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By email only: PR24@ofwat.gov.uk

Re PR24 Consultation: "PR24 and Beyond: Creating Tomorrow, Together"

Dear Aileen,

I am writing with our response to Ofwat's PR24 consultation document "PR24 and Beyond: Creating Tomorrow, Together". I would like to take this opportunity to highlight a few overarching points in relation to Ofwat's proposals and the opportunities and challenges ahead for PR24.

Firstly, we believe that Ofwat has correctly identified the key issues likely to be facing the industry at PR24. Shifting government policy, tighter regulations, and public expectations mean that significant environmental improvements will need to be delivered. We will also need to take steps to meet the challenge posed by changing weather patterns, while playing our part in reducing carbon and addressing the climate emergency. At the same time, at least while the longer-term economic impact of Covid is uncertain, it is likely that affordability will remain a concern. We will need to consider carefully both the trade-off between investment and average bills, and the level of available support for those customers who struggle to pay.

Secondly, many of Ofwat's prescriptions for meeting these challenges appear sensible – a greater focus on integrating the price review with longer-term strategies; encouraging greater collaboration both within and beyond the industry; and maintaining the focus on innovation and efficiency. But as an industry we need to go further and break out of 'one-track' investment planning, with each investment scheme designed to solve an individual identified problem. Companies will generate much greater value by assembling a *package* of investments, where each element addresses multiple problems and delivers multiple benefits: meeting regulatory standards, enhancing resilience, and delivering environmental benefits or carbon reduction, for example.

We would therefore encourage Ofwat to seek ways of introducing greater regulatory flexibility, particularly when it comes to the assessment of investment plan proposals. We very much welcome the proposals to simplify the price review process, such as by publishing more information in advance. Companies also need to know that creative proposals to maximise public benefit will be fairly and reasonably considered by Ofwat as part of its cost assessment process. We would encourage Ofwat to work with companies and other stakeholders to find ways of assessing the value for money of companies' proposals 'in the round'. We would welcome early guidance from Ofwat on how it will assess 'best value', both for individual enhancement cases and for investment plans as a whole.

In Wales the potential to take this kind of approach may be higher, owing to the Well-being of Future Generations Act and the legal obligation on public bodies to work collaboratively to ensure the sustainable management of natural resources. We therefore welcome Ofwat's invitation to consider ways of taking a more collaborative approach to business planning and the price review in Wales. This will also facilitate discussions on the extent to which some aspects of Ofwat's proposals, including targeted challenges, might need to be adapted to circumstances in Wales. We have already shared some initial thinking on the collaborative approach in Wales with Ofwat and look forward to further discussion as we flesh out these ideas together.

We make a number of comments on some of the more detailed aspects of the methodology in our responses to Ofwat's consultation questions below. However we would like to highlight here the importance of looking again at cost assessment modelling for retail. We remain of the view that there is potential to better capture the underlying drivers of bad debt in the retail cost models. We also believe there may be the potential to introduce a cost factor that reflects the relationship between service standards and costs in retail, now that C-Mex is becoming more firmly established as a measure of customer service standards in the industry.

Finally, on customer engagement, we support the general direction of Ofwat's proposals for PR24 – ensuring a sound understanding of customer needs and preferences form the foundation of business planning, while ensuring that customer research is proportionate and meaningful. We know from experience that customers in Wales sometimes have different views on key issues from those in England, so it will be vital that any 'nationwide' or 'standardised' research is able to capture those differences while also reflecting the particular circumstances in Wales. We plan to continue to use our Customer Challenge Group to help us formulate our research plan and discuss the relevance of findings for business plan decision-making. The removal of Ofwat's reliance on Customer Challenge Groups to provide an assurance function in relation to customer research will assist in the effectiveness of this work.

This consultation at an early stage in the process is welcome, but much remains to be done on tight timescales. We look forward to engaging in further work to define the details of PR24 so that we capitalise on the opportunities to help the sector meet the challenges ahead.

Yours sincerely,

[redacted]

Eleri Rees
Strategy and Regulation Director

Dŵr Cymru Welsh Water response to PR24 consultation: "PR24 and Beyond: Creating Tomorrow, Together", 22 July 2021.

Chapter	Questions for stakeholders
2. Ambitions for PR24	Q2.1: Do you agree that the themes we have suggested for PR24 are appropriate for England and for Wales? Yes. We agree that all four themes are important in Wales. We would suggest that in Wales the first two priorities presented – increasing focus on the long-term and delivering greater environmental and social value – are particularly important, and are areas where most change is required in terms of the price review approach. We will also of course continue to ensure we have a clear understanding of the needs of customers and communities, and drive improvements through efficiency and innovation as we have always done. However, for Wales the emphasis and manifestation of those themes may be somewhat different. For example, in relation to climate change, in Wales there is a greater stress on addressing more extreme rainfall patterns, and less (compared to England) on drought concerns. It may also be that customers have different preferences in Wales in relation to how quickly to address those challenges.
	Q2.2: Do you have comments on the considerations we've identified as relevant to the design of PR24? The three trade-offs identified seem highly pertinent to the design of PR24 and it is good to see that Ofwat has identified these early on in the process. We would perhaps add a fourth key consideration: the need to find ways to assess the costs and value of company investment proposals 'in the round', rather than on a narrow basis, while retaining a robust cost challenge and the ability to use cost benchmarking. Companies will not be able to deliver the step change in public and environmental value rightly expected by Ofwat, while they are straitjacketed into a process which rewards simple, narrow, concrete 'solutions'.
	Q2.3: How should we evaluate our progress, and how can we best develop or use appropriate metrics to do so? This is a difficult area, and there are no easy answers. We do know that simplistic measures of success should be avoided – such as the claim during AMP6 that the totex and outcomes framework had reduced costs. It is hard to untangle correlation and causation, and to attribute effects correctly to regulatory causes. Ultimately the measure of Ofwat's success is the value that companies deliver through the provision of core services and wider benefits to customers, society and the environment.
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?

	We are supportive of retaining the basic features of the current 'building block' approach based on outcomes, costs, and risk and return. We believe that Ofwat delivers greatest value for customers, communities and the environment when it focuses on what matters most, creating a robust high-level incentives framework, within which companies have the freedom to operate and determine what works best in their own context. We therefore welcome, for example, the proposal to reduce the number of performance commitments while retaining the essential features of the outcomes and ODI framework. We would recommend that Ofwat adopts a precautionary 'do no harm' approach, ensuring that it is not setting any perverse incentives, and ensure that performance commitments really reflect desired 'outcomes'. An example from PR19 would be the 'unplanned outage' ODI, when such outages may be a design feature of a resilient system, and have no impact on customers.
	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? Ofwat correctly identifies that co-ordination across companies is required in areas such as research and innovation, water resources planning, and bioresources. For us, the biggest opportunities lie in better co-ordination and collaboration across different agencies within Wales, to ensure that problems are wherever possible prevented 'upstream', and dealt with optimally by whichever body needs to be involved, rather than the water company being obligated to address a problem 'downstream'. An example would be our efforts to support a legislative ban on wet wipes, to reduce 'downstream' sewer blockages, or working with local authorities to reduce run-off into our combined sewer network. Ofwat's proposal to explore a more collaborative approach to PR24 in Wales should help us move further in this direction.
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 absolutely agree that integrating five yearly business plans with long-term strategies and plans is important for companies, and this is something Ofwat should look at as part of the price review. The key question though is how the price review framework can adapt to better recognise company responses to long-term challenges. This might mean, for example, allowing for nature-based solutions that have a long lead time, and may not deliver the 'solution' until the next AMP or beyond. It also means recognising that in order to address some long-term challenges such as climate change (increased rainfall), companies need to invest just to maintain current performance levels (investing to prevent deterioration in performance from long-term trends should be an allowable 'enhancement'.) A third example is allowing for investments that begin to make progress on a long-term issue, such as coastal flooding risks, before the problem becomes urgent. Addressing these issues requires

	regulatory flexibility and innovation otherwise companies will end up being forced back within a five-year time horizon.
	Q4.2: What should long-term strategies seek to cover and what details should we expect companies to set out in business plans? Would common requirements help us and other stakeholders to understand each company's approach? We agree that price review business plans should be well integrated with companies long-term strategies. In our view long-term strategies should include: • An assessment of the long-term threats to the resilience of core services provided by companies, and the trends that provide opportunities for companies in the future; • Proposals for the objectives that need to be met in order to meet the threats and capitalise upon opportunities; • An indication of the strategies and interventions needed to deliver upon those long-term objectives over the next 3 to 4 AMP periods. We would suggest that Ofwat makes clear in its methodology its expectations as to how companies should demonstrate links between the five year plan and the long-term. We are already working on a refresh of our long-term strategy, Welsh Water 2050, ahead of PR24. We anticipate that this will feed into the collaborative process in Wales to set long-term objectives. We would therefore suggest that the requirements for the 'long-term strategies' in Wales should come out of these collaborative discussions. We can of course write up our long-term strategy in a way that meets Ofwat's requirements for PR24, but we would not wish to have to repeat or redo elements of our long-term strategy just for this purpose. Early guidance and agreement on this would therefore be helpful.
	Q4.3: How would this build on the work completed in strategic planning frameworks? Long-term strategies need not duplicate other strategic planning frameworks, but the outcomes of processes such as WRMP should be reflected and integrated in long-term strategies such that they cover all of the key objectives and investment requirements.
	Q4.4: How can we allow such strategies and plans to adapt to new information at future reviews while continuing to hold companies to account to deliver expected benefits into the future? This will be a difficult balance to strike. Price reviews should be seen as 'staging posts' and opportunities for course correction on long-term strategies. Any significant changes should be well evidenced. Changes in the strategy should not absolve companies from delivering the benefits of investments in previous periods.
	Q4.5: Would providing our views on comparable aspects of companies' plans in advance of business plan submission streamline the price review process?

	Yes, having an early view of Ofwat's position on cost of capital, base costs, PCLs and ODIs would simplify the business planning process for companies and allow us to focus on those parts of the plan that are within company control and that deliver most value.
	Q4.6: Should we adopt a collaborative approach to developing Welsh companies' plans at PR24? If so, how should we go about doing this? Yes we are supportive of the concept, though it is unclear from the consultation exactly what is mean by 'a collaborative approach'. We believe it would be beneficial for Ofwat to be engaged in the multi-stakeholder discussions on trade-offs, priorities and high-level objectives for the plan. If the scope and ambition of the plan can be agreed early on, Ofwat's role can emphasise the scrutiny of costs, the 'need' for schemes having been agreed jointly. The collaborative process would provide an opportunity for Ofwat to test the extent to which its proposals on common issues, such as 'targeted challenges' are appropriate for Wales.
	Q4.7: What are your views on how we could provide clarity over the long-term regulatory framework? We fully endorse the principle of holding companies to account for past investment. However, this principle needs to be carefully applied to avoid punishing companies for doing the right thing when situations change. We think it would be unwise to fix parameters such as ODIs over several price review periods, as this would be unduly inflexible. However, it would be useful to have greater insight into indicative levels for PCLs and ODIs for the next review. Ofwat proposes potentially deferring ODI payments into future periods. This could work well for long-term investments where benefits may take longer than a single AMP period to materialise. However, we are concerned about the potential for additional complexity. In addition, in the example Ofwat cites companies' rewards for out-performance in 'good' years could be deferred and then not paid at all if a 'bad year' ensues. We are not sure that this is logical and in any event could distort incentives. For example certain PCs are driven in part by external factors such as the weather. If the statistical likelihood is that a company is going to have a bad year at some point for reasons outside its control, thereby nullifying any rewards it earns in the meantime, then its incentive to work on the things that are within its control may be significantly weakened.
	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? Yes. Companies currently make investment decisions based on cost-benefit analysis, which tends to undervalue the societal and environmental gains of 'alternative' solutions as these

	are difficult to value. As we seek to reduce further our carbon footprint and positively enhance the biodiversity of Wales, we need to make sure that we do value such elements of our investment proposals in our process, and it should be valued in in Ofwat's cost assessment methodology as well. This will move us for some proposals away from 'grey' carbon and resource intensive solutions to 'blue/green' catchment and nature-based solutions, which can bring much broader value to our customers. The barriers to progressing such investments could be addressed by the endorsement of a 'multi capitals' approach to investment, which sets out to value such benefits, and so guide our investment programme to deliver greater overall value for our customers. We would welcome guidance from Ofwat on a pragmatic, consistent approach across the industry. Secondly, we believe innovative regulatory approaches are needed to deliver greater environmental and social benefits. There is the potential to introduce new controls to prevent materials such as rainwater and plastics entering into our systems 'at source'. If we could make such controls mandatory these would be more than paid for by the savings created (e.g. by reducing blockages and flooding) or future costs avoided. Along similar lines, the UK Environment Bill includes five environmental principles, which will drive the sorts of regulatory changes we need. Ofwat should ensure that its approach to cost assessment and business plan incentives align with these principles. Finally, it needs to be recognised that nature-based solutions are likely to take longer to deliver than traditional solutions (this will become clearer as companies implement such solutions and learn from best practice), and may be more expensive. Companies will be disincentivised from pursuing such solutions, which will optimise societal benefits over the long-run, unless the regulatory mechanisms show a degree of flexibility over the timing of the delivery of the outcome.
	Q4.9: Do you have any further suggestions for increasing the focus on the long term? If so, what are these? In practical terms, Ofwat's full support and recognition of our DWMPs, both during the consultation phase starting in June 2022, and then for the outcomes to be incorporated into AMP8, would be most welcome given they will set out priority investments for AMPs 8, 9 and 10. Secondly, we believe that a portion of the £200m innovation found should be devoted to research and innovations which are lower down the technology 'readiness' scale, which will deliver value in a future AMP. This will help companies focus on the long-term and deliver greater value beyond AMP8.
	Q5.1: Should we undertake an initial assessment of plans at PR24? If so, what areas should we focus on in this assessment?

5. Strengthening incentives	Yes, we strongly support the inclusion of an IAP step. Although it may not have made a big difference to Ofwat's decisions at PR19, it was very helpful to companies in clarifying Ofwat's expectations and approach to assessing business plans, and hence to set out our plans in an optimal manner. The opportunity for feedback at an IAP stage will also help to minimise changes between the Draft and Final Determinations. We believe it is important that the Draft Determination is essentially the Final Determination, subject to representations from stakeholders. Ofwat should not be making any significant policy changes subsequent to the DD. For Ofwat, to get an early sight of Business Plans at an IAP stage will help prevent this. For companies whose business plans are considered high quality, it might be possible to offer a 'fast tracked' DD, which could occur at the same time as, or shortly after, the IAP stage.
	Q5.2: Should we consider adopting a more light touch approach at PR24 for companies with a strong track record of delivery during the PR19 price review period? If so, what factors should we consider in our assessment and why? Our concern with this approach is that it suggests an inverse correlation between a company's performance in delivering its last business plan, and the level of scrutiny required in assessing its next business plan. We do not think there is a sound basis take such a view. This proposal would also increase complexity by introducing an extra step in the process. This step would require a fair and rigorous process for assessing companies' 'track record of delivery', which would be hard to define objectively, without a great deal of further detail and scrutiny. In our view this would be unwarranted.
	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? Our preference would be for Option 2, with three separate steps, as at PR19. There may be limited scope for some companies to have an early DD that could possibly be combined with the IAP. However, it is hard to reach decisions on everything needed for a 'real Draft Determination' (i.e., with all of the key decisions made and agreed) in one leap as it were. This was not achieved at the Draft Determination in PR19, despite the existence of an IAP stage. In PR19, those companies that had early Draft Determinations still had to wait for key elements to be decided by Ofwat later on (such as cost of capital).
	Q5.4: Is a different approach needed for the initial business plan assessment for companies in England and in Wales? The details of the process for companies in Wales has not been defined yet, so this is a question we will need to keep under review. However, we would suggest that if elements of

	the business plan for companies in Wales have been agreed through a sound collaborative process that meets Ofwat's requirements, these need not be revisited at the IAP stage.
	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 agree that business plan incentives are important. We believe that reputational and procedural incentives are probably more powerful than financial incentives. It is important to learn the lessons from PR19, in which the business plan incentives did not work well in our view. The companies that were 'fast tracked' were those with the most modest enhancement investment plans, and the biggest bill decreases. This may have been a coincidence, but business plan 'quality' is about more than just bill levels. Those companies did benefit from the financial and reputational benefit, but the procedural benefit was limited, with many issues left open until the rest of the Draft Determinations. If Ofwat retain the same process for PR24 we think the incentive will be limited.
	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 would support a process for setting cost sharing rates that is simple and transparent. The methodology for cost sharing at PR19 is reasonable and we would propose continuing with this. Cost sharing is an area where there might be a theoretical rationale for designing an elaborate approach in order to 'tweak' company incentives, but there is a high risk of unintended consequences of such an approach, and any effect on incentives is likely to be marginal in practice. See also our answer to Q8.2. We do not believe the benefits of setting differential cost sharing rates based on Ofwat's ability to monitor asset health status would outweigh the additional cost and complexity of such a process, particularly such any monitoring and measuring of asset health status would involve a significant amount of judgement. Setting the right cost sharing rates is important, but it is not the right tool to use for this purpose.
	Q5.7: Which areas should we be considering targeted challenges for at PR24, and why? We are sceptical in principle about 'targeted challenges'. They imply that an arbitrary percentage improvement determined by the economic regulator is the optimal outcome for customers of all companies. This rejects the notion of an economically optimal level of performance. If Ofwat does decide to consider 'targeted challenges', we do think these need to be considered separately for England and Wales, as the operational context is different in the two jurisdictions. For example, water efficiency and PCC, while important, is a less acute priority in Wales than it is in England. Further, any targeted challenges should be focused on

	the actual outcome or impact for customers and the environment, not an intermediary measure (such as the crude number of CSO spills, for example).
	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? We do not believe that the concept of an innovation-specific incentive mechanism is justified in theory nor would it work in practice. In theory, why should innovation be rewarded and incentivised in itself, when what matters is the outcome of innovation in terms of cost and performance improvement, both of which are already incentivised? In practice, the degree of innovation would be impossible to measure with any precision, as it is so hard to define, so it would not be suitable as a basis for an incentive mechanism.
	Q5.9: In what ways might we promote the themes of EBR through PR24? We believe that the principles underpinning EBR are sound, and that we should seek to move in this direction where possible. We particularly support the second point about EBR cited in the consultation, that regulation will be most effective when it is based on the collaborative involvement of all parties. As discussed elsewhere, there may be potential to pursue this in Wales in particular. We agree with Ofwat that there is a role for incentives in the price review, but in our view that role works best at the high-level, and works less well in the details, where additional complexity dilutes the impact of incentives and there is a potential for unintended consequences. We believe that the principles of EBR will be particularly important as the water industry seeks to pursue further the wider societal goals of the enhancement of the natural environment, carbon neutrality, and other public values. These issues fit less well within traditional methods of cost assessment, and Ofwat will need to work with companies with a degree of trust and flexibility to maximise the potential for water companies to play a significant role.
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 are supportive of the aim of doing 'nationwide' (England and Wales separately) or 'standardised' research to generate results on which Ofwat relies directly for the determination of issues such as PCLs and ODI rates. There will be some challenges in the implementation of this approach in practice, such as reaching agreement on what constitutes an 'unbiased' presentation of the facts for customers taking part in surveys in a consistent way across companies.

	Such difficulties will be particularly problematic for standardised or nationwide research on the acceptability of business plans. It would raise a number of difficult questions concerning what information on plans is presented to customers, at what stage the acceptability research is done, and how the results are used. We therefore propose that standardised or nationwide research is focused on service valuations for PR24. We would emphasise the need for clarity on who is responsible for what in terms of customer research as soon as possible, because of the long lead times for commissioning the research, and ensuring results can be reflected in business planning.
	Q6.2: Do you have any suggestions for how we best implement the collaborative approach to customer research for the price review? As stated in our response to the earlier consultation on this topic, we believe the default should be that there is a separate approach in Wales, overseen by a separate body, given the different context. However, the research methodology should be common across Wales and England to the extent possible and appropriate to facilitate comparability of results. The approach will naturally vary dependent on the objectives and design of the research. Careful thought will be required on governance arrangements, as it won't be possible for every party to be involved in the detailed design of the research.
	Q6.3: Are there aspects of negotiated settlements that could be reflected in our price review framework? We believe that Stephen Littlechild's submission to the CMA made a great deal of sense. We agree with him that the price review process has grown in scope and complexity to the point that it takes up a disproportionate amount of management time and attention, to the detriment of delivery of improvements to the core service. We would like to move in the direction of negotiated settlements, and hope that we can take significant steps in that direction in Wales at PR24 with a more collaborative approach to the price review.
	Q6.4: What are your views on our proposals for customer challenge of business plans and assurance of customer engagement? We believe Ofwat's proposals not to mandate Customer Challenge Groups are appropriate. However, we plan to continue to engage with our Customer Challenge Group for the challenge of business plans as opposed to asking it to provide assurance of our customer research. It seems that the research projects most in need of assurance will be those done as part of the collaborative research. We would point out that in the water industry, where most customers have a low level of awareness of company activities 'beyond the tap and the toilet', customer responses are likely to be highly sensitive to the contextual information provided. It may not be possible

	therefore to ever assure that research materials and questions are totally neutral and 'unbiased'.
	Q6.5: What are your views on whether we should develop minimum standards or provide guidance in other areas? We support the proposal to develop minimum standards. The minimum standards provided in draft are reasonable and helpful, though we think they could better be described as general guidance rather than 'minimum standards', which suggest a specific, measurable set of standards.
	Q6.6: How well does our proposed approach to customer engagement take appropriate account of the different regulatory frameworks in England and Wales? We are satisfied that the proposed approach to customer engagement takes appropriate account of the different regulatory frameworks in England and Wales, though a lot of detail remains to be decided and will need to be carefully considered considering the differences. Please also refer to our answer to Q6.2.
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? The proposed collaborative approach in Wales is likely to help with this. One of the key challenges for PR24 will be that the WRMPs, DWMPs and NEP processes will likely generate need for a great deal of non-discretionary investment expenditure. Bringing the regulators together with the companies to reach agreement on the right balance between this and other vital expenditure, and the affordability of bills, will greatly assist with the business planning process.
	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 expect the primary forum for engagement with regulators in Wales will be the PR24 Forum convened by the Welsh Government. We will also be engaging bilaterally with regulators on our plans as part of our 'business as usual' engagement.
	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? The purpose and functioning of the proposed 'Challenge Panel' is unclear from the consultation document. We would welcome further engagement on Ofwat's plans in this area ahead of the draft methodology consultation. We think the concept could work best as an 'England and Wales' panel which advises and challenges Ofwat on the approach it is taking and how well it will deliver best all-round value for customers and the environment.

	For it to be credible and useful it will need to operate transparently and at arms length from Ofwat.
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 overall proposed approach to the design and implementation of controls.
	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? On water resources, we agree with Ofwat's proposals to ensure that costs are allocated consistently. Concerning, extending the water resources control to include raw water distribution assets and water treatment, we think this needs to be looked at carefully to determine whether the limited benefits from expanding the control outweigh the disruption that would be caused by making further changes at this stage, while the prospects for further development of water resources markets are unclear. Regarding cost sharing, as outlined in the appendix on examining the boundary of the targeted control for water resources, separate cost incentives can result in perverse incentives. The combination of asymmetric cost sharing rates and different sharing rates across price controls could result in companies not taking the best option for customers in order to maximise cost sharing benefits or minimise losses. In some cases companies have the choice to pursue an outcome through alternative schemes in different price controls. An example of this is expenditure to improve the outcomes for acceptability of water. This can be achieved through investment at water treatment works or on the network. We therefore believe that cost sharing rates should be set at an aggregate level for the whole of the water value chain. On developer services, we agree it would be helpful to collect additional data to inform any decisions on a potential future change in approach. It will be important to get this right and we will work with you to this end. On residential retail, we think it is appropriate to re-visit the decision taken at PR14 to set a large part of the price control on a nominal basis. As a matter of principle, if it makes sense for customers to bear inflation risks for the lion's share of their bills, including the retail net margin, there is no fundamental reason why the same approach should not be applied to the cost element of the retail control. This is all the more important given the greater uncertainty around the future path of consumer price inflation than has typically prevailed over the past decade or so. Of course, if allowed retail costs were once again to be indexed it would be appropriate to re-introduce explicit efficiency factors as part of the derivation of

	the price control. As a result there is every possibility that customers could end up better off overall. It is also worth pointing out that the re-introduction of the indexation of retail costs would have the additional benefit of significantly simplifying the price review as regards the treatment of the retail business. The current approach introduces very real difficulties in setting the revenue allowances and financial modelling of bills, and complexity in the presentation of the Final Determination to stakeholders. Aligning the treatment of retail with the wholesale controls would simplify the whole process for everyone, in addition to improving transparency for customers and stakeholders. We do not see any issues with the current average revenue control for residential retail. The current approach allows for both customers and companies to be protected against any changes in actual customer numbers from the Final Determination forecasts. Customer numbers is one of the largest cost drivers for residential retail. The movement to a total revenue control would increase the importance of the customer number forecasts in the price review process. On business retail in Wales, we agree with the proposals. On bioresources we will look forward to working with Ofwat and the industry on understanding how an average revenue control may work in practice.
	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? We agree with the proposals on enhancing the long-term view of major projects. Concerning reconciliations, we welcome Ofwat's recognition that there is an issue with the number of different reconciliations and the complexity that arises as a result. We believe that there is potential to reduce the number of reconciliations and to simplify and standardise those that remain.
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 with the proposal to have a small number of common performance commitments that focus on the outcomes that matter most for customers, such as reliable, safe, and high-quality tap water, and a dependable wastewater service that minimises its impact on the environment. We think that the current asset health and operational resilience measures are not good proxies for the actual condition of assets. They add minimal value, risk creating perverse

	incentives, and add complexity. What matters in the end is service to customers and the environment. Ofwat's position is that measures that are reported to other regulators are included as common measures. We agree that these can be included, but attention as to how they are 'normalised' on a fair basis is important – see our PR19 submission on pollution incidents (see link here, from page 23, Annex 'Comparative measurement of Pollution Incidents'). Just because an environmental regulator accepts a certain measure definition as the basis of reporting to them, that does not make it the right measure for comparison across companies. We acknowledge the impact of financial incentives on management focus, and believe they are most appropriately applied to the common measures and (very) selective bespoke measures which significantly impact the customer experience, and where the measure itself is mature and meaningful. However, we are mindful of the need for customer support for our approach, and in the past our customers have told us that they are in general not supportive of financial incentives.
	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? Yes, we agree it is helpful to make an explicit distinction between PCs and PCDs, and that this is the best approach.
	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? We agree that companies' approaches to social tariffs (affordability for customers who struggle to pay) and measures in place to support vulnerable customers, could be addressed satisfactorily outside the price review process. We work closely with Welsh Government, CC Water and others on both issues. We would continue to publish targets and report against these and other relevant issues in the Annual Report and be held to account on them by our CCG and other stakeholders. We do not believe a formal licence requirement is appropriate or necessary with regard to how companies treat their customers and the most vulnerable in society.
	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?

	Performance commitment levels should in principle be set at the level which best balances marginal cost and marginal benefit to customers and the environment. However, there is no reliable source of data on customer marginal benefit – Willingness to Pay is still an inexact science. Marginal cost data is similarly imprecise. When targets are set, we think a judgement should be made on the level required to meet customer expectations, as against the estimated cost of achieving improvements. Customer research can be undertaken as to their expectations of performance improvements as a priority for investment in relation to other investment priorities. We agree it would be helpful to have an early view of Ofwat's expectation of what levels can be achieved by an efficient company with base costs.
	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? While in theory marginal costs and marginal benefits are the best basis for setting ODI rates, in practice this information is hard to derive and is perhaps 'unknowable' with any certainty. One possible approach to ODI rates could be to put the biggest financial incentives on those measures that customers and stakeholders say they care most about, and the least against the least. Then the total 'at risk' sum should be proportionate and acceptable in terms of the RORE and the bill variation. A more general point about outcome measures and ODIs that is especially relevant for ODI RORE ranges is that water companies can be characterised as a 'risk management' business, in that they are trying to avoid service failures as much as possible. There are few opportunities to go 'above and beyond,' and lots of opportunities to for things to go wrong. The ODI regime is designed as if the 'upside' and 'downside' are symmetrical, but in fact performance is in a sense skewed to the downside by default. For there to be balance, therefore, this implies a system of incentives that provides a small reward in periods characterised by "no material failures" and significant penalties in periods when there are significant shortfalls in performance.
10. Cost assessment	Q10.1: What should be the priorities for improving our approach to cost modelling and assessment? Overall we are supportive of Ofwat's approach to exploring and refining the cost models. The collaborative approach worked well during PR19 and welcome the fact that Ofwat is committed to a similar approach for PR24. We will continue to support the industry modelling group on the development of the cost models and the collection of additional data. The consultation gives consideration to developing a totex model or models as a cross

	check on Ofwat's botex models. We believe that any costs included within such 'base plus' models should meet a clear set of criteria, including for example that they are repetitive (and therefore able to be modelled from historical data) and are driven by the cost drivers in the models. With regard to cost modelling in general, we would take this opportunity to underline the point that cost modelling can only ever provide an *estimate* of efficient costs per company. It is not an exact science. There are many variables that cannot be reliably measured across companies, and others factors that despite having an impact on costs cannot be proven statistically with sufficient certainty to be included in the models. We therefore continue to urge Ofwat to take a cautious approach to the application of the results of cost modelling, in terms of setting average versus upper quartile allowance, and setting the cost efficiency frontier movement. This is particularly the case for residential retail, where the models have weaker explanatory power, and where in our view there is still significant scope to improve the models, especially with regard to the factors underlying bad debt costs. We also believe that there may be the potential to introduce a cost driver that reflects the relationship between service standards and costs in retail, now that C-MeX is becoming a more firmly established measure for customer service standards in the industry.
	Q10.2: In what areas (both historical water sector and external) can we improve the range of benchmarks we use in cost assessment? The use of external benchmarks should consider performance in the round, considering the relationship between costs and service. Any industries used for external benchmarking should have similar characteristics to ensure comparability. This should be considered within the regulatory framework. For retail a key component is the level of service that is provided and incentivised within the water sector through C-MeX.
	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? On net zero, companies should be incentivised to take the low carbon option when delivering their investment schemes, even when those solutions cost more (within reason). We agree that a certain level of net carbon reduction will be achievable from 'normal' activities. However if we are to achieve the ambitious targets set by the sector, and supported by customers, companies will need to have the option to set out investments to take them beyond these 'base' carbon gains, subject to an efficiency assessment. Without investment, it is clear to us today that we will not achieve the targets we have set ourselves, or indeed those set out by Government in its legislative programme.
	Q10.4: Do we need to amend our cost assessment approach to take account of nature based solutions?

	Yes. As with carbon, nature-based solutions will in most cases be an extra cost to required investments. While they may not always cost more, it will usually be the case that they do. We welcome Ofwat's recognition that there is a potential issue with opex-based nature-based solutions being disincentivised under the current methodology for cost assessment. Our view is that the solution proposed by United Utilities looks unnecessarily complex, and that a simpler approach such as that taken in Scotland could work, especially in Wales, with a ring-fenced allowance to provide for the additional costs of nature-based solutions. This could be set following an approach drawing on the existing 'company specific factor' approach. We would note, however, that in many cases the lowest cost solution will be an 'upstream' intervention to deal with a problem 'at source'. The required upstream intervention will usually need to be taken by a regulator, or a third party, to prevent the problem which manifests in our network. An example which is growing in importance is plastics in sewers, which can much more easily and cheaply be dealt with by preventing the problem 'upstream' rather than having to remove them 'downstream'.
	Q10.5: Where can we enhance our evidence base on the relationship between costs and service? First, we welcome Ofwat's recognition of this as an important area to explore further, taking into consideration the views of companies and the CMA at PR19. We believe that further evidence is required to understand the relationship between cost and service, especially when setting the upper quartile performance level. A solution would be to incorporate service levels within the econometric modelling. However, the multi-faceted nature of service in the water industry makes this challenging. One approach could be to develop a composite measure of service which can be used as a driver within the modelling. For retail, a reasonable 'composite' measure of service now exists – C-Mex. We believe there may be the potential to use C-Mex as a cost driver within retail cost modelling, to reflect the ongoing additional costs in retail of delivering consistently high service levels. We would urge Ofwat to explore this within the cost assessment working group. We would make two further observations in relation to cost and service. First, we do not believe it is right to model upper quartile costs, and then to model upper quartile performance separately, and to expect an 'efficient' company to be able to achieve both of these at the same time. This in our view is a fundamental 'design flaw' in Ofwat's approach

	that needs to be corrected for, in order to appropriately incentivise companies and set appropriate levels of risk and reward. Secondly, the methodology states that service improvements should be funded from base allowances. This has implications for the productivity factor to be applied within cost assessment, as the degree of 'underlying' improvement in service improvements should be taken into account. Productivity can be improved either by decreasing inputs whilst holding outputs constant or by increasing outputs, taking into account improved quality whilst holding inputs constant. If a company is delivering service improvements (outputs) for the same costs (inputs), this is in itself a productivity improvement that should be 'netted off' against Ofwat's expected productivity improvements, which are currently imposed irrespective of the expected 'underlying' performance 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? We think it is appropriate to use ODIs for this purpose.
	Q10.7 – Is there more that we need to do to reflect future pressure on operational resilience in our approach to cost assessment? To accommodate future pressures on operational resilience, Ofwat's approach will need to recognise that in some cases investments will be needed now as preventive measures, before these issues become urgent or where the consequence of failure is significant but there is uncertainty around the probability of a hazard occurring. It is difficult to make a convincing 'need' case when an issue is not yet urgent. Some such investments may not deliver any immediate visible performance improvements but will prevent long-term deteriorations in performance or reduce the likelihood of shock events. The 'need' element of Ofwat's cost assessment approach at PR19 did not adequately recognise this. We would propose that for resilience investments, the company needs to set out a long-term plan, which is improved jointly with stakeholders, and then that plan is broken down into a series of 5-year investment programmes, also approved by stakeholders in advance of business plan submission. This should largely take away the need for the 'need' test at cost assessment, leaving Ofwat instead to focus on the cost efficiency of the proposed scheme. We agree that it will often be difficult to directly benchmark proposed resilience investments, and other methods will need to be found. One approach could be to require third party assurance of the solution and efficiency of costs for resilience investments. We support the CMA's view that Ofwat should seek to incorporate a forward-looking element to its cost assessment modelling for base maintenance. In our view a reliance solely on historical costs has the effect of a downward 'ratcheting' of costs and maintenance activity based on the companies that have 'squeezed' maintenance budgets the most in any

	given period. This creates a downward bias in botex allowances, rather than achieving the appropriate 'efficient' allowance for maintenance. We would therefore argue that a 'forward looking' element could help adjust for this. One reason why forward-looking costs might be different to those incurred in the past could be the additional maintenance costs of new assets required to meet higher environmental standards, something we anticipate being a significant factor in the next two AMPs.
	Q10.8: Are the most significant challenges to the operational resilience of the sector adequately captured within current strategic planning frameworks? In our view the DWMP and WRMP processes only partly capture operational resilience challenges. There are other key operational resilience issues that currently lack a structured strategic planning framework, including the reliance on critical assets, single sources of supply, cyberattacks, supply chain security, sewers in rivers, bioresources resilience (particularly in relation to threats to future distribution to land), and other issues. These issues will need to be addressed in companies' long-term plans.
	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? The price review incentives currently focus on performance rather than risk and we need to consider the appropriate balance between the two. Companies should be incentivised to manage risk in both the short and long term. Sewer flooding is a good example. The incentives to achieve high performance levels push companies to operational solutions like jetting but this does nothing to address the long-term resilience threat posed by climate change. Sustainable drainage solutions are a relatively expensive way to address short term performance issues but deliver long term resilience benefits. However, this risk reduction is not adequately incentivised through the existing mechanisms. We recognise that it is more straightforward to benchmark short-term performance and therefore to incentivise leading performance. Furthermore, risk assessments are not consistent with each other and it would be challenging to achieve consistency. However individually companies can present an audited risk position and be incentivised to maintain or improve that state. Without action, companies' risk will increase over time due to long-term stresses such as climate change, population growth and asset deterioration. Whilst some of these impacts may not materialise for several years we need to start making progress in addressing these risks now to avoid unfairly burdening future generations. Whilst some aspects of long-term risk are managed effectively through the DWMP and WRMP this doesn't cover all risks as outlined in our response to question 10.8.

	Incentivising the management of long-term risk is in customers' interests. Due to differences in risk assessment techniques across companies, cross-industry benchmarking may not offer a reliable way of ensuring it is unlikely that stretching performance, the selection of optimal solutions and efficiency of costs could be achieved through. Instead, third party assurance and a bottom up approach to assessing appropriate cost allowances may be required.
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? A key component of the risk allocation framework is the IDOK provisions in company licences. We note that in a recent report for Ofwat CEPA observed that the general IDOK provisions were "…now somewhat out of line with the rest of the regime e.g. in how they categorise and consider costs". It is a long-established principle that the objective of the IDOK framework is to make whatever adjustments are necessary to put companies and customers broadly in the same position in which they would have been had the "relevant change in circumstance(s)" or "notified item(s)" been known about and allowed for at the last price review. Prior to 2014, Ofwat's five-year price review methodology explicitly provided for adjustments to RCV as part of the "midnight adjustment" to add (or subtract) incremental RCV brought about by an interim determination during the previous five-year period. However, as far as we can see the PR14 and PR19 price review methodologies contained no such provision, and the "reconciliation rulebook" models published by Ofwat for PR24 appear to contain no mechanism (as yet) to accommodate totex that is allowed at an IDOK but is not yet recovered through customer bills. As CEPA identified, certain stakeholders (notably investors and rating agencies) attach considerable importance to the IDOK provisions and the protections they are perceived to offer both companies and customers. To re-affirm confidence, therefore, we think it would be very helpful to set out the detail of how the IDOK provisions now work and how they fit together with the five-year price review methodology 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? As the paper suggests, measures may be taken to improve comparability across companies. However, it must be recognised that *ex ante* RoRE ranges are the product of highly subjective judgements, made in the face of inevitable uncertainty. So the "insights into the balance between risk and reward" will always and inevitably be limited. We agree that there is some value in retaining the measure, and there are incremental improvements that may be made to the preparation of estimated ranges, but expectations of what this can produce should be realistic, and it should not entail disproportionate resources.

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

First, we think it needs to be made explicit whether Ofwat is considering indexing just the risk-free rate element of the equity return. Our answer is based on the assumption that it is, on the basis that indexation of the other elements would be problematic for a number of reasons.

As a matter of principle there does not seem to be a strong rationale for indexation. The risk-free would not be expected to be highly volatile in normal market conditions. If it moves down over a five year period, investors will lose out, and if it moves up, customers will lose out – and vice versa. The risks are symmetrical, so there does not seem to be a serious problem here in search of an indexation solution.

Practically, there are stronger arguments against indexation of the risk-free rate. It is far from clear how a settled view of the appropriate measure of the risk-free rate could be reached, particularly in light of the unusual market movements in the past 10-15 years, which remain a subject of considerable debate among experts. Indexation involves 'hard wiring' such a methodology, which would be inflexible and problematic should the risk-free rate move again in unexpected ways.

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 believe that companies should be penalised for the cost of efficiently raised embedded debt. In our view the use of balance sheet data is appropriate in setting the allowed return on embedded debt whilst the use of index data seems appropriate when setting the forward looking cost of new debt.

Q11.5: Should we allow adjustments to the sector allowed return based on company size – and how should this be assessed?

We do not have strong views on this in principle. This should be assessed based on the evidence.

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

Our view would be that should there be a very strong evidence-based reason to move away from the PR19 notional structure, then any change should follow the evidence. However, in general we think stability is desirable when it comes to the notional structure, so in the absence of persuasive reasons to change it, the PR19 notional structure should be unchanged for PR24. We would just add that the fact that other regulated industry may have

	different notional structures should have little or no bearing on the water industry, which has its own risks, RCV profiles and so on.
	Q11.7: Do you have any suggestions for mechanisms which could incentivise financial resilience within the price control process? In our view the owners and creditors of water companies are best placed, both in terms of incentives and expertise, to ensure the financial resilience of water companies. Therefore the most important (and only) role for the regulator is to ensure that quality-assured information is generated and made available to them. This will complement the important non-price control role that the regulatory regime makes in establishing and operating the “financial ring-fence”. Indeed the requirement to maintain an investment grade credit rating is a sufficient incentive. We would also like to affirm here our support for the CMA’s view that the WACC should be set at a level that supports the financeability of the notional company, rather than making adjustments to cash flows from future periods using the RCV run off rate.
	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? In our view there is merit in transitioning in full to CPIH indexation beyond 2025.
12. Next steps for PR24	Q12.1 - What are your views on the draft timetable for PR24? We are content with the proposed timetable for PR24. Regarding the timing of the publication of Ofwat’s view of base costs, performance commitment levels and the WACC, we believe this must be sufficiently in advance of business plan submission to be taken into account in company business plans. We would suggest that 12 months ahead of business plan submission would be appropriate.
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? Ofwat has correctly identified the factors that limit the efficacy of the current water resources control. The importance of trade-offs between transportation costs and treatment costs of raw water mean that excluding them from the scope of what is ‘in the market’ is likely to be problematic. This is because competition between ‘water resources providers’, whether directly in a market or by means of comparisons made by regulators, will be distorted without consideration of where a resource is located and what needs to happen to

	it to bring it into supply. We therefore support consideration of moving the boundary of the control to include raw water distribution and treatment.
	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? See our answer to question 14.1 above. We would add that as we have consistently argued (see, for example, the "Position Paper" submitted in response to Ofwat's consultation on competition in 2007) the extension of markets in our sector offers most promise at the level of water abstraction and rights in the environment. The scope for gains at the 'production' level, whether defined as 'water resources' alone or 'water resources and treatment', is likely to be limited by comparison.