and Final Determination being the only regulatory publications. The primary driver for the Revised Final Determinations was changes required to Ofgem's cost models. We think that the Gas Distribution Network CMA appeals relating to the cost models arose partly because Ofgem needed to make these changes at pace and outside of its planned process.

Similarly, at PR19, Ofwat changed its cost models both at Draft Determination and at Final Determination. We therefore think that reducing the number of assessment stages creates a risk for Ofwat because it may need to make changes, particularly with respect to its cost assessment, and also to areas such as the financeability assessment where, again, Ofwat made changes to its approach at the Final Determination.

Some, more qualitative, customer benefits came from the IAP stage, such as companies' action plan commitments on resilience.

We think that improvements to both companies' plans and to Ofwat's assessment of them are more likely to come from repeated external scrutiny of one another, given that organisations may be prone to confirmation bias.

Nonetheless, we recognise that PR19 was a highly intensive process and that there could be benefits to companies of removing the initial assessment of plans stage. However, these will only be realised if the additional time benefit of removing the stage is allotted fairly between companies and Ofwat.

The IAP response stage at PR19 was eight weeks for the companies and the Draft Determination response six weeks (spanning the school summer holidays). It is important that we are able to test the revisions we make to plans with our customers and that we have sufficient time to carry this out. We are particularly likely to want to gather additional evidence where our customer base shows a different preference to the national average customer, and where we have bespoke plans. The very short timescales allowed for companies to respond to assessments and Determinations make it very difficult to gain high quality and meaningful views from customers, especially when customer views need to be sought within a short time window which also needs to allow for other stages, for example, properly defining the revision to the plan, gaining additional assurance and Board sign off.

The Draft Determination response spanning the entire school summer holidays was especially problematic for a water only company with limited resources. Issuing the Draft Determination earlier, for example in June, would have helped mitigate this.

It would also be helpful if Ofwat could release any actions or findings early for areas of the plan where companies need to invest more time in preparing a response, such as in relation to customer engagement. Giving an early or advance view of any areas where Ofwat anticipate significant changes would allow companies to gather the required evidence to help Ofwat's deliberations. However, we recognise that Ofwat may prefer to issue assessments in the round if it publishes an initial assessment.

On balance, although we see potential benefits to removing the initial assessment, we favour including an initial assessment of plans, which we think benefits both Ofwat and the sector.

Q5.3: Should we streamline the price review by combining different steps in the process? If so, which of the three options outlined in this paper should we consider? And are there other options we can usefully consider?

Please refer to our answer to 5.1.

We note that the early Draft Determinations at PR19 led to changes in Ofwat's approach for the slow track Draft Determinations that were not reflected in the early DD companies' Draft Determinations. We think this probably makes it more difficult for an early DD company to respond, as the companies potentially needed to respond to the slow track/significant scrutiny DDs as well as their own. Hence, we support option 2.

Q5.5: What incentives should we provide for high quality plans at PR24? If we don't make use of early draft determinations, how else might we strengthen incentives to table high quality plans on first submission?

We note that in past price reviews, Ofwat has provided financial, procedural and reputational incentives for high quality plans. Regardless of what incentives are set, Ofwat must be clear about the criteria for a high quality plan across each of the areas it will be assessing. Ofwat needs to set out early within the process how it will assess plans, and how each of the ways it will test the plans should be evidenced.

Q5.6: How might we set cost sharing rates at PR24? Should we consider an approach based on our ability to monitor companies' asset health status?

We agree that using the approach of cost sharing ensures that the risk is shared between companies and customers in an appropriate manner. We also agree that a lower cost sharing rate could reduce any incentive to underspend on maintenance. We note Ofwat's intention is to focus on monitoring asset health status, which would allow for a potential raising of the rate in future.

Affinity Water

Q5.7: Which areas should we be considering targeted challenges for at PR24, and why?

In our response to question 9.1, we propose a measure focused on leaving more water in the environment. Should this not be implemented, we agree with Ofwat's suggestion that a targeted challenge could be implemented for PCC. We also agree that there is opportunity and scope to manage non-household water efficiency in a more effective and co-ordinated way and that our efforts in partnering with retailers would benefit from recognition through the price control. For example, we are currently working with retailers in our area on water efficiency in holiday parks and expect this to deliver benefits in reduced water use.

Q5.8: Should we use innovation specific incentive mechanisms at PR24? If so what would these be, and what would they add in addition to the other mechanisms outlined in this chapter?

Innovation specific mechanisms in AMP8 should reflect the specific stimulus needs of the sector. We expect that the AMP7 innovation fund projects will generate findings that will need to be rolled out across the industry. Therefore, similar to mechanisms put in place by Ofgem, there may be a need to stimulate roll-out of successful innovations across all companies (not just those involved in the projects).

There are also likely to be emerging areas where innovation is needed – we think that there may be benefit in targeting specific areas where Ofwat wants to see improvements such as nature-based solutions. At the same time, constraining the subject areas too much could lead to a risk that innovative ideas could be ignored relating to other areas that are not named, but have equal potential to give an industry-wide benefit. We can see merit in running targeted and non-targeted innovation funds or incentives in AMP8.

Chapter 6: Reflecting customers' preferences

Q6.1: What are your views on the merits of our proposals for a collaborative approach to standardised and/or nationwide customer research to inform company business plans and our determinations?

We support the inclusion of acceptability testing in collaborative customer research. We think that this would work best taking a standardised approach, by using an industry agreed questionnaire with individual companies responsible for delivering the market research.

We also agree that there could be benefits of carrying out Willingness to Pay work using a national survey, steered by companies and commissioned jointly by companies, providing there is a sufficient sample size for it to be meaningful and representative for each company. This would remove the differences in timing, methodology and supplier that can all introduce variations in results.

However, we are very concerned over the proposed timetable for this work as discussed in the Customer Engagement working groups, because the results would be delivered too late for meaningful inclusion in business plans, and to enable the testing of those plans with customers. We are designing our PR24 process to ensure that our customers' views are at the heart of the business plan. We are concerned that we may not realise any cost savings as a result of national willingness to pay research, if that research does not deliver results until late 2022. We therefore need to consider whether to undertake our own willingness to pay research this year to help us shape our plan. We will also incur additional costs in making amendments to our plan if the national research is given primacy as Ofwat suggests in its document. So, while we support the principle of national collaborative research, it must be delivered at the right time to avoid any risk of a duplicative approach which will be costly for companies and ultimately customers.

If there are additional bespoke outcomes not included in the national research that companies need to test, such as large price control deliverables or outcomes that might be delivered by DPC, companies' research will need to dovetail with the national research. Given that research relating to single issues may potentially bias customer views (as they do not have the full picture) there is a risk of duplication that the industry will need to manage. Completion of any national research early in the process would help mitigate this risk, as engagement on bespoke priorities could take place within the context of the whole plan.

Q6.2: Do you have any suggestions for how we best implement the collaborative approach to customer research for the price review?

We think it will be difficult to build consensus between all of the companies, CCWater and Ofwat. We therefore think that the approach to developing the research needs to be structured and involve clear timelines that allow companies to build their plans. The timetable for national research as previously discussed in the Customer Engagement Working Group delivers engagement results too late to drive the optimisation of investment in the business plan.

We think if national research is to provide meaningful input into plans and PCs, the timetable will need to be accelerated. This requires the common service attributes and associated PCs to be defined, preferably by autumn 2021 and a common willingness to pay questionnaire to be fully scoped by end of December 2021.

Q6.4: What are your views on our proposals for customer challenge of business plans and assurance of customer engagement?

Customer challenge can take many forms. We agree that it is important to first understand what our customer expectations of us are, and to base our plans on our customer priorities, and then to test those plans at various stages as they develop with our customers to enable them to have the opportunity to challenge and inform decision making. We also agree there is benefit in customer representatives reviewing and challenging our plans throughout the process.

We support the intention that companies decide on how to provide challenge and assurance, as companies are best placed to make those decisions. We also note that constructive challenge ideally involves the exchange of ideas and is a different and separate activity to assurance. It therefore makes more sense to separate these activities.

Q6.5: What are your views on whether we should develop minimum standards or provide guidance in other areas?

We agree that the minimum standards are a good place to start for the customer engagement at PR24. However, we note that at this stage the standards are still quite high level, and we think there needs to be further detail and clarity provided for each of the topics covered.

Chapter 7: Planning together for PR24

Q7.1: How can we ensure that companies bring together the outputs of the strategic planning frameworks in the most coherent and effective way for business plans?

To the extent possible, we need co-ordination of all the processes involved in developing our PR24 plans, including RAPID gates and DPC control points as the SRO projects mature. Although our bandwidth is likely to be constrained in places, we think that this is most likely to be felt by our water resources team given that we are involved in two regional water resource planning groups, while developing our company WRMP and are involved in RAPID gated process for multiple projects. These activities rely on similar skills within our organisation. We would therefore ask that Ofwat considers how the RAPID process interacts with the price control, especially beyond Gate 2, with a view to an arrangement that spreads the industry's workload and avoids burnouts for all parties involved.

We also note that the outcome of the UKWIR programme on capital maintenance, including a value framework and asset health metrics will impact our approach to long term capital maintenance planning and needs to be factored into any discussion about strategic planning frameworks.

As the regional water resource plans will need to be prepared in time to feed into individual companies' WRMPs (i.e. earlier), there is an even greater need to receive early information from Ofwat about PCLs, expectations for delivery through base expenditure and areas where Ofwat is expecting a step change in performance. This would enable us to take a holistic view when we consider the long-term phasing of our investment, which will be more difficult if we need to make assumptions about what we will be required to achieve.

Q7.2: What are your views of our thinking on our and companies' roles in engaging with other regulators between business plan submission and our issuing of the final determinations?

We agree that it will be important for us to maintain a constructive dialogue with our other regulators as we develop our plans and to reflect their views and challenges on our emerging proposals. We also agree that it is appropriate for Ofwat to obtain feedback from our other regulators on the submitted version of our plans.

Q7.3: How could we best involve a 'PR24 Challenge Panel' in the price review process to help ensure that our decisions best reflect the interests of customers, communities and the environment?

We think that there is potential for similar risks or issues to arise with a PR24 Challenge Panel as have arisen in the past with the CCGs – this includes that the panel ultimately fails to maintain its independence to challenge the process if it is too heavily involved at the design stages.

We think that a good way to mitigate this would be to convene several PR24 Challenge Panels with membership and leadership of the panel changing during each stage of the PR24 process. We think that this would be more likely to result in genuine, independent challenge throughout the process.

The remit and scope of the challenge panel also needs to be clear. We think that assurance and ideation should be separate functions – if both are required, it may make sense to have two different panels. The skills on the panel should match the scope of challenge required, and we think the industry should be involved in agreeing a scope.

Chapter 8: Design and implementation of price controls

Q8.1: Do you agree with, or have any comments on, our general approach to the design and implementation of controls, i.e. to retain separate controls with the same broad structure as at PR19, but with improvements to our implementation?

We agree with the approach Ofwat is taking, to retain the control structure used at PR19, with some refinements.

Q8.2: Do you agree with, or have any comments on, our proposals for specific parts of the value chain, i.e., for water resources, developer services, residential retail and business retail in Wales?

We support the proposals for the developer services part of the value chain and agree that further cost allocation guidance would be helpful. We would support removing developer services from the network plus price control (either as a separate control or via capped charges) as we believe that there is good potential for a regulated market in this area. It would also make the network plus control easier for Ofwat to determine given that the volume of new development varies with the economic cycle (but recognising that reinforcement volumes would still require some adjustment for outturn new development rates).

We have provided comments about the boundary of the water resources control in our answer to Q3.1. We would like to see Ofwat guidance on what would constitute sufficient ambition in developing water resources. We note that there is now a regional contribution to optioneering within the WRMP, which raises the possibility of regional failures.

We would welcome further clarity on Ofwat's proposals for the residential retail control. If Ofwat moves towards targeting allowed revenue directly for household retail, we think that this potentially places a risk to companies that outturn new customer numbers would diverge significantly from the up-front forecast. This is both because new development rates could diverge if economic conditions are not as forecast at the time of the plan or determination and because the level of competition from (and therefore new customers adopted by) NAVs may be more or less than predicted.

Q8.3: Do you agree with, or have any comments on, our proposals spanning multiple parts of the value chain, i.e., for major projects and future reconciliations?

Major projects

We support the principle of using DPC for major projects and welcome that Ofwat is considering how best to incentivise the use of DPC. Early sight of any changes to the current approach, in particular any amendment to the cost threshold for DPC, would be beneficial. This will enable us to develop our business plans and associated customer bills with greater certainty.

If Ofwat proposes to allow it, we think that it would be helpful for Ofwat to set out the rules through which incumbents would be permitted to bid for DPCs including consideration of competition law issues, and appropriate separation of resources from the price controlled incumbent function. For example, if an incumbent were to be permitted to bid for its own DPC relying on finance from its existing shareholder should that be through a legally separate company with separation of management teams? If undertakers are permitted to help with preparing DPC bids for other undertakers' projects on behalf of their shareholders, how should this activity be ringfenced from the core operations of the company?

We think that for large SROs that are likely to provide significant quantities of water to multiple companies (especially where loss of that source would cause a significant decrease in level of service for one or more companies), there is a potential need for more direct regulation of the asset owner, given the strong reputational incentive that companies have to secure sufficient resilient high quality drinking water supplies for their customers. Ultimately, the duty for resilience will fall to the licensed undertaker and given the nature of risks from high impact-low likelihood events (such as major outages, severe drought or flooding), customers will need protecting against inappropriate risk appetite from the bidders. This will need to apply during operation, where it may be impossible to rely purely on contractual arrangements to ensure that providers are maintaining and updating their assets as required to provide the contracted resilience.

Unlike the energy market, it is not feasible for water companies to rapidly find alternative capacity suppliers in the event of a major failure during stress conditions. We think that the SIPR criteria could apply in these cases both regionally and for individual companies relying on the water. We think that third party ownership of such assets would be preferable to one of the recipient parties owning and operating the source.

While we can see potential advantages for standardising the bid process for DPC, we can also anticipate that the diversity of assets potentially eligible for DPC may mean that there are bespoke risks and issues with every project that is procured. We suggest that a framework could be developed whereby aspects of the procurement that are likely to be generic are standardised, and aspects of the framework that are likely to be bespoke have principles in place to help guide bidders.

We note Ofwat's comments about benchmarking the costs of major projects. We do not think that it will be possible to undertake a simple unit cost or econometric approach to benchmarking major project costs. This is because such projects generally have bespoke risks and specific locational factors that will have a direct impact on the individual project costs. We think that the proposal to use expert consultants to assess the efficient cost of these projects would be a sensible way to understand whether the site-specific aspects of the costs are efficient, justified and properly optioneered. We think that this could be done in a similar way to the assessment of costs for the TTT at PR14, where companies give access to detailed cost breakdowns for Ofwat's consultants via a 'data room' arrangement.

Reconciliations

We will wait to see further information about Ofwat's proposed approach on reconciliation. In principle, we would expect reconciliations to be provided for areas where there is a relatively high chance that that they will be needed, that reconciliations would be symmetrical, and that they would only be applied where the outcomes for the given area are not certain at the time of the price control.

Chapter 9: Outcomes

Q9.1: What kinds of performance commitments should we include in the price review? What outcomes require financial incentives for all companies for the foreseeable future?

We agree that refocusing the outcomes framework is important, and this includes reducing the number of bespoke PCs or removing bespoke PCs altogether and replacing those that are most important to customers with PCDs. Affinity Water has fewer PCs than other companies, and we think it is possible that across PCs and PCDs we would see an increase. Hence, for us, we think the changes may mean standardisation rather than simplification. In particular, we expect the number and complexity of asset health indicators could increase.

In general, we think that a narrow focus on financially incentivised PCs whose penalties and/or rewards are focused purely on operational service to customers is likely to mean that marginal benefits to natural capital beyond the minimum target are not incentivised and therefore not delivered. We think that consigning measures that benefit natural capital and perhaps even benefits to social capital that only impact parts of the customer base (e.g. vulnerable customers) would be an opportunity missed. As the environment supports society, in the long run it is likely to be in customers' interests that we make marginal gains in areas where we are best placed to do so, so that a sustainable environment is available to support customers in the future. Similarly, societal health is better supported if we provide bespoke services to customers who most need them.

We also want to see an outcomes framework that has a fair balance between penalties and rewards with companies having sufficient opportunity and incentive to outperform. We think it is vital that rewards accurately reflect the risks in the sector, and also recognise the future need for investor capital to support long term environmental improvements.

In considering potential refinements to and simplifications of the performance commitments companies are required to put forward, we think there is the potential for introducing a measure focused on leaving more water in the environment. Currently, this is achieved through the leakage and PCC measures, and we think these could be combined to allow focus on the ultimate goal which is to abstract less water. This combined measure would allow companies the flexibility to focus on the best way of achieving the end goal for their customers and the local environment.

We recognise that leakage in particular is an iconic issue for customers, and customers would be unlikely to support any reduction in effort and focus on tackling leakage. We also note Ofwat's suggestion that PCC may be subject to a 'targeted challenge' at PR24, perhaps involving a stretching, industry-wide step change in reduction which should nevertheless take into account regional differences.

To ensure that companies delivered a minimum in each of these areas, the measure could include minimum standards for the key components. We propose that the new measure focuses on water abstracted / left in the environment because of demand side improvements and is supported by three sub-measures, setting targets for leakage, PCC and non-household consumption. The new measure would need to include water supplied to customers in our area from our own sources and from bulk supplies we receive. It would need to be scaled (by number of households in our operating area plus the number of non-households served by retailers in our area). For simplicity, we suggest that the water we bulk supply to NAVs and the number of customers served by NAVs operating within our geographic area should be excluded from the measure. We propose that the consolidated measure would be a financial measure and the supporting measures of leakage and

PCC be reputational. We think the supporting measure of non-household consumption would be financial and would need to include an incentive to be shared with retailers. We do not think a system where wholesalers have obligations and retailers have incentives will ensure the outcomes required will be delivered. It could also lead to a scenario where primarily household customers pay for wholesalers to meet an obligation, rather than the cost being shared between all parties. We think it is necessary to offer an incentive to retailers because significant reductions in consumption by non-households would affect the return a retailer can earn.

This would allow companies to focus their effort where it would deliver best value for their specific customers and geographical environments.

Introducing a measure designed to incentivise companies to abstract less water may also offer opportunities for further simplification of ODIs. For example, the Abstraction Incentive Mechanism and any bespoke PCs relating to abstraction reduction may also be folded into the measure, further reducing the number of individual performance commitments. In any case, we think the design of the Abstraction Incentive Mechanism would need to change to reflect the differing circumstances under which it is expected to operate, to ensure that there was no perception of benefitting twice from the same management action. It could reflect, for example, increased pace in bringing forward WRMP or WINEP commitments from future regulatory periods where this is supported by the Environment Agency, Defra and Natural England that may be factored out of a water into supply target as needed.

We think that the definition for a drought resilience PC could be improved to make it more robust and more representative of our true annual drought resilience position, as reflected in the delivery requirements in our WRMP. In general, we think that the industry has mechanisms for understanding resilience at the treatment works level at present but does not yet have good measures to understand resilience at the customer's tap. We therefore think that a more holistic view is needed. We intend to share a proposal on this with Ofwat either through the Ideas Lab or in separate correspondence, potentially jointly with other companies.

In PR19, a range of bespoke PCs were developed in relation to carbon, energy, natural capital and biodiversity. A common PC approach to Net Zero should be developed based on the standardised reporting of operational and embedded carbon emissions that Ofwat is introducing into the APR process.

Nature based solutions are mentioned throughout the consultation, however Natural Capital is not specifically discussed. In PR19, there were a range of bespoke PCs on Natural Capital. A common PC on either baseline assessments of measuring a positive improvement or environmental net gain could help companies better implement these approaches. Natural Capital is already included in the Water Resources Management Plan guideline and by explicitly considering this in PR24 it will enable water companies to play their part in delivering against long-term targets set by the Environment Bill. Our preference would be for a common PC or PCs with financial incentives linked to the wider value to society of the solutions being put in place, based on a six capitals approach.

We think in developing such an approach based on the six capitals, care should be taken in the design to ensure that any regional variations can be dealt with as part of the approach rather than requiring adjustments on a company-by-company basis. This would allow a consistent approach to be adopted by all companies, while ensuring solutions are expedited for regions of the country where the impact and benefit will be greatest.

We note Ofwat's intention appears to be to place reputational incentives outside the price control. We agree that no longer measuring them would offer a simplification, assuming that regulatory reporting and audit of these measures is no longer required.

As well as customer priorities, we think that deeper dive evidence into what really matters to customers should help inform the ODIs, rates and the PC definition. One area we intend to investigate in our customer research is supply interruptions – from our operational experience, we suspect that what matters most to our customers is our response to interruptions rather than the duration. Areas which we think may matter most are our timeliness in informing customers of an interruption and that we do what we say we will. If our research with customers confirms this is the case with strong evidence, we may propose that the measure considers the nature of our response rather than solely the number of minutes. If our initial discussions with customers support it, we may also gather customer evidence into whether any particular days of the week or times of day affect our customers more acutely. If we find clear evidence, we may propose that our incentives are targeted towards the performance that matters most to our customers. We can then target our investment and the carbon impact of interventions such as tankering where it matters most.

Bespoke PCs

We think that it would help the industry if Ofwat were to put in place criteria for either retaining existing bespoke PCs or proposing new ones. We think that PCDs may, in effect, become continuations of some of the existing bespoke PCs. We agree that the remaining bespoke PCs should only be retained for circumstances that are either unique or rare within the industry.

Q9.2: How do you think we should monitor outputs that are not clearly linked to the outcomes incentivised in the price control? Would it help to distinguish between PCs that monitor outcomes and PCDs that monitor outputs? What other options could we consider?

There are a number of circumstances where a PCD might apply, and the process of defining these circumstances more closely is likely to be a key task in developing Ofwat's PR24 methodology. It is not clear to us at this stage whether Ofwat will set criteria for us to define all PCDs in our business plans, that Ofwat defines common PCDs and sets criteria for companies to put forward bespoke ones (which would be our preference), or that Ofwat sets criteria and leaves it for the industry to define PCDs in their plans.

We think that PCDs could replace project-specific PCs and support Ofwat in making the distinction between deliverables that need to be defined and performance that needs to be incentivised. We think, as stated above, that opportunities to deliver marginal value to the benefit of the environment and society may be missed if the common PCs are narrowly defined as being service measures that are of immediate interest to customers with natural capital benefits delivered solely through PCDs.

We also think that PCDs could be used to define unit costs for activities where forecasts are uncertain and outside of management control – for example network reinforcement to enable new developments. This approach would be more akin to the volume drivers Ofgem set for similar activities in RIIO-2 with an indicative level of investment included in the price control that is then trued up annually.

PCDs could potentially be used to set unit costs and overall investment caps for activities such as mains replacement, targeted towards DMAs that have the highest background leakage. However, we can also see potential downsides to such an approach – if companies' activities are constrained too much upfront it will become more difficult to deliver innovations and make productivity gains. We think that Ofgem's distinction between 'mechanistic' and 'evaluative' PCDs could be helpful to mitigate this risk.

We think that the number of PCDs could become quite large and therefore would like to see criteria for introducing a closely defined PCD versus allowing companies flexibility to deliver innovatively. Targeting the use of PCDs would help to meet the simplification of the outcomes framework that Ofwat is seeking to achieve. We think criteria could include the following:

- Major, well defined projects that companies need to complete with a materiality criterion to help decide whether a PCD is appropriate. We think this would be likely to include all projects put forward for DPC.
- Major projects that are time limited, with a major reputational or compliance implication if they are not delivered by a given date. Where flexibility is needed to allow for innovation, we suggest that delivery dates may be more appropriate as a PCD with project outcomes (rather than prescriptive outputs).
- Where Ofwat needs to hold companies accountable for an output in their plans that the industry has historically underinvested in when given non-prescriptive cost allowances.
- Programmes and programme level outcomes (rather than prescriptive outputs) to meet DWI and EA requirements. We note that EA and DWI will hold us accountable separately to our specific compliance obligations including through their own enforcement and penalty regimes. We therefore think it is important that Ofwat reviews the potential for double jeopardy in relation to any PCs it is considering in these areas.

Finally, we think it will be important for Ofwat to undertake a review of PCs and PCDs in the round when it makes its determinations to consider any potential distortions in companies' incentives to deliver the entire business plan and to prioritise outcomes over outputs, and to avoid duplication.

Q9.3: Do you consider there are aspects of company performance where it would be better not to set expectations as part of the price control? What approaches should we consider in these cases, so that companies act in the interests of customers?

The industry needs to take a step back and focus on what customers and communities value. We also need to be careful not to create unintended consequences.

Taking activity outside of the price control may not necessarily improve the level of complexity, and we think that Ofwat will still need to consider or give guidance on aspects of any areas taken outside of the price control as part of the PR24 process. Part of our strategic direction is to offer tailored service, where supported by our customers, that meets their wants and needs. Vulnerable customers need specific services from us, the scope of which will vary for different communities. Customers who are struggling to pay their bills also need specific services from us which again will vary across communities. Whereas other communities within our customer base may want and be willing to pay for additional services from us.

We think that ongoing regulation of the minimum standard, for example for vulnerability, could be taken outside of the price control. That said, we remain to be convinced that this is a genuine simplification. We would still need clarity over what the minimum standard is so that we can base our plans on that standard, and to enable us to decide whether our Determinations are acceptable in the round.

We think that the price control remains the appropriate mechanism for Ofwat to scrutinise our proposals for tailoring service to our customers, regardless of whether that tailoring is related to what they want from us or what they need from us.

If metrics are taken out of the price control but still required to be reported to Ofwat annually, this would not be a true simplification. We think that this could be the case for secondary asset health metrics for example.

Q9.4: What should be our aim in setting the levels of performance commitments? Do you agree with the proposal that performance commitment levels should be set, as a starting point, at what can be achieved by an efficient company with base costs and that deviations from this are proposed in company business plans? If not, what alternative proposals should we consider?

We think that using efficient company levels would be a pragmatic starting point for service areas that are a priority for our customers. This is assuming that common PCs are selected because they represent high priority areas and would not be set where the service attribute is not a priority for customers. Hence, we welcome Ofwat's suggestion that customer evidence could be used to make a case for higher or lower PCLs that Ofwat suggests.

PR19 set some clear limits on the PC levels that are funded through base expenditure – for example we now have clear targets for what Ofwat expects us to deliver within base for leakage, interruptions to supply, mains repairs, PCC and unplanned outage. Further stretch on the levels funded at PR19 will not have been funded through base expenditure (companies will have funded this through ODI rewards). Regardless of whether a PC is categorised as base or enhancement, stretch targets above what we have already been explicitly funded to achieve need to be recognised in Ofwat's AMP8 funding assumptions. ODI rewards would presumably be used to fund outperformance against the PCLs that Ofwat sets.

Q9.5: What approach should we take to setting ODIs? How should we take account of marginal costs and marginal benefits in setting ODI rates? What are the risks and benefits of the approaches that we set out, or any others that you propose?

Ofwat has several potential data points available to value ODIs – companies' estimates of the marginal costs which will be available through business plan data, customer valuations through willingness to pay research and companies' assessments of the wider economic benefits if the company chooses to provide them (e.g. to natural capital stocks and flows). We agree that, although it may ultimately choose one main approach, Ofwat should nonetheless triangulate between available evidence to check that the ODI rates are providing sufficient incentive to improve or deterrent to underperformance. Consideration of whether to adjust ODI rates for individual companies or the industry should also be based on an understanding of the relative priority customers place on the PC.

The example Ofwat gives (asset health), suggests that there may be a need for Ofwat to set out a hierarchy of the evidence it would consider in setting ODI rates – for example use of customer valuations first, but defaulting to marginal costs where customer evidence is difficult to obtain.

We support Ofwat's proposal to publish early information about ODI rates ahead of the business plan submission.

Ofwat gives consideration to incentive payments contingent on industry performance or stakeholder involvement. We do not think incentives available to a company should be dependent on the performance of all other companies. While we agree with the principle that frontier shift can have the effect of moving the whole industry forward, we do not think that this ensures all companies will improve, even if the company seeking the reward takes all reasonable actions to share best practice with all other companies.

Chapter 10: Cost assessment

Q10.1: What should be the priorities for improving our approach to cost modelling and assessment?

We summarise our view of the priority areas for attention under the headings below. Please also refer to our response to Q11.1, where we set out some wider thoughts about Ofwat's regulatory framework that would impact benchmarking and reconciliation.

Growth

At PR19, growth related expenditure was modelled as base expenditure. We think this may not have captured regional differences in housing market construction rates or regional differences in contractor costs as growth expenditures particularly well because the costs are small relative to base totex. We would support collection of comparable developer services data which could either be used directly to set cost benchmarks, or which might be suitable for econometric analysis to estimate efficient new connection costs, potentially as a separate developer services econometric model. We note that the treatment of growth costs may need to be different from PR19 depending on Ofwat's approach to regulating the developer services market. We have commented in more detail on separation of developer services activity in section 8.

Enhancement opex

We recognise that there is a risk of 'capex bias' against enhancement opex solutions, as highlighted by UU. Compared to the certainty of cost recovery of capex through return on RCV and drawdown charges, opex solutions that span multiple AMP periods are less certain, and companies may therefore be disincentivised from adopting them. We think UU's suggestion to include enhancement opex in the RCV for release to allowed revenue over time should be considered further. While it could create additional reporting requirements, and a further step in financeability assessments, these interventions do not seem overly complex if they lead to appropriate incentives.

We discuss nature-based solutions further below.

Unmodelled costs

We agree that certain costs are subject to regional variation that is outside of management control, for example business rates and abstraction charges. We think these should continue to be treated as unmodelled costs for econometric assessment. However, at PR19, frontier shift efficiency targets were applied to unmodelled costs. We think the logic for this is not sound as these charges are outside of management control and not capable of reduction through productivity improvement. We ask that the price setting methodology is amended to discontinue this approach.

Disaggregated cost models

Where reliable segmental models can be developed, they can provide additional insight into costs and can be triangulated with overall totex models to improve the reliability of results. Although there is not necessarily a guarantee of success, we support Ofwat's intention towards developing models, for growth costs and water resources. We note that there needs to be a balance between a simplified approach using aggregated models and the more detailed insights that can be gained from disaggregation. We support use of a mixture of models to describe totex, and these should be balanced to manage the information burden on companies and the models' potential to explain the industry's costs.

Retail models

The PR19 retail econometric models gave considerable weight to explanatory variables relating to deprivation. While we do not dispute the existence of a link between retail costs and deprivation, we suspect that it may be over-estimated and would suggest that Ofwat should explore the distribution of income as an additional candidate cost driver.

Productivity improvement and frontier shift

We welcome Ofwat's objective towards better understanding the water sector's productivity improvement relative to that in the economy overall, and which is reflected in consumer price inflation. We think that there are challenges in measuring the product, adjusting the product for quality improvements and taking into account externalities - the water sector is better placed than other sectors to improve the aquatic environment for example and it is not clear that the benefits of this to society as a whole are counted in productivity statistics. Another example is that, in AMP7, we are working towards significant reductions in leakage and PCC which reduce the amount of product we deliver to our customers. This activity, while it is vital for building our resilience, may not be reflected in increased productivity unless it is specifically accounted for in an assessment of our output.

Flexibility versus governance for enhancements

We agree, and welcome that there is currently flexibility and adaptability in the existing price control framework. This allows us to innovate and adapt to new information as we deliver our totex. We think there is potential for some of this flexibility to be lost, depending on how Ofwat uses PCDs and its enhancement benchmarks at PR24. We recognise that there is likely to be a need to protect customers in relation to bespoke enhancements, and potentially uncertain volumes. We think PCDs are likely to be a useful tool for achieving this.

If Ofwat adopts a rigid benchmarking approach (e.g. on unit costs) with rigid deliverables through a PCD for the more bespoke projects within our totex portfolio, our ability to innovate as we scope and deliver the project in light of new information could be curtailed. For example, water resources projects where locational factors and scale can make a significant difference to the costs and scope of the project. We think these projects are more suited to a deep dive assessment for each project than to a unit cost benchmarking approach.

Although RAPID has improved our ability to scope and optioneer, it is not realistic for all our projects to be fully scoped and ready to build at the time we submit our plans. Instead, we would like to see a balance of plans based on robust optioneering and good outline scoping for the major projects we put forward with flexibility within the regulatory mechanisms for us to continue to innovate as we deliver.

Q10.2: In what areas (both historical water sector and external) can we improve the range of benchmarks we use in cost assessment?

We can see potential merit in developing alternative benchmarks as long as they take account of sector-specific requirements – for example, the depth that pipes are required to be laid at for water versus gas.

Q10.3: How can we take account of longer term ambitions such as delivering net zero and increasing public value in our approach to assessing costs?

Delivering Net Zero using a 'reduce carbon, reduce costs' approach needs to be supported in our longer-term investments. Given the long life of assets, and that we have clarity now that net zero will be a national requirement, it is important that we address total carbon in the investments we propose at PR24 rather than waiting until we are closer to the Government's 2050 date for reaching Net Zero. As a sector we can drive innovation in lower carbon materials and construction processes, however demand for these will increase as we get closer to the 2050 deadline – this may lead to cost pressures and potentially shortages of appropriate materials. We think, as Ofwat sets out, that there may be an element of invest to save and that companies should be able to expose to Ofwat through the price control process instances where we will not see the benefits within AMP8.

We agree that driving emissions down should be, and is, our main objective. Reducing our emissions will require innovation and working with partners – we do not have all the answers now and will need to be agile, improving our emissions reduction plans as we reduce our operational emissions by 2030. In the meantime, we think offsetting can play a key role in mitigating the emissions that we are working on innovative solutions to remove. If we can mitigate our existing emissions through offsetting, then we should because overall it contributes to the Government's wider targets.

We think there is a role for direct funding of programmes where there is clear customer support and willingness to pay for enhancements and use of ODI rewards where companies are making marginal improvements. We think that using ODI rewards to finance investments where there is clear customer and/or regulatory and Government support could become difficult to manage where significant improvements are being delivered, as there will be implications on how Ofwat and the industry considers the value at risk through RoRE.

We agree that valuing the benefits of projects that deliver public value is an important part of justifying the investments proposed. Earlier in our response we have suggested that companies put forward 'value cases' using a total impact or natural capital approach to demonstrating the value added from their activities. We would expect Ofwat to provide, through the PR24 methodology, guidance on its expectations for such cases, how they should be constructed, and the extent to which comparable cases can and should be provided for common areas where value might be created. We expect that such guidance would be informed by the outcomes of industry collaboration, for example through working groups and industry research. While we agree that comparable valuations could be a challenge, it would be an opportunity missed to provide improvements that benefit society if we fail to embrace opportunities at PR24. We agree that industry collaboration is likely to help. Noting that this is a new area, we think that there are likely to be lessons for the industry from the PR24 submissions that will help the industry deliver even greater value at PR29.

Increasing public value can be achieved through greater partnership working. However, it is often the case that the costs and benefits of partnership projects do not align. Ofwat have set out, and we agree that customers and our statutory remit need to remain the focus and receive the benefits of water company investment. We agree that the underlying investment to deliver wider public value should be accounted for in cost allowances based on the investment's benefit to the water company from a societal perspective (e.g. the benefits to recreation, biodiversity, air quality and other ecosystem services from river restoration).

Ideally, the price control framework should incentivise partnership working to deliver public value but not be prescriptive about the optimal route to delivering such activity. We think allocating value between companies and hypothetical partners up front is not within Ofwat's remit. Ofwat's focus should be on assessing the value to customers and the water company. Our business plan will need to explore the market for partners to fund their share of the investment needed, and we (internally) will need to put in place a mechanism for Affinity Water to manage the process of Ofwat challenge through the price control with the partners we put in place.

Q10.4: Do we need to amend our cost assessment approach to take account of nature based solutions?

Please see our comments on enhancement opex in our response to Q10.1 above.

Q10.5: Where can we enhance our evidence base on the relationship between costs and Service?

We think that two key areas where the industry should aim for improved understanding of the relationships between expenditure and service are in control of leakage and per capita consumption. The recent CMA referral process highlighted the difficulties regulators face in understanding the relationship between leakage control activity and service levels, distinguishing between improvement in service that ought to be achievable through base expenditures versus enhancement and protecting customers from 'paying twice' for leakage improvements. We foresee the potential for similar uncertainties at PR24 with continued per capita consumption improvement.

Q10.6: What mechanisms should we consider for the efficient funding of performance levels, set in a long-term context, that vary from those an efficient company would deliver through its base allowance?

The framework paper suggests that ODI rewards could be used to provide funding for service levels over and above what could be expected from base expenditure. This would suggest that there may be more ODIs in AMP8, and we think it is therefore not consistent with Ofwat's objectives towards simplification. We would prefer to see an approach where companies put forward their proposals for greater/lesser service improvement alongside supporting evidence in their business plans, leading to cost allowances in Ofwat's determinations.

As stated above, we think that Ofwat is likely also to need to amend its approach to RoRE if it is to use ODIs as a funding mechanism rather than as a reward for incremental performance improvements. We think explicit funding could be preferable if this recalibration were to result in a two-track set of ODIs (e.g. funding ODIs with significant volumes of improvement assumed potentially outside of the RoRE range and incremental reward ODIs inside the RoRE range). We think there is a risk that ODIs could effectively be used as 'volume drivers' and that an explicit volume driver might work better where the volume of investment is less certain or more flexible – perhaps classed as a PCD within enhancement expenditure.

Q10.7 – Is there more that we need to do to reflect future pressure on operational resilience in our approach to cost assessment?

We would welcome the introduction of a forward-looking element of cost assessment for asset maintenance, and that companies will have an opportunity to demonstrate how the future is different from the past. This could be done mechanistically, for example through use of forecast asset health indicators to explain the investment profiles proposed or more qualitatively through deep and shallow dive assessments targeted towards the value of any uplift sought. We think that both approaches are potentially valuable as companies' asset health challenges are to some degree bespoke depending on the history of the network, topography, demographic and other physical attributes.

We note Ofwat's commentary on resilience indicators. We think that these will need to be well designed and tested given that it is challenging to quantify robustly the risks of extreme events. We mention above that we will be developing a proposal on improving the drought resilience metric used during AMP7 as we think that it does not reflect the level of service we are delivering (as set out in our WRMP).

Q10.8: Are the most significant challenges to the operational resilience of the sector adequately captured within current strategic planning frameworks?

The WRMP is not all encompassing of resilience on our system. Our water quality programme delivers to DWI's requirements for mitigating risks, shocks and stresses on our system, whether maintenance-based interventions (base) or enhancements to our existing service. Resilience is addressed within our Drinking Water Safety Plans and therefore does fall within the planning framework.

Areas that are missing in existing planning frameworks include how we use capital maintenance to mitigate resilience risks, how we respond to more minor shocks and stresses on a day to day basis, resilience of our customer facing services and how we maintain our corporate and financial resilience to future shocks and stresses.

Resilience works at multiple levels – some of which need to be captured in detail in our business plans and others are likely to be more appropriately captured in summary. More detail would be needed on investment to mitigate key risks or hazards (e.g. drought, flooding, rising sea level). We think that the business plan rightly contains less detail than we use to run our business where it relates to our day to day operations, although there is no less need to have controls and mitigations in place to maintain our resilience. For example, our production plan for the year contains controls for shocks and stresses and interacts with our drought plan to help us deliver resilient supplies, but we would not expect it to be discussed in depth in our business plan. Detailed plans do, however, inform our business plan baseline.

Following the delivery of the resilience action plans, we think there is opportunity to consider the optimal balance of risk mitigation interventions and whether our intervention strategies are sufficiently resilient on balance. For example, response and recovery activities that rely on specific individual employees are just as risky as a single point of failure within our asset system. We need indicators that capture the underlying level or risk and come to an industry consensus of what the appropriate level is in AMP8 and in the long term.

We also think there may also be a need for the industry to consider new information as it emerges and not just at price controls. For example, if there are significant updates to UKCP18 that emerge between price controls we may need flexibility to adapt our approach to operational resilience in period.

Q10.9: How can we strengthen incentives for long-term operational resilience and improve the assessment of resilience enhancement expenditure while continuing to protect customers' interests?

We think that a clearer definition of what base service has funded historically has emerged during PR19 with the introduction of specific PCLs funded within base. This is helpful in protecting customers and in providing companies with clarity over the level of service that Ofwat expects within base allowance and therefore service levels that would sit outside of base service. This means that resilience improvements beyond base levels should be able to be justified using the baseline set at PR19.

We welcome that Ofwat is considering more targeted resilience investment. Given that base expenditure is better defined now than it was in AMP6, we think that the 'resilience enhancement' category could usefully be split into more targeted sub-categories with guidance on what Ofwat expects of a business case to help companies submit high quality cases in this area. We think that this is an area that would benefit for collaborative working with the industry to define an approach.

Chapter 11: Risk and return

Q11.1: Are there areas of our risk allocation framework where mechanisms could be added, simplified or removed in a way which would benefit customers?

We would support targeted simplifications of the reconciliation framework in the interests of customers and of better regulation.

Performance and costs that will need reconciliation have arisen during the AMP7 period as a result of the pandemic. We think that the performance impacts of Covid-19 on companies' costs and performance should be dealt with on a case by case basis as Ofwat has set out, and do not lend themselves to a standard reconciliation approach across the industry, nor should ideally they be considered as part of PR24 price review but rather considered separately to ensure an objective assessment approach (rather than in-the-round determination). For example, demographic factors such as the proportion of demand from households versus non-households (and the types of non-household in a company's operating area) affect the overall impact on individual companies.

We think that some impacts of the pandemic may be enduring, such as widespread homeworking and the resulting water usage patterns. We think that such long-term societal changes will need to be reflected in Ofwat's thinking and models, and therefore in companies' targets.

We also consider that companies will increasingly see divergence between ‘normal’ and ‘extreme’ operating conditions as climate change increasingly manifests in the weather patterns we experience. The way we operate and therefore our costs will also increasingly flip between normal operations and extreme weather operations. We think that Ofwat should consider whether modelling for and allowing for a proportion of extreme weather running would be appropriate as part of its long-term focus for PR24.

Q11.2: How should we improve our use of RoRE risk ranges to provide insights into the balance of risk and reward, and improve comparability across companies?

We think it is important that the rewards and penalties available to companies should be appropriately balanced, with opportunities to earn rewards as well as penalties. At PR19, the use of upper quartile targets and ODIs skewed the balance of risk and reward to the downside, while setting stretching targets for companies, unreasonably penalised what would otherwise be regarded as good performance. This aspect was acknowledged by the CMA when setting the base cost of financing parameters. It will be important at PR24 for the reward available to companies to be achievable and with symmetrical penalties, particularly if performance commitments are fewer in number, with stronger incentives. We also think that the overall level of reward available for companies to earn should be larger than was available at PR19. This would act as another additional incentive for companies to strive for improved performance.

We think that a standardised scenario approach for RoRE that Ofwat defines as part of its methodology would help with comparability across water companies.

As stated above, we think that the definition of RoRE ranges and value at risk could become more complex to define if Ofwat relies on ODI rewards as a means of delivering service improvements. Hence, we would not support the use of ODI rewards for this purpose and this would represent a substantial change in regulatory approach.

We note that Monte Carlo simulation can be complex and may be more difficult to achieve for smaller companies. We would welcome Ofwat guidance on its expectations in this area.

Q11.3: Should we index the allowed return on equity, and if so, how ought this to be implemented?

We welcome in principle Ofwat’s proposals for indexing the cost of equity and moving to full CPI-H inflation for RCV.

Q11.4: To what extent should we place weight on a) balance sheet data; and b) index data when setting the allowed return on debt?

We do not support Ofwat’s proposal to consider a single allowance for new and embedded debt. We think that a focus on the balance sheet would be objective and reflective of reality if Ofwat moves towards a single data source, whereas it is difficult to access index data that is reflective of the water sector’s position.

Q11.6: Should we make different assumptions for the PR24 notional structure compared to PR19, and how should such a change be implemented?

We do not agree with Ofwat’s proposal to reduce gearing for the notional company, and we think Ofwat needs to set out why this would be in customers’ interests or any way helpful in furthering key policy objectives. Ofwat has repeatedly been clear that it is for companies, their management and Boards to decide the most appropriate capital structure, and to provide Board assurance over that structure. At PR19, we undertook extensive stress testing on our actual balance sheet as part of the plan to assure ourselves that our capital structure remained resilient to shocks and stresses. We would expect to do the same at PR24.

Affinity Water has a securitised financing structure which involves protective covenants and a security package with meaningful restrictions which enhance protection against insolvency and disruption to customer services. Furthermore, the CMA found no evidence of a link between company financeability and customer risk. Given that the CMA dismissed the GOSM and other interventionist measures regarding capital structures in its CMA21 redeterminations, we were surprised to see that Ofwat continues to be considering amending both the notional approach and whether additional customer protections are required.

In light of the above, we do not think that further work on 'risky structures' is necessary, and reference to 'risky' structures is not only unhelpful for the sector but to date, remains unsubstantiated. Indeed, in the current global pandemic, the water industry has continued to deliver high quality services, with no change in availability for customers, Affinity Water have made no use of the furlough system on which many other sectors have relied, and the industry has collectively implemented many additional measures designed to help customers as well as providing significant liquidity to non-household retailers which have operated in a liberalised market since 2017. This should be seen as confirmation that the current structures in place work, and work under the most extreme circumstances that could have been envisaged.

Q11.7: Do you have any suggestions for mechanisms which could incentivise financial resilience within the price control process?

See answer to Q11.6.

Q11.8: To what extent should we further increase the share of the notional company RCV which is indexed to CPIH in our assumptions for the period 2025-30, and how should this be implemented?

We accept Ofwat's proposal to move to full CPI-H inflation for RCV.

12. Next steps for PR24

Q12.1 - What are your views on the draft timetable for PR24?

We welcome confirmation of the business plan submission date at this stage. Early sight of key dates such as this are important, particularly for water only companies with limited resources available, and we encourage Ofwat to confirm such key dates well in advance throughout the PR24 process. In particular, as we have set out in our response to question 4.5, we note that Ofwat are considering publishing key parameters such as WACC, common performance commitments and the corresponding performance expected from base investment, and urge Ofwat to confirm what will be published, to what level of detail, and when, at the earliest opportunity.

The sector would also benefit from advance notice of specific dates for the IAP, IAP response deadline (if these are used), DD and DD response deadline. This will allow us to plan so that we have staff and other resources available at key points in the process and to help us with scheduling Board engagement.

We also note that the draft timetable does not include an Initial Assessment of Plans. As set out in our answer to question 5.1, we believe on balance that the IAP stage has significant value within the overall process for both Ofwat and companies. We hope that the exclusion of that stage in Ofwat's draft timetable does not indicate that Ofwat has already decided to remove that stage of the process. In the event that Ofwat does decide to remove the IAP stage of the process, we think Ofwat should commit to the timetable, and specifically, that Ofwat should commit to not re-introducing a further stage in the process at a later date.

Appendix - Examining the boundary of the targeted control for water resources

Q14.1 - How can costs and incentives for the existing water resources control be targeted more effectively?

We agree that there are likely to be multiple circumstances relating to the type of assets in use for shared resources and in a future market for bilateral trades. Given that the market is specifically for new resources rather than existing ones, we would question whether redefining the boundary is needed to enable the market, the SROs, any other shared resources or bulk supplies.

We are not likely to be incentivised any differently by a change in price control boundary. We have a need for water and limited options to provide it within our own boundaries, therefore we will seek shared resources and bulk supplies to meet our customers' needs regardless of how the costs are allocated.

If Ofwat decides that the boundary of the control needs to change, we think it would help to implement this change and any licence modifications required, using the APR as soon as is feasible. This would take any issues arising about cost allocation outside the price control allowing us to focus more effectively on preparing our business plan and evidence.

Q14.2 - Would amending the boundary to include raw water distribution or to extend it further to include water treatment improve the operation of the control? What are the issues involved?

Please see our response to Q14.1.

We think that water resources assets are diverse in nature and that this is what makes them difficult to benchmark using an econometric model. Although bundling with treatment costs may produce a viable econometric model, the water resources costs that are included within that model may nonetheless be poorly explained because they are diverse which we think calls into question the rationale for changing the price control boundary for the main purpose of being able to benchmark costs more effectively.