Southern Water Response to Ofwat's PR24 High Level Consultation

PR24 and beyond: Creating tomorrow, together

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from Southern Water

Contents

1. Introduction & Key Points

Thank you for the opportunity to respond to your high-level design document for the next price review, PR24. The document captures the challenges and opportunities facing the sector, and sets out a clear direction of travel, not only for PR24 but the longer term. It is clear that Ofwat has listened carefully to stakeholders and learned from the PR19 process and the subsequent review by the Competition and Markets Authority.

We support proposals to require companies to set their business plans within the context of longer-term strategic plans. These plans will provide an important function in ensuring that the various planning frameworks – the WRMP, DWMP, RAPID process and the business plans – are all integrated and based on a clear long-term direction of travel. They will also need to reflect the Government's ambitions for the sector, as set out in the 25-year environment plan and the Environment Bill that is currently going through Parliament. The sector is facing some critical challenges over the next 25-years – addressing harm from CSOs, de-carbonisation, greater resilience to a changing environment - and it is vital that the regulatory regime that is established at PR24, is capable of addressing these challenges in a planned way, while managing any necessary increases in customer bills.

Meeting these challenges will require even greater co-ordination between regulatory bodies in future. While significant progress has been made in this area recently, for example through the RAPID process, there remain differences in approach and timelines which make it more difficult for us to meet the Government's long-term ambitions for the sector.

All companies will be developing their long-term strategies over the next twelve months and so if Ofwat is to provide guidance on the content of these plans, it would be helpful to have this well ahead of the publication of the draft methodology next year. We have already begun to consult with customers and stakeholders on long term ambition and so it would be helpful to have an Ofwat perspective to feed into this process at the right time.

We welcome the commitment to stability of the regulatory regime over time. That is not to say that it should not evolve and adapt to the challenges and opportunities facing the sector, but regulatory certainty is important both in attracting investment into the sector and supporting long-term decision making where a clear understanding of the regulatory impacts of decisions over multiple AMP cycles is needed.

The regulatory system, including the price review process needs to support the sector's move towards a systems thinking approach and increasing the level of partnership working if we are to deliver the wider societal and environmental benefits that all stakeholders want to see. Some aspects of the price review process – such as discrete, binding price controls for specific parts of the value chain – may have the effect of stymieing progress in these areas. This may require more in-period flexibility and space for dialogue between Ofwat and companies about flexing aspects of the regulatory settlement where this facilitates the delivery of better outcomes.

Simplification and streamlining of both process and regulatory mechanisms is an important objective for PR24. PR19 was extremely complex in terms of both process and the detail of the regulatory settlement, with more than 20 true-up mechanisms in place and typically 40-50 performance commitments for each company. We accept that simplification is not an end in itself. But, as the regulatory process becomes increasingly complex and the regulatory demands placed on Boards becomes ever greater, this can divert attention from the core function of delivering for customers.

In that regard we strongly support the proposal to consolidate the outcomes framework to focus on a small number of long-term customer priorities, established through consistent centralised research – with company engagement focused on local issues and service delivery as well as specific regional challenges - such as the impact of growth - which may have differential impacts between companies.

It is also important that as the regulatory process matures, regulators do not seek to identify and capture, ex-ante, all scope for outperformance. As PR19 demonstrated this can lead to the use of multiple true-up mechanisms, the combined impact of which is difficult to assess. Incentives to outperform remain an essential part of an incentive-based regulatory regime, revealing the efficient costs of delivery and levels of performance.

In addition to this, it is important that Ofwat supports those companies striving to improve quickly in addition to rewarding those performing at upper quartile. A careful balance must be struck in penalising companies that underperform against the investment required to improve, whilst customers rightly need protection their longer term interests are aligned with performance improvement. Therefore, we support Ofwat in trying to close these company performance gaps through regulation that supports poor performers to get better quicker, whilst allowing the best performers to continue to improve performance to new levels. One means of facilitating this catch up may be to provide a mechanism, with customers' consent, for partial re-investment of ODI underperformance payments in improving poorer service levels (on an unremunerated basis outside of the totex menu). This would not only provide a means of levelling up sector performance, but would have customer benefits in terms of bill stability.

We also support Ofwat in its goal to improve cross-sector collaboration, best practice knowledge sharing and improving cost efficiency. All of this will benefit more customers across the UK in the long run; which is a key aim for all involved in the sector.

In terms of the PR24 process, we support the suggested removal of the Initial Assessment of Plans stage. However, it remains important that there is an opportunity for Ofwat to provide feedback on companies' plans and for companies to respond to this feedback ahead of the draft determination. We would like to see the sector move to a more collaborative process to Ofwat feedback and iteration of business plans (involving customers), between plan submission and draft determinations.

Finally, it is essential that the price review supports the long-term financial sustainability of the sector. There is a need to ensure cash flow is sufficient to support the necessary investment and ensure the sector's financial resilience. We would ask Ofwat to carefully consider the CMA's recent findings in this area and to work with the industry collaboratively. The sector would benefit from continued stability in approach given the long-term nature of investors.

2. Ambitions for PR24

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

The four themes - an increasing focus on the long term; delivering greater environmental and social value; reflecting a clearer understanding of customers and communities; and driving improvements through efficiency and innovation – are all ones that we would welcome and support.

We particularly welcome the strong focus on ensuring that companies' plans are built on a clear long-term strategic direction. It will be equally important that the regulatory framework is also adapted to ensure a long-term focus and that both company plans and Ofwat's framework are adaptable to new challenges. We support Ofwat's stance on providing greater clarity over future price reviews. We would also like to see a focus on even better co-ordination between regulators to support the delivery of the Government's long-term ambitions for the sector.

We would suggest that the second theme, reflecting a clearer understanding of customers and communities, could be expanded to cover collaboration with stakeholders and customers as well as just "understanding" them.

We were however surprised that resilience is no longer an explicit theme for the price review, given wider stakeholder concerns and Ofwat's statutory duties in this area. We accept that the long-term focus will support a more resilient sector, but we think it is important that resilience in all its forms is specifically considered.

We also believe that an important objective for PR24 is to reduce the regulatory burden and simplify process so that companies and their Boards are focused on delivering for customers rather than a very complex regulatory process.

It is important that the draft objectives that Ofwat has set for the price review are kept under review and revisited once the Government has published its own objectives for Ofwat in the Strategic Policy Statement later this year. It is also important that they reflect the Government's ambitions for the sector, as set out in the 25-year environment plan and the Environment Bill that is currently going through Parliament.

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

We support the proposal to provide greater clarity on how price reviews will be conducted in the future. This clarity is important in enabling companies to consider better the long-term impact of decisions in a sector characterised by long-term assets.

Streamlining of the price review should be an important consideration. We agree that simplification is not an end in itself, but as regulatory process becomes more complex it reduces the impact of regulatory incentives as the link between decision making and regulatory outcomes becomes less clear. Also, ever-increasing regulatory expectations of Boards means more and more of their time is spent on regulatory rather than operational matters. We believe regulatory simplicity is generally in the best interests of customers, a good example being the C-Mex measure.

It is important that local diversity of views is accommodated within the price review process, but for the core aspects of service we believe most customers want the same things from their water company - though there may be differences of emphasis driven by regional issues, such as growth rates. Local priorities, for example our bathing water improvement programme or the important partnership work that we are undertaking in Chichester harbour, need to be reflected but these local priorities should be built on a common core service offering.

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

We would suggest the key metric for the sector is the extent to which the regulatory framework supports delivery of customer and society's expectations. Where the sector is falling short in this regard the critical issue is to understand the drivers of any shortfall and ensure that the regulatory regime is sufficiently agile to respond. We don't believe it is necessary or helpful to develop a suite of additional metrics which could divert focus from delivering against this core objective.

In terms of measuring the broader impact that the sector has on society, we think this is an area where Ofwat could provide some leadership. Companies have all begun to embrace natural capital and the wider six capitals frameworks for accounting for the wider costs and benefits of their activities. But the practical application of these concepts remains relatively immature, and we believe Ofwat could provide a lead in helping develop common measurement frameworks for the sector, which could be reflected in regulatory decisions.

3. How we regulate

3.1. 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 believe retaining the basic price review building blocks is a pre-requisite for the financeability of the sector. Regulatory certainty is essential for the sector and its ability to deliver customers' expectations and to finance continuing investment in environmental outcomes.

We strongly support reducing the number of performance commitments and focusing these on the key issues for customers, making us of other regulatory tools where these are more appropriate. In reducing the number of performance commitments, it is important that an appropriate RoRE range is determined that balances risk and reward. This is important if the sector is to continue to benefit from a relatively low cost of capital.

3.2. 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?

In embracing a systems thinking approach, collaboration is vital. We would ask that our regulators continue to strengthen their collaboration and co-ordination. RAPID is a positive example of this; collaboration between companies through regional groupings and RAPID can be an important enabler of better outcomes.

There is an inherent tension between the desire to create new markets and collaboration within the sector. In some instances collaboration will deliver better outcomes, while in others the market may be better placed to deliver – it is important that Ofwat seeks to objectively determine whether collaboration or competition is likely to better serve customers in each set of circumstances.

With respect to the role of a system operator, the long-term planning role of a system operator is effectively being undertaken for water resources by regional groupings and RAPID. There may be a case for looking at extending this approach beyond water resources as the DWMP process matures.

4. Increasing focus on the long term

4.1. 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 are supportive of Ofwat's increased focus on the long term and we agree that it is important to set business plans in the longer-term context. We would completely agree with the statement that: *"Five-year price reviews should be staging posts within a long-term context"*.

We would like to see Ofwat continue to discuss the longer term within a resilience context. Whether by design or not it appears that the word "resilience" is being used far less frequently by Ofwat at this early PR24 design stage. We firmly believe that resilience in the short and long term, in all its forms, remains an important part of the regulatory business planning language going forward. Especially as Ofwat and water companies have clear resilience duties to meet in the long term around climate change, population growth and other threats.

The concept of setting plans within a long-term strategic context is not a new one. We note that Strategic Direction Statements were introduced at PR09 with very limited impact on the actual price review process at the time. Therefore, it is important that long-term strategies and plans have a clear link to, and impact on, this next price review process.

The sector would benefit from further clarity from Ofwat as to how long-term plans will be assessed and then used at future price reviews. One thing is certain, long term threats and opportunities will change. For example, climate change impact predictions are likely to develop, the political landscape could change, and the Covid-19 pandemic could have far-reaching consequences on society that we are yet to fully understand in a longer-term context. Inflexible long-term plans could lead to inefficiency and the wrong performance outcomes for customers in future. Therefore, it is important that long-term plans set at PR24 remain sufficiently flexible.

4.2. What should long-term strategies seek to cover and what details should we expect companies to set out in business plans? Would common requirements would help us and other stakeholders to understand each company's approach?

We agree that common requirements would be useful – including on the relationship/hierarchy between these long-term strategies and other long-term plans such as WRMPs and DWMPs. We will need to understand these requirements early in the PR24 process. Earlier understanding of the requirements will enable companies to provide better data and supporting evidence.

Guidance from Defra on strategic ambitions will be a significant input into setting any long-term requirements. However, longer-term strategies should cover as a minimum:

- Indicative outcomes targets for core common measures
- Long term asset replacement / maintenance plans
- Details of strategic projects
- Uncertainties and key risks (both internal and external)
- Demographic changes/assumptions
- Long term bill trajectory (based on most likely enhancement requirements)

4.3. How would this build on the work completed in strategic planning frameworks?

It is important that the same long-term strategies noted above inform all the strategic plans and planning frameworks (WRMP, DWMP etc.). Companies should have a clear corporate vision, ambition and overarching set of long-term delivery strategies that provide an overarching long term strategic view. This is not to say that the long-term plans are static though. We expect these strategic planning frameworks to help to inform, develop and improve these overarching longer-term plans and strategies in future. We expect overarching long-term plans to draw upon these strategic planning frameworks to provide a strategic wrapper that brings everything together.

4.4. 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?

It will be important that plans are flexible and there should be a presumption that long term strategies and plans will need to develop and change over time. We must ensure that we do not start with a blank piece of paper every five years, but seek to challenge, review and evolve from the previous plans as new long-term threats and opportunities are understood and/or realised.

Changes should be subject to a regulatory change control process based on clear evidence of either changes in customer preferences, technical feasibility or external factors/requirements. It will be important that mechanisms used by Ofwat to hold companies to account for longer term commitments and expected benefits are subject to this well-evidenced regulatory change process.

It should be noted that there are good examples of where multi-AMP projects or programmes of work have successfully been delivered (i.e. projects for the long term). We suggest using these previous experiences when developing thinking on this. Our Thanet Sewers project, for example, was identified as a 15-year programme of work. With the support of the regulators involved, at each of the last three price reviews we have presented the long-term approach and phases of activity whilst stating our case for funding for the next five-year period. Having clear support for the project at the beginning allowed us to progress this project but returning every five years enabled us to re-affirm our approach, adjust the plan if necessary, and ask for the correct level of funding for the next five-year period. The full funding was not provided up front, but funding was provided at each five-year phase of the project to meet the overall goals of the project. Customer protection measures went alongside these proposals. We envisage that similar multi-AMP projects or programmes of work, such as catchment, resilience or partnership activities, could be managed, reviewed and funded in a similar way to these previous experiences.

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

We are supportive of Ofwat providing their views of comparable aspects of companies' plans in advance of business plan submission. However, it is critical that these comparative parameters are provided at an early stage, so that the process of building the plan takes account of this information. Providing early comparative data will certainly streamline the price review process and could improve business planning transparency.

Base Costs: Providing early base cost data may allow us to take some of the potential contention out of base cost discussions during the price review process. If, early on in the price review process, we are clear on base cost modelling we can focus on:

1) Delivering an optimal, productive and efficient base cost delivery plan.
2) Providing stronger evidence for un-modelled base cost adjustment claims that are specific to our company situation/region.
3) Improving our evidence for our enhancement plans (and ensuring that we clearly understand what is base or enhancement activity up-front).
4) Improving our understanding of financeability and bill profiles, allowing us to have more informed up-front discussions with investors, stakeholders and customers.

Allowed Return on Capital: Providing an early view of allowed returns and their calculation will ensure a more informed view of financeability, risk, and return. It would also allow for improved customer and stakeholder engagement as allowed returns are understood early in the process. Early understanding of allowed returns allows companies to assess financeability and enables actions to be undertaken or agreed ahead of final business plan submission rather than later in the process.

Performance commitment levels (PCLs) for common performance commitments and outcome delivery incentives (ODIs) for common performance commitments: Providing early clarity to customers, stakeholders and Board on expected performance impacts in common performance areas will, amongst other things, allow for improved planning, business plan evidence gathering and delivery.

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

No comment.

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

A lot of detailed regulatory change has taken place over the last two price reviews but the fundamental building blocks have been consistent since privatisation. Having clarity and stability on the long-term regulatory framework will provide confidence in the overall framework and will enable long term investment in the sector.

To provide even greater clarity, Ofwat could set out the areas in which there would be a presumption of no change. Clearly these would not be set in stone but would require clear evidence, impact assessment and consultation to move away from. In addition, Ofwat could set out the areas that have higher potential for change in future. For these potential change areas Ofwat could identify the expected most likely impact range for regulatory change. Providing this sort of information would give confidence to take account of impacts beyond the immediate five-year period.

Our view is that regulatory clarity will need to be at a relatively granular level for it to be more impactful and beneficial (e.g. the level of ODI under / outperformance payments).

4.8. 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?

We welcome the move by Ofwat to focus the sector on providing greater environmental and social value. As we note in Q2.3, we think Ofwat could provide a lead in helping develop common measurement frameworks for the sector, which could be reflected in regulatory decisions.

Where projects that deliver the greatest environmental and social value are also least cost, we see no fundamental barriers to delivery. However, where projects are not least cost, but provide greater environmental and social value, then their selection is dependent on reputational incentives.

Our view is that there needs to be some form of regulatory mechanism for logging up additional costs of not delivering the least cost option where clear evidence proves that it will deliver greater environmental or societal benefits and customers are willing to pay for these. This could be achieved through carefully crafted ODIs, a bespoke mechanism, or a social value fund along the lines of the innovation fund (where the additional costs could be recovered).

Clearly wider questions remain though that Ofwat will need to tackle head-on to ensure absolute clarity for the sector. For example: Is it right for water customers to pay for these wider additional environmental and social benefits (where not cost beneficial in the traditional water industry sense)? If customers are willing to pay more through water bills for greater environmental and social value, what are the limitations on this? How will these limitations be set? Ofwat, working with other agencies such as Defra, will need to be clear early on in the business planning process how they expect to treat projects that may not be least cost in the traditional sense.

Of particular importance is that the regulatory framework is able to recognise and fully support co-funded, partnership projects that have wider environmental and societal benefits (and customer/stakeholder support). These types of projects may only be cost beneficial when combining all of the co-funded costs and wider benefits together. For some co-funded projects, we may be required to put a greater share of the cost in to make the project work too. Failure for us to secure the appropriate funding level will likely lead to the failure of the partnership altogether and a loss of trust by the parties involved. Therefore, it is important that there are regulatory mechanisms in place to ensure these projects can be put forward successfully within business plans with appropriately approved funding levels, over the life of the project, to ensure environmental and social value is realised. The cost adjustment claim mechanism could be one possible option for successfully reviewing and funding these more complex projects. Another point to note is that partnership groups often have longer time frames for successful completion and can change direction quickly if other threats come into play during the project's life. Therefore, any mechanism put in place needs that longer term flexibility and acknowledgement that benefits may not be realised until later on.

See also our response to Q10.4. As for partnership funding for projects, nature-based solutions will need clear funding mechanisms in place. This is especially so, given that that nature-based solutions are often funded over a longer period, reliant on partnership working, future outcomes are less certain, and benefits can come later on in the period rather than cost and benefit being realised straight-away. The regulatory framework will need to address these potential issues with these types of projects. Again, this could be achieved through carefully crafted ODIs, a bespoke mechanism, or a nature-based solution value fund along the lines of the innovation fund (where the additional costs could be recovered).

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

We support the proposals for giving clarity over long term regulatory regime.

Regulatory stability is a significant driver for long-term thinking and decision making. The greater the ability of companies to predict the impact of their decisions over multiple AMPs the more these effects will be taken into account. Conversely if the regulatory rules change every five years, then companies will focus principally on the shorter term impact of their decisions.

5. Strengthening incentives

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

We support any efforts to simplify and shorten what has become a very lengthy price review process. The Initial Assessment of Plans (IAP) represented an important feature of the process as it is the only opportunity for companies to receive and respond to company feedback on their business plans. Historically the same objective has been achieved through the submission of a draft business plan on which Ofwat provided feedback prior to submission of a final business plan.

We think this opportunity for feedback on plans and subsequent iteration should be retained but we would like to explore how this could be done in a more collaborative way between companies, customers and Ofwat. The process should be aimed at getting to the best possible business plan for customers and stakeholders and the current competitive and adversarial approach does not necessarily support that objective. Furthermore, our experience is that the customer voice, while critical in the development of company business plans, can often be lost following plan submission. An alternative, collaborative process would provide greater opportunities for customers and stakeholders to remain central to the process.

5.2. 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?

The process of assessing company plans should be objective and the same for all companies, to avoid any risk of unconscious bias in the process. Within this, track record is a consideration, but we do not believe it should be a primary consideration. The focus should be on whether company plans are credible and deliverable not on historic performance.

There is a clear risk of double jeopardy for companies if they are penalised for historic performance through the outcome delivery incentive regime and then also through the business plan assessment process. Similarly, it is not right that companies who have been rewarded for good performance with outperformance payments should also receive a further automatic benefit through the business plan assessment process.

5.3. 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?

As we describe above, we think it is important to retain a feedback stage in the price review. But we think a more collaborative approach to plan iteration – including stakeholders, customers and their representatives - could be adopted to get to the best outcome for customers and to ensure that their voice is not lost as the regulatory 'machine' takes over.

The draft determination is a critical step in providing companies with the opportunity to correct errors in the determination. Without this the only remedy for such errors would be a full referral to the Competition & Markets Authority which would, in most cases, be wholly disproportionate. Where companies are content with the draft determination, we think it should be made possible to allow them to accept the draft determination in full – potentially with a 'hold harmless' provision. This would provide these companies with the procedural benefit of an earlier start to delivery of their plans, whilst allowing Ofwat to focus on resolving material issues for remaining companies.

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

In general, regulatory consistency is important to avoid the risk of any bias in the process, but we recognise that the different constitutional arrangements may require a slightly different approach in Wales. Any differences in approach should be only those that are necessary to respect these arrangements.

5.5. 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 think the focus of the business plan assessment should be solely on reputational and procedural incentives. Early draft determinations, or (as described above) the opportunity to accept the draft determination in full would provide companies with the significant benefit of early regulatory certainty and allow an early start to delivery.

We question whether it is possible to objectively assess ex-ante with sufficient certainty a "high quality" company plan given the variation between companies. Against that backdrop we do not believe financial incentives which depend on a regulatory assessment are appropriate, rather we support objective measures of ex-post performance (ODIs).

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

We agree with the CMA view that differential cost sharing rates based on an assessment of the 'quality' of a company business plan is not appropriate, for the reasons described above. We think cost sharing rates should be common across companies and indeed across price controls.

Cost sharing rates are an important consideration in company decision making and we don't believe it is in customers' interests that decisions about their services are affected by regulatory judgements of business plan quality, made several years previously, and over which they have no influence. For the same reasons we don't believe different sharing rates for different price controls are appropriate as they will inevitably distort in-AMP decision-making and risk sub-optimal outcomes for customers.

We do think there is some merit in setting cost sharing rates for asset health related expenditure which do not encourage companies to underspend in this area. This would reflect the fact that the risk to customers of investment in asset maintenance that is 'too high' is far lower than risk of asset maintenance expenditure that is too low.

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

We acknowledge that the targeted challenge applied to leakage at PR19 was successful in persuading companies to include ambitious leakage targets in their business plans. We think that targeted challenges could have an important role to play in areas where there is clear customer concern or where they are necessary to deliver Government policy as set out in the Strategic Policy Statement to Ofwat.

Where targeted challenges are used to drive the rate of improvement faster than that achieved historically by the sector, there needs to be a clear linkage to the cost assessment process to ensure that these ambitions are reflected in appropriate cost allowances.

5.8. 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 think the introduction of the innovation competition in the current AMP was a positive step and appears to have been effective in stimulating interest in sector innovation. The linkage to productivity gains is clearly unproven but needs to be kept under review. It is important that the innovation competition genuinely delivers cashable benefits for customers and that these can be evidenced. It is not, so far, obvious that any productivity gains associated with the innovation competition are entirely additive to those that the sector would deliver absent the competition.

Ultimately, if the regulatory regime contains strong incentives for outperformance, available productivity gains from innovation should reveal themselves regardless of any specific "innovation incentive". There may be a real challenge around risk tolerance and the higher risk associated with adopting innovative solutions. If that is the case, then an alternative means of sharing this risk between customers and companies may be worth exploring.

5.9. In what ways might we promote the themes of EBR through PR24?

We are very supportive of moving towards a regulatory regime that embraces the principles of Ethical Business Regulation (EBR). It is an area which our Board has been closely engaged in over the last few months. We have developed a new Code of Ethics to ensure that all our staff understand the expectations about how we want to do business and are driven by a sense of doing the right thing for our customers and the environment - going beyond rules-based compliance. We are committed to absolute transparency in what we do, and we are continuing to look for areas where we can further embed ethical business practices within our organisation.

There are already many areas of the price review process – transparency, assurance, collaboration – which reflect the fundamentals of EBR. These remain critical to the success of the process. Our proposal to move away from an adversarial to a more collaborative approach to the development and iteration of business plans, involving customers and stakeholders in all parts of the decision-making process (see above), rather than just upfront, is consistent with EBR principles and we would like to see Ofwat adopt this approach for PR24.

EBR is a relatively new area of thinking and fast-evolving, so as well as looking for opportunities to reflect current thinking in the price review process, it is important that we all ensure that the sector and its regulation reflect the latest thinking. The focus should be on sharing best practice and Ofwat has already done some significant work in this area with the publication of its board leadership and governance principles and highlighting of best practice in its annual report on how companies are meeting the principles.

6. Reflecting customers' preferences

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

We support a collaborative approach to both nationwide and standardised customer research, believing this will ultimately lead to greater transparency and better outcomes for customers through a stronger application of insight. We have welcomed the collaborative workshops through 2021 so far in building out how, when and where to apply the collective research to the Price Review process.

We feel nationwide research could help set the ambition for the industry and drive a clearer high-level understanding of what matters to customers. The simplicity of 'one version of the truth' on shared areas of research (e.g. valuations, common performance commitments, social tariffs) and overarching elements (e.g. acceptability testing) would allow companies to then focus their engagement on the local and regional issues as part of their Business Plan. Our main concern would be on timing to ensure that any high-level outputs are available early in the PR24 process to enable companies to effectively bring customer preferences into their plans.

More standardised approaches could be used in areas of commonality where the challenges of nationwide research (e.g. alignment of timing) outweigh the benefits. However, the standardised approaches would need to offer some flexibility to be able to reflect the issues of the region, the differences in companies (e.g. their performance or relationship) and allow for innovation.

The undertaking of this research would need to be highly collaborative across all the companies, CC Water and Water UK. For the effective design of the nationwide research, we feel there is benefit to stepping outside of the limitations of PR24 timing, and considering how the approaches will work best in the long-term. By using triangulation, the use of existing research and insight (especially from PR19) can be central to form the foundations of future engagement.

We would also note that it is worth reflecting on the roles of customer and stakeholder feedback. With stakeholders playing a crucial role in any co-delivery it is important they are part of the overall engagement and there is a clear remit in the process for their preferences to influence plans.

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

We strongly support the current method of working collaboratively with the sector and feel the combination of workshops, external expertise and guidance is the right approach. Active engagement from across the industry is needed and we would agree that we all have a role to play.

We support the current process around the use of subgroups, which can help drive greater pace of progress. These subgroups should ensure they use a range of expertise (e.g. insight / research, customer focus, regulatory, economic) and from a range of companies – perhaps ensuring regional representation. Water UK or CC Water could then play a central role to ensure all companies have an opportunity to feed in, without creating such large groups that administration slows down pace.

Any research agency appointed should be independent, and funded by all companies to allow for collective ownership. This method was used in the regional WRMP research for WRSE and we have found this to be a highly effective approach.

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

We appreciate the idea in principle, although we struggle to see how they would work in practice. We would therefore need greater detail on the objectives and purpose of the approach. Our greatest concern is who we would be negotiating with, as currently we don't feel there would be the relevant counter-party to hold an effective negotiation. Negotiated settlements work best with two clearly opposing sides; in the creation of Business Plans there is an extensive range of customers, stakeholder and regulators involved. We would also need to understand how this would work with 17 different companies.

We do feel there is a strong benefit of creating a more continuous and informed engagement with customers through the Business Planning process. We could look towards a more iterative approach through continuous engagement and dialogue, although we would need to ensure that that customer voice isn't lost after the submission of business plans.

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

We welcome Ofwat's proposals for customer challenge and assurance of customer engagement on business plans and the flexibility these recommendations would bring. However, we are cautious to ensure we don't lose the extensive benefits that CCG's bring to Price Review processes, and in particular the strength of challenge and the opportunity for co-creation. CCG's are able to facilitate and promote co-creation through their expertise and holistic understanding of plans. In PR19 our CCG's challenge and support enabled a number of important activities (e.g. Target 100 and continuous insight) to be co-created in an effective and enduring way.

For PR24 we are evolving our approach to incorporate the best aspects of the CCG process and our learnings from PR19 in our new body – the Environment, Customers and Climate Group (ECCG), which will bring together senior stakeholders from across our region to input to, co-create and challenge our long-term plans.

Assurance and review is a key part of a continuous improvement journey, however, the role varies depending on the issues, experience and situation of each company. Clarity is needed around how engagement is being used (by the companies) and how it's going to be assessed and incorporated into price control decisions (by Ofwat).

Challenges and assurance programmes need a clear set of objectives, although we believe flexibility is needed as to the relative importance of those to individual companies, as well as the form and make-up of these groups. For example, companies without an insight team will likely need greater scrutiny on their approaches compared to those with expertise in-house. We think this guidance should stretch to help looking not just five years in the future, but 10 and 25-years ahead to our water future.

For areas that require comparability, where a national framework is not used, best practice guidance for approach and stimulus is needed. Whilst this won't remove all differences in customer preferences due to varying approaches, it will greatly reduce the impact on comparability. Best practice and greater sharing of lessons learnt around engagement is important to drive innovation and continual improvement.

Whilst there is a need for both the flexibility of assurance and clarity around the level of influence, challenge groups (or similar) could have greater dialogue early in the PR24 process with Ofwat / CC Water and companies to help ensure the right model and focus is adopted.

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

We support clearer guidance on how high-quality research will be assessed and further guidance in areas where the need for comparability outweighs any potential concerns of reducing the use of innovative approaches.

Our concern with minimum standards is that they could reduce the incentive to go above and beyond and this would therefore reduce overall aspiration to innovate. To help mitigate against this, the need to go above and beyond should be clear and form part of the assessment. We would also recommend clarity from the outset that these standards are to drive better outcomes for customers and therefore would need guidance on how their application would be assessed.

Any standards would need to be clear and to account for individual company circumstances and local issues. These minimum standards should be aimed at the best practice (e.g. Market Research Society guidance) and by using lessons learned from previous price reviews. We would recommend CC Water's review of engagement at PR19 as the first step towards these standards. We should also be careful not to create additional barriers for customer engagement by creating an entire industry. These standards should be guides to ensure high quality engagement rather than a lengthy 'tick box' process.

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

No comment.

7. Planning together for PR24

7.1. 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?

We completely support the ambition to bring together outputs of the strategic planning frameworks together. We feel these strategic plans should include WRMP, DWMP and SRO (past Gate 3) schemes and feel the phasing of these can work well together. However, there could still be some timing issues around WINEP. We would note that for these long-term strategic plans there are some regulatory aspects that aren't certain.

To ensure that these planning frameworks are brought together in an effective way for Business Plans we would need to ensure better alignment of regulatory timetables. Where alignment or certainty isn't possible, there will need to be an understanding from Ofwat where funding would be allowed and clarity on the mechanisms to determine this. It would also be helpful to have strong links between the three regulators and building closer working relationships through continuous/regular dialogue through the PR24 process.

The creation of long-term PC's (e.g. common PC's) would set the strategic direction, and then the five-year business plans would forecast how we propose to deliver against these. A degree of flexibility to account for differences between the business plan periods would be needed.

It is worth noting, that with any greater partnership working with regulators and stakeholders, the challenges of different objectives and measurement metrics can create significant barriers. As with the alignment of timing, common objectives which are measured in the same way between companies and regulators could help promote the bringing together of plans more effectively.

7.2. 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 engage extensively with all of our regulators in developing our plans and ensuring they reflect our statutory obligations as well as our customer and stakeholders preferences. We think that moving to a more collaborative model for feedback and iteration of business plans would provide greater scope for engaging with other regulators, as well as customers and stakeholders, as we revise our plans to reflect Ofwat feedback.

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

We are not convinced that there is a need for a central body in addition to companies' own assurance and challenge processes, to *"help ensure that customer and environmental representatives are heard"*. However, we think such a panel could play an important role for Ofwat in allowing it to test and be challenged on its key decisions, ensuring that they take proper account of Government policy, and customer and stakeholder views, in much the same way that CCG's challenge companies plans. The group's activity would need to be transparent with the outputs of their challenge and clear line of sight to the actions then taken.

For such a Challenge Panel to be effective it would need to have a clear remit, purpose and terms of reference. Without the clarity of purpose there is a risk it could cause confusion with other stakeholder or challenge groups.

8. Design and implementation of price controls

8.1. 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 see no pressing case for adding to the number of price controls. Additional price controls not only add to the regulatory burden faced by companies, but the need to allocate costs between controls can raise issues around consistency/comparability and can distort incentives (e.g. around cost sharing). They invariably add to the quantity of data required by regulators, when we think the ambition should be to reduce the data burden compared with PR19. When combined with asymmetric and potentially differential cost sharing rates between price controls there is a risk of sub-optimal choices being made driven solely by the unequal regulatory incentives.

Companies are moving increasingly in the direction of systems thinking, considering how the constituent parts of the water supply system inter-relate and how they relate and interact with external systems. Separate price controls pull against this systems thinking dynamic and may inhibit the right choices being made. To counter this Ofwat should consider increasing the flexibility of funding across price controls, where it can be demonstrated that this will lead to better outcomes.

In this respect, we would question whether the water resources price control is clearly adding value. The difficulty in modelling water resources costs separately may be a symptom of the lack of real-world separability of these costs. Southern Water certainly does not distinguish in an operational sense between water resources and the rest of the water supply value chain - wholesale water is run as an integrated business unit. Furthermore, when addressing supply demand deficits, the choices will often be between supply side solutions which (typically) sit in the water resources price control and demand management solutions which sit in a separate network plus price control. This adds unnecessary complexity and risks the wrong decisions being made as a result of the regulatory separation of these activities. Set against these risks we have seen little evidence that the separate water resources price control is delivering any benefit at all for customers. With increasing moves towards collaboration rather than markets as the driver of innovation in water resources, Ofwat should revisit whether there remains a case for a separate water resources price control.

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

We comment above on the water resources price control, which we believe is adding little value for customers. We welcome the pragmatic decision not to pursue bilateral markets at this time. With the increasing drive for collaboration and region-wide solutions, there is a risk that introducing markets conflicts with these objectives.

In terms of the proposal to move towards a gate fee-based price control for bioresources, we think this is a sensible evolution, but it is important that there is an end-of-period reconciliation process to ensure that the legacy RCV continues to be remunerated.

We support the removal of all contestable developer service activities from the price control. This will remove one of the challenges in forecasting growth expenditure. There may indeed be a case for going further and removing all developer-related activity from price controls and relying on Ofwat's ex-post competition regulation powers in this area.

8.3. 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 support seeking the best value for customers, even where this means using non-conventional procurement methods. However, we do not support the Direct Procurement for Customers (DPC) process, in its current form. In seeking to emulate the Thames Tideway model on a smaller scale, Ofwat has not taken account of the unique features, and risk mitigants that were necessary to make that model a success. DPC in its current form is closer in substance to the Private Finance Initiative of the 1990's and early 2000's which is now been widely seen as failing to deliver value for money.

Before pursuing further DPC projects in AMP8, it will be important to objectively evaluate its success in AMP7 in delivering measurable benefits for customers, as well as the potential long-term impacts of a fragmentation of ownership and operation of key national infrastructure. We would suggest an independent review of the AMP7 experience is carried out once we have made further progress on procurement of the DPC projects.

In terms of future reconciliations, we strongly support the continued publication of the reconciliation rulebook. Clarity over the 'rules of the game' is critical to good decision making, which takes account of regulatory incentives. In this respect, consolidating the number of reconciliation mechanisms is important. The existence of multiple, complex, interacting reconciliation mechanisms can make it difficult for company Boards to understand clearly the regulatory impact of their decisions.

Alongside consolidation of the number of mechanisms it is important to review the balance between in-period and end-of-period reconciliations. Our own experience is that maintaining bill stability – a key consideration for customers - is very challenging with multiple annual adjustments to allowed revenues.

9. Outcomes

9.1. 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 strongly support the proposal to have fewer performance commitments (PCs) focused on areas of most importance to customers and stakeholders. These should ideally be at outcome level, but there may be a case for some more targeted PCs in areas of significant stakeholder interest such as leakage (which is in reality a sub-indicator of the outcome of reducing abstraction).

It will be important that the core outcomes that endure for the foreseeable future are grounded in a robust understanding of customer priorities. Based on our understanding of our customers' priorities, we would suggest the core set of outcomes (and associated metrics) would be as follows:

Outcome	Key metrics
Safe drinking water	CRI
Constant supply	Interruptions Pressure
Reducing abstraction	Distribution Input
Flooding	New impact-base measure
Meeting environmental standards	WTW compliance Pollution incidents
Customer service	C-MeX
Environmental impact	Carbon Biodiversity

9.2. 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?

The role for Price Control Deliverables (PCDs) should be to replace what are currently scheme delivery ODIs, for which ring-fenced funding has been provided. In our case, this would cover our AMP7 ODIs for Thanet Sewers, Bathing Waters, Impounding Reservoirs and Long-term Supply Demand Schemes. PCDs would essentially represent an update of the logging down process used historically in the sector.

The distinction between outputs and outcomes is not always black and white, so we don't think this is the right way to distinguish between what should be PCs and what should be PCDs.

9.3. 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?

Ofwat has a range of regulatory tools at its disposal including annual monitoring, publication of comparative performance, and enforcement action. We agree that Ofwat should make wider use of these tools rather than incorporating all aspects of company performance and behaviour within the price review.

Just as five years is too short a time horizon for many aspects of company activity, there are other areas where a more nimble approach may be better. Affordability is a critical issue for customers, but one that needs to be considered in an agile way to respond to evolving circumstances. The experience of Covid-19 provides a perfect example of this need to be agile to circumstances that may be difficult to predict within a five-year framework. There is also a risk that overall bill levels and the affordability challenge faced by some customers get conflated, to the detriment of customers as a whole. This is an area which lends itself to collaboration and so there may be a role for cross-company bodies in monitoring and policing affordability.

Asset Health may also be an area where there is an important role for ongoing monitoring and regulatory challenge, in addition to setting of asset health related targets within the price review context. The onus should be on companies to demonstrate responsible asset stewardship to Ofwat and other stakeholders.

9.4. 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?

The relationship between cost assessment and performance commitments needs to be much stronger than it was at PR19. However, we recognise that including service level variables in cost models has proved impossible to do in the past.

As a pragmatic solution we think that base costs should be assumed to deliver a level of improvement no greater than that achieved by the most efficient companies, with diminishing returns offset by innovation and technology improvements. Improvements beyond the level delivered historically need to be funded either through ODI rewards or as enhancement schemes.

The regulatory regime needs to incentivise sustainable performance improvements. We do not think deferred incentive payments are appropriate, but there may be a case for future penalties where performance worsens. This would ensure companies focus on sustainable long term service improvement, rather than short-term fixes to hit five-year targets.

9.5. 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?

We agree that the approach using marginal costs and benefits, while theoretically correct, was not robust because, (a) improving performance does not always have direct, identifiable costs and, (b) the relationship between marginal costs and benefits which was used at PR19 was entirely theoretical, given that the sector is forecasting to operate at performance levels that have not been achieved historically.

We believe Ofwat should give primacy to customer willingness to pay in setting incentive rates, subject to a cross check against notional marginal costs to protect customers from paying far more than it costs to improve performance.

10. Cost assessment

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

Botex modelling is relatively mature, and we agree with Ofwat that the PR24 cost modelling approach should build on the PR19 assessment. Consistency over time is an important objective for modelling costs in a sector where the underlying cost structure will not change markedly from one AMP to the next. The only exception to this is with growth costs, which should be removed from the botex cost models. Our view is that growth costs can be assessed in a more accurate, transparent and consistent way through the use of bespoke enhancement growth cost assessment models.

We support Ofwat's willingness to looking at a forward-looking view of capital maintenance expenditure in the botex modelling. Incorporation of a longer-term, forward-looking, view of capital maintenance expenditure that takes account of increasing underlying asset risks is something that we fully support.

At the moment, the link between cost modelling assessments and performance is not clear. It is important that Ofwat ensure that there is a transparent link between cost assessment and performance commitments.

Additionally, it is important that there is a transparent link between cost, risk and performance. Companies may well have good short-term plans for delivering performance at low cost, but at high risk to the customer both now and into the longer term. This underlying risk position is important to understand when assessing companies' cost and performance positions.

A more robust process is needed for determining efficient costs for enhancement expenditure. Our view is that Ofwat need to assess efficient enhancement costs through modelling or via deep dives.

As detailed in our response in section 4 (longer term planning), off-model adjustments, or new cost assessment mechanisms, may be necessary to take account of programmes of work that deliver long-term benefits against threats such as climate change or through nature-based solutions, partnerships and other projects that provide wider social and environmental benefits.

One final area for improvement in cost assessment will be ensuring that there are appropriate mechanisms for taking account of input price pressures that are not captured within CPIH. We expect the next few years to be characterised by significant price volatility in many markets and thus the issues of how these are treated in the regulatory regime are likely to be more acute than in the past.

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

Our view is that there is likely to be limited scope for out-of-sector benchmarks. While there is commonality of activity with some other sectors at a very granular level (e.g. pipe-laying or HR/Finance costs), incorporating such granular level cost comparisons within the regulatory framework would require a huge amount of focus on consistent definitions and consistent cost allocation. This would seem like a disproportionate level of activity for the potential benefits gained.

Granular water sector analysis and external functional benchmarking is the sort of thing that we carry out for internal management purposes. However, these assessments are not necessarily appropriate for a regulatory process.

We do agree that historical data is an important source of insight, but when it is used, we need to ensure that, (i) it is like-for-like (consistent), and (ii) adjustments are made to take account of new pressures such as climate change, innovation and population growth etc.

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

There is a need to make substantial progress towards meeting the Government's 2050 net zero ambitions, and the sector has made a clear commitment to progress in its net zero 2030 milestone. We think it is vital that Ofwat recognise the importance of this 2030 commitment in charting a course to 2050 and funds it appropriately at PR24.

Our view is that net zero should be treated separately as an enhancement cost. The need has been accepted by all stakeholders, so the challenge is to ensure efficient delivery. Companies should be required to demonstrate that their net zero plans are based on robust analysis of the available options. This is likely to be company specific, with different baseline starting positions and asset bases, so not amenable to comparative modelling.

With respect to delivering net zero, we note Ofwat's comments that the primary focus should be on driving carbon emissions down, rather than offsetting them. We agree that driving down emissions must be the primary focus. However, it is important to note that, as set out in Water UK's Net Zero 2030 Routemap, even in the most ambitious of scenarios for the sector, some degree of offsetting will be required in order to meet the ambitious targets the sector has set for itself, and this should be supported by the regulatory regime where it is demonstrated that this is the best solution for customers.

Where companies choose schemes that are not lowest cost but deliver greater public value we think this could be addressed through one of:

- Carefully crafted ODIs.
- A bespoke mechanism.
- A cost adjustment claim type mechanism.
- A social value fund along the lines of the innovation fund – where the additional costs could be recovered.

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

Our view is that cost assessment for enhancement projects should typically reflect conventional solutions. This maximises the incentive for companies to seek to identify more innovative delivery routes, including using nature-based solutions.

Nature-based solutions are often lower cost, longer term, and come with greater risk / uncertainty. Where lower cost nature-based solutions are delivered then companies will be rewarded for taking on this additional risk and customers will share in the benefits through the normal cost sharing routes. As nature-based solutions become established they will, over time, become the conventional solution and this should be reflected in future cost modelling.

Alternatively, as described in section 4 and in 10.1 above, nature-based solutions, as with partnerships and projects that provide long term environmental and social value may lend themselves to bespoke off-model adjustments or new cost assessment mechanisms.

We would note that currently not all companies are permitted by the Environment Agency to deliver their statutory obligations through nature-based solutions, because of the linkage with the Environmental Performance Assessment. If the Agency persist with this policy into AMP8 this restriction will need to be acknowledged in Ofwat's cost assessment process.

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

There is no simple and consistent relationship between costs and service that can be comparatively modelled. The relationship between cost, risk and service/performance levels will be different for each company and for each area of service.

We would suggest an approach based on a principle that botex is assumed to fund only the level of service improvement that has been achieved by the most (cost) efficient companies historically, with service enhancements above and beyond this being treated as enhancement expenditure for which companies should make the case in their business plans.

Where maintaining a higher level of service is deemed to be more costly, and customers support maintaining this higher level of service, then the cost adjustment process should be used.

10.6. 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?

Our view is that if there is customer support for performance levels that are better than those funded within base cost allowances, these should be treated as enhancement expenditure. These could be reflected in PCDs to ensure that customers interests' are protected.

The alternative would be to fund these through ODI outperformance payments, with targets set at the level funded in base costs.

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

Operational resilience has been maintained over recent years through increased focus on better operational interventions, which have allowed companies to deliver performance improvements without significant investment in the asset base. This has increased the underlying asset risk that will need to be addressed at some stage in the future. Such risks are not well understood or reflected in the current regulatory framework.

The operational, short-term, performance-focused approach and its ability to continue to deliver performance improvements will necessarily be subject to diminishing returns. In addition, climate change and population growth will add additional pressure to our networks. These future pressures will not be reflected in historic datasets and so there is a need to consider the extent to which maintaining operational resilience will require additional investment in future.

We think it is right that the onus is on companies to demonstrate the impact of these factors on their future maintenance needs. However, in turn, where Ofwat allow for greater investment, it is right that they should ensure that companies are held to account for delivery. This is likely to require a degree of input regulation (e.g. a commitment to delivering a certain length of additional mains replacement by a certain date).

In considering the case for additional investment Ofwat need to consider the balance of risks between not investing enough in the resilience of our networks and over-investing. We think the risk of the former significantly outweighs the latter and this should inform Ofwat's assessment.

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

The strategic planning frameworks (WRMP and DWMP) will capture some elements of operational resilience, but they are not comprehensive. For example, the WRMP will not capture water network-related operational risks. Furthermore, the DWMP process is still maturing and may not fully capture all elements of resilience. Therefore, it is our view that there are gaps in the current strategic planning frameworks when it comes to operational resilience. These gaps need to be addressed through the price review process.

Where they do exist, the 'needs' identified and agreed with regulators, customers and stakeholders as part of these strategic planning frameworks should be included within totex allowances, without a further 'needs assessment' challenge. Similarly, selecting the best whole-life cost option is also reviewed, assessed and agreed through these strategic planning frameworks, with Ofwat as a statutory consultee. Therefore, our view is that projects approved through strategic planning frameworks should be treated as lower risk and thus subject to less scrutiny during the price review process. The main area for review for these strategic framework projects during the price review process will be to ensure cost efficiency of the selected schemes. However, it could be argued that ensuring cost efficiency of options selected should be part of the strategic framework process in any case. We would certainly welcome any form of cost assessment process that reduces the regulatory burden and works in a more connected way with the strategic planning frameworks.

We do think that common assumptions on things like population growth and climate change would be important in providing a consistent foundation for business planning. But if they are to be useful it will be essential that these planning assumptions are provided very soon, or companies will have already begun their planning processes.

A more pragmatic approach needs to continue to be taken to the funding of needs that are identified outside of these strategic planning frameworks (e.g. Industrial Emissions Directive needs).

10.9. 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 Asset Management Maturity Assessment (AMMA) process which Ofwat has recently initiated provides a good basis for assessing how companies are managing operational resilience and improvements they intend to make in the future.

We think that this AMMA approach should be the principal vehicle for understanding companies' approaches to operational resilience; ensuring that best practice is shared between companies to improve the whole sector's approach to long-term asset maintenance and resilience. A sector-wide roadmap for improvement would provide an important driver for progress towards some common standards in this area. This will need to be supported by the development of a set of common and objective metrics for measuring asset health and risk.

In terms of assessing enhancement expenditure to improve operational resilience, it is likely that these will be highly company specific and therefore an assessment approach will need to be based on a bottom-up assessment of expenditure needs, which could reflect the degree of confidence in a companies' asset maintenance processes, as assessed through the AMMA. The asymmetry of risk between under and over-investment in operational resilience suggests Ofwat should err on the side of caution in considering such cases.

11. Risk and return

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

The number of reconciliation mechanisms included as part of the PR19 final determination appears to be part of a regulatory shift towards seeking to identify and capture ex-ante all scope for outperformance. As PR19 demonstrated this can lead to the use of multiple true-up mechanisms, the combined impact of which is difficult to assess. Incentives to outperform remain an essential part of an incentive-based regulatory regime, revealing the efficient costs of delivery and levels of performance.

We agree that regulatory simplification is of course not an end in itself. The number and complexity of regulatory mechanisms does not simply create an additional regulatory burden, it can distract company management from the core focus of delivering for customers and risks distorting decision-making. It can also lead to an excessive focus on the regulatory impact of decisions rather than the proper focus on customers, stakeholders and the environment.

As such, we do not think there are any areas where additional risk allocation mechanisms are required. The core risk sharing/incentive mechanisms in our view are:

- Revenue reconciliation
- Totex sharing
- Outcome Delivery Incentives
- C-MeX
- Logging up/down for funded outputs

The bar for the inclusion of additional mechanisms should in our view be a high one, with a careful consideration of the incremental costs and benefits.

With respect to the interim determination mechanism, this only provides an effective safety net for companies if there is a realistic prospect of successfully invoking it where the (narrow) criteria are met. The fact that there has not been a successful application since 2007, and no applications at all since 2013, suggests that companies do not regard it as an effective real-world risk mitigant. If that is the case, then investors will price in the lack of an effective re-opener mechanism, and this is unlikely to be in customers' wider interests.

11.2. 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?

The RoRE metric provides a reasonably helpful way of decomposing, ex-post, companies' achieved returns, though even this requires a degree of approximation. We are not convinced that the use of the RoRE metric to capture forward-looking risks within the periodic review process reasonably captures the real-world risks faced by companies in a coherent way. The input data on which the analysis is based is, by and large, estimated in a fairly subjective way and there is limited understanding of the interaction between the risks captured within the framework. The inconsistent nature of the analysis means it is particularly unsuited to presenting comparative risk across companies.

We would suggest that, if it is going to continue to be used in this comparative way, some fairly detailed and prescriptive guidance needs to be provided in relation to the development of input variables as well as the interaction of individual risks.

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

As an overarching point, we believe the priority in this area should be for Ofwat and the sector to examine closely the most recent CMA findings in respect of the cost of equity and ensure these are appropriately reflected in the PR24 methodology. In general, we do not support the introduction of a new mechanism where the existing approach has worked well over time and is well understood by investors in the sector.

Implementation of any such mechanism is likely to be very challenging given the limited number of listed companies in the sector. It would be wrong to assume a simplistic relationship between the observable risk-free rate and the cost of equity, including the equity risk premium, but it is not clear that there is the available data to do anything more.

Furthermore, the transfer of risk from investors to customers, which such indexation would represent, appears to be contrary to the general principle that risk should be borne by those best able to manage it.

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

The regular, consistent capture of financial instrument data (debt and interest/inflation derivatives) through company annual reporting should improve understanding of the actual cost of debt incurred by companies, improving the accuracy of allowance setting and protecting customers. We therefore support exploration of this as an approach, with more weight being attributed to balance sheet data. The continued use of an index, if only as cross-check, may be useful.

We note the potential to remove the separate allowances for new and embedded debt. We believe that the separate allowances provide useful clarity and allow more meaningful tracking of actual performance against the final determination allowance.

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

Currently only the cost of debt is adjusted. The cost of equity is not adjusted. We would advocate collaboration between Ofwat and the industry to take heed of the CMA's recent determinations. We believe this is the approach best likely to promote stability.

Should there be a need to adjust either the cost of equity, or cost of debt we would anticipate the need for extensive industry consultation and a minimalist approach to implementation.

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

The notional geared company needs to reflect a real-world scenario for it to be an effective measure of notional geared company financial resilience. In our view it needs to:

- Be consistent with both the allowed cost of debt and the equity return.
- Accurately replicate credit rating agency ratios.
- Properly take account of credit rating agency views in important areas such as fast/slow money regulatory mechanisms.
- Ensure the notional geared company flows from one regulatory period to the next, avoiding unrealistic step-changes (for example, Southern Water's final determination assumes we end AMP7 at 62.8%, so a reduction to 60% at PR24 has additional challenge).
- Realistically incorporate the impact of other regulatory changes (for example, the potential increase to gearing due to reduction of proportion of RCV linked to RPI).

The notional company inflation hedge should reflect the typical company balance sheet.

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

Financial resilience needs to be considered broadly. It is impacted not only by capital structure, but also by operational risk, capital investment delivery risk, and the stability/predictably of the regulatory environment. Any incentive mechanism would need to recognise the full breadth of factors that impact the financial resilience of companies, rather than just focusing on one aspect that could distort decision making.

We believe that the need for investment grade credit ratings provides a robust mechanism to monitor financial resilience.

There is a clear need for the sector and Ofwat to work more collaboratively in this area to better understand each other's perspectives and address any perceived problems. We would suggest that the most appropriate approach would be to require companies to set out clearly their strategy for maintaining financial resilience in a way that encompasses all relevant factors. This could then form the basis for dialogue between Ofwat and companies where there were material issues of concern.

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

We agree that full transition to CPIH would significantly simplify the regulatory regime, increasing transparency and reducing the risk of error. This must, however, be balanced with companies' exposure to RPI, given its long-standing use as the regulatory index.

The consultation notes that, with the proposal that RPI is discontinued from 2030, most RPI-linked liabilities would be converted to CPIH indexation. Our understanding is that the approach to adjusting/re-stating existing RPI-linked financial instruments is not yet fully clear and that companies could still face exposure which, while tracking CPIH, might include a compensating margin for instrument holders.

Alternatively, there could be a cost to convert RPI-linked instruments to CPIH – assuming that there is sufficient market depth to do so.

12. Next steps for PR24

12.1. What are your views on the draft timetable for PR24?

We welcome consideration of ways to shorten the price review process. As the timeline shows, the price review begins just a year into the current AMP. This is, to a large degree, driven by the complexity of the current process. We would note that, as a result of consolidation, there are fewer companies in the sector than at any point in the past, yet the price review process has lengthened considerably. Such an extended timeline is likely to encourage companies to focus too much on the price review process, which is now close to being an ever-present feature rather than a short, yet significant, one-off activity during a five-year period.

A key aspect of the timeline is that it does not include the IAP stage. In a regulatory context we are supportive of this. However, as noted in our response to Q5.1, to enable well-evidenced and customer/stakeholder supported plan revisions to take place post business plan submission, it remains important that there is some form of feedback to companies prior to the draft determinations. We think this opportunity for feedback and response should be retained but we think we should explore how this could be done in a more collaborative, possibly more informal way, between companies, customers and Ofwat. We have concerns that the customer voice can be lost after submission of our final business plans. Whether the IAP stage is included or not, we need to ensure the customer voice remains central to the process post business plan submission.

It will be important that Ofwat share parameters for business planning early. The proposal to share information on botex baselines, WACC, ODI rates etc. is all very much welcomed. However, this data all needs to be provided early on in the price review process in order for it to be built into company plans in a timely, supported and considered way. The risk is that companies will have built their plans before we have sight of these business plan critical parameters. Our view is that these parameters need to be published alongside the final methodology (December 2022) at the latest.

We agree that early submission of some elements of PR19 plans – for example ODI definitions – was beneficial. However, submission of more significant elements of the business plan is likely to be challenging. May 2023 would mean submission almost two years before price controls come into effect and would give the opportunity to reflect just two years of actual data from the current AMP. Additionally, submitting elements of the plan early assumes that there is little or no connection with the other elements of the plan that may be submitted later on. The reality is that decisions taken for earlier submissions may end up constraining or having adverse impacts on some of the decisions for later final submission. Early submission of botex data, for example, seems reasonable on paper as base and enhancement activity appear separate. However, decisions around total levels of overall business totex expenditure may end up being constrained if base data has already been submitted. Although we are supportive of early submission of some aspects of business planning it is critical that consideration is given to the impacts of these likely early submissions on the later submitted final business plans. There may need to be opportunity for changes to be made to earlier submitted plans if good evidence can be provided as to why these changes had to be made at the final submission stage.

As described in our response to Q7.1, we have concerns around timings of the price review process and some of the key regulatory frameworks that feed into this process (e.g. net zero plans, DWMP, WINEP etc.). We support Ofwat's efforts to work with all relevant regulators and stakeholders to ensure strategic frameworks align well to the price review process. It is important too that any early business plan submission requirements are not adversely impacted by the timings of these wider strategic frameworks. We support Ofwat in its efforts to make sure there is a good amount of time between outputs coming from these strategic frameworks and business plan submissions. However, there needs to be sufficient time to review outputs, consider the implications of these outputs within our plans and agree revised plans with our customers, stakeholders and Board (at least eight months is needed). Where timings do not align with the price review process, we would like to see clear guidance from Ofwat on how we manage these aspects of our plan through the price review process.

A minor point to note is that the PR24 methodology consultation is due to come out in June / July 2022, which will coincide with the regulatory Annual Performance Report (APR) and end of financial year statutory reporting. Those most involved with responding to this consultation within our business are likely to be focused on accurate APR and financial reporting. Therefore, we would welcome either an extended period of time for responses to come back or for the methodology release to occur at a different time in the year. If the consultation process were able to be brought forward, we would also welcome earlier release of the final methodology document too. The earlier we consult and have final methodology released the more time can be spent getting plans up to the required final submission standard needed and allowing more time to collaborate with customers, stakeholders and Board on the final plan submission.

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

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

A key part of the stated rationale for a separate price control for water resources was 'more targeted incentives'. In practice it is not clear that there is any difference in the incentives faced in the water resources price control as compared to the water network plus control. Ofwat has applied the same cost sharing rates and has relied on a simple allocation of modelled costs to set efficient cost baselines for this price control.

Nor is there any evidence that a separate price control is having any impact on the development of water resources markets. Ofwat has recognised, in its decision not to pursue bilateral markets at this stage, that there is little genuine scope for water resource markets and a collaborative, regional framework approach is likely to yield more benefit for customers.

Any concerns around consistency of cost allocation are likely to be exacerbated rather than reduced by different incentive regimes.

What is clear is that an additional price control adds regulatory complexity and adds to the regulatory burden faced by companies. We have not seen any benefits for customers that would outweigh these additional regulatory costs.

When taken together with the evident challenges in developing robust cost models to support the price control, and the fact that the solutions to water resource challenges will involve a combination of demand management (which is within the network+ price control) and new resources (which are in the water resources price control), the case for retaining the control looks weak.

We think Ofwat should re-evaluate the case for this separate price control to ensure that there are real benefits that outweigh the additional costs it imposes on the sector.

14.2. 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?

Yes. More closely reflecting the operational realities of the sector and removing an artificial regulatory boundary between water resources and treatment would be a sensible step. However, the driver for expanding the price control seems to solely the ability to develop cost models rather than any a priori economic rationale.

Given that there are also close synergies between treatment and networks, in particular where supply demand balance options can span both controls, there is a need to revisit whether the benefits of a separate water resources price control outweigh the costs and the risk of distorting incentives at the boundary.