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David

PR24 and beyond: Creating tomorrow, together

Many thanks for the opportunity to comment on the consultation on PR24 issued in May 2021.

We welcome the early engagement from Ofwat with respect to PR24 and are pleased that the above consultation builds on the recent kick-off webinars, outcomes and cost modelling workshops and prior discussion documents on customer engagement and public value.

Overall, we support many of the key principles contained in Ofwat's proposed PR24 framework, in particular:

- A greater focus on the long-term throughout and looking beyond one price review.
- Acknowledgement of the need to focus on environmental and social value.
- Simplification of the price review where possible.
- Incentives for companies to provide well evidenced cases for costs early.

However, there are several aspects of the consultation where we have stated certain views or raised questions and clarifications for Ofwat to consider, including:

- Clarification on when "early views" will be available on items such as base costs and cost of capital.
- That Ofwat's centralisation of customer research must be complemented by local research.
- That while CCGs are proposed as optional, we will maintain our Customer Scrutiny Panel.
- A request that Ofwat define the scope of their proposed "PR24 Challenge Panel" further.
- That a lower number of overall PCs would be welcomed.
- The need to enhance retail modelling and ensure the use of company-specific adjustments.

Our response also reflects initial comments from the chairs of our Environmental and Customer Scrutiny Panels.

As always, we welcome further engagement with Ofwat on these matters and look forward to discussing our response with you at the appropriate time.

Yours sincerely

[redacted]

Ian Cain
Group Chief Executive Officer

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

Response:

We agree with the four themes proposed by Ofwat for PR24. In particular, the "increased focus on the long term" was a key area of focus for us during the PR19 process, and so we are pleased that this area is being specifically addressed by Ofwat in PR24. This will encourage companies to look past the short-term goals of a five-year planning cycle and focus on a long term view of customer needs and preferences, including those of customers in vulnerable circumstances. In addition, we are aligned with Ofwat on the need for a greater focus on the sector's ability to deliver environmental and social value, which have been core to the formation of our internal Environmental and Customer Scrutiny Panels. In particular, focus on achieving net zero carbon within this price control is key, not only in terms of alignment to individual company's roadmaps recently published in this area, but also as without active customer participation in terms of behaviour changes and potential impact on bills, the step-up in activity required to achieve net zero carbon will not be met.

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

Response:

When designing PR24, we agree in principle with the items identified by Ofwat, namely, to provide more clarity about the conduct of price reviews in the long term, streamline the price review process and reflect local and national diversity in the price review while maximising the benefits of comparability.

For SES Water, as one of the smaller Water Only Companies (WOCs), streamlining the price review process is absolutely key for us given the limited resources we have available to address the requirements of price reviews. We strongly advocate streamlining of the timetable as indicated in the consultation, but also request that Ofwat implement simplification (without losing the benefits of sophistication) within the contents of the price review itself, such as reducing the complexity of performance commitments (PCs) and associated outcome delivery incentives (ODIs) and carefully considering the quantity of data being requested. A simplified set of PCs should drive genuine improvements in customer service and focus on outcomes for customers as opposed to inputs (for example moving from the "number of customers added to the priority services register" to the "number of customers actually accessing priority services register services with tangible positive impacts for them").

Q2.3: How should we evaluate our progress, and how can we best develop or use appropriate metrics to do so?

Response:

Evaluation of progress in terms of how far PR24 delivers for customers, communities and the environment need to be based around a set of metrics that are derived from the performance commitment measures implemented by companies during PR24 and previous price reviews that have worked well, proved effective, are easy to measure and have proved adaptable over recent years. We would recommend that development of such assessment metrics be part of the PR24 process and strongly linked to effective historical measurement criteria. The starting point for such metrics should be the direct impact on customers and should be substantiated by well researched evidence.

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 proposal to maintain our 'building block' approach based on outcomes, costs and risk and return?

Response:

The basic model that Ofwat has developed across many years is still the best way to regulate the sector for delivery of value for customers, communities, and the environment – involving an outcomes regime, coupled with a cost assessment and risk and return framework. Maintenance of such "building blocks" is therefore appropriate, as is the recommendation to simplify by reducing the number of PCs, simplifying incentive rates and linking incentives further to long-term benefits. We would support early publication of initial views on Performance Commitment Levels (PCLs) that correspond to base costs.

However, Ofwat's considerations for potentially indexing the allowed return on equity to protect customers and shareholders and incentivising financial resilience to protect customers from "risky" financial structures will require further detail and review before we can assess the impact of these items.

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?

Response:

Overall, we strongly support the need for greater co-ordination across the water sector. SES Water has already benefited from such interaction in recent years in areas such as leakage and water resource management plans, so would encourage further co-ordination across all stakeholders.

In terms of utilisation of "markets" to help companies operate in the complex water sector, whilst the system operator models noted on National Grid Electricity Transmission (NGET) and the "catchment system operator" are, as indicated, worth further exploration, the latter may not necessarily aid coordination on water resources and abstraction – companies' operating areas may differ from natural catchments, resulting in inefficient and ineffective results if coordination is performed along different lines. The continued work via RAPID is a good example of where effective coordination of regulatory bodies and sector companies work effectively. Similar initiatives – and importantly displaying the benefits of such work – is the best way to promote co-ordination across companies.

We would recommend that Ofwat consider the impact of certain "league table" based performance commitments such as C-MeX and D-MeX on the overall co-ordination across companies. Such measurements, while clearly trying to drive service improvements, inevitably create a competitive dynamic between companies where not all companies may be able to achieve incentivised levels, which may actually act as a disincentive to change. We recommend consideration of stretching but achievable improvement targets based on each company's performance levels, thereby fostering greater levels of collaboration in these important areas while improving the collective performance of the sector for our customers.

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?

Response:

We agree with the shifting of focus from the five-year base cost planning to strategy, outcomes and deliverables for the long term. This type of thinking has been part of our thought process in the past, especially with respect to our operational and financial resilience. Ensuring that business plans are focused on long term plans for asset investment, asset maintenance, environmental goals and overall business model development, utilising changing technological innovation, is always something we have championed.

In terms of Ofwat's recommendations for reducing the focus on the short term:

- We welcome being provided with an early view on the allowed return on capital.
- Early sight of Ofwat's view of base costs (and the associated cost models), PCLs and ODIs is also welcomed and will improve both the transparency and predictability for business planning. We appreciate that since it is an early view, such modelling may not encompass all the base expenditure needs of individual companies and may risk assuming a level of cost allowance for a notional company. Therefore, we would encourage Ofwat to treat this early view with sufficient flexibility and ensure there is a smooth mechanism for transitioning from this early view to the submitted business plan.

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?

Response:

The long-term strategies to be covered in business plans should be closely aligned to the overall themes which have emerged at a national and governmental level in recent years, such as environmental sustainability, strategic water resources, asset maturity and long-term financial viability. The associated investment and appropriate PCLs in the short term to plan effectively to deliver longer terms goals should be explicitly detailed in companies' business plans. There will be common requirements associated with other recent initiatives (such as the sector's Public Interest Commitments) that will provide appropriate benchmarks to understand each company's approach. In addition, we agree with Bristol Water's recommendation that companies work with local stakeholders, including local government, to build consensus around a range of plausible business plan scenarios with a focus on the longer-term.

Q4.3: How could this build on the work completed in strategic planning frameworks?

Response:

We would expect that the long-term strategies and plans to be covered in companies' business plans would enable clear long-term roadmaps to be developed – at a more granular and company/region specific level to complement the work completed in the strategic planning frameworks.

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?

Response:

The regulatory framework would need to be flexible to allow for consideration of new information or circumstances at future reviews without unduly punishing companies for strategic decisions made in the past. Regular updates of long-term strategies within the business plan during the price review period would aid this flexibility.

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

Response:

Yes – such comparable data would be helpful in providing companies an initial reference point for their business plans and reduce the burden on management in developing a base cost plan.

Q4.6: Should we adopt a collaborative approach to developing Welsh companies' plans at PR24? If so, how should we go about doing this?

Response:

While this question may be directed to Welsh customers and the priorities of the Welsh government, we would always encourage national collaboration for the benefit of customers.

Q4.7: What are your views on how we could provide clarity over the long-term regulatory framework?

Response:

As noted above, we welcome Ofwat's early views on expectations of costs, service levels and incentives rates ahead of business plan submissions. We would encourage face-to-face meetings between Ofwat and individual companies in this regard.

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?

Response:

As expected, shifting to a longer-term and broader approach to service delivery, and ensuring environmental and social value is delivered, within the current regulatory framework, is naturally a challenge. However, it is also a key step that companies should follow, regardless of barriers. In terms of potential blockers to water companies changing their delivery mechanisms, these will include obtaining appropriate funding, internal resources and balancing the delivery of such outcomes against other regulatory requirements. However other regulatory barriers to delivering environmental and social value change cannot be underestimated – this includes the needed reform on the environmental regulatory framework to align to Ofwat's regulatory framework to focus on outcomes, not merely prescribed outputs and inputs.

Q4.9: Do you have any further suggestions for increasing the focus on the long term? If so, what are these?

Response:

We have no further suggestions outside of the items noted above, but we would again emphasise the need for early consideration of costs required to achieve the long-term goals of net zero carbon and associated environmental targets. The latter should also consider the extent to which Ofwat will incentivise investment in such long-term outcomes in light of the government's 25-year environment plan and the sector's net zero carbon commitments.

In addition, with respect to the focus on environmental matters, clarity is needed on the extent to which Ofwat will ensure, via appropriate incentives, the use of nature-based solutions for water companies to deliver their required obligations, ensuring alignment to the reform of WINEP.

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

Response:

While we believe there is merit (in terms of streamlining the price review process) in conducting an initial assessment in conjunction with the Draft Determination stage of the price review (Option 1 as noted in Figure 5.2 of the consultation), we still consider that there needs to be adequate time for companies to consider Ofwat's early views of business plans and respond accordingly. The initial assessment allowed that to occur in PR19, although for our Company there was little difference between the outcomes at initial assessment and Draft Determination stage, despite the considerable internal efforts to address queries raised at the initial assessment stage. However, we continue to advocate early views on business plans from Ofwat in PR24, whether via an initial assessment or other mechanism.

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?

Response:

Yes – we agree that a more light-touch approach for such companies would save both Ofwat's and companies' time and resources in preparing and assessing the business plan. In addition, the move towards a more streamlined assessment would provide another incentive for companies to improve their delivery, albeit that should always be driven by customer needs as opposed to a potential easing of the regulatory process. Factors to be considered in this assessment could include performance on common PC delivery (both absolute and relative), accuracy of revenue forecasting, totex performance and achievement of financial resilience targets.

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?

Response:

As noted in our response to Q5.1, we advocate early assessment of business plans by Ofwat. Combined with the early view of base costs planned by Ofwat, this approach would provide more predictability for companies' business plans. At this stage, we do not propose any other options for consideration.

Q5.4: Is a different approach needed for the initial business plan assessment for companies in England and in Wales?

Response:

While this question may be directed at other stakeholders, we do not see any reason for using a different approach.

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

Response:

For high quality plans, despite any mergers of the initial assessment and Draft Determination stages, we still believe that "early certainty" mechanisms would provide a good basis for procedural incentives for companies. Giving specifics early in the process about key aspects of submitted plans is a significant incentive to started engaging stakeholders, including supply chain partners. Early financial incentives may also play a part on encouraging companies to submit high quality plans, although there would have to be very specific bars set to eliminate interpretation here and ensure a level playing field across submissions. We do not believe that directly applicable penalties early on the PR24 process would encourage the right level of collaboration and support between Ofwat and the sector.

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?

Response:

We believe that setting the cost sharing rate about 50-55% as in PR19 would be appropriate. High cost-sharing rates would impose unnecessary actions whereby companies may be encouraged to underspend on areas such as asset health, which contradicts the long-term goals of PR24.

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

Response:

From our perspective as a WOC, we agree with water efficiency as a targeted challenge area, inclusive of water efficiency and leakage matters. However, care would require to be taken on assessing such challenge areas, depending on a company's current status and performance in each area – and not holding each company to the same level of generic challenge.

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?

Response:

While we agree with Ofwat's statement that it is vital for companies to innovate in the coming years, developing a specific incentive mechanism for innovation at PR24 is difficult at present when certain other mechanisms to encourage innovation have only recently commenced, such as the innovation fund. We recommend reviewing how the latter has progressed and its success before adding further innovation incentive mechanisms.

Q5.9: In what ways might we promote the themes of EBR through PR24?

Response:

We agree that use of EBR themes to reflect a more trust-based approach to regulation would be beneficial for all, but the recent work performed by Ofwat through its board governance, leadership and transparency initiatives has considerably moved the dial in terms of the sector in this area. Reflecting back on these objectives within the PR24 review should be sufficient to ensure that Boards, and companies, are conducting their business plan process within suitably ethical parameters.

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?

Response:

We support the initiative of a collaborative approach to customer research. The approach would reduce duplication and overlap in customer research conducted by multiple companies and their contracted third parties. In terms of an approach, while we believe that either a nationwide or standardised approach to customer research, conducted in a consistent and collaborative manner, would be better than the current practice, for a small company, the nationwide approach could be more beneficial from an efficiency and cost saving standpoint. Either way, as we noted in our response to "PR24 and beyond: Creating tomorrow, together, Appendix – Reflecting customers' preferences", any standardised or national research would need to be complemented by our own local customer research. In addition, if nationwide research is implemented, we consider that this is appropriate for "higher-level" matters only, albeit a regional approach may be more appropriate, as we have noted from our recent work with Water Resources South East discussions. For any such nationwide or regional research, all stakeholders must have an equal voice and the results not dominated by larger companies. Finally, care should be taken on selecting any external suppliers to conduct such research – individual water companies know their customers and how best to interact with them – which needs to be replicated as much as possible by any external supplier conducting nationwide or regional research.

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

Response:

Any collaborative approach will need to be as straightforward and transparent as possible to ensure optimal customer engagement. Therefore, methods such as standardised questionnaires complemented by virtual workshops may be appropriate, although the input and outcomes of such activities would need to be closely aligned to individual companies' local research.

Q6.3: Are there aspects of negotiated settlements that could be reflected in our price review framework?

Response:

We do not advocate the use of negotiated settlements – these tend to be very resource intensive for both regulators and companies, often resulting in another layer of legal and regulatory review. In addition, obtaining appropriate representation for a proactive "customer forum" can prove difficult. The concept of detailed customer engagement implicit in negotiated settlements can be achieved via the local and standardised/national approach recommended in this Consultation.

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

Response:

We support the suggestion by Ofwat that each company is to put in place challenge and assurance solutions for customer engagement that meet its specific needs and ambitions. As always, any internal challenge and assurance process needs to be well designed, efficient, and effective to avoid challenge and assurance merely being a "tick-box" exercise. We will be maintaining our internal Customer Scrutiny Panel (CSP) which has proved effective in the past on ensuring customer challenge is provided to the Company.

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

Response:

While we do not believe that it is necessary to set minimum standards in the respect of the requirements for challenge and assurance, guidance on expectations of high-quality research, customer challenge and independent assurance is welcomed.

Q6.6: How well does our proposed approach to customer engagement take appropriate account of the different regulatory frameworks in England and Wales?

Response:

We cannot comment on the regulatory framework for Wales, although the generic suggestions in this document would appear to be applicable agnostic of regulatory frameworks.

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?

Response:

A clear roadmap, with set milestones, complemented by effective communication, will allow Ofwat to ensure that all companies can bring together the outputs of the various strategic planning frameworks in the most effective manner. Based on the high-level roadmap in Figure 7.1 of the consultation, Ofwat should be able to provide a more detailed roadmap specifying the interaction points with companies ahead of issuance of standalone business plans.

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?

Response:

Ofwat should communicate with other regulators in a consistent manner between business plan submission and final determination but ensure that individual companies participate in ongoing dialogue during this process where applicable. From a company perspective, while we agree that the role of water companies is to seek challenge to their plans from other regulators and stakeholders in advance of submission, it would be beneficial to be kept apprised of Ofwat's interactions with other regulators during the review process, ensuring that companies do not need to consult two or more different regulators for the same requirements. We strongly support the continued work of Ofwat with the Environmental Agency and the DWI through RAPID to accelerate the development of new water infrastructure and design future regulatory frameworks.

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?

Response:

Further detail is required on Ofwat's plans for a "PR24 Challenge Panel" for us to provide meaningful feedback in this area. If this is a panel to aid Ofwat itself in its deliberations on whether business plans properly reflect the interests of customers, communities, and the environment, then we can see the merit in such an approach to ensure improving the ultimate quality of the business plans. But the interaction with individual companies would need to be clarified to ensure the objective of streamlining the PR24 process is not compromised.

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?

Response:

We agree with the general approach to the design and implementation of controls – the approach allows for targeting and proportionate regulation for different activities. We comment on the proposed enhancements in Q8.2 below.

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?

Please note that specific questions related to a) the structure and boundary definition of the water resources control are set out in a separate appendix; and b) our review of the bioresources market are set out in a separate consultation document.

Response:

We broadly agree with the proposals for specific parts of the value chain, with points to note as follows:

- Water resources control: we support the proposal to work with the industry to ensure appropriate cost allocation across the current water resource and water network plus controls, in addition to examining the boundary of the water resources control. However, from our perspective, care would need to be taken to ensure the appropriate treatment of our power costs associated with pumping of water if the boundaries were going to be changed.

  We would also encourage Ofwat to review the incentives for water trading. If the intention is to introduce more competition and efficiency improvement in water resources, but the market is not reacting as predicted, the basis for water trading incentive requires revisiting.

- Bioresources: this control is not applicable to our Company.

- Developer services: we strongly support the steps recommended by CEPA to further develop regulation for developer services at PR24. We have significantly enhanced our developer services offering in the last year at our Company, and we are seeing the level of competition in developer services continue to increase. Therefore, developing further developer services' cost allocation guidance to ensure charges are fully "cost reflective", substantiated by enhanced collection and use of developer services data, would be welcomed. Again, simplification and streamlining of the PR24 process as it applies to the developer services price control is also recommended.

- Residential retail: while we agree with the proposal in this chapter of the Consultation to simplify the future residential retail regulatory reconciliation process, we still have concerns over the suitability of Ofwat's retail models as detailed in our responses in Section 10.

- Business retail for Welsh Companies: this control is not applicable to our Company.

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?

Response:

We agree with the proposals spanning multiple parts of the value chain and have no further comment. With respect to future reconciliations, we broadly agree with the proposals noted in the Consultation but would emphasise that simplification and standardisation of future reconciliations is key in streamlining the PR24 process.

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?

Response:

We support the streamlining of outcomes resulting in a rationalisation of the number of associated PCs for each company, with the continuation of common and bespoke PCs (and limiting the number of bespoke PCs will allow companies to be focused on key common PCs). We would also recommend reviewing previous bespoke PCs that are similar among companies and support the move toward overall environmental objectives such as replacement of lead pipe, carbon emission related performance, etc. In addition, as noted on Pg 90 of the Consultation, there is still a place for bespoke PCs to address matters such as our statutory duty to soften water.

In terms of the kind of PCs to be included in the price review, we agree with the focus on PCs that are of enduring interest to customers. In line with comments elsewhere in this response, this will naturally be focused on environmental and water resource/efficiency-based outcomes.

With respect to outcomes that would require financial incentives for all companies in the foreseeable future, we agree with Ofwat's view that these will fall into 3 categories – customers receiving excellent service every day, environmental outcomes and asset health and operational resilience. We support the idea of reducing the number of outcomes with financial incentives and increase the incentive amounts.

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?

Response:

While we agree that it is helpful to distinguish between PCs and Price Control Deliverables (PCDs) where there is a need to link funding to specific outputs, there would need to be clear guidance and definitions around mechanistic or evaluative PCDs. In addition, the burden of proof still rests on the company to demonstrate cost savings attributed to the PCD, and Ofwat need to carefully consider introduction of such measurements in line with their overall proposal to streamline the price review process.

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?

Response:

At this stage of PR24, it is difficult to note any aspects of company performance where expectations should not be set as part of the price control. Consideration of common and a lower level of bespoke PCs should be performed first and – if assessed comprehensively – this should provide all the metrics required for consideration of companies' delivery over PR24 for customers and other stakeholders.

Q9.4: What should be our aim in setting the levels of performance commitments? Do you agree with the suggestion 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?

Response:

We agree that level of PC should be set at a level considered to be stretching but achievable from a set base cost level, similar to PR19. Such PC levels would be based on the consideration of efficient levels of performance for common PCs and provided ahead of the business plan submission using historical data. However, companies should still be able to propose deviations based on their own specific characteristics, especially in terms of variations to continue to be able to deliver outcomes in the long term. We do not propose any alternatives for setting PC levels at this stage of the price review.

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?

Response:

We continue to support the use of ODIs in the price review process as an effective method for incentivising companies to deliver committed levels of performance for customers. In terms of setting ODI rates, we agree that such rates should consider the best information from a collaborative approach to research. We would welcome the proposed removal of Ofwat's reliance on estimating marginal costs (to avoid complexity and spurious accuracy), unless more evidence can be collected about ODI rate setting. The current approach based on marginal costs and benefits work relatively fairly, although not perfect for all PCs. Whichever approach is ultimately selected, Ofwat should not further complicate the ODI rate setting process by making it more confusing for customers.

Cost assessment approach

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

Response:

The following priorities should be considered with respect to Ofwat's approach to cost modelling and assessment:

Modelling approach

While we broadly concur with Ofwat's approach to build on the PR19 models for PR24, the start for any approach to modelling improvement is to acknowledge the limitations of each historical approach and determine what a modelling method can or cannot actually achieve. For cost assessment, historically this has involved a consideration of a combination of both econometric and non-econometric modelling.

The econometric modelling has, in our view, historically performed well in predicting an efficient base cost and should therefore continue to be the key modelling approach for consideration of the total cost. The key challenge for PR24 is how to link cost efficiency more strongly with performance or service level. (See Response to Q.10.5)

Cost drivers

We recommend cost drivers to represent the following effects: scale, complexity, economies of scale as proxied by density, and any non-linear effects. However, it is the underlying data that empirically decides the result, as it is frequently the case that cost drivers that represent one effect are also correlated other effects. An example was sewage treatment complexity variables (e.g., level of ammonia, etc.) is highly correlated with scale, which means large companies tend to have higher level of sewage treatment complexity. Having both scale and complexity in the sewage treatment model would benefit large companies twice.

The technical solution for this type of problem can either be:

- redesign the cost driver building blocks with other categories of effect, rather than scale and complexity and/or
- construct a composite index or variables that capture various aspect of complexity that are somehow independent from scale.

Growth related cost

We agree that some growth elements should be included in the base econometric model if they are common across all companies and reflect urbanisation or demographic shifts that are beyond companies' control. However, developer services is too diverse and geographic specific to be modelled across companies for base cost. We recommend that developer services should be modelled separately.

Disaggregated cost model

When considering disaggregated cost models, there needs to be clarity about what Ofwat require from such models and how much the data input is required to ensure appropriate functioning of such models, as the data generated from operational processes may not reflect exactly an isolated price control unit characteristic.

Therefore, the level of cost disaggregation for modelling must be subject to testing and comparing between different levels in order to decide which one makes sense. Each level of disaggregation has its own virtues and shortcomings. The triangulation process should also consider both sides to decide a reasonable weighting system if different cost level models are selected for cost allowance determination.

Apart from all the standard econometric test and criteria for selecting the models, consideration is required of how stable the models are in predicting allowed cost. If a set of models is sensitive to certain cost drivers, giving a very dissimilar efficiency ranking and allowed cost level every time there is a change to a key variable, it should not be selected.

Residential retail

Future residential retail model enhancements are required to ensure the associated cost drivers are representative for both WOCs and WASCs. The PR19 residential retail models appeared to favour WASCs more. For example, the use of the "proportion of dual customers" cost driver was relevant for WASCs only and there is not a robust and clear justification for having this cost driver in the model, neither *ex ante* expectation of the sign of the coefficient. One can either argue that dual customers cause either more cost to serve due to complexity or less cost to serve due to the economies of scale.

Cost drivers that represent ability to pay are reasonable to include but should be of higher frequency than those used in PR19. The Index of Multiple Deprivation used in PR19 was only available for every five years and based on survey conducted in the previous two to three years. Therefore, the data available for modelling would be eight years old for PR24, hence may not correctly reflect current circumstances.

Again, we recommend that any cost model at granular level should be tested and cross checked with more aggregate level to confirm consistency and cost pattern. Triangulation, if any, should take into consideration the model quality for the weighting.

Cost adjustment claims

We agree that cost adjustment claims remain a key part of the cost assessment process, since no model could capture all the specific and unique operating characteristics of all companies.

Regarding symmetric cost adjustment, we believe that this will be difficult to implement. We agree in theory that a positive cost adjustment to a company should be weighed against all other companies that do not share the same characteristics or rank at the opposite end of the scale. However, without a widely acceptable methodology or previous practice, it is not practically possible to conduct this step of cost adjustment.

Enhancement cost assessment

We support the approach for enhancement cost assessments in PR19, with benchmarking wherever possible and bespoke solutions in other circumstances. When PR24 cost assessment commences, there should be more data available for such benchmarking.

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

Response:

Both cost and delivery metrics can be benchmarked on a normalised basis to see if there is any correlation between company’s scale and efficiency that would be predicted theoretically. This would lead to further analysis to determine what factors contribute to efficiency and outcome, other than scale.

Long-term ambitions

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?

Response:

Longer term ambitions and delivery of public value would be suitable as reputational outcomes. These are desirable aspects of service, but difficult to quantify in a short to medium term. The current approach of assessing the progress towards long term ambitions in the five-year plan should be maintained. This progress can also be benchmarked across companies and externally for common requirements such as net zero carbon emission.

Nature based solutions

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

Response:

We support the move toward nature-based solutions, as it is a path to an environmentally sustainable operation. However, we do not think that adding the NPV to totex allowance and RCV is an appropriate tool of assessment. It unnecessarily complicates reporting requirements and information analysis without necessarily changing companies’ behaviour toward a desirable direction.

Service and cost relationship

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

Response:

We consider that – for technical reasons – performance cannot be part of the cost model, as it would bias the prediction and causes circular effect. One method that may address this challenge is to develop in parallel a reverse model for performance and use the results from that model for post-model adjustment to cost allowances. The approach can be described as follows:

- Build and run the cost model as in PR19, with cost as a function of scale, complexity, density, plus any other characteristics that are beyond management control
- Build a different model for performance of service level. Each performance outcome (e.g. leakage, customer complaints etc.) is a function of operating characteristics or environment (again beyond company's control, e.g. average temperature during the year or peak month), and the related/relevant cost.

By adding relevant cost as another variable that drives performance, we can isolate its effect on performance from all other effects. This performance model may answer the question of what makes a company deliver better performance, given the same level of cost.

Results and answers from step 2 can be used in post-cost modelling adjustment. While technical modelling details would require review, this method would address the concern of giving an incentive for "racing to the bottom" in cost.

A key aspect of performance to be considered for cost assessment modelling, which was not properly accounted for in PR19, is the level of service delivery that would determine the scope of further improvement. A company that is at very advanced stage of a performance outcome may not find it easy to significantly improve the service further without a substantial capital investment to bring it to another level. The relationship between cost and quality is not linear throughout the evolution process of service delivery. For this reason, past performance needs to be factored in as one variable in the performance models.

Finally, all PR24 models should have their predictive power tested. This can be conducted by removing the final one to three years latest years from the dataset, run the same models to produce the coefficients and the predicted costs, then compare the difference between the modelled cost with the actual cost in the dataset. For example, the whole dataset that goes into the baseline model is 2012-2023, the predictive test model can run on a dataset of 2012-2021. The predicted cost for 2022-2023 from the model can be compared with the actual data. This step was not possible for PR19, given the short time series available at the time. For PR24, there should be sufficiently long time series to conduct this test.

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?

Response:

Econometric modelling can be utilised as a tool to explore the determinants of performance levels other than simply cost allowances - analysis of long-term trend in cost, shifts in cost pattern, and level of performance would help establish reasonable funding requirements.

Operational resilience

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

Response:

We support the forward-looking approach proposed by Ofwat to consider future operational resilience, but there needs to be clear evidence from companies about how forward-looking costs with respect to the capital maintenance and asset health at PR24 may differ from costs incurred in prior periods. Understanding such matters, and then triangulating the results from the econometric modelling of historical costs, would be an appropriate approach.

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

Response:

Yes - we believe that the most significant challenges to the operational resilience have been adequately captured within the current strategic planning frameworks.

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?

Response:

Early guidance on clearly defined investment categories associated with "resilience enhancement", as opposed to a general "resilience enhancement" category is the first step in improving the incentives and assessment of resilience enhancement expenditure for companies and customers. This will allow better evidenced proposals for enhancements to resilience from companies, and therefore allow associated incentives to be better targeted. Furthermore, moving to a long term approach to incentive setting for such resilience measures, whereby measurement may match an expenditure period that exceeds the five-year regulatory cycle, would be appropriate.

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?

Response:

While we consider that the six components of the PR19 risk regime as detailed in Section 11.2 are still relevant for PR24 and should not be reduced further, we believe that a further component - a company's size - should be added to risk analysis. A single percentage point of allowed risk across the board may work in favour of large companies that are in much better position to spread the risk over larger capital and customer base. Ignoring a company's size in assessing risk may force smaller companies to implicitly take greater risks to compensate for matters not formally allowed or recognised as part of the risk framework and may affect customer's interests.

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?

Response:

The RoRE risk should be redesigned to allow greater weight to be allocated to the more important components of risk or the components of risk with a higher probability of downside. This would therefore result in greater weighting to totex, followed by outcomes and financing costs. Further consideration would be needed to determine whether C-Mex, D-Mex and water trading should receive the same importance and weighting as the other elements of risk.

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

Response:

We would require to further understand the impacts of indexing the allowed return on equity before concurring with implementation of this recommendation, and the matter should be approached with caution, with consideration of floors or ceilings to protect from extreme movements in inflation. In a low inflation environment indexing may provide additional incentives to investors without significant impact on customers. However, if the inflation rises to the upper end of the one-digit level, indexing returns on equity may cause distortion in both incentives and bills.

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?

Response:

We agree that there is merit in placing a reasonable level of weight on both historical balance sheet and index data, focusing on average costs of debt for companies over a set period of time, but any final decision needs to await the results of Ofwat's redesigned instrument-level data collection from the 2021-22 APRs.

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

Response:

As we have indicated in previous price reviews, we strongly support adjustments to allow returns based on actual company size – focusing on the analysis of debt costs. We have noted the CMA's determination of allowing the uplifts in embedded debt cost, issuance cost and liquidity cost for Bristol Water, and believe this is a reasonable approach to follow in PR24. Assessment should be evidence-based as part of a Company's business plan submission.

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

Response:

We consider that the assumptions underpinning the PR24 notional structure should be decided based on recent market data analysis, even if that different from PR19 assumptions.

If the notional structure does not represent an average company in water sector or other comparable sectors, adjustments will be required.

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

Response:

We consider that there are sufficient mechanisms in place to incentivise financial resilience outside of the price review process at present – for example, the detailed consideration of financial resilience as part of the long term viability statement work, its consideration in updated dividend policies and the embedding on long term financial resilience criteria into executive long term incentive plans. We do not consider additional financial resilience incentives are needed in the price control process but welcome the discussion paper to be published by Ofwat in autumn 2021 on the subject.

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?

Response:

The increase in CPIH indexed proportion of RCV should be based on the share of remaining RPI indexed part and be smoothed to ensure the impact of eventual transition to full CPIH-indexation is minimal. Such "smoothing" should also take into account the fact that – with an expected upward bill pressure in PR24 to address key priorities – companies should be allowed a degree of flexibility to mitigate the impact of the transition to CPIH on customer bills.

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

Response:

We broadly agree with the suggested timetable for PR24 as detailed in Figure 12.1 of the Consultation. However, we would appreciate views as early as possible from Ofwat on ODI rates, PCLs, base costs and WACC. We would welcome an ongoing dialogue at a Company level with Ofwat during the PR24 process.

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

Response:

We believe that costs and incentives for the existing water resources controls can be targeted more effectively through aligning RCV with the price control unit.

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?

Response:

We agree with the suggested 'sourcing of treated water' control that includes water resources, raw water distribution, and water treatment. Raw water distribution consists of a very small proportion in total cost and asset, and yet has a structural link with water resources, which makes it difficult to separate the two. However, combining water resources and raw water distribution does not change the cost profile significantly and does not eliminate the cost allocation problem, as water treatment cost still depends on the type of water resources.

Defining the prince control by “sourcing of treated water” and “distributing treated water” also aligns with the PR19 cost modelling, as PR19 modelling exercises were unable to produce satisfactory models based on the current water resource and water network plus control unit.

The current water resources control unit does not achieve the regulatory purpose of encouraging and introducing competition into this part of the value chain. However, for consistency and comparability, we suggest that Ofwat maintains the current classification of value chain units for reporting purpose.